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Preface

Although estate plans are implemented with documents such as wills and trusts, the documents must be preceded by the plan itself. The planner must review the client's assets, ascertain client objectives, educate the client concerning the feasibility of obtaining those objectives, and then formulate the means to accomplish them. A good plan accomplishes client nontax objectives while minimizing taxes, the risk of attack by predators, and the risk of distortion as a result of future client inattention. A successful estate plan finds ways to accomplish client objectives despite a wide variety of laws limiting transfers of property or taxing transfers of property.

In the late 1970s, CEB determined that its document drafting books (now including California Will Drafting, 3d Edition, Drafting California Revocable Living Trusts, 3d Edition, Drafting California Irrevocable Trusts, 3d Edition, and California Durable Powers of Attorney) should be augmented with a book focusing on the planning process. This decision resulted in the publication of Estate Planning for the General Practitioner in 1979. In 1986, that book was significantly revised and republished under the name "Estate Planning Practice." The change in title reflected the realization that, although useful to the general practitioner, the book necessarily provided sophisticated discussion of complex estate planning topics and was more properly directed to attorneys who identified themselves primarily as estate planners.

Estate Planning Practice is now being replaced by California Estate Planning. The change in title emphasizes that this is a book intended for use by practitioners who must be cognizant not only of federal law, but also of California's unique community property laws, real property laws, and other laws, as well as California's comprehensive Probate Code.

The change in title also emphasizes the extensive differences between this book and its predecessors. Of the 31 chapters, only three are substantially based on chapters that appeared in the previous work. The change in title and content reflects the many changes in estate planning in recent years. When Estate Planning for the General Practitioner was first published in 1979, the California inheritance tax threshold was $300, the federal estate tax threshold was $60,000, federal estate taxes were usually owed at the first death because of marital deduction limits, revocable trusts were the exception rather than the rule for middle class clients, pension planning was considerably simpler, GRATs and QPRTs did not exist, and Clifford trusts shifted income. Now, the California inheritance tax has been repealed, the federal estate tax threshold has been significantly increased, the revocable trust has become the favored estate planning vehicle for most clients, pension planning has become far more complex, and modern estate planning employs such sophisticated devices as GRATs, QPRTs, family limited partnerships and LLCs, and installment sales to defective grantor trusts.

This book was designed by CEB Attorney and Project Manager Jeffrey A. Dennis-Strathmeyer, a certified specialist in Estate Planning, Trust and Probate Law, who has served since 1983 as legal editor of the CEB Estate Planning and California Probate Reporter.

CEB is particularly pleased to acknowledge the distinguished authors who contributed to this book. Rarely have so many talented planners contributed to a single estate planning publication. Their biographies appear in the "About the Authors" section that precedes the first chapter.

Most of the chapters in this book were substantively edited by CEB legal editors Robert Denham and Jean Magistrale, both members of the State Bar. The timely publication of this book was made possible by their exceptional knowledge and efforts. Other chapters were edited by attorneys Debra Landis, Judith Landis, Frederike Schilter, and Susan Widule. Chapters were also reviewed by CEB attorneys Jeffrey A. Dennis-Strathmeyer, Hale Kronenberg, and Janette Tom. Legal research analysis was provided by Alan Flatt, Nancy Lawlor, Adriana Paula, Shawn Ridgell, Sally St. Lawrence, Frederike Schilter, Kate Sheppard, and Mary Wilke.

Rosalind Iiams was responsible for copyediting and production. She was assisted by Richard Dempewolf, Cinda Ely, Paul Green, and Kindra Kemp. The index was written by CEB's Indexing Staff. Composition was performed by CEB's Electronic Publishing Staff.

CEB plans to supplement this book on a regular basis. We solicit your suggestions and comments to help us keep it

accurate and up to date. Suggestions concerning legal issues may be sent to CA.ESTPLAN.UPDATE.SUGGESTIONS@ceb.ucla.edu.

March 2010 Update

CEB wishes to thank the authors of this update: Richard S. Aiello, Concord; Sondra J. Allphin, San Jose; Alan Leigh Armstrong, Huntington Beach; Frayda L. Bruton, Sacramento; Michael Burnstein, San Francisco; Sandra J. Chan, Santa Barbara; Jeffrey C. De Francisco, Pasadena; Monica Dell'Osso, Oakland; Jeffrey A. Dennis-Strathmeyer, Lafayette; Erik Dryburgh, San Francisco; Steven Murray Goldberg, Santa Rosa; Richard S. Kinyon, San Francisco; Beth L. Kramer, San Francisco; Robert J. Lowe, Los Angeles; Kim Marois, Santa Rosa; Genevieve M. Moore, San Francisco; Kenneth G. Petrulis, Los Angeles; Max Riederer von Paar, Washington, D.C.; and Robert E. Temmerman, Jr., San Jose.

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Selected Developments

March 2010 Update

In 2009, both the Senate and the House of Representatives considered legislation to temporarily or permanently address the repeal of the estate tax in 2010, but to the surprise and dismay of many in the estate planning community, Congress failed to resolve the issue. Accordingly, there is no estate tax or generation-skipping transfer (GST) tax applicable to decedents dying in 2010. For 2010, the gift tax remains in effect with a $1 million lifetime exemption equivalent. The step-up in basis to date-of-death values has been significantly reduced and replaced with modified carryover basis provisions in IRC §1022. For the moment, $1.3 million of basis increase can be allocated to the decedent's property, as well as additional amounts for a decedent's built-in losses and loss carryovers, with an additional $3 million for property passing to a surviving spouse. For these purposes, the survivor's share of community property is treated as property owned by the deceased spouse and passing to the surviving spouse. Information returns must be filed for every estate with non-cash assets exceeding $1.3 million, and each heir must be notified of the income tax basis of property passing to him or her. IRC §6018. There are many other technical aspects of the estate tax repeal, including provisions that further limit the step-up in basis of property passing to nonresident aliens and provisions relating to the holding period for inherited property to qualify for long-term capital gain taxation. No regulations have been issued with respect to the new law, and there are no cases interpreting it. Thus, there is great uncertainty about how it will actually operate. For further discussion of these provisions, see chap 10 with respect to the estate and gift tax, chap 11 with respect to the GST tax, and chap 12 with respect to income tax basis.

Many practitioners believe that Congress will soon address these issues and reinstate the estate tax and GST tax, probably retroactively to January 1, 2010. There are constitutional questions regarding whether a tax can be made retroactive, so there will likely be litigation if the estate tax and GST tax are restored retroactively. Retroactivity is more problematic for the GST tax on lifetime gifts than the estate tax. Accordingly, it may be possible to make unlimited generation-skipping gifts in 2010 and pay only the current 35-percent tax on lifetime gifts in excess of $1 million. Note, however, that if Congress fails to act this year, the estate tax will be reinstated effective January 1, 2011, with an exemption equivalent of $1 million and a maximum rate of 55 percent, and the GST tax will be reinstated with a tax rate equal to the maximum estate tax rate. In the meantime, practitioners should advise clients who are elderly or in poor health to consider whether any revision to their estate plan is necessary. In particular, these clients should be advised to confirm that estate tax repeal does not adversely affect the desired arrangements for a surviving spouse or other beneficiaries, which are often determined by a formula based on the exemption equivalent. For example, a typical marital deduction formula clause would allocate all of the decedent's property to the bypass trust and none to the QTIP trust. Depending on the survivor's respective interests in the two trusts, and the degree of identity in the remainder beneficiaries of the two trusts, this might not produce the desired result. Similarly, if no legislation is passed in 2010, practitioners should evaluate how their clients' plans will work if there is only a $1 million exemption equivalent.

The update also discusses the following developments:

The IRS has issued regulations and additional guidance regarding tax return preparers, as defined, including attorneys who prepare documents used in connection with the preparation of tax returns. Notice 2009-5, 2009-3 Int Rev Bull 309. See §2.7A.

In *Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895, the court held that the exemption for spouses in the disqualified person statute applied to a former spouse who became the transferor's care custodian and then remarried the transferor. See §3.8.

In *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502, the court held that a waiver of omitted spouse protection contained in a premarital agreement was enforceable by the decedent's estate against the surviving spouse even though it failed to comply with the Family Code requirements for premarital agreements. See §4.27.

The California Supreme Court decision legalizing same-sex marriage (*In re Marriage Cases* (2008) 43 C4th 757, 76 CR3d 683) and the subsequent decision that upheld Proposition 8 eliminating the right of same-sex couples to marry in

California (*Strauss v Horton* (2009) 46 C4th 364, 93 CR3d 591) create a new classification that includes an estimated 18,000 same-sex married couples who married in California before the passage of Proposition 8. The issues affecting these couples and same-sex couples who married in other jurisdictions before November 5, 2008, are almost identical to the issues affecting registered domestic partners. Married couples are discussed in §§4.2-4.40E. Domestic partners and the issues that impact same-sex married couples differently from opposite-sex married couples are discussed in §§4.41-4.64.

Court decisions limiting the application of the "express declaration" requirement for transmutation of separate property into community property are discussed in §4.39E.

In *Charisma R. v Kristina S.* (2009) 175 CA4th 361, 96 CR3d 26, the court held that the registered domestic partner of the biological mother of a child was the child's presumed mother. See §4.57.

In *Estate of Lensch* (2009) 177 CA4th 667, 99 CR3d 246, the court held that the executor of the beneficiary's will had the burden of proving by clear and convincing evidence that the beneficiary survived the testator under Prob C §220. See §5.44.

The legislature has enacted a new comprehensive statute that further restricts the category of actions defined as contests and excepts actions brought with probable cause from the effect of a no-contest clause beginning January 1, 2010. See §6.21.

In *Stoltenberg v Newman* (2009) 179 CA4th 287, 101 CR3d 606, the court held that a suit against a successor trustee in her fiduciary capacity that was based on alleged fraud committed by the deceased predecessor trustee while acting as trustee was subject to the 1-year limitations period of CCP §366.2. See §6.53.

In *Rands v Rands* (2009) 178 CA4th 907, 100 CR3d 632, the court held that a settlor lacked capacity to revoke his revocable trust when two physicians had previously determined that the settlor lacked capacity to manage his personal and financial affairs. See §6.68.

In *Stevens v Tri-Counties Bank* (2009) 177 CA4th 236, 99 CR3d 188, the court held that a financial institution was liable for withdrawals made by an individual who was purportedly added as an additional "party" to an account without the written consent of the original parties. See §7.32.

In *Estate of Farnam v Commissioner* (8th Cir 2009) 583 F3d 581, the court held that notes evidencing a debt owed by a family business corporation to the deceased shareholder did not constitute qualified family-owned business interests (QFOBIs) in determining whether 50 percent of the decedent's gross estate consisted of QFOBIs. See §10.57.

In *Thomas H. Holman* (2008) 130 TC 170, the court held that gifts of limited partnership interests made 5 days after formation of the partnership by the donor did not result in gifts of partnership property to the limited partners. See §10.88.

The update has an expanded discussion of the IRC §645 election for qualified revocable trusts. See §§13.160A-13.160E.

In *Fashion Valley Mall, LLC v County of San Diego* (2009) 176 CA4th 871, 886, 98 CR3d 327, the court confirmed that an individual limited liability company (LLC) member does not enjoy the beneficial use of the property owned by the LLC. See §15.20.

In *Estate of Noordin M. Charania* (2009) 133 TC No. 7, the court ruled against the estate of a U.K. citizen, resident of Belgium, whose estate owned 250,000 shares of Citigroup stock and ordered the estate to pay over $2 million in U.S. estate taxes. See §§16.17, 16.40A.

The update has a new discussion of foreign bank account reporting (FBAR) requirements. See §§16.84A-16.84E.

Several court decisions on the application of the step-transaction doctrine to gifts of partnership interests are discussed in §18.37D.

The IRS has issued guidance on the limitation on employer-owned life insurance contracts and exceptions to the transfer-for-value rule regarding taxation of life insurance proceeds. See §§19.42-19.46.

The update has an expanded discussion of annuities in Medi-Cal planning and estate planning for elderly clients. See §20.38.

In *In re Willis* (Bankr SD Fla 2009) 104 AFTR2d 5669, the court held that a bankruptcy debtor's IRAs were not exempt because the debtor borrowed funds from the IRAs. See §21.13.

The $100,000 income limitation on conversion of a traditional IRA to a Roth IRA does not apply to taxable years beginning on or after January 1, 2010. IRC §408A(c)(3). See §21.16.

In *Kiva Dunes Conservation, LLC*, TC Memo 2009-145, the court allowed a $28.7 million deduction for a

conservation easement that effectively preserved the current use of a golf course. See §23.97.

The IRS has identified certain transactions involving sales of charitable remainder trust interests as transactions of interest. Persons engaging in such transactions must report them. See §24.10D.

In *Henry E. & Nancy Horton Bartels Trust for the Benefit of Cornell Univ. v U.S.* (Fed Cl 2009) 2009-2 USTC ¶50,475, 104 AFTR2d 5117, the court held that securities purchased on margin by a tax-exempt trust were "debt-financed property" and that the income derived from the sale of the securities was debt-financed income subject to unrelated business income tax. See §24.28.

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Cutoff Dates and CEB Citation

Cutoff Dates

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Overview of Estate Planning Practice

Richard S. Kinyon
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§1.1 I. ESTATE PLANNING PROCESS

"Estate planning" is the process of putting an individual's personal and financial affairs in order. The goals are to maximize the individual's enjoyment of his or her estate during his or her lifetime and the beneficiaries' enjoyment of the estate after the individual's death. Estate planning involves:

- Managing the individual's real and personal property during his or her lifetime and providing for the disposition of the property before and after his or her death;
- Structuring business, investment, and employee compensation arrangements to better achieve these goals;
- Executing testamentary and related instruments incident to entering into a marriage or domestic partnership and the dissolution or termination of such a relationship;
- Protecting and managing the individual's estate in the event of his or her incapacity or bankruptcy;
- Planning for personal and health care decision-making in the event of the individual's incapacity; and
- Minimizing the impact of many different types of taxes.

"Estate administration" is the process of carrying out the individual's estate plan and administering his or her estate following his or her death. It is the process of winding up the decedent's affairs and distributing his or her assets in accordance with his or her estate plan.

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§1.2 A. Challenges of Estate Planning

Successful estate planning presents challenges for the client as well as for the attorney. Some clients are reluctant to begin the estate planning process because it forces them to acknowledge their own mortality. Other clients find it difficult to complete the process and make final planning decisions that will become irrevocable at death. Planning may be especially difficult for a client who must decide how to provide for minor beneficiaries, for beneficiaries with special needs, or for beneficiaries whose current problems (*e.g.,* substance abuse, creditor problems, or marital obligations) may change over time. The client also faces the practical challenges of collecting financial information from various sources and transferring title of assets to a revocable trust if one is created. Finally, the client incurs the legal costs of creating and implementing the estate plan.

Each client has his or her own personal and family situation, assets and liabilities, and estate planning objectives that require creative analysis and customized planning. For example, a client's assets might be of sufficient value to make tax planning a key component of the estate plan. Or a client's main asset might be an interest in a closely held business that requires reorganization or a buy-sell agreement to carry out successful business succession planning as well as personal, nonbusiness objectives. A client's unique family situation or gifting objectives may require individually tailored arrangements, such as family partnerships or LLCs, specialized trusts, or the creation of charitable entities.

The attorney's challenge is to create a plan that meets the client's specific objectives and to fit these objectives into a system of divergent and complex laws: estate, gift, and generation-skipping transfer tax laws, income tax laws, real property and documentary transfer tax laws, family law, corporate law, and state law constraints on the transfer of property. The attorney must keep current on changes in the law. It is often a challenge to draft dispositive provisions in accord with the client's wishes that do not also have serious adverse tax consequences. Additionally, there is the constant challenge of explaining these laws and the proposed plan in a way that results in the client's informed consent and a general if not thorough understanding of the plan.

Although these challenges require a significant effort by both the attorney *and* the client, the result of a successful estate planning effort will usually be a client who is relieved to have put a comprehensive plan in place and who is grateful for the assistance in ordering his or her affairs.

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§1.3 B. Consequences of Failure to Plan; Intestacy as Default Estate Plan

Every California domiciliary has an estate plan by design or default. Without a written estate plan, the disposition of a decedent's assets is subject to the provisions of applicable law. For example, property held in joint tenancy passes by operation of law to the surviving joint tenant (CC §683.2(c); see §§7.19-7.29), and property subject to contractual arrangements (*e.g.,* death benefits under life insurance policies (see chap 19), annuity contracts (see chap 20), or retirement plans) passes by beneficiary designation or the provisions of the specific policy or plan. Property held in trust passes in accordance with the trust instrument. The disposition of the decedent's remaining assets is governed by the laws of intestate succession if he or she has no valid will. Prob C §§6400-6455.

Under the intestacy laws, the decedent's property will be distributed to the decedent's heirs, *i.e.,* the decedent's spouse or domestic partner, the decedent's issue (*i.e.*, lineal descendants of all generations), or other specified relatives in shares generally determined by their degree of relationship to the decedent. The administration and disposition of these assets is generally supervised by the probate court in an estate administration proceeding, one function of which is to ensure that the proper parties have adequate notice of the estate administration. In *Estate of Carter* (2003) 111 CA4th 1139, 4 CR3d 490, the court set aside a decree distributing an intestate decedent's estate when the administrator failed to give notice of administration to claimants, despite knowledge of facts indicating that they might be decedent's children. Small estates and property passing to a surviving spouse, however, are governed by statutory provisions (see Prob C §§13000-13660) that do not require a full probate administration. See §§7.3, 7.5-7.18.

The default estate plan may work well for some people, but most people can benefit by executing wills, trust instruments, and powers of attorney, and by changing title to property and beneficiary designations in a way that facilitates a more orderly and comprehensive scheme for managing and ultimately disposing of their assets.

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§1.4 C. Benefits and Objectives of Estate Planning

One of the key benefits of successful estate planning is that it yields a comprehensive analysis of an individual's personal and family situation and his or her assets and liabilities. Another benefit is that the process yields a document (whether it be a simple or complex will or a trust instrument coupled with a "pourover" will) that governs the disposition of the individual's estate in a comprehensive manner. As a result of the process, the attorney becomes a knowledgeable advisor who can assist the fiduciary and beneficiaries with the administration and distribution of the estate following the client's death. Successful estate planning can thus provide welcome certainty and direction at a difficult time of transition.

Although clients' specific objectives with respect to their estate plans will differ, most clients share certain general objectives. They engage an estate planning attorney because they want to arrange their affairs to protect themselves, their loved ones, and their assets, during their lifetimes (including provisions for management of their assets and decisions regarding their personal and health care if they become incapacitated) and after their deaths. They also want to minimize the expense and taxation that can accompany the transfer of assets before and after their deaths. Clients may also want to arrange for, or at least leave a written statement of their wishes regarding, the disposition of their remains, directions for anatomical gifts, and directions concerning autopsies. See chap 31.

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§1.5 1. Planning for Personal and Family Needs

One of the primary objectives of estate planning is to provide for the needs of the client and his or her family members. A young couple with little accumulated property may visit an estate planning attorney primarily to name a guardian or to create custodianships or trusts for minor children. Other clients may be motivated by the need to create a specialized arrangement for a disabled child, or to provide for an aged parent. A client may have recently received an inheritance or be the recipient of powers of appointment that he or she can exercise, or may wish to determine the best way to make a significant gift to a favorite charity. A client with a same-sex partner may wish to discuss domestic partner registration and its implications, or the uncertain prospects for lawful marriage, and the best ways to provide for each other. Another client may be driven by a desire to preserve a business after he or she is gone. The specific objectives are unique to each client.

Most clients also want to provide a plan in the event of their own incapacity. As the average life span of individuals increases, the possibility of a person becoming incapacitated at some point in his or her lifetime also increases. A client's comprehensive estate plan will therefore include arrangements for personal and health care and property management decision-making by agents or other surrogates in the event of the client's incapacity. A wide range of planning devices may be used, from simple powers of attorney for personal and health care and financial decisions to complex trust and business succession arrangements. For a detailed discussion of incapacity planning, see chap 29.

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§1.6 2. Minimizing Expense and Taxation

Another primary objective of a client's estate plan is to arrange for the transfer of the client's property to others without excessive effort, expense, or taxation. This objective may be satisfied in various ways depending on the client's particular situation. For example, a revocable trust (see chap 6) might be used to minimize the cost, court supervision, and publicity that a probate proceeding can entail, and various types of lifetime and testamentary gifting arrangements (see chap 8), outright or in trust, might be used to minimize estate taxes. Different types of entities may be created to provide for the succession of a client's business with as little adverse tax consequence and expense as possible. Various devices can be used to structure the transfer of assets to take advantage of gift, estate, and generation-skipping transfer tax deductions, credits, and exemptions. For a discussion of estate and gift tax planning, see chap 10. On the generation-skipping transfer tax, see chap 11.

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§1.7 3. Planning for Postmortem Asset Management

The estate plan will of course include provisions for the postdeath disposition or management of a client's assets. These provisions may range from simple outright bequests to the creation of complex trusts that continue for many years after the client's death. They also may include buy-sell agreements or other business arrangements to carry out a client's business succession planning, or investment and management directives designed to transfer property to or for the benefit of a surviving spouse and issue.

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§1.8 D. Implementing Estate Plan

The estate plan is only as effective as its implementation. Once a plan has been formulated, other actions may be necessary to fully implement it. The scope of these actions, and when they will occur, depends on the type of plan chosen.

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§1.9 1. Wills and Revocable Trust Transfer Arrangements

If the estate plan is based on a will, after it is signed there is often little implementation necessary, although it may be necessary to change forms of joint ownership or beneficiary designations to enable the overall estate plan to operate properly.

To implement an estate plan based on a revocable trust, however, after the trust instrument is signed, title to the client's assets should be transferred from his or her individual name to the name of the trustee. This may involve preparing and recording new deeds for the client's real property, changing title to bank and brokerage accounts and insurance or annuity policies, changing beneficiary designations for life insurance policies and retirement plans, assigning business interests, and recording the share ownership changes of corporations, partnerships, and other entities. Although the process can be tedious and time consuming, after the trust is funded the client generally sees no substantial difference from day to day in how his or her assets are managed. The client (assuming he or she is the sole trustee) continues to manage and control the trust property as trustee, and trust income, deductions, gains, losses, and credits continue to be reported on the client's personal income tax returns.

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§1.10 2. Incapacity Arrangements

If a client becomes incapacitated, partial administration of the estate by a fiduciary may occur before death. It may become necessary to use the client's powers of attorney or activate trustee succession provisions in the client's revocable trust instrument. The estate planning attorney can assist with these actions to keep the client's personal and financial affairs operating as smoothly as possible.

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§1.11 3. Transfers at Death and Continuing Arrangements Concerning Trusts

The provisions of a client's will or revocable trust become irrevocable and can no longer be amended after the client's death. If the client's estate plan is based on a will, and if the will must be probated, the probate court of the county in which the client was domiciled generally will supervise the administration and distribution of the probate assets.

If the estate plan is based on a revocable trust, the administration and distribution of the trust assets may be handled by the trustee without court supervision, although access to the court is available to resolve problems or uncertainties and use of court procedures may be advisable for certain actions taken with respect to trust assets. When a trust holds community property, generally only the provisions governing the disposition of the deceased spouse's half of the community property and his or her separate property become irrevocable and unamendable on his or her death. The provisions governing the disposition of the surviving spouse's half of the community property and his or her separate property continue to be revocable and amendable by the surviving spouse.

Even if all of the client's assets are held in a revocable trust at the time of his or her death or otherwise pass outside probate (*e.g.,* by beneficiary designation or joint tenancy), it may be advisable to initiate a "dry" probate proceeding, *i.e.*, filing a petition for probate and following through with the procedural aspects of a conventional probate proceeding. No assets are inventoried or distributed in this process. Although there are some extra costs associated with the proceeding, it can serve to:

- Establish the validity of the will and the authority of the personal representative to act (should that authority be needed in the future for any reason);
- Establish the authority of a guardian designated in the will to care for minor children;
- Shorten the creditor claims period from (generally) 1 year after the date of death (CCP §366.2(a)) to 4 months after letters testamentary are issued to the personal representative (Prob C §9100(a)(1));
- Deal with certain assets or circumstances as well as disputed creditor claims that may be enforceable against the decedent's estate generally, including but not limited to the trust property; and
- Establish the validity of the exercise of a testamentary power of appointment contained in the will.

On when a probate proceeding might be used for purposes of asset protection, see California Trust Administration §§10.30-10.32 (2d ed Cal CEB 2001).

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§1.12 II. ROLE OF ATTORNEY

An estate planning attorney must have legal expertise in the areas of estates and trusts, and should have at least some familiarity with other related areas of the law, such as property, family, business, nonprofit organization, employment, insurance, intellectual property, and federal, state, and local tax law. In addition, interpersonal skills, common sense, objectivity, and, of course, the highest ethical standards are also extremely important. See §1.14.

The tasks of an estate planner are varied and may typically include:

- Corresponding and meeting with clients;
- Drafting documents;
- Checking real estate records;
- Advising clients regarding pre- and post-nuptial agreements or marital settlement agreements incident to dissolution of a marriage;
- Advising clients regarding domestic partnership registration and property agreements between domestic partners;
- Forming a corporation, partnership, or limited liability company and registering it with the Secretary of State, or advising on an existing business entity;
- Assisting with a client's organ donation directives and personal care directives;
- Advising clients about planning alternatives to finance a child's education;
- Advising clients on ways to satisfy their philanthropic goals, including outright and deferred charitable gifts and other gifting possibilities;
- Attending board meetings for a client's private foundation;
- Working with the client's accountant, financial planner, trust officer, retirement plan administrator, life insurance underwriter, and appraisers; and
- Filing income, estate, and gift tax returns and handling audit and litigation issues with the IRS and state and local tax officials.

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§1.13 A. Legal Expertise; Attention to Detail

The estate planning attorney must possess a comprehensive and working knowledge of federal, state, and local tax laws relating to the estate plan as well as the laws governing real estate, employment benefits, estates and trusts, domestic relations, businesses, nonprofit organizations, intellectual property, and insurance policies. In addition, the attorney must have the ability to attend to detail, particularly in determining the client's assets and liabilities and how they are titled, and in carrying out or directing transfers of assets and beneficiary designations required to render the plan effective.

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§1.14 B. Ethical Standards

An attorney must render legal services in compliance with the highest ethical standards. The ethical rules governing this practice area are contained in the California Rules of Professional Conduct and the ABA Model Rules of Professional Conduct, as well as in statutes and case law. For a detailed discussion, see chap 2.

The attorney who engages in estate planning and trust and estate administration should be experienced and competent in areas of law for which services will be provided. If the attorney lacks experience or competence in a relevant area of the law, he or she may have a legal obligation to associate an experienced colleague or specialist or refer the matter to such a person. Cal Rules of Prof Cond 3-110(B). See discussion in California Will Drafting, chap 1 (3d ed Cal CEB 1992).

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§1.15 C. Interpersonal Skills

The estate planning attorney must possess sensitivity, insight, and the ability to elicit information and inspire confidence. More than in other areas of the law for which a client seeks legal assistance, in the estate planning field the client divulges personal information that the client may not have shared with family members or other professionals. Inspiring a client's confidence and respect can help ensure a sound and thorough estate plan and a successful attorney-client relationship.

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§1.16 D. Practical Experience

The attorney is a key player on the client's team of professional advisors. Often the attorney can offer practical solutions, drawn from his or her own experience, for situations a client is facing. For example, a client with several children may be unsure how to dispose of tangible personal property or interests in a closely held business after the client's death in a way that is fair and impartial. The attorney may be able to suggest creative solutions to this common problem based on his or her experience. Another client may have a strong philanthropic intent and the wish to inculcate this in his or her children. The attorney may be able to offer various suggestions for involving the entire family in philanthropic endeavors. A married person may have children from prior marriages, and it may be difficult to determine how best to provide for both the current spouse and the children. Again, the attorney may be able to provide creative suggestions while ensuring family harmony. Practical experience can extend beyond situations encountered with other clients to concepts shared with other attorneys or in continuing legal education programs.

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§1.17 E. Objectivity

Assuming the attorney becomes known to the client's family and business associates, he or she can be a trusted advisor and an objective voice in the client's business and personal affairs. The attorney also can be a useful arbitrator at times if there is a difference of opinion within the family on any matter that touches on the estate plan. For example, it is not uncommon for the attorney to be consulted on the tax ramifications of proposed actions involving a family business or other endeavor, to provide an independent assessment of those actions, or to suggest the best way to divide the estate among the various family members and ongoing trusts—keeping in mind, of course, the duties owed to the primary client.

The need for an attorney's objectivity is one of the reasons that restrictions have been placed on an attorney serving as a fiduciary or being named as a beneficiary in the instruments prepared by that attorney. See Prob C §§10804, 21350-21356. See also §§2.7, 3.6, 3.8.

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§1.18 III. STEP-BY-STEP PROCEDURE FOR DEVELOPING AN ESTATE PLAN AND PUTTING IT IN PLACE

There are certain considerations and practices that are common to the estate planning process. Although every attorney has his or her own style and system for handling new estate planning engagements, the following is a procedure that is shared, to some degree, by many attorneys. There is no "ideal" way to handle these engagements, and circumstances or resources may dictate that procedures be abbreviated or expanded in certain situations. It is important for an attorney to develop his or her own procedure, regardless of how it may differ from the one outlined below. Having a regular procedure can contribute greatly to an efficient and rewarding practice.

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§1.19 A. Step One: Initial Contact

The initial contact often occurs when a potential client contacts the attorney to see whether he or she might be able to handle the client's estate planning. Assuming the potential client is a stranger to the attorney, this first contact can be an excellent occasion to obtain information, both for the attorney *and* for the client. The initial goal is to determine whether the potential engagement is the right "fit" for the attorney and the client. The attorney should obtain enough information about the client to ensure that the engagement presents no conflicts of interest with the attorney's other clients. The attorney also should discuss the nature of the proposed engagement and any timing issues to determine whether the matter is something he or she wants to take on and whether it comports with his or her schedule.

This also is a good time generally to discuss attorney fees. Although it may be difficult to estimate fees without knowing much about the client's situation or the type of estate plan that will be appropriate, it is often helpful to quote the attorney's hourly rate and a likely range of fees at this point. Then, if the client (either at that time or on later reflection) concludes that the likely fees are more than he or she wishes to pay, neither party will invest significant additional time and effort in the endeavor.

The initial contact also provides an opportunity for the attorney to obtain basic personal information about the client, including the following, that can be used to tailor the questionnaire (see §1.23):

- Basic personal information (*e.g.*, name, address, phone number);
- The client's family situation;
- Whether there is an existing estate plan; and
- For married couples or registered domestic partners, whether the couple acquired property while married or in a legal union in another jurisdiction and living outside California (which might mean that the couple has quasi-community property as well as community and separate property).

The attorney may want to develop an interview checklist on which all this information can be recorded. Also, the attorney may wish to discuss the need to obtain more detailed information about the client, his or her family situation, and his or her assets and liabilities to create an effective estate plan, and inform the client that the partially completed questionnaire that the attorney sends out will aid the client in putting this information together. This simple statement and the fact that the questionnaire is tailored to make it more user friendly can make all the difference in whether the client views the questionnaire as a chore rather than an aid in helping him or her gather the necessary information.

During this initial contact, the attorney may also wish to set a time for the initial client meeting. The meeting date should then be confirmed in the initial/engagement letter to the client. See §1.22.

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§1.20 B. Step Two: Conflict Search

Once the attorney obtains the names of the client and his or her immediate family members, as well as any business entities controlled by the client, the attorney should perform whatever internal office review is necessary to ensure that the engagement presents no conflicts of interest with the attorney's existing or former clients. This should be done before the attorney receives sensitive information from the prospective client. For a discussion of when conflicts may exist and an attorney's duties to make disclosure and obtain consent, see chap 2.

If conflicts or potential conflicts exist, they should be thoughtfully and carefully evaluated. The attorney may need to obtain letters from the new client and an existing client consenting to the engagement, or from family members when more than one family member will be represented. See §2.16. The results of the conflict search, together with any signed consent letters, should be kept with the attorney's files for the relevant matters.

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§1.21 C. Step Three: First Written Communication

After the initial contact and conflict check, and after any potential conflicts with the attorney's existing or former clients have been resolved, the attorney should follow up with a written communication to the prospective client. The first written contact might include an engagement letter (see §1.22), a questionnaire (see §1.23), and educational materials (see §1.24).

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§1.22 1. Initial/Engagement Letter

The initial letter also can be an engagement letter, which typically includes:

- A reference to the initial telephone contact and the place and time of the first meeting, if one was scheduled.
- A description of the scope of the engagement.
- An outline of the basic choices the client will be required to make so that he or she can begin considering them (*e.g.,* will versus revocable trust as the primary dispositive vehicle, choice of fiduciaries, specific bequests, use and establishment of ongoing trusts).
- The written fee agreement required under California law. Bus & P C §6148.

NOTE: Business and Professions Code §6148 requires a written contract in any engagement in which it is reasonably foreseeable that the total expense to the client will exceed $1000. The contract must contain the attorney's hourly rate and other standard fees and charges, the nature of the legal services to be provided, and the respective responsibilities of the attorney and client.

- A description of any conflicts that may be presented by the engagement (*e.g.,* by the dual representation of a husband and wife or domestic partners) and a request for a waiver by the client(s) with respect to those conflicts. The letter also might request a waiver for any potential future conflicts relating to other clients or positions in other matters that might be adverse to this client, provided that those other matters are not substantially related to the estate plan.

The initial/engagement letter, containing the fee agreement and waivers, can be confirmed by asking the client(s) to sign a copy of the engagement letter and return it to the attorney before or at the time of the first meeting. For a sample initial/engagement letter for use with a married couple, see §1.62.

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§1.23 2. Questionnaire

The initial written communication may include a questionnaire for the client that is designed to give the attorney a comprehensive view of the client's situation. It is critical to the effective estate planning process that the attorney acquire accurate and detailed information about the client, his or her family situation, and his or her assets and liabilities. At its best, this is an interesting process and a way to develop a strong relationship with the client; at its worst, it is a tedious and time-consuming (and therefore expensive) effort. The client is usually the primary source of this information, although it also may be possible to obtain information, with the client's consent, from his or her accountant, financial advisor, or other professional. An attorney's skill and tenacity in gathering relevant data about the client, as difficult as this may prove to be, can mean the difference between a good estate plan and a poor one. Many attorneys have developed appropriate forms or questionnaires; for two sample forms designed for use with a married couple, see §§1.63-1.64. See also California Will Drafting, chap 2 (3d ed Cal CEB 1992).

Often, the most effective approach is to discuss the need for the questionnaire during the initial contact with the client and then send it out before the first meeting, so that the client has adequate time to consider the relevant issues. The substantially completed questionnaire should either be returned to the attorney before the first meeting so that the attorney can become familiar with the client's affairs and form tentative planning strategies for discussion, or be brought to the first meeting to serve as a discussion tool.

In addition to the completed questionnaire, the attorney should ask the client to provide copies of any relevant documents, such as existing wills, premarital agreements, deeds, and trust instruments. An existing will or revocable trust instrument can serve as a springboard for discussion and provide the attorney with valuable information about the client's family and current estate plan, even though it may be out of date. Further, because the attorney must have a thorough understanding of the title and character of a client's property, the attorney should request copies of title documents for major assets (*e.g.,* real property deeds, stock certificates, partnership or LLC agreements, and documents relating to bank and brokerage accounts, insurance and annuity policies, and retirement or deferred compensation plans). The attorney should consider obtaining copies of the last vesting deed with respect to realty from a title insurance company, because the client may have forgotten about or be unaware of changes in title since the property was acquired.

These documents should be obtained from single clients as well as married clients and domestic partners because distinctions between joint tenancy and tenancy-in-common arrangements are frequently misunderstood among individuals who own such property jointly. In addition, because title documents do not always reflect the true character of the property in a marital or registered domestic partnership situation, it is necessary to explore the history of the marriage or domestic partnership to determine the true character of the couple's property. This can be a time-consuming process but one that is important for a sound estate plan.

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§1.24 3. Educational Materials

Many attorneys provide clients with separate written materials summarizing estate planning issues (*e.g.,* a discussion of the fundamental concepts of estate planning, and the advantages and disadvantages of a living trust versus a will). The California State Bar publishes several pamphlets on the subjects of wills, living trusts, and estate planning that may be sent to the client with the initial engagement letter. They may be ordered from the State Bar or downloaded from its website at http://www.calbar.ca.gov.

A client may benefit greatly from reading any such educational materials beforehand; this also may save considerable time during the first meeting. The client should retain the materials for future reference, to be read or consulted at his or her leisure, as part of the estate planning process. In addition to aiding the client, providing such materials can serve to counter any later argument by a client or the beneficiaries of his or her estate that the client did not understand the plan.

Certain substantive areas seem to prompt the most questions, and an attorney particularly may wish to address them in educational materials. These troublesome areas include:

- The distinctions between separate, community, and quasi-community property, and property ownership and title issues generally (see chap 4);
- The inclusion of an agreement between spouses or registered domestic partners that changes the character of property in the estate plan (see §1.39);
- The distinction between the probate estate and the gross estate for estate tax purposes; for example, some people believe that by using a revocable trust to hold title to all of their assets or by naming a beneficiary other than the estate of life insurance proceeds or other benefits, they can not only avoid probate, but also avoid estate taxes (on estate tax issues, see chap 10; on revocable trusts, see chap 6); and
- The inclusion in a decedent's gross estate of interests in retirement plans (see chap 21) and life insurance proceeds (see chap 19), as well as interests in joint tenancy property.

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§1.25 D. Step Four: First Meeting

After the written materials have been sent to the client, the next contact is often the first meeting between the client and the attorney. The first client meeting may be the only time when the attorney will have the opportunity for a lengthy, free-ranging discussion with the client, so it is important to maximize this opportunity. If the clients are a married couple or domestic partners, both of them should attend the initial meeting if possible. In some situations, it might make sense to include other family members as well, if this presents no conflicts and there are no concerns about undue influence. However structured, the first meeting must allow the client to speak candidly with the attorney.

The first meeting enables the attorney to ascertain and refine the client's particular estate planning objectives. Among other things, the discussion can provide the means to explore the nature of the client's relationships with various family members or specific medical issues that may affect the client's planning needs. In the discussion, the attorney can explore the client's thoughts about his or her business, such as its economic viability and future prospects in the event of the client's death or disability. The attorney also can explore the client's philanthropic intent, to determine whether any charitable gifts are appropriate, and make an initial assessment of the client's competence on this subject. The client may not be aware of the many ways in which such gifts can be structured.

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§1.26 1. Finalizing Engagement

As a preliminary matter, the attorney should obtain the signed engagement letter, if it has not already been signed and returned by the client before the first meeting. If the client has not signed the letter because of any specific concerns (*e.g.,* fee issues, joint representation and confidentiality issues, conflicts, or waiver requests), the meeting presents the opportunity to discuss those issues. To the extent that the issues cannot be resolved, it may be best to simply abandon the engagement before any further time is spent with the client or in reviewing his or her personal information.

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§1.27 2. Eliciting Additional Information

The first meeting provides the best opportunity for the attorney to explore the nature and extent of the client's assets and liabilities. If the client has returned a completed questionnaire, it is extremely helpful at this point to go over the entries, item by item, to confirm the information and to elicit additional facts. The attorney can also learn more about the client's family situation. This information can be useful when discussing who might be best suited to act as the client's fiduciaries after his or her incapacity or death. In addition to obtaining additional information from the client, the attorney can answer any fee questions that the client has and deal with existing or potential conflicts.

The first meeting also provides a good opportunity to learn the identity of any other professionals who work with the client, such as the client's accountant, financial planner, insurance agent, and investment advisor. These individuals can often provide important information and documentation (with the client's authorization), and can even serve as a sounding board for estate planning proposals. If the attorney initially establishes a good working relationship with the client's other advisors, the long-term result can be a well-coordinated team that supports the client for many years in an efficient and cost-effective manner.

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§1.28 3. Determining the Best Way to Update Existing Estate Plan

If the client already has an existing estate plan and he or she wants to make only discrete changes to it, the attorney must decide whether to make the requested changes by amending an existing instrument or redrafting the entire plan document. If the changes are minor, simply drafting a codicil or a trust amendment probably is the most cost-effective approach. It is generally preferable to incorporate all changes to an existing instrument in a single amendment rather than have multiple amendments. If the client wants more extensive changes, often it is advisable for the attorney to redraft the client's documents, using the attorney's own current forms. Typically this takes less time than it would take for the attorney to become thoroughly familiar with the existing instruments. Redrafting documents often costs the client less money and provides a much better end product. Redrafting also avoids the possibility that the attorney might misunderstand the provisions of the existing documents or make a change that is not internally consistent with the rest of the document. However, the attorney should review the existing documents to determine whether there are special or unusual provisions that should be carried forward into the new document.

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§1.29 4. Assessing Client's Competence and Possibility of Fraud or Undue Influence

The first meeting provides an opportunity for the attorney to assess a client's competence and to learn more about medical issues that may affect the client's situation or planning considerations. The attorney should inquire about family medical history generally and be alert to references to possible medical issues.

The attorney should also be aware of signs of fraud or undue influence. It is not uncommon for a client (typically an elderly client or one with physical impairments) to come to the meeting accompanied by a family member or friend. However, the attorney generally should conduct all dealings directly with the client and, depending on the circumstances, meet alone with the client at some point in the process to ensure that the client has the opportunity to discuss his or her wishes without the third party being present.

In addition, the attorney should watch for "red flags" in this situation, such as proposals to change the client's estate plan to disproportionately favor the person accompanying the client or his or her relatives or friends, to prepare a durable power of attorney for financial matters naming that person as attorney-in-fact, or to place assets in joint tenancy with that person or make other title changes "for convenience." Although these requests are warranted in many situations, they can be the means by which an unscrupulous person can take advantage of the client. For further discussion of potential "predators" and techniques for guarding against them, see §§3.6, 3.8.

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§1.30 5. Further Education

The client may have questions based on the educational materials supplied by the attorney. Questions may also arise in the course of the discussion of the client's estate planning objectives. The attorney should be sensitive to clients who have little or no familiarity with the subject, as well as to the fact that, for many clients, it is unpleasant to discuss their own mortality. This emotional reaction can sometimes impede a client's clear understanding of the legal concepts discussed at the first meeting, or thereafter.

Often a client's understanding of the nature and extent of his or her assets may be incomplete or inaccurate. On problem areas for clients, see §1.24. The attorney may need to spend some time educating the client about the character of the property owned and the effect of different forms of title.

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§1.31 6. Establishing Timetable

At the first meeting, the attorney should establish a schedule for the completion of the estate plan. This makes the expectations of the engagement clear to both attorney and client. The attorney should set a reasonable timetable, however, because deviations from it can lead to a client's disappointment and frustration. If the attorney is delayed in meeting deadlines, he or she should communicate this as soon as possible to the client and set a new timetable. On dealing with delays caused by clients, see §1.48.

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§1.32 E. Step Five: Formulating a Plan

The attorney may be able to provide the client with a proposed estate plan at the initial meeting and discuss its various details. On the other hand, the attorney may need to become more familiar with the information provided by the client, perform research, or simply spend some time in reflection before forming a comprehensive plan proposal.

The attorney may wish to contact the client between the first meeting and the preparation of draft documents. If the proposed plan is complex and its nature was not substantially determined at the initial meeting, the attorney may want to first send a letter to the client outlining the plan before drafting the documents. The letter should also explain matters that require the client's informed understanding (even if this reiterates the discussion of the first meeting) and should note matters that require the client to make a specific decision. The attorney should obtain the client's approval of the proposed plan and should obtain any needed additional information or decisions by the client before beginning to draft the plan documents.

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§1.33 F. Step Six: Typical Documents

Once the attorney has enough information and has formulated the estate plan, the plan documents can be prepared. The typical estate plan centers on a will or a revocable trust instrument that contains the basic dispositive provisions of the client's estate plan. A will contains only provisions that apply after a client's death, while a revocable trust instrument contains provisions that govern during the client's lifetime as well as after his or her death. On the advantages and disadvantages of a will as the primary planning vehicle, see chap 5; on the relative merits of revocable trusts, see chap 6.

The instrument should name the client's desired fiduciaries and, depending on the client's wishes, may set forth investment directives, make certain outright bequests, exercise powers of appointment, or establish ongoing trusts that may continue long after the client's death.

If a goal of the plan is to minimize transfer taxes, the will or trust instrument also should contain certain tax-saving or tax-deferral provisions. These might include a bypass or credit shelter trust to hold the applicable estate tax exclusion amount under IRC §2010, a type of marital deduction bequest or trust under IRC §2056 (see chap 17), or bequests or trusts to take advantage of the generation-skipping transfer tax exemption under IRC §§2601-2664 (see chap 11). For the charitably inclined client, the estate plan also might include bequests or trusts to take advantage of the estate tax charitable deduction under IRC §2055. See chap 23.

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§1.34 1. Will

A client who needs an estate plan should almost always have a will. The principal types of wills are a formal, witnessed will and a holographic will. A formal will generally is typed or printed and must be signed by the testator and by at least two witnesses. See Prob C §6110. A holographic will must be written entirely in the testator's own handwriting and signed by the testator; it need not be witnessed. See Prob C §6111. Although neither type of will has to be dated to be legally valid, a will always should be dated to determine which of several instruments is the decedent's last will. A will should name an executor who will manage the administration of the estate. For a more detailed discussion of the requirements for each type of will, see chap 5.

Even if the primary estate plan is contained in a revocable trust instrument, it is advisable to have a short pourover will, which transfers any probate assets to the trust after the client's death. On pourover wills, see §6.41. A will may appoint a guardian for minor children, and it also may be necessary for the exercise of a power of appointment that has been granted to the client, depending on the terms of the instrument granting the power, although it may be possible to appoint such guardians and exercise the power of appointment in a separate written instrument.

A California statutory will (see Prob C §§6200-6243) may be appropriate in some situations, *e.g.,* if the client's assets and objectives are simple, or if timing considerations (*e.g.,* imminent surgery or travel) make it necessary to have a "stopgap" will in place while a more comprehensive document can be prepared. See §5.13. The attorney may provide the client with a statutory will form, and perhaps a uniform statutory form power of attorney (see §1.37) and a statutory advance health care directive (see §1.38) as well.

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§1.35 2. Revocable Trust Instrument

A revocable or "living" trust is a common estate planning device in California. The client typically retains control over the trust by acting as the trustee until his or her death or incapacity, and trust assets are fully available to the client during his or her lifetime.

A single client might have one revocable trust that holds title to all his or her assets. Married clients or clients who are registered domestic partners might have a community property trust and respective separate property trusts. Alternatively, if the clients have similar estate plans, community and separate property might be held in one trust and simply segregated into separate accounts under the provisions of the joint trust instrument.

The property transferred to the trust is generally treated as being owned by the client for tax and creditor's claim purposes, because the client can recover it and amend or revoke the trust at any time. IRC §§676(a), 2038; CCP §709.010. As long as the trust continues to be revocable and amendable:

- No taxable gift occurs on a transfer to the trust;
- The income, deductions, gains, losses, and credits attributable to the property are reportable directly on the client's income tax return; and
- The property is includable in the client's gross estate for estate tax purposes.

Thus, little or no tax saving is achieved by establishing a revocable trust as opposed to making a will with trust provisions. For a detailed discussion of revocable trusts, see chap 6.

In preparing a revocable trust instrument, it is important to list the property that the client intends to transfer to the trust. This can be done on a schedule attached to the trust instrument, or by a general assignment that either lists all of the client's assets being transferred to the trust or simply refers to all the assets owned by the client as being transferred. A schedule or assignment listing the assets being transferred can provide a clear record of the assets for which the trustee is assuming responsibility, and it provides proof of the transferor's intention that specific assets be part of the trust. Should the client pass away before actually changing title to one or more of the assets, this statement of intention can be used to support a *Heggstad* petition and avoid probate. On using general assignments for revocable trusts, see §6.48. On using a *Heggstad* petition, see §6.49.

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§1.36 3. Beneficiary Designations for Retirement Plans and Life Insurance Policies

A comprehensive estate plan will ensure that retirement benefits and life insurance proceeds are disposed of in a way that is consistent with the objectives of the client's overall estate plan. This may result in consolidating the benefits and proceeds, after death, within the revocable trust or various subtrusts. If so, the beneficiary designations for the policy proceeds and plan assets must be changed to name the appropriate trust as the primary or contingent beneficiary. In naming the trust as the beneficiary of retirement plan benefits, the attorney must remember that, unless specific Internal Revenue Code requirements are met, potential income tax deferral opportunities that are available to an individual as the beneficiary will be lost. See §§21.44-21.46. Alternatively, the beneficiary designation for retirement plan benefits might provide that any amount otherwise payable to a beneficiary under age 25 instead be payable to the person who is acting as trustee (or the trustee's designee) as custodian for the beneficiary until age 25 under the appropriate Uniform Transfers to Minors Act. For discussion of the California Act, see §8.26.

The estate planning attorney also should be aware of Prob C §100(b), which allows spouses and registered domestic partners (see Fam C §297.5(a)) to agree in writing to divide their community property on the basis of a nonprorata division of its aggregate value. See also Prob C §101(b) (agreement to nonprorata division of quasi-community property). This can be a useful tool when, for example, sizeable retirement benefits would pass directly to the surviving spouse or registered domestic partner outside a community property trust, but the individual's separate property and one-half of the value of the property held in the community property trust would be less than the deceased spouse's remaining estate tax applicable exclusion amount. By agreeing to a nonprorata allocation of their entire community and quasi-community property, the couple may obtain the full income tax benefits of an IRA rollover by the surviving spouse while leaving enough property in trust to fully utilize the deceased spouse's estate tax applicable exclusion amount and GST exemption. For further discussion, see chap 10.

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§1.37 4. Durable Powers of Attorney for Financial Management and Personal Care Decisions

A durable power of attorney for financial management typically authorizes the agent to engage in all types of arm's-length transactions with respect to the principal's property. An agent may even be given the power to make gifts to certain individuals and charitable organizations. If the principal has established a revocable living trust, the agent generally should be authorized to transfer the principal's property to the trust, after which the property would be managed by the trustee under the terms of the trust instrument. If the principal has not established a revocable trust, the agent may be authorized to establish one, in which case the property transferred to the trust during the principal's lifetime typically is distributed to the beneficiaries of the principal's estate after his or her death, but without subjecting the trust property to probate administration. Such an instrument also can avoid the need for a court-supervised conservatorship of the estate. See California Powers of Attorney and Health Care Directives (Cal CEB 2008).

A durable power of attorney for personal care decisions may be appropriate for an elderly or disabled individual who may become unable to make decisions relating to his or her personal residence or other personal matters in the near future. Such an instrument can avoid the need for a court-supervised conservatorship of the person. It can fill the gap between the powers given to an agent or attorney-in-fact for financial management (discussed above) and a health care agent under an advance health care directive (see §1.38).

The California statutory form power of attorney, including powers for both financial management and personal care decisions, is set forth in Prob C §4401.

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§1.38 5. Advance Health Care Directive

An advance health care directive, among other things, allows an individual to direct his or her physician to withhold or withdraw life-sustaining medical treatment in the event of terminal illness or permanent unconsciousness, or if the risks and burdens of treatment would outweigh the expected benefits. The individual also may direct that he or she receive treatment necessary to provide comfort and to relieve pain. See Prob C §4701.

An advance health care directive also authorizes an agent to make health care decisions for the principal if he or she is unable to make decisions even when life-sustaining treatment is not an issue. The agent may determine the nature of the medical care to be provided as well as whether to withhold certain types of medical care. Generally, a health care agent has

- The same right as the principal to receive information regarding the proposed health care, to receive and review medical records, and to consent to disclosure of medical records;
- Priority over any other person to make health care decisions for the principal; and
- Authority to make postdeath decisions regarding organ donations under the Uniform Anatomical Gift Act, an autopsy, and disposition of the deceased principal's remains. See Prob C §§4600-4690. On planning for incapacity, see chap 29.

A California statutory advance health care directive is set forth in Prob C §4701.

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§1.39 6. Agreement Between Spouses or Registered Domestic Partners Regarding Character of Property

The standard estate plan may include, when appropriate, an agreement between the spouses or registered domestic partners that changes or confirms the character of their property as community or separate. Commonly, such an agreement provides that assets held in joint tenancy are really community property. For married couples, a provision of this nature will result in a new income tax basis for both halves of the community property on the death of either spouse, whereas joint tenancy assets generally receive a new basis only for the decedent's one-half share. IRC §1014. Certain assets also can be held by spouses or registered domestic partners as community property with right of survivorship. CC §682.1; Fam C §297.5(a). On the character of property held by married persons, see chap 4. Care should be taken when advising clients who are agreeing with respect to the character of their property, and it may be advisable to obtain separate representation for each spouse before they sign the agreement.

The community property regime generally applies to registered domestic partners. The step-up in basis also may apply to registered domestic partners for California income tax purposes, but not for federal income tax purposes. See §§8.13-8.14, 8.36.

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§1.40 7. Business Succession Documents

A complex estate plan may have to address business succession planning issues. It may be necessary to create an entity to hold the client's interest in closely held business assets or to transfer interests in an existing entity. Thus, an estate plan for a client with closely held business interests or assets may include:

- An LLC operating or partnership agreement, or corporate bylaws or shareholders' agreement, or other document creating and governing the operation of and transfers of interests in the business;
- An assignment or other transfer of interests in the business to the client's revocable trust; or
- Gifts to family members or others.

Closely held corporations, partnerships, limited liability companies (LLCs), and tenants-in-common agreements provide opportunities for saving taxes and for managing in a unified manner interests in property held (or to be held), directly or indirectly, by various family members. The simplest form of corporation, partnership, or LLC is one in which all the shareholders, partners, or members have an interest in the profits and losses in proportion to the value of the property each of them contributes to the entity. Family members who do not own substantial property of their own can acquire property to contribute to the entity, or an interest in the entity itself, through an intrafamily loan, gift, or purchase. Tenants in common may hold equal or unequal undivided fractional or percentage interests in an asset. See CC §§683, 685.

For a discussion of estate tax rules applicable to interests in qualified real property and qualified family-owned businesses, see chaps 10 and 18.

In addition to an analysis of the tax issues surrounding the creation and transfer of interests in these types of entities, the estate planner may need to consider related business and real property law issues.

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§1.41 8. Irrevocable Trusts

A complex estate plan may include various irrevocable trusts. Irrevocable trusts are most commonly used for a variety of tax-saving and other purposes. See chap 6A. The following are some of the more commonly used types of irrevocable trusts:

- *Crummey* trusts (see chaps 8, 10);
- Dynasty-type generation-skipping trusts (see chap 11);
- Grantor retained interest trusts (see chap 25);
- Charitable lead trusts (see chap 23A); and
- Charitable remainder trusts (see chap 24).

For further discussion of these and other types of trusts, see Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

A gratuitous transfer of property to an irrevocable (and unamendable) trust generally is treated as a completed gift, in whole or in part, for gift tax purposes. See IRC §§2501, 2511. With certain exceptions, transfers to an irrevocable trust generally do not qualify for the gift tax annual exclusion because they usually create at least some future interests in the property. The income, deductions, gains, losses, and credits attributable to the trust property generally are taxable to the trust or its beneficiaries for income tax purposes unless the trust is a "grantor trust" under IRC §§671-679 (see chap 13). Further, the property generally is excluded from the transferor's estate for estate tax purposes unless the transferor retains an interest in the trust that causes inclusion under IRC §§2036-2039. For a more detailed discussion of gift and estate tax issues, see chap 10.

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§1.42 9. College Education Financing Devices

The client may wish to make other arrangements to finance a child's, grandchild's, or other person's education. For example, federal tax law has made it very attractive from an income, estate, and gift tax perspective to establish IRC §529 college savings accounts or prepaid tuition plans. See §8.30, chap 21A.

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Source: Estate Planning/California Estate Planning/1 Overview of Estate Planning Practice/§1.43 G. Step Seven: Producing and Transmitting Documents

§1.43 G. Step Seven: Producing and Transmitting Documents

An estate planning attorney should ensure that he or she has consistent policies and procedures with respect to the production and transmission of documents. Sections 1.44-1.48 discuss considerations that should inform these policies.

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§1.44 1. Drafting Issues

A primary goal of estate planning is to create documents that are a clear expression of the client's objectives and intent. This is important not only so the client can understand his or her own estate plan, but also so that documents are unambiguous and easy to follow after the client's death or incapacity.

PRACTICE TIP: A form that focuses first on the areas of the client's particular interest, and then on generic administrative provisions, is preferable to a form in which the key provisions are buried among the typical boilerplate provisions. It is helpful, therefore, to name fiduciaries and set out the dispositive provisions in the front part of the document, perhaps in a double-spaced format, and then set out generic administrative (boilerplate) provisions thereafter, perhaps in a single-spaced format. This assists the client in focusing on the provisions that are particular to his or her plan as well as the provisions that are of the most interest to him or her. It also facilitates the presentation of a certification of trust as authorized by Prob C §18100.5. See §6.4.

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§1.45 2. Production Issues

Nearly all major estate planning documents are now generated by computer (word processing or document assembly software). The attorney typically uses a master form and/or exemplar to generate the initial drafts of a client's will, trust instrument, and other documents, with further specialized provisions being added thereafter. It is important to ensure that, if master forms and/or exemplars are used regularly in the attorney's practice, the forms are kept current and the resulting documents are fully and carefully analyzed and reviewed by the attorney before being sent to the client.

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§1.46 3. Further Explanation of Draft Instruments

Transmitting draft instruments to the client provides yet another useful opportunity to explain the provisions of the plan to the client. This can be accomplished in a cover letter or by reference to any educational materials the attorney provided to the client. See §1.24. This helps to ensure that the client understands the estate plan being created.

The transmittal also can provide an opportunity for the client to review and confirm the attorney's understanding of the client's assets. For example, the attorney may wish to send a copy of the completed questionnaire to the client and ask him or her to review it (particularly the assets and liabilities listed and the fiduciaries and beneficiaries named in the various instruments) for accuracy and completeness. See §1.27. For a sample transmittal letter, see §1.65.

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§1.47 4. Documenting Unusual Decisions

Sometimes, a client decides to structure an estate plan in a way that might have adverse implications at a later date. For example, the client might have reasons to distribute property unequally to his or her children. In other cases, the client may desire a plan that does not minimize the overall tax burden on the estate, *e.g.,* by not taking full advantage of tax exemption, deduction, or deferral opportunities. This is typically done when personal or family considerations outweigh tax-saving considerations and can be entirely appropriate under the circumstances. In such situations, the attorney should confirm the decision in a writing to the client in enough detail to foreclose any later argument that the client was not adequately advised of adverse tax consequences, or to address any family discord.

NOTE: The attorney should keep in mind that any argument about the client's plan is likely to come from the beneficiaries who have no relationship with the attorney and who were not a part of the estate planning process. Arguments may also arise years after the work was performed by the attorney, when the client is gone and when memories have faded. Copies of documents, letters, and notes may be the only tangible record of the decedent's understanding and intent. The attorney should keep clear and complete notes in each client's file.

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§1.48 5. Delay Issues

If a delay is unavoidable in the production of estate plan documents (or at any stage in the estate planning process), the attorney should communicate with the client and make every effort to minimize the effect of the delay. Malpractice issues can arise when a client dies or becomes incompetent before the estate plan has been put in place. The beneficiaries who suffer as a result may then seek redress from the attorney.

Of course, it may be the client who is responsible for the delay. It is not uncommon for a client to stall the planning process by not responding to requests for information, commenting on draft documents, or even simply scheduling a meeting to execute completed plan documents. Often this is due to scheduling conflicts, but sometimes it is due to an aversion to making the final planning decisions. The attorney should be sensitive to the psychological or emotional issues involved.

Whatever the reason, if the client is responsible for the delay, the attorney should have a procedure to address the problem. It might include sending periodic reminder letters to the client and documenting the reminders in the file, or it might entail setting deadlines for the project. On setting a timetable, see §1.31. Another useful technique to cure a client's delay problems is to bill the client for the work to date (assuming the fee agreement permits interim billing), rather than waiting until after the documents are signed.

One problem with any significant delay is that asset information becomes stale, or provisions in the instrument become obsolete or out of date, requiring significant (and expensive) updating efforts once the client finally decides to proceed.

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§1.49 H. Step Eight: Executing Documents

The attorney should have an established office procedure for executing documents. Some attorneys require, as a rule, that documents be signed in their offices, so they can more easily make any last-minute changes and supervise the necessary testamentary formalities, particularly with respect to the client's will. On signing ceremonies for wills and trusts, see California Trust and Probate Litigation, chap 2 (Cal CEB 1999). If documents are sent to the client to be signed, it is a good idea to include written instructions on how they should be executed. For a sample memorandum of instructions, see §1.66.

If the attorney believes that the client's competence while signing his or her plan documents may be subject to question at a later date, it might be advisable to record in the file the attorney's perception of the client's competence, or even to have the client's competence evaluated by a geriatric psychiatrist (or other professional). See Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide April 2010).

WARNING: Taking extra steps to document a client's competence can actually raise competence questions later, especially if those steps deviate from the attorney's standard procedure.

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§1.50 I. Step Nine: Processing Documents, Transferring Title to Assets, and Other Implementation Tasks

Once the will and other instruments have been executed, it is common to feel that the engagement is completed. This usually is not true, however. The following tasks must still be accomplished:

- The original, executed instruments should be copied, bound (if desired), and put into a safe storage facility.
- Title to assets and beneficiary designations for life insurance policies and retirement plan benefits should be changed, if necessary.
- If a revocable trust has been created, title to all of the appropriate assets should be transferred to the trust, either by the attorney (or the attorney's staff) or by the client; if by the client, the attorney should provide adequate instructions (see §1.53).
- If an irrevocable trust has been created, it may be necessary to obtain a taxpayer identification number for the trust and make sure that any necessary appraisals of transferred property values are obtained and fiduciary income and gift tax returns are properly filed.
- If any business entities have been created, or interests in them transferred, the entity's governing documents and share register should be drafted or amended to reflect the transactions and filed as necessary with state authorities.
- If real property is transferred or title is changed for any reason, deeds must be recorded and real property preliminary change-of-ownership reports and parent/child property tax exemption forms (if applicable) must be filed.
- If *Crummey* trusts are created, power-of-withdrawal letters should be sent to trust beneficiaries and acknowledged by them or their representatives.

Throughout the estate planning process, the client may need to make investment and financial planning decisions. Although the typical estate planning attorney may be many things, it is important to remember that he or she usually is not a financial planner or investment counselor. Ideally, the client will have a financial planner or investment counselor who can be consulted with respect to financial and investment issues and who can help carry out estate planning decisions. A financial planner can become even more important in the estate administration process if any irrevocable trusts are created and funded.

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§1.51 J. Step Ten: Final Communication to Client

The attorney should communicate with the client once more in writing after the implementation of the plan is completed. The final communication serves various purposes, including giving directions about safekeeping of the original documents (see §1.52), directions about title transfers (see §1.53), making recommendations for future review (see §1.54), and documenting disengagement (see §1.56). For a sample letter, see §1.67. This letter also might include a short summary or diagram of the plan. For an example of such a diagram for a typical married couple, see §1.68.

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§1.52 1. Safekeeping Original Documents and Copies

Because attorneys often have fireproof safes or vaults, many lawyers have traditionally offered document storage services to clients. In any event, the original documents should be kept in a safe and logical place, and their location should be noted on the attorney's file copies and reflected in the final written communication to the client.

Rules governing the deposit of documents with the attorney and the attorney's duties and liabilities are set forth in Prob C §§700-716. The rules provide that an attorney who agrees to hold a client's original documents for safekeeping must exercise ordinary care for the preservation of the documents and hold them in a secure location. Prob C §710. Further, an attorney offering storage services should consider how he or she will handle the documents in the event of his or her own incapacity, retirement, or death, particularly if a client cannot be located. See Prob C §§730-735 (exclusive methods of terminating deposit). Because the responsibilities and logistics of keeping clients' original documents, perhaps for decades, can be daunting, many attorneys do not keep clients' original documents, and they have chosen to return original instruments to their clients for safekeeping. It is also important for the attorney to safeguard sensitive information in his or her files, such as the client's social security number and bank account data. For directions to clients on safekeeping originals, see §1.67.

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§1.53 2. Directions About Title Transfers

In the final letter to the client, the attorney should address the issue of title transfers in some detail, especially if the client has established a revocable trust. If the client will handle the necessary transfers of title, the letter should set forth detailed instructions, showing the name in which title should be taken. The client should be advised to take title to subsequently acquired assets in the name of the trust. This recommendation should be made in writing and kept with the file copies of the instruments.

Many clients opt to handle title transfers on their own in order to save costs, although commonly the estate planning attorney prepares, supervises the execution of, and records the deeds and related real property forms that may be necessary to implement the plan. The attorney may invite the client to call with any questions that arise in the title-transfer process.

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§1.54 3. Recommendations to Client for Future Review

Attorneys should consider what to recommend to a client about subsequent review of his or her estate planning instruments. The attorney might suggest, at the close of an estate planning engagement, that the client review his or her estate plan every 5 years or so, on the birth of a child or death or incapacity of a family member, the acquisition (or loss) of valuable property, the receipt of significant property by gift or inheritance, a move to another state, a serious health problem, entry into a marriage or domestic partnership, or a dissolution of marriage or domestic partnership. The client should be instructed to have the plan reviewed as well, if there is a significant change in the tax law that may affect the estate plan.

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§1.55 4. Income Tax Deduction for Attorney Fees

Clients often inquire whether any of the legal fees for their estate planning work are deductible for income tax purposes. The Internal Revenue Code does not specifically allow the deduction of attorney fees for estate planning purposes, but they may be deductible as a business expense under IRC §162, or as an expense for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, under IRC §212. Internal Revenue Code §212(3) apparently allows the deduction of legal fees for the tax planning aspects of the estate plan. Therefore, the attorney should estimate what portion of the total legal fees relate to tax planning, and provide that information in a letter to the client, subject to the Circular 230 legend at the end of the engagement letter in §1.62. See discussion of Circular 230 in §2.7A. The attorney might suggest that the client discuss the use of this deduction with his or her accountant to determine whether it is appropriate. Section 212 deductions are allowable only to the extent that they exceed 2 percent of the client's adjusted gross income. IRC §67. See §13.17. In some cases, a portion of the legal fees and other costs of the estate plan not currently deductible for income tax purposes may be considered capital expenditures and added to the basis of an asset, such as shares of an investment company. These capitalized costs may be amortized over a 5-year period under IRC §§248 and 709(b).

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§1.56 5. Terminating Engagement

The attorney may wish to use the final letter to disengage from the estate planning project and specify that the attorney's work has been completed. This should eliminate any argument that the attorney has a duty to keep the client informed of changes in the law that might affect the client's estate plan, and puts the duty squarely on the client to reactivate the engagement if he or she believes it advisable for any reason, such as personal or financial changes or changes in the law generally.

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§1.57 IV. CONTACTING CLIENT AFTER ESTATE PLAN IS IN PLACE

Once the documents are signed, any transfers are completed, and the original documents are safely stored, there are different views on how to handle subsequent activities.

The attorney may wish to inform clients of significant changes in the law, even though the attorney may have no duty to do so. There is some difference of opinion on this issue. On the one hand, advising clients periodically about some changes in the law arguably creates a duty to do so for *all* significant changes. This may involve more work and expense than the attorney is willing or able to undertake.

On the other hand, periodic updates can be effective as a marketing tool, whether they appear as legal updates or simply as reminder letters every few years that a client should review his or her estate plan.

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§1.58 V. OFFICE MANAGEMENT PROCEDURES

General office procedures have a direct bearing on the attorney's practice. General management issues are critical to the ongoing success of an attorney's estate planning practice. Calendaring (see §1.59) and docket control (see §1.60) systems should be in place to anticipate and manage these issues. In addition, the estate planning attorney must maintain a filing system that allows ready access to copies of the client's documents by the attorney and his or her staff. This is often of critical importance on the client's incapacity or death, when the family needs copies of documents promptly.

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§1.59 A. Calendaring Deadlines

Although the estate planning process does not routinely involve the type of deadlines that arise in the administration of estates and trusts (*e.g.,* probate and tax filings), it is still imperative that the attorney have a reliable calendaring system to keep track of important dates, including deadlines that do arise. For example, tax returns or reports may need to be filed and tax elections may need to be made within a specified time period after certain gifts or changes in business entities. Registration or notification periods may apply to intellectual property assets, such as copyrights and patents. Periodic filings may be necessary with the Secretary of State, the Department of Corporations, or the Attorney General for certain business and charitable entities. Depending on the attorney's level of involvement in the notice procedure required for *Crummey* trusts (see chaps 8, 10), it may be helpful to calendar those types of reminders as well. An effective calendaring system can also be used to remind the attorney that a client has not returned draft documents within a reasonable period of time, or that documents sent out for recordation or filing (*e.g.,* deeds, new beneficiary designations) have not been returned in a timely fashion.

These calendaring systems can range from a simple office calendar to elaborate computerized systems that generate periodic reminders as a deadline approaches. The attorney should also ensure that all deadlines, hearing dates, and other important matters are calendared by his or her staff responsibly and thoroughly.

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§1.60 B. Docket Control

The office docket control system should be an outgrowth of the marketing system for obtaining estate planning work. When a lawyer performs estate planning work, there should be a follow-up system. For example, the lawyer might send out a reminder letter to the client to consider reviewing his or her estate plan 5 years after the existing documents were executed.

The fact-gathering process and the drafting and execution of documents need control to ensure that matters are dealt with in a timely fashion. See Cal Rules of Prof Cond 3-110. The docket control system should include an inventory of work in process and an inventory of completed projects segregated for each client. Inventories should be maintained by a secretary or legal assistant expressly responsible for them. A conscious effort should be made to monitor work in progress.

Legal assistants can be extremely useful in an estate planning practice. They can gather and organize client information, maintain comprehensive asset summaries, maintain office forms and sample forms, assist with drafting, and oversee the title transfer process. An attorney employing legal assistants must, nevertheless, ensure that they have the skills commensurate with their responsibilities. The attorney must also remember that the ultimate responsibility for the legal assistant's work lies with the attorney.

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§1.61 VI. POSTDEATH EVENTS

In the trying months after the client's death, when his or her family members or other loved ones are coping with their grief, a thorough and thoughtful estate plan, with documents and information in place, can be of great assistance. The will or revocable trust instrument directs the administration and disposition of the client's assets. An up-to-date schedule of assets and liabilities will serve as a centralized repository of information about the client's financial situation that can assist immeasurably in creating probate inventories, trust administration records, and income, gift, and estate tax returns that may need to be filed.

The estate planning attorney is often asked to handle the estate and trust administration work because of his or her familiarity with the asset information and with the plan itself. The attorney may already know the other professionals, such as the accountant, financial planner, investment counselor, securities and insurance brokers, trust officer, and appraisers who may be called on to assist with the administration of the client's estate or trust after the client's death. The team can move seamlessly in support of the client's family to navigate the administration process. This is often when the planning efforts are most fully appreciated.

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VII. SAMPLE DOCUMENTS

§1.62 A. Form: Initial/Engagement Letter for Use With Married Couple

1.62-1 Initial/engagement letter for use with married couple

_ _[*Date*]_ _

Dear _ _ _ _ _,

1. Estate Planning Information

In accordance with our recent telephone conversation, I am sending you the enclosed set of partially completed estate planning information sheets, requesting certain personal and family information plus information relating to your assets and liabilities. It will be very helpful to us in preparing new wills and related instruments for you and in counseling you regarding your estate plan if you would complete the information sheets to the extent reasonably possible and either return them to me in advance of, or bring them with you to, our initial meeting in my office, at _ _[*address*]_ _ on _ _[*date*]_ _, starting at _ _[*time*]_ _. Because our fees for estate planning are based primarily on the time spent in personal and telephone conferences as well as preparing documents, etc., the more information you can provide us with ahead of time, the less time it will take and the lower the cost.

Also enclosed are _ _[*specify educational materials enclosed*]_ _.

The enclosed asset and liability sheets consist of a one-page summary of the approximate or estimated present market values of your assets and liabilities by general categories, followed by a number of schedules relating to specific items. You should specify the way in which you hold title to each of your significant assets and liabilities on the appropriate schedule. (If any item is held in a custodial, agency, or revocable trust account, simply list the account on the appropriate schedule and attach a copy of the most recent statement.) Please check the deed, passbook, certificate, note, policy, or other document of title and indicate whether you hold title in either of your names alone, in both of your names, or in the names of either or both of you and another or others as trustees of your revocable living trust, as community property, as joint tenants, as tenants in common, or otherwise. The rights associated with a particular asset and the tax consequences with respect to it generally are determined by the way in which title is held.

The information relating to your present marriage, requested in Part C of the Personal and Family Information sheets, as well as the financial information, will be used to distinguish any separate or quasi-community property that either of you may have from your community property. For a brief discussion of the importance of determining the characterization of your property and the ways in which title may be held, see the enclosed educational materials. That discussion should be helpful to you in completing the information sheets. During our conference we can determine the character of the property now owned by the two of you and discuss in more detail your respective interests in and rights with respect to it. If you have not already done so, it may even be desirable for you to enter into an agreement establishing the character of your property, to minimize the possibility of a later dispute with the taxing authorities, between yourselves, or among the beneficiaries of your respective estates.

In addition to the data to be included on the estate planning information sheets, it would be very helpful if you would have available at our initial meeting the originals or copies of the following: (1) your present wills, revocable trust instrument, and powers of attorney, if any, (2) the grant deeds or title insurance policies relating to all real property owned by either or both of you, (3) life insurance policies owned by either of you, (4) the Summary Plan Description of each employer-sponsored retirement plan in which either of you is a Participant or Beneficiary, (5) relevant instruments and agreements relating to closely held partnerships, corporations, or limited liability companies of which either of you is a general or limited partner, a shareholder, or a member, (6) relevant instruments and agreements relating to intellectual property, such as copyrights and patents, (7) any agreements you have ever entered into regarding the separate or community character of your property, (8) any marital settlement agreement and/or divorce decree relating to a previous marriage of either of you with respect to which there are continuing rights or obligations, (9) your most recent federal income and gift tax returns, (10) all trusts, custodianships, educational savings accounts, and private foundations or supporting organizations now in existence that either or both of you have created or in which either or both of you or your issue (*i.e.*, lineal descendants) have an interest, and (11) any other instruments or documents having a bearing on your estate plan.

2. Estate Plan

Before the initial meeting, you should each give some thought to how you generally would like to dispose of your estate when you die. In determining the beneficiaries, please bear in mind that an individual may not survive you. In that event you should consider whether anyone else should receive the proposed gift instead, such as the individual's surviving spouse or issue. Also, if you make an outright gift to someone, the beneficiary can later give what is left of the property to whomever he or she chooses; however, if the gift is in trust, the trust instrument can specify who ultimately receives the property or successive beneficial interests in it. A gift in trust also may save estate taxes on the beneficiary's death and can protect the trust assets from the claims of creditors and predators. Finally, if all of your specified beneficiaries should die before your estate has become fully distributable, how would you like to dispose of any remaining property? We usually include a general provision leaving any such property to your heirs at law determined as of that time, but you might prefer to leave it to others, including one or more charitable organizations, particularly if your heirs at law are likely to be people you do not even know.

Also, you should bear in mind that the size and composition of your estate may be very different at the time

of your deaths from what it is now. Therefore, it usually is better to dispose of assets in general terms rather than referring to specific items, and to dispose of the bulk of your estate in shares rather than specific dollar amounts.

A fundamental decision that you will need to make (if you have not already done so) is whether to establish a revocable living (or inter vivos) trust, along with a "pour-over" will, as opposed to a will with or without trust provisions. The former arrangement is more expensive to draft and implement than the latter, and a revocable trust can be somewhat burdensome to fund and administer, but it could result in significant savings in time and estate settlement costs and would better protect your privacy in the event of the death or incompetence of either of you. However, you should realize that, in general, no tax savings will result from the use of a revocable living trust as opposed to a will containing trust provisions.

If your estate plan involves the establishment of a testamentary trust under your wills following your deaths rather than a revocable living trust, you generally should not hold title to your property in joint tenancy form, since a joint tenancy can also give rise to unintended and often unfavorable tax consequences. Furthermore, the trust named as the beneficiary of the residue of your probate estate generally should be named as the primary or contingent beneficiary of your life insurance policies, employee benefit plans (including IRAs), and pay-on-death (POD) accounts, so as to better coordinate the disposition of your entire estate, but without subjecting it all to probate.

You also should consider whom you would like to appoint as the executors of your wills and the guardians of the person and estate for your minor children, and, because we are likely to determine that a trust is advisable, you will need to appoint the trustee(s). In addition, if you have not already done so, you may want to appoint an agent (or attorney-in-fact) to act on your behalf, particularly in the event you become incompetent, for property matters, health care, and other personal decisions. You may name each other, another adult individual, or a qualified institution (such as a bank or trust company) to serve separately or jointly in each of these fiduciary capacities, although an institution cannot serve as guardian of the person of a minor and generally should not be named as a health care agent. You should consider naming at least one successor for any individual appointed as a fiduciary, in case he or she should fail to qualify or cease to act for any reason.

3. Dual Representation

Although you are married and generally have common legal interests and obligations, conflicts of interest may arise between the two of you with respect to various matters during or following the estate planning process, such as the character of your property (*i.e.*, whether it is separate, community, or quasi-community property) and how to dispose of it during your lifetimes and at your deaths. Despite the possibility of potential conflicts, you have requested this firm to represent both of you with respect to your estate plan. However, if you anticipate that such conflicts would be serious, it may be better for each of you to have separate independent counsel at the outset to avoid the possibility that our advice to one of you is unduly influenced by our dual representation. Under such circumstances, one attorney ordinarily may not represent both of you.

If you decide to go forward with our dual representation of you, and one or more conflicts arise between the two of you of such a nature that it is impossible in my judgment for us to perform our obligations to each of you in accordance with this letter, we will withdraw at that time from all further dual representation of both of you and advise either or both of you to obtain independent counsel.

Finally, you have each agreed that all information that we receive from either or both of you in the course of our dual representation of you is nonconfidential between you regardless of the manner in which it is obtained (*e.g.*, in conferences with both of you or in private telephone or personal conferences with only one of you, including any conferences that may have taken place before the date of this letter). However, this agreement would not prevent either of you from changing or revoking your will or other estate planning instruments after we have completed your estate plan, without the knowledge or consent of the other.

4. Nature of Representation

This will confirm that, unless we agree otherwise in writing, our engagement is solely with the two of you individually. By entering into this agreement, we do not represent you in any fiduciary or other capacity or any other individuals or entities not named as clients herein, whether or not affiliated with you.

5. Waiver of Future Conflict

Our agreement to provide estate planning services to you is conditioned upon the understanding that we are free to provide legal services to any clients (including your adversaries) and take positions adverse to you in any matters (whether involving the same substantive area(s) of law for which you have retained us or some other unrelated area(s), and whether involving transactions, counseling, litigation, or otherwise) that are not substantially related to your estate plan or other matters for which you may hereafter retain us. In this connection, you should be aware that we provide services on a wide variety of legal subjects, to a large number of clients. (A summary of our current practice areas and the industries in which we represent clients can be found on out website at _ _[*website address*]_ _. You acknowledge that you have had the opportunity to consult with other counsel about the consequences of this waiver.

6. Billing Policies and Procedures

I also am enclosing for your information a copy of our firm's general Billing Policies and Procedures statement to our clients, covering the manner in which we compute our fees, the relevance of hourly rates and other factors used in the determination of a reasonable fee for our services, the payment of disbursement items, the timing and content of billing statements, and the expected payment period. Please review this statement carefully before our initial meeting, and do not hesitate to ask any questions you may have regarding billing matters at any time. We maintain errors and omissions insurance coverage applicable to the services to be provided to you.

While hourly rates are not the sole determinant of our fees, they are a major factor to which we refer in

determining our monthly billings. Our firm's hourly rates presently range from _ _[*dollar amount*]_ _ for our newer associates to _ _[*dollar amount*]_ _ or more for our most senior and experienced partners. We presently anticipate that the primary services relating to your estate plan will be performed by me (at a current hourly rate of _ _[*dollar amount*]_ _), by one or more of our estate planning associates (whose current hourly rates range from about _ _[*dollar amount*]_ _ to _ _[*dollar amount*]_ _), and/or by one or more of our estate planning legal assistants (whose current hourly rates range from about _ _[*dollar amount*]_ _ to _ _[*dollar amount*]_ _). Staffing decisions will be made by me as the partner in charge of the engagement, with the objective of providing services to you on the most efficient and cost-effective basis. We reassess our hourly rate schedules from time to time, generally on an annual basis.

As I mentioned to you during our telephone conversation, the legal fees and disbursements for a fairly basic but complete estate plan frequently total _ _[*dollar amount*]_ _ to _ _[*dollar amount*]_ _, and it will vary depending on whether the plan involves a revocable living trust with "pour-over" wills as opposed to reciprocal wills with or without trust provisions, the complexity of the plan generally, and the extent to which the wills and any other instruments vary from the norm. If you wish, I will give you an estimate of the total amount of the fees and disbursements for the services we agree to perform for you at the end of the initial meeting, but please bear in mind that the total bill could be substantially more or less than the estimate due to the uncertainties involved. Bills generally are sent out monthly and payment is expected within 30 days after receipt.

[*If applicable, add the following option*]

We request that you give us a retainer in the amount of _ _[*dollar amount*]_ _ at the outset of this engagement. We will deposit your retainer in an interest-bearing trust account on your behalf and will return it to you at the end of the engagement, or simply apply it to the amount you owe us if our work is completed within 2 or 3 months. The firm in its discretion, as a condition to further work during the course of this engagement or further engagements, may require a further or increased retainer. You further agree that, in the event a fee statement is not paid in a timely manner, the firm in its discretion may apply the retainer to any outstanding balance. You would then be required to deposit replacement funds into your trust account to bring its balance back up to the agreed-on retainer level, if our work has not been completed.

[*Continue*]

Subject, of course, to our ethical and professional obligations, you agree that the firm may terminate its legal services and withdraw from this engagement in the event our fee statements are not paid in a timely manner.

If you agree that, because of the limited scope of our representation, we are free to represent clients or take positions that might be adverse to you in matters that are not substantially related to your estate plan, if you agree to the terms of our dual representation of you, and if our billing policies and procedures are acceptable to you, please sign and date the enclosed copy of this letter and return it to me _ _[*along with your check for _ _[dollar amount*]_ _]_ _ in the enclosed, self-addressed, stamped envelope so as not to impede the commencement of our work on your behalf.

7. U.S. Treasury Department Circular 230

As a result of new rules promulgated under U.S. Treasury Department Circular 230, effective June 20, 2005, and subsequent amendments, any written advice rendered by our firm concerning a federal tax issue is subject to certain requirements concerning form and content. Depending on the nature of the federal tax issue or issues addressed by the advice, it is possible that you may not be able to rely on the advice to avoid U.S. federal income tax penalties with respect to issues addressed therein. Alternatively, you may not be able to rely on the advice to avoid U.S. federal income tax penalties with respect to issues or conclusions not specifically addressed by the written advice. The extent to which our written advice is intended to provide protection against U.S. federal income tax penalties, and the cost of providing such advice, will be discussed with you from time to time as appropriate.

Sincerely,

__[*Signature*]__
_ _[*Attorney's typed name*]_ _

APPROVED AND AGREED TO:

Date: _ _ _ _ _ _ **By:** __[*Signature*]__
_ _[*Client's typed name*]_ _

Date: _ _ _ _ _ _ **By:** __[*Signature*]__
_ _[*Client's typed name*]_ _

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§1.63 B. Form: Schedules of Assets and Liabilities

Print

sf-1205492

Summary Page

Assets & Liabilities of __[*Clients' names*]__, as of __[*date*]__

Schedule	Type of Property	Separate Property Wife's	Separate Property Husband's	Quasi-Community Property Wife's	Quasi-Community Property Husband's	Community Property	Total
A	Tangible Articles of a Personal Nature and Club Memberships						$
B	Real Property (Including Mineral Rights)						$
C	Cash and Readily Marketable Securities						$
D	Non-readily Marketable Securities and Other Business or Investment Property						$
E	Interests in Employee Benefit Plans and Annuity Policies						$
F	Life and Accidental Death and Dismemberment Insurance Policies						$
G	Interests in Trusts, Estates, Custodianships, Educational Savings Accounts, Foundations, and Supporting Organizations						$
	TOTAL ASSETS	$	$	$	$	$	$
H	Liabilities					$	$
	PRESENT NET WORTH	$	$	$	$	$	$
Net Life Insurance Proceeds on Non-Accidental Death of:	Husband						$
	Wife						$

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Key to Schedules A through H

(1) Insert owner's initials. If owned by a revocable trust, insert date of trust followed by "RLT." If two or more owners, indicate form of ownership below owners' initials.

- CP Community Property
- TC Tenancy-In-Common
- JT Joint Tenancy
- TE Tenancy by the Entirety
- HW Husband & Wife
- CPRS Community Property with Right of Survivorship

(2) How Acquired

- P Purchase
- G Gift
- TFE Tax-free Exchange
- SD Stock Dividend
- SS Stock Split
- ESO Exercised Stock Option
- L Loan
- IS Installment Sale
- E Through Employment
- RO Rollover From Qualified Plan
- O Other

(3) Character of Property (or Obligation)

- HSP Husband's Separate Property
- WSP Wife's Separate Property
- CP Community Property
- HQCP Husband's Quasi-Community Property
- WQCP Wife's Quasi-Community Property
- N/A Not Applicable

(4) Use of Property

- PR Principal Residence
- VH Vacation Home
- IP Income-Producing
- HO Home Office
- O Other

(5) Type of Account

- CA Checking Account
- SA Savings Account
- CD Certificate of Deposit
- TB Treasury Bill
- CP Commercial Paper or Bankers' Acceptance
- TEPN Tax-Exempt Project Note
- BA Brokerage Account
- O Other

(6) Type of Policy

- OL Ordinary Life
- UL Universal Life
- IT Individual Term
- DT Decreasing Term
- GT Group Term
- SD Split-Dollar
- TA Travel Accident
- ADD Accidental Death & Dismemberment
- D Disability
- SPL Single Premium Life

(7) Type of Plan

- PP Pension Plan
- PSP Profit-Sharing Plan
- IP Investment Plan
- TP Thrift Plan
- ESOP Employee Stock Ownership Plan
- IRA Individual Retirement Account
- TSA Tax-Sheltered Annuity
- A Annuity
- DCP Deferred Compensation Plan (Non-Qualified)
- ISO Incentive Stock Option
- NSO Non-qualified Stock Option
- O Other

(8) Type of Interest

- LE Life Estate
- SLE Successor Life Estate
- TC Term Certain
- A Annuity
- R Remainder or Reversion
- PR Power of Revocation or Withdrawal
- GTPA General Testamentary Power of Appointment
- STPA Special Testamentary Power of Appointment
- QHEE Qualified Higher Education Expenses

(9) Type of Entity

- TT Testamentary Trust (including a revocable trust after the Settlor's death)
- RLT Revocable Living Trust
- IRT Irrevocable Reversionary Trust
- IET Irrevocable Educational Trust
- CLT Charitable Lead Trust
- CRT Charitable Remainder Trust
- PIF Pooled Income Fund
- GRIT Grantor Retained Interest Trust
- ILT Other Irrevocable Living Trust
- EST Estate
- CUST UTMA Custodianship
- QTP IRC §529 Qualified Tuition Program
- AT Administrative Trust
- PF Private Foundation
- SO Supporting Organization

(10) Subject to Item - Insert item number of liability, if any, on Schedule H, to which this asset is subject.

(11) Secured by Item - Insert item number of asset, if any, on Schedules A through E, by which this liability is secured.



Schedule A. Tangible Articles of a Personal Nature and Club Memberships

Relatively valuable tangible articles of a personal nature, such as personal automobiles and boats, artwork, antiques, oriental rugs, coin, stamp, and other collections, jewelry, furs, and other items that are normally listed separately or under a personal rider to your homeowners' or tenants' insurance policy, plus club memberships

	Description of Item	Owner(s) of Record (1)	Date Acquired	How Acquired (2)	Subject to Item (10)	Character of Property (3)	Federal Cost or Basis	Estimated Present Value Totals
1.			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
			__/__/__					
	Miscellaneous Other Items							

Total: $

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Schedule B. Real Property (Including Mineral Rights)

Interests in real property owned outright. List interests in closely held corporations, partnerships, or LLCs owning real property on Schedule D.

Description (Including Address or Location)	Use of Property (4)	Owner(s) of Record (1)	Date Acquired	How Acquired (2)	Subject to Item (10)	Character of Property (3)	Federal Cost or Basis	Estimated Present Value
1. _____ _____, CA 9_____			__/__/__	_____			_____	_____
APN _____, _____ County								
Assessed Value (2003-2004): $_____								
Previously Unrecognized Gain							(_____)	
Capital Improvements								
_____			__/__/__				_____	
_____			__/__/__				_____	
_____			__/__/__				_____	
2. _____	____	_____ -___	__/__/__	_____	_____	_____	_____	_____
APN _____, _____ County								
Assessed Value (2003-2004): $_____								
Previously Unrecognized Gain							(_____)	
Capital Improvements								
_____			__/__/__				_____	
_____			__/__/__				_____	
_____			__/__/__				_____	
3. _____	____	_____ -___	__/__/__	_____	_____	_____	_____	_____
APN _____, _____ County								
Assessed Value (2003-2004): $_____								
Previously Unrecognized Gain							(_____)	
Capital Improvements								
_____			__/__/__				_____	
_____			__/__/__				_____	
_____			__/__/__				_____	
						Total:	$_____	

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Schedule C. Cash and Readily Marketable Securities

Checking and savings accounts, certificates of deposit, treasury bills, commercial paper, bankers' acceptances, tax-exempt project notes, and stocks, bonds and options regularly traded on a national or foreign exchange, over-the-counter, or otherwise, for which quotations can readily be obtained from established firms, plus units of a common trust or mutual fund.

	Type of Acc't., No. of Shs. or Face Amt. (5)	Depository, Broker, Issuer or Obligor	Account or Certificate Number	Owner(s) of Record (1)	Date Acquired	How Acquired (2)	Subject to Item (10)	Character of Property (3)	Federal Cost or Basis	Estimated Present Value
1.					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					
					__/__/__					

Total: $

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Schedule D. Non-Readily Marketable Securities and Other Business or Investment Property

Stocks, bonds, and options not regularly traded on a national or foreign exchange, over the counter, or otherwise, interests in general and limited partnerships and limited liability companies, sole proprietorships, promissory notes, royalties, individually owned business or investment assets, and other assets not listed elsewhere.

	No. of Shares or Face Amount	Issuer or Obligor and Description of Interest	Certificate or Account Number	Owner(s) of Record (1)	Date Acquired	How Acquired (2)	Subject to Item (10)	Character of Property (3)	Federal Cost or Basis	Estimated Present Value
1.	_____ shs.	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____
	_____	_____	_____	_____	__/__/__	_____	_____	_____	_____	_____

Total: $_____

Print

Schedule E. Interests in Employee Benefit Plans and Annuity Policies

Interests in pension, retirement benefit, death benefit, stock bonus, stock option, profit-sharing, savings, thrift, deferred compensation, and similar plans maintained for the benefit of employees (including plans maintained for the benefit of self-employed individuals and individual retirement accounts and annuities), plus privately purchased annuity policies. For stock options show the number of shares and issuer in the 1st column, the date of grant in the 4th column, and the period of exercise (beginning and ending dates) in the 5th column.

Plan or Account Sponsor or Other Payor of Annuity	Type of Plan (7)	Participant or Annuitant	Date Participation Began	Date Payments Begin	Percent Vested	How Acquired (2)	Subject to Item (10)	Character of Property (3)	Federal Cost or Basis	Estimated Present Value
1. Social Security	PP		__/__/__	__/__/__	100%	E	N/A	N/A	N/A	XX
2. Social Security	PP		__/__/__	__/__/__	100%	E	N/A	N/A	N/A	XX
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____
_____	___	_____	__/__/__	__/__/__	___	____	_____	_____	_____	_____

Total: $_____

Print

Schedule F. Life and Accidental Death and Disability Insurance Policies

Ordinary, individual term, and group term, life and accidental death and dismemberment insurance policies. Show policy loans in parentheses below estimated present cash values rather than on Schedule H.

	Face Amount	Insurance Co. and/or Group Policy Holder	Type of Policy (6)	Policy Number	Insured	Policy Owner (1)	Date Acquired	How Acquired (2)	Designated Beneficiary(s)	Character of Property (3)	Estimated Present Value
1.							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				
							/ /				

Total: $

Print

Schedule G. Interests in Trusts, Estates, Custodianships, Educational Savings Accounts, Foundations, and Supporting Organizations

Trusts or custodianships established by you that are still in existence, and trusts, estates, or custodianships established by others in which you have any interests or powers as a beneficiary or fiduciary, IRC §529 Qualified Tuition Programs, private foundations, and supporting organizations

	Name (and Creator) of Entity, Taxpayer ID Number, and GST Tax Inclusion Ratio (if applicable)	Date Established	Name of Fiduciary	Name (s) of Beneficiary (s)	Type of Interest (8)	Type of Entity (9)	Character of Property (3)	Estimated Present Value
1.	_____ TIN: _____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____
	_____ TIN:_____ GST Tax Inclusion Ratio: _____	__/__/__	_____	_____	____	____	____	_____

Total: $ _____

Print

Schedule H. Liabilities

Mortgages, promissory notes, substantial credit card balances, judgments, contingent liabilities and guarantees, and other obligations.

Original Face Amount	Creditor	Interest Rate	Date Incurred	Maturity Date	Obligor(s)	Secured by Item (11)	Character of Obligation (3)	Estimated Amount Owed
			__/__/__	__/__/__				
			__/__/__	__/__/__				
			__/__/__	__/__/__				

Source: Estate Planning/California Estate Planning/1 Overview of Estate Planning Practice/§1.64 C. Form: Personal and Family Information of Married Clients

§1.64 C. Form: Personal and Family Information of Married Clients

PERSONAL AND FAMILY INFORMATION OF:
_ _[*CLIENTS' NAMES*]_ _, **AS OF** _ _[*DATE*]_ _

A. HUSBAND'S INFORMATION

1. Name: _____
2. Full (Previous) name(s):_____
3. Social Security number: _____
4. Cell phone:_____
5. Home e-mail address:_____
6. Principal residence address:_____
   City, State and Zip: _____
   County: _____
   Telephone: _____
   Fax:
7. Vacation home address: _____
   City, state & zip: _____
   County: _____
   Telephone: _____
   Fax: _____
8. Birthdate and age: _____
   Birthplace: _____
9. Citizenship: _____
   U.S. immigration status: _____
10. Employment:
    Occupation: _____
    Position or title: _____
    Employer's name: _____
    Street address: _____
    City, state & zip: _____
    Telephone: _____
    Fax: _____
    Business e-mail: _____
11. Are you now married? (If so, please complete Parts B and C.) _____
    If not, do you plan to marry in the near future? ___
    Have you ever been married before? ___ (If so, please complete Part D.)
12. Have you ever had children? ___ (If so, please complete Part E.)
    If not, do you plan to have any children? _____
13. Total taxable gifts made to date: $_____
14. Unified estate and gift tax credit used: $_____
15. Generation-skipping transfer tax exemption used: $_____
16. California property tax parent/child exemption used for transfers of real property other than principal residence: $
17. Have you established any "IRC §529" College Savings Account Programs? ___ (If so, please list them on Schedule G of the asset and liability schedules.)
18. Date of current will: _____
    Date of last codicil: _____
19. Date of current revocable trust: _____
    Last restatement and/or last amendment: _____
20. Date of current durable general power of attorney: _____
21. Date of current Advance Health Care Directive: _____
22. Location of original instrument(s): _____
23. Do you anticipate receiving any substantial gifts or inheritances in the near future? ___ If so, please describe:
    _____
24. Please list below your parents, brothers and sisters (whether living or not), grandparents (only if living), and others (only if relevant to your estate plan). If an individual is married, list the spouse's name in brackets below the individual's name. *If an individual is deceased, indicate in parentheses his or her residence (city and state) at the time of death, the date of death, and his*

or her age at death, in place of the individual's address and telephone, birthdate, and age. If a deceased relative has a surviving spouse, list his or her name in brackets below the relative's name and also list the surviving spouse's address, etc.

Father: _____

Address and telephone: _____

_____

Birthdate and age: _____

Mother: _____

Address and telephone: _____

_____

Birthdate and age: _____

Sibling(s): _____

Address and telephone: _____

_____

Birthdate(s) and age(s): _____

Others: _____

Relationship: _____

Address and telephone: _____

_____

Birthdate(s) and age(s): _____

B. WIFE'S INFORMATION

1. Name: _____
2. Full (Previous) name(s):_____
3. Social Security number:_____
4. Cell phone: _____
5. Home e-mail: _____
6. Birthdate and age: _____

Birthplace: _____

7. Citizenship: _____

U.S. immigration status: _____

8. Employment:

Occupation: _____

Position or title: _____

Employer's name: _____

Street address: _____

City, state & zip: _____

Telephone: _____

Fax: _____

Business e-mail: _____

9. Have you ever been married before? (If so, please complete Part D.)

_____

10. Have you ever had children? (If so, please complete Part E.)_____

If not, do you plan to have any children? _____

11. Total taxable gifts made to date: $_____
12. Unified estate and gift tax credit used: $_____
13. Generation-skipping transfer tax exemption used: $_____
14. California Property Tax Parent/Child exemption used for transfers of real property other than principal residence: $
15. Have you established any "IRC §529" College Savings Account Programs? ___ (If so, please list them on Schedule G of the asset and liability schedules.)
16. Date of current will: _____

Date of last codicil: _____

17. Date of current revocable trust: _____

Last restatement and/or last amendment: _____

18. Date of current durable general power of attorney: _____
19. Date of current Advance Health Care Directive: _____
20. Location of original instrument(s): _____
21. Do you anticipate receiving any substantial gifts or inheritances in the near future? ___ If so, please describe.

_____

22. Please list below your parents, brothers and sisters (whether living or not), grandparents (only if living), and others (only if

relevant to your estate plan). If an individual is married, list the spouse's name in brackets below the individual's name. *If an individual is deceased, indicate in parentheses his or her residence (city and state) at the time of death, the date of death, and his or her age at death, in place of the individual's address and telephone, birthdate, and age. If a deceased relative has a surviving spouse, list his or her name in brackets below the relative's name and also list the surviving spouse's address, etc.*

Father: _____

Address and telephone: _____

_____

Birthdate and age: _____

Mother: _____

Address and telephone: _____

_____

Birthdate and age: _____

Sibling(s): _____

Address and telephone: _____

_____

Birthdate(s) and age(s): _____

Others: _____

Relationship:_____

Address and telephone: _____

_____

Birthdate(s) and age(s): _____

C. INFORMATION RELATING TO PRESENT MARRIAGE

1. Date and place of marriage: _____

2. Beginning with the date of your marriage, list every state or country in which you have been domiciled and your approximate net worth upon establishing your domicile in each state or country.

Date commenced: _____

State or country: _____

Husband's net worth: $_____

Wife's net worth: $_____

Joint net worth: $_____

3. Beginning with the date of your marriage, please list your employers or occupations.

Husband:

Employer: _____

Occupation: _____

Date commenced: _____

Wife:

Employer: _____

Occupation: _____

Date commenced: _____

4. Since the date of your marriage, has either of you received any substantial gifts or inheritance?

If so, please describe: _____

Date received: _____

To whom: _____

From whom: _____

5. Have you entered into an agreement with each other concerning the status of your property as separate or community?

If so, when and what does the agreement provide? _____

_____

D. PREVIOUS MARRIAGE(S)

HUSBAND

1. First marriage

Name of former wife:_____

Address (if living): _____

Date of _ _[death/divorce]_ _: _____

Title of _ _[probate/divorce]_ _ court: _____

Case number: _____

Other information: _____

2. Second marriage

Name of former wife:

Address (if living): _____

Date of _ _[death/divorce]_ _: _____

Title of _ _[probate/divorce]_ _ court: _____

Case number: _____

Other information: _____

WIFE

1. First marriage

Name of former husband: _____

Address (if living): _____

Date of _ _[death/divorce]_ _: _____

Title of _ _[probate/divorce]_ _ court: _____

Case number: _____

Other information: _____

2. Second marriage

Name of former husband: _____

Address (if living): _____

Date of _ _[death/divorce]_ _: _____

Title of _ _[probate/divorce]_ _ court: _____

Case number: _____

Other information: _____

E. CHILDREN AND GRANDCHILDREN

Please list below your children and grandchildren, whether living or not. Grandchildren should be listed right after their parent. If a child or grandchild is married, list the spouse's name in brackets below the child's or grandchild's name. If a child is deceased, indicate in parentheses his or her residence (city and state) at the time of death, the date of death, and his or her age at death, in place of his or her address, telephone, birthdate, and age. If a deceased child or grandchild has a surviving spouse, list the spouse's name in brackets below the child's name and also list the spouse's address, etc.

1. Children and grandchildren of present marriage:

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

2. Children and grandchildren of _____'s prior marriage to _____:

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

3. Children and grandchildren of _____'s prior marriage to _____:

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

Name: _____

Social Security number: _____

Address and telephone: _____

_____

Birthdate and age: _____

F. AGENTS AND ADVISORS

1. Estate lawyer

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

2. Tax accountant

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

3. Financial planner

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

4. Investment counselor

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

5. Stockbroker

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

6. Commercial banker

Name: _____

Address: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

7. Trust officer

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

8. Life insurance broker

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

9. Automobile insurance broker

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

10. Property insurance broker

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

11. Health insurance broker

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

12. Husband's physician

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

13. Wife's physician

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

14. Other

Name: _____

Firm or company: _____

Address: _____

Telephone number: _____

Fax number: _____

E-mail: _____

G. INSURANCE INFORMATION

1. Automobile

Company name: _____

Policy No.: _____

Renewal date: _____

Coverage limits: _____

2. Property

Company name: _____

Policy No.: _____

Renewal date: _____

Coverage limits: _____

3. Excess liability

Company name: _____

Policy No.: _____

Renewal date: _____

Coverage limits: _____

4. Health

Company name: _____

Policy No.: _____

Renewal date: _____

Coverage limits: _____

5. Disability

Company name: _____

Policy No.: _____

Renewal date: _____

Coverage limits: _____

H. SAFE DEPOSIT BOXES

1. Name and address of depository: _____

_____

2. Box No.: _____

3. Who has access: _____

4. Location of key: _____

I. ADDITIONAL NOTES AND COMMENTS:

_____

_____

_____

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§1.65 D. Form: Transmittal of Drafts Letter to Married Clients

1.65-1 Transmittal of drafts letter to married clients

_ _[*Date*]_ _

Dear _ _ _ _ _,

Enclosed are drafts of the following instruments that we have prepared along the lines I discussed with you in our offices on _ _[*date*]_ _ :

(1) Your community property revocable trust instrument;

(2) Your separate property revocable trust instruments;

(3) Your "pour-over" wills;

(4) Your Durable General Powers of Attorney for Financial Management (and Nomination of Conservator of Estate);

(5) Your Durable Powers of Attorney for Personal Care Decisions (and Nomination of Conservator of the Person); and

(6) An Individual Grant Deed conveying your home into the revocable trust and a Preliminary Change of Ownership Report.

Please review these drafts very carefully to make sure that you understand all of the provisions, at least in general, and that they are in accordance with your wishes. The more important provisions of the trust and general powers of attorney are in the front part of each instrument, double-spaced to make them easier to read. You should pay more attention to these provisions than to the more technical, single-spaced provisions in the back part of the instrument. Some of the single-spaced and other general provisions may not be applicable to your situation at this time, but I would prefer to leave them in the instruments in the event a subsequent amendment or a change in circumstances makes them applicable later on.

To better understand the complex provisions of your trust instrument, I suggest that you read the educational materials we sent with our prior letter.

If you have any questions or wish to make changes in any of these drafts, please let me know before our next meeting here on _ _[*date*]_ _ , starting at _ _[*time*]_ _, at which time the original instruments, with any changes, can be formally executed.

In addition, I am enclosing two printed Advance Health Care Directive kits, published by the California Medical Association, for your consideration. You may want to designate each other, and then other individuals, as your health care agents, to make health care and other personal decisions for you in the event you are ever unable to make them yourself. These directives can be executed at the same time as the other instruments if you would like to do so. *Please bring these kits with you to our next meeting.*

Also enclosed are copies of your personal and family information sheets and schedules of your significant assets and liabilities as of the present time. Please also review these forms very carefully and advise me of any significant errors or omissions. It is important that they be as complete and accurate as reasonably possible to ensure that your estate plan will be effectively implemented.

[*Finally, I also am sending copies of the enclosed instruments and information sheets to _ _[other advisor]_ _ for _ _[his/her]_ _ review and comment before our next meeting, if possible.*]

_ _[*Add confirmation of revised estimate of total fees and disbursements, if desired*]_ _

Sincerely,
__[*Signature of attorney*]__
_ _[*Typed name*]_ _

Enclosures

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Source: Estate Planning/California Estate Planning/1 Overview of Estate Planning Practice/§1.66 E. Form: Instructions to Married Clients for Signing Instruments

§1.66 E. Form: Instructions to Married Clients for Signing Instruments

MEMORANDUM

To: _ _[*Clients' names*]_ _
From: _ _[*Attorney's name*]_ _
Date: _ _ _ _ _ _
Re: Instructions for Signing Instruments

Once the draft instruments are satisfactory to you, they should be formally executed. The trust instrument, the powers of attorney, and the deed should all be notarized, and your wills should be witnessed. The Advance Health Care Directives may be either witnessed or notarized.

(a) The trust instrument should be executed first, in the presence of a notary public. The other instruments may then be executed in any order.

(b) The wills should be executed in accordance with the following procedure specified in the "attestation clause" following the line for your signature:

(1) Each of you and two witnesses (who should both be adults who are not related to you or named as beneficiaries or fiduciaries in your wills or trust) all should meet at the same time. You should tell them that these instruments are your wills, that you know the contents, and that you would like them to act as witnesses. You should then sign the wills in their presence, filling in the date and place of execution, on the lines indicated.

(2) After both of you have executed your wills, you should request the witnesses to both sign and print their names and fill in the blanks for their addresses and the date and place of execution, on the lines indicated, in your presence and in the presence of each other.

(c) After all of the instruments have been fully executed, please return them to us for processing.

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Source: Estate Planning/California Estate Planning/1 Overview of Estate Planning Practice/§1.67 F. Form: Transmittal of Executed Instruments Letter to Married Clients

§1.67 F. Form: Transmittal of Executed Instruments Letter to Married Clients

_ _[*Date*]_ _

Dear _ _ _ _ _,

Enclosed are originals and photocopies of the following instruments that you executed in our offices on _ _[*date*]_ _, together with your estate planning information sheets as of that date:

(1) Your community property revocable trust instrument;

(2) Your separate property revocable trust instruments;

(3) Your "pourover" wills;

(4) Your Durable Powers of Attorney for Financial Management (and Nomination of Conservator of Estate); and

(5) Your Durable Powers of Attorney for Personal Care Decisions (and Nomination of Conservator of the Person).

I suggest that you put all of these originals in your safe deposit box for safekeeping, along with the originals of your other estate planning documents, and that you keep all of the copies and the information sheets in an appropriate place in your home for ready reference, along with your copies of those other estate planning documents. In that regard, I suggest that you add your new revocable trust as a joint depositor on the box, which would make access to it easier in the event of your deaths. I am also enclosing three extra copies of the trust instrument and powers of attorney for property matters, because you may need to give copies to your accountant, banker, broker, or others in connection with the administration of the trust and your property generally.

Also enclosed are the originals of your Advance Health Care Directives that you executed at that time. These should be kept readily accessible in case the need for them arises. I also enclose an extra copy of each of your advance health care directives, as you may want to give them to your primary care physicians.

Bankers, brokers, and others with whom you deal as trustees of your revocable trust may prefer to receive (and you may prefer to provide them with) a "certification of trust" from you as trustees rather than a copy of the trust instrument, to establish the existence or terms of the trust. California Probate Code §18100.5 specifies the contents and effect of a certification of trust. If you would like us to prepare such a certification for you, or review such a certification presented to you to sign, please let me know.

To maximize the benefits of your new revocable trust, substantially all of your assets should be assigned to it, and title to assets that you acquire in the future should be taken in the name of the trust. In general, your community property should be registered as follows: "_ _[*clients' names*]_ _ as Trustees of the _ _[*name of trust*]_ _, dated _ _[*date*]_ _ (community property)."

Your separate or quasi-community property generally should be registered as follows: "_ _[*name of spouse*]_ _, as Trustee of the _ _[*name of spouse trust*]_ _ under the _ _[*name of trust*]_ _ instrument, dated _ _[*date*]_ _ (_ _[*name of spouse's*]_ _ _ _[*separate/quasi-community*]_ _ property)." The appropriate trust should be named as both the owner and beneficiary of your insurance policies.

Either of your Social Security numbers may be used as the Taxpayer Identification Number with respect to the community property trust assets and liabilities. The appropriate spouse's social security number should be used as the Taxpayer Identification Number with respect to assets and liabilities in his or her separate trust.

If you are uncertain or disagree about the character of a particular asset, or if it is a combination of two or more types of property, I suggest that it be registered in either or both of your names as set forth above, but without any designation of the character of the property in parentheses. Also, any interest in or asset relating to a business, profession, or other activity that one of you is operating or managing, all or part of which is community property, may be registered in his or her name alone, as "Trustee of the _ _[*name of trust*]_ _, dated _ _[*date*]_ _ ," with or without a distinction in parentheses as to its character.

In general, taxes will be minimized if your assets, particularly those that are worth substantially more than their income tax bases, are held in community property form. However, community property generally is subject to liability for debts incurred by either or both of you during your marriage, whereas the separate property of either of you generally is not subject to liability for debts incurred by the other before or during your marriage.

With respect to death benefits payable under retirement plans (including IRAs) of which either of you is the Participant, in general, the primary beneficiary should be the nonparticipant spouse. The first contingent beneficiary should be "the _ _[*name of community property trust*]_ _, dated _ _[*date*]_ _," and the second contingent beneficiary should be "the Participant's issue per stirpes (by right of representation), provided, however, that any money or other property otherwise payable to any such individual _ _[*who is under age 25*]_ _ shall instead be paid to the person designated by the Trustee of the _ _[*Name of Trust*]_ _, dated _ _[*date*]_ _," as _ _[*Trustee of the "Conduit Trust" established under that trust instrument for the individual's benefit/custodian for the individual until age 25 under the California Uniform Transfers to Minors Act*]_ _."

To keep the proceeds of your cross-owned life insurance policies from being subject to estate taxes in the

event of your simultaneous deaths, the premiums should be paid with checks drawn on the owner's separate property account. Community property cash can be divided periodically into equal amounts of separate property cash to replenish your separate property accounts.

If you would like our assistance in making any of these assignments or beneficiary designations, please contact me or one of our legal assistants. It is important that these actions be taken so that your estate plan will be effectively implemented.

I am also sending you copies of your estate planning information sheets updated to the present time. You may want to indicate changes in your personal and family data and your assets and liabilities from time to time, and update them as of the end of each year in conjunction with the preparation of your income tax returns, in which case I would appreciate receiving a copy for our files. If the data is kept current, it will not only be a good source of information for you personally, but it also will be very helpful to us, your accountants, and your other advisors and counselors. These asset and liability schedules should not be treated as an agreement between yourselves as to the character of your property. Instead, they should be regarded as simply my best estimate of how your assets and liabilities would be characterized in the event of the death of either of you in the near future.

It was a pleasure _ _[*meeting you/seeing you again*]_ _ and assisting you in connection with the _ _[*preparation/updating*]_ _ of your estate plan, and I hope you will not hesitate to call whenever we can be of further service to you in any regard. Because of the possibility of significant changes in the law and your personal circumstances from time to time, you should thoroughly review your estate plan periodically, preferably every 5 years or so, and update it if necessary. For the time being, unless and until we hear from you again and are engaged to perform additional legal services, we will close our file and consider our engagement for you concluded.

Sincerely,

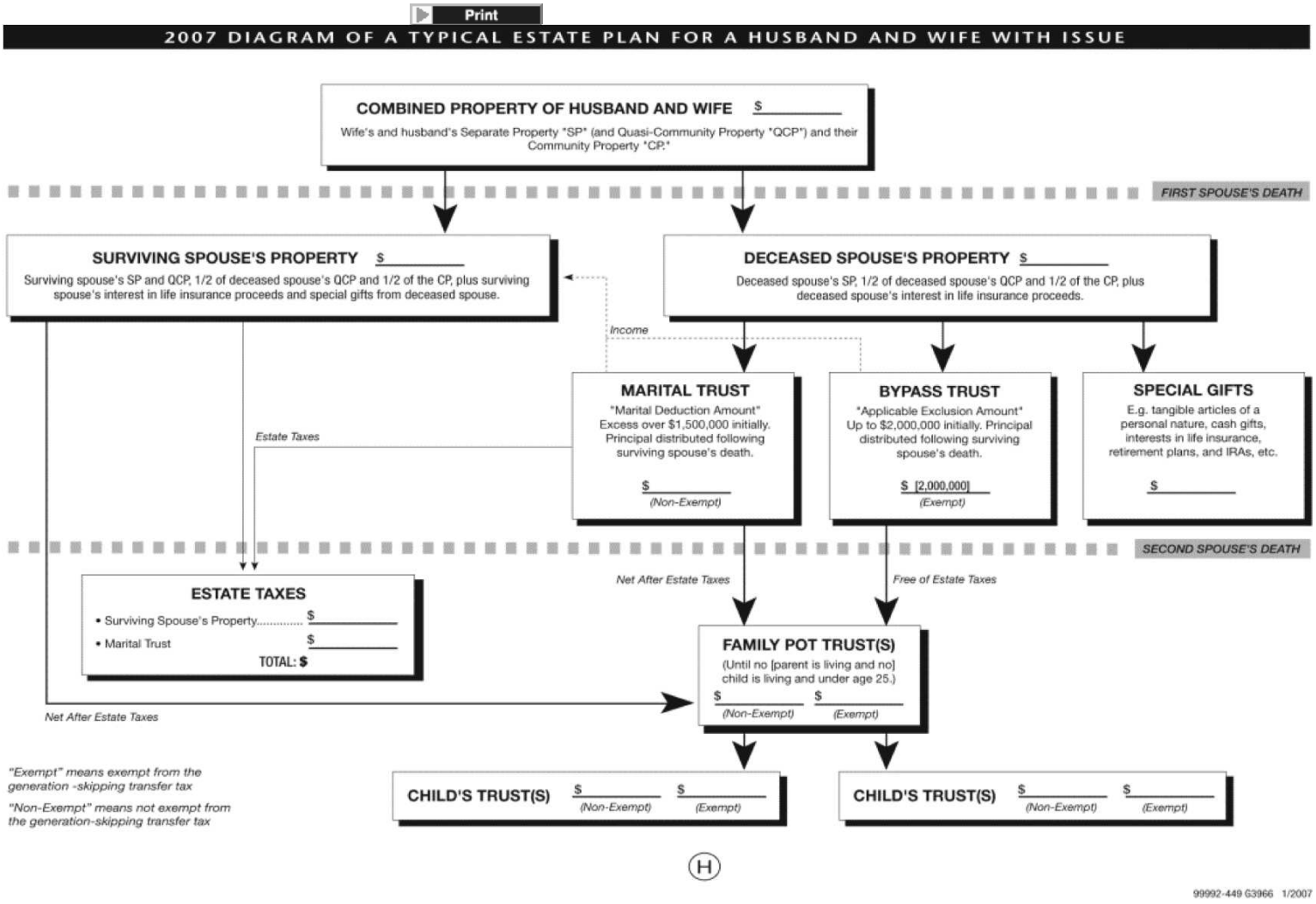
__[*Signature*]__
_ _[*Attorney's typed name*]_ _

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Source: Estate Planning/California Estate Planning/1 Overview of Estate Planning Practice/§1.68 G. Form: Diagram of Typical Estate Plan for Married Couple With Issue

§1.68 G. Form: Diagram of Typical Estate Plan for Married Couple With Issue



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2

Ethical Considerations

Susan T. House

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I. OVERVIEW

§2.1 A. Where to Find Rules Governing Ethics

The rules of professional conduct governing California attorneys are sui generis. Unlike the rules in many other states, they are not the ABA Model Rules of Professional Conduct; in fact, they are not even derived from the Model Rules.

Unfortunately for the practitioner, the California rules are found in many places, including the California Rules of Professional Conduct (promulgated by the California Supreme Court), the Business and Professions Code, the Probate Code, the Evidence Code, the Penal Code, and the Welfare and Institutions Code. Interpretive authority is found in case law, formal opinions issued by the Standing Committee on Professional Responsibility and Conduct of the State Bar of California, and informal opinions of county bar associations.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.2 B. Rules That Apply to Estate Planner

§2.2 B. Rules That Apply to Estate Planner

Every California attorney, regardless of practice area, must abide by all the rules of ethics in California when relevant to the facts and circumstances. The rules most commonly of concern to the estate planner are the following:

- The duty to enter into a written contract (Bus & P C §6148(a));
- The duty to avoid actual and potential conflicts of interest (Cal Rules of Prof Cond 3-310);
- The duty to maintain the client's confidences (Bus & P C §6068(e));
- The duty to perform services competently and diligently (Cal Rules of Prof Cond 3-110);
- The duty to avoid third party interference with the attorney's independent judgment (Cal Rules of Prof Cond 1-600(A));
- The duty to communicate with the client (Cal Rules of Prof Cond 3-500);
- The duty not to charge unconscionable fees (Cal Rules of Prof Cond 4-200(A)); and
- The duty to segregate a client's trust moneys (Bus & P C §6211(a)).

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§2.3 C. Consequences of Violating Rules

The most obvious consequence of violating one of the ethical rules is discipline by the California State Bar. The bar imposes attorney discipline, ranging from probation to suspension to disbarment, for violation of ethical rules. Many instances of discipline arise from the attorney's commingling of client funds with his or her own funds or the attorney's failure to perform the work for which he or she was engaged. But there are other ethical grounds, as well, *e.g.,* when an estate planning attorney becomes involved in preparing living trusts in conjunction with a "marketer" who holds seminars strongly urging attendees to obtain living trusts. See California State Bar Formal Opinion No. 1997-148 (Apr. 21, 1997). As noted in that opinion, such an arrangement may raise ethical issues such as interference with independence of professional judgment and representation of adverse interests. See also *In re Flack* (Kan 2001) 33 P3d 1281, in which the Supreme Court of Kansas imposed discipline on an attorney for participation in a "trust mill." The attorney did not meet with clients or supervise nonattorneys who met with clients. The analogous California rules that might be implicated in such an arrangement include Cal Rules of Prof Cond 1-300 (Unauthorized Practice of Law), 1-320 (Financial Arrangements With Nonlawyers), 1-400 (Advertising and Solicitation), 3-110 (Failing to Act Competently), 3-310 (Avoiding the Representation of Adverse Interests), and 3-500 (Communication).

Less obvious to some attorneys is the potential malpractice liability arising from ethical violations. Violation of an ethical duty by the estate planning attorney (*e.g.,* representing multiple clients despite a conflict of interest without first obtaining the clients' informed written waiver) is often the most valuable tool a malpractice plaintiff's attorney has, first to force settlement, and ultimately to impose liability at the trial level. For a discussion of the interplay between the attorney's ethical duty and liability for malpractice, see *Day v Rosenthal* (1985) 170 CA3d 1125, 217 CR 89. One statement by the *Day* court sums up the entire concept: "An attorney's duty, the breach of which amounts to negligence, is not limited to his failure to use the *skill* required of lawyers. Rather, it is a wider obligation to exercise due care to protect a client's best interests in all ethical ways and in all circumstances." 170 CA3d at 1147.

Even less obvious to some attorneys is the fact that an ethical breach by an estate planning attorney can result in an unraveling of the client's estate plan, as illustrated in *Haynes v First Nat'l State Bank* (NJ 1981) 432 A2d 890. In *Haynes,* the attorney prepared an estate plan for a client's mother. Under that estate plan, the mother essentially disinherited her other child, leaving her entire estate to the child who was the attorney's client. After the mother's death, the New Jersey Supreme Court set aside the estate plan on the grounds of undue influence, partly because the mother had not been advised of the conflict of interest inherent in the attorney's representation of both the daughter and the mother. The court stated that it might have reached a different result if the mother had been fully advised in writing and had executed a written waiver of the conflict of interest. The estate planning attorney does well to keep the *Haynes* decision in mind, not only as an incentive to watch for such conflicts, but also as a way of explaining to the client in a multiple representation situation why the written explanation and waivers are necessary: they do not protect just the attorney.

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§2.4 D. Overview of Estate Planning Problem Areas

The ethical rules of most interest to estate planning attorneys are listed in §2.2. Although the facts of a particular case may make the application of, and compliance with, any one of these rules a challenging proposition, some rules are likely to cause trouble more often than others. In some cases the difficulty will be readily obvious; in others, there are "hidden traps." The problem areas are summarized below and are explored in more depth later in the chapter.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.5 1. Representing Mentally Impaired Client

§2.5 1. Representing Mentally Impaired Client

The duties to communicate with the client (Cal Rules of Prof Cond 3-500) and to provide competent representation (Cal Rules of Prof Cond 3-110) can be particularly problematic for estate planning attorneys who with increasing frequency deal with an older population. Diminishing mental capacity, greater susceptibility to undue influence, or a combination of the two can make competent representation impossible if the client cannot understand and intelligently evaluate the advice being given.

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§2.6 2. Potential Conflicts of Interest and Confidentiality Breaches

The estate planning attorney is often called on to represent multiple parties in the estate planning context. For married couples, it is more common than not for the attorney to represent both spouses. In family situations, an attorney often represents members of multiple generations in their estate planning. In the business environment, an attorney may represent multiple business associates in their respective estate plans, especially when the business is represented by the attorney. In both the family situation and the business situation, it is common for the estate planning attorney to represent a succession of related parties as the years go by. The first client may be the parent or the child interested in estate planning. Then, several years later, the first client directs his or her child or parent to the attorney, also for estate planning. Sometimes an estate planning client later becomes involved in a business venture, and the attorney is consulted on behalf of the business entity itself and by the original client's business associates. In all of these cases, the duty to maintain confidences and the duty to avoid actual and potential conflicts of interest can trap the attorney into serious ethical violations if he or she is not careful.

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§2.7 3. Benefiting From Client's Estate Plan

The estate planning attorney is particularly subject to issues arising from becoming a beneficiary of a client's estate plan. After many years of representation in which the attorney has worked closely with the client, giving valued advice in many emotional and very personal situations, it may be difficult to determine where the professional relationship ends and friendship begins. As the line between those relationships blurs, and as the client becomes increasingly vulnerable because of the physical and mental infirmities that often accompany the aging process, the client can become increasingly dependent on the estate planning attorney. The relationship of extreme trust combined with increasing dependence may cause the client to ask the attorney to be the client's fiduciary (conservator, executor, or trustee). It can also cause the client to view the attorney as a possible object of his or her bounty in gratitude for the years of advice and counsel.

Although these situations pose ethical problems for any attorney under Cal Rules of Prof Cond 4-400, the estate planning attorney is in a particularly awkward position because the client also expects the attorney to prepare the documents required in both of these situations. Attorneys are forbidden to do so except under very narrow circumstances. See §2.22.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.7A 4. Effect of Circular 230

§2.7A 4. Effect of Circular 230

In recommending tax-saving strategies, the estate planning attorney must consider the effect of Circular 230 (31 CFR pt 10). Attorneys who practice before the IRS may be fined, suspended, or disbarred for violations of the regulations. For these purposes, actions constituting practice before the IRS include "rendering written advice with respect to any entity, transaction, plan or arrangement" having a potential for tax avoidance or evasion. 31 CFR §10.2(a)(4). Practitioners are generally prohibited from charging a contingent fee for services rendered in connection with any matter before the IRS, including tax planning and advice. 31 CFR §10.27(b)(1), (c)(2).

With respect to tax returns, the final tax return preparer penalty regulations under IRC §6694(d)(2) provide that a practitioner may not sign a return as a preparer (which may include preparation of a document used in connection with the preparation of a return under IRC §7701(a)(36) and Treas Reg §301.7701-15(b)) unless there is substantial authority for each position taken on the return, or there is a reasonable basis for each position and each position is adequately disclosed to the IRS as provided in Treas Reg §1.6694-2(d). See Notice 2009-5, 2009-3 Int Rev Bull 309; TD 9436, 73 Fed Reg 78430 (2008), discussed in 30 CEB Est Plan Rep 91 (Feb. 2009). See also discussion of the regulations as proposed in *Tax Return Preparer Penalties: New Proposed Regulations and a Possible Statutory Change*, 30 CEB Est Plan Rep 5 (Aug. 2008).

Circular 230 also imposes standards in connection with written opinions on tax matters. Under 31 CFR §10.35(b)(2), a "covered opinion" includes written advice (including e-mail) concerning federal tax issues arising from any plan or arrangement if the advice concludes that it is more likely than not that the taxpayer will prevail on the issue (reliance opinion) and a significant purpose of the transaction is the avoidance or evasion of any tax. Under 31 CFR §10.35(c), advice in the form of a covered opinion must comply with detailed requirements relating to the use of reasonable factual assumptions and the need to provide a conclusion with respect to each significant issue considered in the opinion.

Cautious practitioners should avoid writing opinions that directly or indirectly state that it is "more likely than not (a greater than 50-percent likelihood)" that one or more tax issues will be resolved in a client's favor. In the context of tax shelters, the taxpayer may not have protection from accuracy-related tax penalties in the absence of an opinion containing such a "more likely than not" assessment, but in other than tax-shelter cases the opinion will normally provide such protection even without a likelihood estimate, provided it states that there is "substantial authority" for the specified tax treatment. IRC §6662(d)(2)(B)(i), (d)(2)(C); Treas Reg §1.6664-4(f).

Alternatively, the practitioner may include a prominent disclosure that the opinion was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. For example, the disclosure may state: "The tax advice, if any, contained in this communication does not meet Treasury Department standards for legal opinions that can be relied on by a taxpayer for the purpose of avoiding tax penalties." If such a disclosure is used, the advice is not a reliance opinion, and therefore it will not be a covered opinion unless the plan or arrangement is a listed transaction under Treas Reg §1.6011-4(b)(2) or the transaction has the "principal purpose" of tax avoidance or evasion as defined in Treas Reg §1.6662-4(g)(2)(ii). Under that definition, a plan or arrangement does not have the principal purpose of tax avoidance or evasion if it has as its purpose the claiming of exclusions from income or other tax benefits in a manner consistent with the statute and Congressional purpose. Even in the absence of a prominently disclosed penalty disclaimer, an opinion is not a reliance opinion unless the IRS has a "reasonable basis" for a successful challenge to the proposed transaction. 31 CFR §10.35(b)(3). For further discussion of covered opinions, see *The New Circular 230 Regulations: Keeping the Tempestin the Teapot*, 26 CEB Est Plan Rep 97 (Feb. 2005); *"Revised Revised" Final Regulations and Continuing Debate—The Ongoing Circular 230 Controversy*, 26 CEB Est Plan Rep 157 (June 2005); *Proposed Amendments to Circular 230 Concerning Practice Before the IRS*, 27 CEB Est Plan Rep 98 (Feb. 2006).

The regulations further provide that a practitioner may not advise a client to submit a document, affidavit, or other paper to the IRS that is frivolous, or to take a position in a paper submitted to the IRS unless the position is not frivolous. 31 CFR §10.34(b). The practitioner also must inform the client of any penalties that are reasonably likely to apply to the client with respect to any position taken on a tax return, if the practitioner prepared or signed the return or advised the client with respect to the position, and any document, affidavit, or other paper submitted to the IRS. 31

CFR §10.34(c). In advising a client to take a position on a tax return, document, affidavit, or other paper submitted to the IRS, the practitioner generally may rely in good faith without verification on information furnished by the client, but the practitioner may not ignore the implications of information furnished to (or actually known by) the practitioner, and the practitioner must make "reasonable inquiries" if the information furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete. 31 CFR §10.34(d).

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II. CONFIDENTIALITY

§2.8 A. Duty to Maintain Client Confidences

One of the cornerstones of the attorney-client relationship is the attorney's duty to maintain client confidences. The California rule is found in Bus & P C §6068(e), which provides that it is the duty of an attorney to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."

In the estate planning context, confidentiality can be particularly problematic in the following circumstances:

- When the representation entails the use of one or more agents (*e.g.,* accountant, life insurance agent, appraiser);
- When the attorney represents multiple clients, either jointly or separately;
- When the attorney has represented a couple jointly during their marriage, their marriage is dissolved, and both former spouses wish to continue using the attorney separately for estate planning purposes; and
- When the attorney is approached to represent the fiduciary (nominated trustee or agent under a power of attorney) of an existing client.

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§2.9 B. Third Party Agents and Family Members

Disclosure of confidential information to agents assisting the attorney in rendering estate planning services is often essential to performing the services. Technically, the client should give written authorization before the attorney discloses any confidential information to anyone. In practice, however, this is usually impossible. It is not expected that the attorney will obtain the written consent of the client in every instance (*e.g.*, for disclosure to the attorney's or client's office staff, the client's accountant, or life insurance agent), but when the services require the use of outside agents such as appraisers or other experts, the attorney should always obtain the written authorization of the client.

Note that Bus & P C §6068(e) differs from ABA Model Rules of Prof Cond 1.6. The ABA rule takes a much more practical approach on this point. Unlike the California statute, the ABA rule explicitly recognizes that there will be "disclosures that are impliedly authorized in order to carry out the representation." ABA Model Rules of Prof Cond 1.6(a).

The estate planning attorney faces a special set of confidentiality issues in many cases because of the role that family members can play in the representation. Issues may arise when the client relies on a child or other close relative for assistance in the estate planning process, ranging from simply accompanying the client to the attorney's office, to gathering information needed for the attorney, to being involved in the actual estate planning process itself. In other cases, the issues arise after the estate plan is complete and the client instructs the attorney either "to work freely with my daughter" or "to let my son know what is going on."

The attorney needs to be especially careful in all these cases to ensure that the client knows the confidentiality ramifications of these instructions, and the attorney should determine exactly what role the client intends the child or other person to play. To make this determination, the attorney should conduct a frank discussion, positing various questions and describing alternative scenarios to determine what the client would want. For example, does the client want the attorney to inform the child whenever any change is made to the plan and send a copy of the change? Many times, when presented with a specific example and question, the client rethinks the initial broad directions and tailors them to suit the client's actual goals. Regardless of what the client decides, the extent to which the attorney may disclose information should be documented and signed by the client.

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§2.10 C. Current or Former Clients

The duty of confidentiality also is found in Cal Rules of Prof Cond 3-310(E):

> A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

In this situation, there is a direct connection between the duty of confidentiality and the duty to avoid conflicts of interest (see discussion in §§2.14-2.23). It is in this area that the estate planning attorney must be particularly careful not to overlook the possibility of conflicts between family members or business associates. In both cases, confidential information in the estate planning context from the first client may be obtained that would be relevant to the representation of the other client to the detriment of the first client.

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§2.11 D. Multiple Representation

Except for problems that arise in regard to the client's family members, the duty to maintain a client's confidences seldom poses a problem when only one person is involved in the representation. As soon as there are two or more clients, additional confidentiality issues must be addressed.

The most common questions are:

- If the attorney represents a husband and wife or domestic partners, is there any confidentiality of information relating to the representation as between the two of them?
- If the attorney represents a husband and wife or domestic partners, and if one of the spouses or partners reveals information to the attorney with the direction that the attorney not reveal it to the other spouse or partner, what should the attorney do?
- If the attorney represents multiple family members separately in their estate plans, but there is a shared desire to coordinate the plans, what confidentiality rules govern?

In the first two instances, there can be no confidentiality with regard to information needed to properly represent the other party because the estate planning attorney who is representing two spouses or domestic partners jointly cannot perform the services competently without a free exchange of information. Consequently, the duty to maintain confidentiality irreconcilably conflicts with the duty to perform competent services and the duty of loyalty to both clients.

The client must decide which duty is more important. If confidentiality prevails in the client's mind, multiple representation is not possible. This informed, conscious decision by the client must be documented in writing and signed by the client.

If the attorney does not address the confidentiality issue in the engagement letter when the multiple representation is undertaken, does not put the clients on notice that there can be no confidentiality between them, and does not have them waive the usual confidentiality rules, the attorney will be faced with an impossible situation when one of the clients expects or demands that information be withheld. To avoid this situation, the attorney who represents two clients in their estate plan must always address this subject in the engagement letter. For sample language for married clients, see §1.62.

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§2.12 E. Ethical Duty Compared With Evidence Code Privilege

Although the confidentiality rule of Bus & P C §6068(e) is certainly related to the attorney-client communications privilege defined in Evid C §952, the scope of the confidentiality rule is much broader than that of the Evidence Code privilege. Because the purpose of the ethical confidentiality rule is to encourage complete candor with the attorney and to ensure that every aspect of the attorney-client relationship will further the client's interests, even nonverbal "communications" with the attorney are covered by the duty of confidentiality. Nowhere is this duty more obvious than in the context of a challenge to the capacity of the client to make a will or execute other estate planning documents. Because such capacity is often most easily determined based not on what a client says, but on the client's demeanor and actions, the strictures of Bus & P C §6068(e) apply to those types of communications or "secrets" as well. In other words, there is an absolute prohibition against divulging a client's secrets, of any type, to the client's disadvantage.

It is beyond the scope of this book to address evidentiary questions arising in contested conservatorships or will or trust contests, but it should be said that the duty to maintain a client's confidences (often obtained during the estate planning representation) creates many problems in both contexts. This is especially true when the rule in Bus & P C §6068(e) collides head-on with Evid C §952 and its explicit exceptions (*e.g.,* disclosure is allowed in a fee dispute with the client (see Evid C §958), or if the attorney reasonably believes that disclosure is necessary to prevent the client from committing a criminal act likely to result in death or substantial bodily harm (Evid C §956.5)). There are no such exceptions to the ethical rules—there is no guidance for the estate planning attorney caught in the middle. For a discussion of this dilemma, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel §§V.A.1-2 (State Bar of California 2008 ed).

For a discussion of the attorney-client privilege in estate and trust litigation, including a discussion of waiver by the personal representative after the client's death, see California Trust and Probate Litigation, chap 10 (Cal CEB 1999).

The "absolute" nature of the Bus & P C §6068(e) rule of confidentiality has been reaffirmed in various ethics opinions and other forums as if the principles behind the various Evidence Code exceptions were irrelevant. If the privilege is indeed "absolute," the attorney is placed in the untenable position of being permitted (if not required) to disclose certain confidential information under the Evidence Code, but prohibited from disclosing that same information under the ethical rule of Bus & P C §6068(e).

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§2.13 F. IRS Demands for Information

Because of the nature of the work done by the estate planning attorney, information obtained during the estate planning process is often of interest to the Internal Revenue Service during the audit of the client's tax returns. This has been especially true in recent years in connection with the audit of family limited partnership transactions when the IRS has regularly demanded to see all of the attorneys' correspondence relating to the planning, creation, funding, and administration of these entities. That demand has taken the form of letters, items on checklists, and even a summons by the IRS to the estate planning attorneys. See *Segerstrom v U.S.* (ND Cal 2001) 2001-1 USTC ¶50,315, 87 AFTR2d 1153, in which the court quashed an IRS summons issued to several estate planning attorneys demanding certain documents related to the formation, operation, and valuation of a limited liability company after the attorneys had refused to produce the documents on the grounds of attorney-client privilege. Documents relating to tax advice by accountants who are federally authorized tax practitioners also may be privileged under IRC §7525. Faced with this situation, the lawyer must either obtain a waiver by the client if the lawyer and client conclude that it will actually further the client's case to disclose the information, or refuse to make the disclosure based on both ethical (Bus & P C §6068(e)) and evidentiary privilege (Evid C §952) grounds. However, estate planning attorneys should be aware that communications relating to tax return preparation are not privileged. *U.S. v Lawless* (7th Cir 1983) 709 F2d 485; *U.S. v KPMG LLP* (D DC 2002) 237 F Supp 2d 35.

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III. CONFLICTS OF INTEREST

§2.14 A. Duty to Avoid Representing Conflicting Interests

Another cornerstone of the attorney-client relationship is the attorney's duty to avoid representing conflicting interests. The applicable rule, Cal Rules of Prof Cond 3-310, reads in part as follows:

> (C) A member shall not, without the informed written consent of each client:
> (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or
> (2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict; or
> (3) Represent a client in a matter and at the same time in a separate matter accept as a client a person or entity whose interest in the first matter is adverse to the client in the first matter.
> ....
> (E) A member shall not, without the informed written consent of the client or former client, accept employment adverse to the client or former client where, by reason of the representation of the client or former client, the member has obtained confidential information material to the employment.

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§2.15 B. Hidden Conflicts in Estate Planning Practice

Applying Cal Rules of Prof Cond 3-310 can be very difficult, because it is not always easy for the estate planner to foresee the problems at the outset of the representation. This difficulty is inherent in estate planning practice because of its very nature. Estate planning representation often takes place over many years and involves family issues, relationships, and personalities that change over time. The estate planning attorney may find it difficult to determine when the representation of an estate planning client begins and ends. Estate planning practice is thus in sharp contrast to the practice of those attorneys, particularly litigators and certain business attorneys, who are involved for a clearly defined period of time in discrete transactions or pieces of litigation that have a beginning and an end. As a result, the estate planning attorney may suddenly realize long into the representation of a client that, in the context of performing estate planning services for one family member, the attorney has also tendered services and advice to another, developed conflicts of interest, and possibly breached confidences.

Consequently, the ethical estate planning attorney must be constantly mindful of both the confidentiality duty and the duty to avoid actual and potential conflicts of interest, and must be especially sensitized to look for the areas in which it is easy to run afoul of them in the context of estate planning.

For a comprehensive discussion of conflicts of interest, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel, chap 4 (State Bar of California 2008 ed).

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§2.16 C. Existing Client

Without the informed written consent of an existing client, an attorney must not undertake the representation of a new client when the interests of the new client are adverse to the interests of the existing client. Cal Rules of Prof Cond 3-310(C)(3). The estate planning attorney will most often encounter difficulties with this prohibition when the attorney has represented one or more family members over a long period of time and another family member seeks to retain his or her services for the first time. If the new client is at odds with the existing client or clients, and if there is any possibility that the services to be rendered for the new client will have an adverse impact on the existing client, the attorney should decline the representation because it is more likely than not that the attorney has obtained confidential information in the prior representation that would be material to the new representation. Rule 3-310 permits the attorney to represent the new client after obtaining the informed written consent of the existing client, but the attorney should be cautious about relying on this solution in volatile family situations. When something goes wrong, the attorney will be blamed.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.17 D. Former Client

§2.17 D. Former Client

Without the informed written consent of a former client, an attorney must not undertake the representation of a new client when the interests of that new client are adverse to the interests of a former client and would require disclosure of confidential communications obtained in connection with the first representation. Cal Rules of Prof Cond 3-310(E). The same likely scenarios and caveats apply to this situation as to the existing-client situation discussed in §2.16.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.18 E. Multiple Clients

§2.18 E. Multiple Clients

Without the informed written consent of each client, the estate planning attorney may not represent multiple clients whose interests *actually* conflict. Cal Rules of Prof Cond 3-310(C)(2).

Without the informed written consent of each client, the estate planning attorney also may not accept representation of multiple clients in one matter in which the interests of the clients *potentially* conflict. Cal Rules of Prof Cond 3-310(C)(1). This rule is unique to California and does not exist in the ABA Model Rules of Professional Conduct. It creates problems for all transactional attorneys, but particularly for estate planning attorneys, who regularly work with multiple clients (*e.g.,* spouses and multiple family members) whose interests always potentially conflict. Rule 3-310(C) is intended to apply to the representation of multiple parties in a single transaction or other common enterprise or legal relationship, including the preparation of joint or reciprocal wills for couples. Comment to Cal Rules of Prof Cond 3-310. The Comment to Rule 3-310 makes clear that the attorney must obtain the clients' *further* consent under Rule 3-310(C)(2) to continue the joint representation if the potential conflict under Rule 3-310(C)(1) becomes actual. As a result, it is necessary in every multiple representation situation to obtain informed written consent under Rule 3-310.

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F. Conflicts Between Attorney's Interest and Client's Interest

§2.19 1. Adverse Business Interests

Without compliance with a number of written disclosure and waiver requirements, Cal Rules of Prof Cond 3-300 forbids the attorney from entering into a business transaction with a client and from knowingly acquiring a pecuniary interest adverse to the client. This rule is supplemented by Cal Rules of Prof Cond 4-210, which forbids the attorney from paying personal or business expenses incurred by or for the client except under certain circumstances.

There are a number of common circumstances in which the estate planning attorney runs the risk of running afoul of Cal Rules of Prof Cond 3-300. They include the following:

- When the estate planning attorney is also in the business of selling insurance or other financial products and proposes to sell those products to the client (see Bus & P C §6175.3);
- When the estate planning attorney is designated as a fiduciary by the client; and
- When the estate planning attorney invests in a partnership or other business with the client.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.20 2. Attorney Selling Financial Products

§2.20 2. Attorney Selling Financial Products

The estate planning attorney who also sells financial products (*e.g.,* annuities) must be aware not only of Cal Rules of Prof Cond 3-300, but also Bus & P C §6175.3 , which requires specific disclosures and consents before an attorney may sell financial products, as defined in Bus & P C §6175(c), to a client or recent former client who is an elder or dependent adult.

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§2.21 3. Attorney as Fiduciary for Client

The potential for conflicts of interest between the client and the estate planning attorney who is also serving as the fiduciary for his or her client is enormous. During the client's lifetime, if the attorney is the fiduciary for a trust created by the client for a third party, there may be a difference of opinion between the client and attorney about the proper investment of trust assets or the proper exercise of discretion. If the attorney is the fiduciary for a trust created by the client for himself or herself, or the attorney is the client's conservator, there may be serious disagreements between the client and the attorney about when the attorney should step in as fiduciary (when the client's mental capacity is at issue) and how the financial affairs of the client should be managed. In both cases, this conflict of interest between the client and attorney is untenable under the basic obligation of loyalty to the client above all else under Cal Rules of Prof Cond 3-310(E) and 3-300 (assuming that the attorney is to be paid for serving as fiduciary).

Both before and after the death of the client, there is the potential for a violation of Cal Rules of Prof Cond 3-310 (conflict of interest) if there is a disagreement about the administration of the trust or probate estate and the attorney has previously represented any of the beneficiaries. Also, the attorney runs the risk of violating Bus & P C §6068(e) if the attorney uses information obtained from the client while serving as fiduciary if the attorney and client are at odds, or the attorney and the beneficiaries (who are often themselves also clients of the attorney) are at odds.

In addition to the difficulties created by the strictures of Cal Rules of Prof Cond 3-300 if there is a disagreement about the administration of the trust or probate estate, the attorney must also keep in mind the restrictions of (1) Prob C §15642(b)(6), which permits the removal of the attorney if he or she is serving as the sole trustee and would be a "disqualified person" under Prob C §21350(a) (see §2.22), and (2) Prob C §§2645, 10804, and 15687, which restrict the compensation that may be paid to an attorney for legal services rendered when he or she also serves as the conservator, executor, or trustee. These restrictions may preclude the attorney from being adequately compensated and should be considered at the estate planning stage when the client and attorney can discuss the alternatives.

The attorney should be especially careful when asked to include a provision in the document directing the fiduciary to retain that attorney as legal counsel. Although there is no specific ethical proscription against doing so, the attorney should counsel the client that it is neither necessary nor customary to do so, and that in California it is not a legally enforceable direction to the trustee or executor. The fiduciary is always entitled to choose his or her own counsel. See *Estate of Ogier* (1894) 101 C 381, 35 P 900.

For a detailed discussion of the ethical hazards of serving as fiduciary for the client, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel §IV.C.3 (State Bar of California 2008 ed).

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.22 4. Attorney as Beneficiary of Client's Estate

§2.22 4. Attorney as Beneficiary of Client's Estate

The estate planning attorney whose client wants to leave a gift to the attorney is faced with a serious ethical problem. California Rules of Professional Conduct 4-400 prohibits the attorney from inducing his or her client to make a substantial gift to the attorney or certain relatives of the attorney unless the attorney and client are related. In addition (and apart from the traditional presumption of undue influence that attends such a gift in the event it is challenged), Prob C §§21350-21356 make void *any* gift *of any size* made to an attorney who drafts the donative instrument or causes it to be drafted. The only exceptions are if the attorney is related by blood or marriage to, or co-habits with, the donor, or if the client consults an independent attorney who prepares and signs a Certificate of Independent Review stating that the gift was not the result of fraud, menace, duress, or undue influence by the attorney. Prob C §21351.

For further discussion of donative transfers to the attorney, see House & Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel §IV.C.7 (State Bar of California 2008 ed).

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§2.23 5. Fees

The ethical rules governing attorney fees are found in Prob C §§2645, 10804, and 15687 (restricting dual compensation to the attorney serving as both attorney and fiduciary), Cal Rules of Prof Cond 3-320 (prohibiting fee-sharing arrangements except in certain circumstances), and Cal Rules of Prof Cond 3-310(F) (governing situations in which compensation is paid by a third party).

The dual compensation rules are discussed in §2.21. The fee sharing rules and the third party payment rules are equally relevant to the estate planning attorney because of the number of common situations to which they might apply. For example, Cal Rules of Prof Cond 3-310(F) directly applies when a parent offers to pay the legal fees of a child (or vice versa). In that case, the attorney must ensure that there is no interference with the attorney's independent professional judgment, the confidential information must remain confidential (subject to a client waiver), and the client, after disclosure, must consent to the third party agreement to pay. California Rules of Professional Conduct 3-310 also applies to the situation in which an attorney is retained by a trust mill to prepare estate planning documents. Unless the attorney can meet personally with the client, and makes the necessary disclosures under Cal Rules of Prof Cond 3-310, the attorney will be in violation of the rule.

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IV. WHO IS THE CLIENT?

§2.24 A. Importance of Identifying Client

"Who is the client?" and "What is the scope of the representation?" are two questions that must be answered at the outset of the representation, and the answers should be regularly reconsidered as the representation continues. The answer to "Who is the client?" in many instances is not as easy as it appears. If the attorney fails to consider the question or answers it incorrectly, there can be serious ethical risks.

The answers to these two questions are essential because of two fundamental ethical rules governing all California attorneys, namely,

(1) An attorney shall not represent parties having adverse interests (Cal Rules of Prof Cond 3-310) (see §2.14); and

(2) An attorney shall keep the client's confidences inviolate (Bus & P C §6068(e)) (see §2.8).

Knowing "who is the client" and "what is the scope of the representation" will help the estate planning attorney to avoid violation of ethical rules in the following common scenarios:

- When the attorney is about to undertake representation of a new client whose interests may be adverse to an existing or former client and the attorney has obtained confidential information from the existing or former client material to the representation (see Cal Rules of Prof Cond 3-310(E));
- When the attorney is about to represent Client #2 in his or her estate planning, Client #2 has an interest in an existing matter handled by the attorney on behalf of Client #1 (Matter #1), and Client #1 and Client #2 are adverse in Matter #1 (see Cal Rules of Prof Cond 3-310(C)(3)); or
- When the attorney is faced with potential "joint" clients whose representation may raise questions of conflict of interest or confidentiality (*e.g.,* a couple wishing to do estate planning, multiple generations seeking estate planning, multiple family members seeking advice about a common problem, or a business entity or its members, or both, seeking advice) (see Cal Rules of Prof Cond 3-310; Bus & P C §6068(e)).

Once the attorney determines who is the client, the conclusion must be documented in the engagement letter.

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§2.25 B. Dealing With Multiple Representation

The estate planning attorney must be able to answer the question "Who is the client?" at all times. If the representation is of two clients jointly, then every action taken in the course of the estate planning process is done for both of them, there must be full disclosure, and if one of them requires estate planning services, those services are considered rendered to both of them jointly. There must be a written engagement letter explaining the confidentiality and potential conflict issues, and there must be a written waiver by the clients. Without the explanation and waiver, the attorney has breached his or her ethical duties. Nothing should be assumed—in any dual representation situation, the ethical issues must be addressed in writing. Failure to do so is a violation of Cal Rules of Prof Cond 3-310 (see §2.14).

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§2.26 1. Joint Representation

In the estate planning context, it is common for the attorney to have multiple clients in a single representation. In such situations in California (as opposed to some other jurisdictions), the attorney usually represents multiple parties as "joint" clients, and, unless otherwise explicitly agreed, an attorney who represents multiple clients with regard to related legal matters is presumed to represent them jointly. The most common example of joint representation in estate planning is that of a husband and wife who wish to plan their estates to benefit each other and their children.

Joint representation rests on the premise that, absent contrary evidence, no actual adversity exists between the parties. It also implies that all information received by the attorney on the subject of the representation (*i.e.,* their joint estate plan) will be shared between the clients and that confidentiality will be maintained as to all other matters and other people. Assuming that no actual conflict of interest exists, multiple parties in a legal matter are often better served by joint representation because it produces a more coordinated result at a lower cost than if each party were individually represented by a different attorney.

Even if the estate planning or other goals of the clients are not entirely consistent, the attorney is not necessarily precluded from representing all parties. The mutual attorney may still be able to advise the parties who have somewhat different objectives, and advice and counsel may be consistent with the clients' interests and the estate planning attorney's traditional role as the attorney for the "family."

In the case of joint representation of multiple clients, the information imparted by one client to the attorney is not privileged from disclosure to the other client. In the event of litigation between jointly represented parties, no protection from disclosure of evidence provided to the attorney is available. The conflict of interest waiver signed by the clients (see discussion in §§2.11 and 2.14) should clearly disclose the fact that there can be no privileged communications as between the parties with respect to the transaction (*i.e.,* their estate planning).

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§2.27 2. Separate Representation

Some estate planning attorneys, particularly in states other than California, regularly represent both spouses as "separate" clients. This practice is rare and of questionable propriety in California in light of Bus & P C §6068(e) (keeping all confidences inviolate) and Cal Rules of Prof Cond 3-310 (duty of undivided loyalty). This practice is more common, however, in the multigenerational context in which the same attorney represents family members from different generations in their respective estate plans. In those situations, the attorney must establish a clear understanding among the clients regarding what information will be shared and what will not. Generally, the clients all want the estate plans to be coordinated but do not expect that there will be a completely free exchange of information. In these situations, it is especially important that the understanding of everyone involved be described and acknowledged in writing in the engagement letters or other similar consent/waiver document.

For a discussion of the confidentiality problems inherent in "separate" representation of spouses, see House & Ross, Guide to the California Rules of Professional Conduct §IV.B.2.c (State Bar of California 2008 ed).

There is also no duty to withdraw from representation until the interests of the multiple parties actually become adverse. Care should be taken, however, to avoid representation when actual adversity of interests might or does exist, *e.g.,* in estate planning in which the spouses are asserting different rights to the same assets or when one spouse undertakes to conceal assets belonging to the other. In such cases, the two spouses have truly adverse interests and continued representation of both of them by one attorney would be inappropriate under Cal Rules of Prof Cond 3-310.

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V. SCOPE OF REPRESENTATION

§2.28 A. Importance of Defining Scope of Representation

The estate planning attorney wants to determine the scope of the representation for each of the following reasons:

(1) Under Bus & P C §6148(a)(2), the attorney must describe the nature of the services to be rendered (*i.e.,* the scope of the representation) in the engagement letter.

(2) Failure to define the scope of the representation can result either in the attorney failing to provide fully the services expected by the client (resulting in a possible malpractice action) or in the attorney providing too many services (resulting in the client's refusal to pay for something he or she did not want or expect).

(3) Defining the scope of the representation may focus the attention of both the attorney and the client on the related question, "Who is the client?" and bring attention to possible conflicts or other ethical problems at an early stage, when they are easier to resolve or avoid.

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§2.29 1. What Hat Is the Client Wearing?

In many instances, "Who is the client?" is inextricably linked to "What is the scope of the representation?" The attorney may know who is seeking the legal advice, but may not know in what capacity that person seeks assistance. It can be dangerous to make assumptions.

For example, if the estate planning attorney is being engaged to prepare an estate plan for a new client who is about to inherit trust assets from a family member, does the client expect also to receive advice regarding *that* trust and the client's rights as a beneficiary? If the client is also a fiduciary in that other matter, is it clear that he or she has other legal representation in that capacity? Because estate planning attorneys often have expertise in trust and probate estate administration, confusion in this regard is common, and most individual clients are not sophisticated and experienced enough to recognize a problem, much less help resolve it. The attorney should be careful to identify and address the question openly (and in writing) if it arises.

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§2.30 2. What Services Are Expected?

Crafting an estate plan can involve a complicated cross-section of legal, accounting, and investment advice. For instance, if the estate planning attorney prepares a plan involving various business entities, either new or existing, does the client expect the attorney to form those entities? To advise them on business matters? To represent them in the future? If the estate planning attorney is being engaged to give advice regarding lifetime gifts (*e.g., Crummey* trusts, QPRTs, GST trusts, CRTs), does the client expect the attorney to prepare the gift tax returns that will be required for the year of the gift? Will the estate planning attorney preparing a life insurance trust assist with selecting the insurance? To what extent will the attorney be responsible for title changes associated with setting up a trust? Some of the most serious problems in estate planning arise because of continuing uncertainty about the division of responsibility (*e.g.,* among attorneys, between the attorney and accountant, between the client and attorney). The attorney should clarify the answers to these questions as early as possible and document the scope of the representation and division of responsibilities in the engagement letter.

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§2.31 3. Certificate of Independent Review

A particularly narrow but compelling example of the need to define the scope of the representation arises for the attorney asked to prepare a Certificate of Independent Review under Prob C §21351(b). The Certificate has a very particular purpose, namely, to qualify a donative transfer to a transferee who would otherwise be a "disqualified person" as defined under Prob C §21350.5. The need for such a certificate may arise in a wide variety of circumstances because of the prohibition on transfers to care custodians. Under the decision in *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248, the definition of "care custodian" may include personal friends of the transferor. While some practitioners believe that the drafting attorney may issue the certificate in these circumstances, on the theory that the certificate was intended to qualify transfers to the drafter or persons related or connected to the drafter, the legislature has thus far declined to amend the statute to make clear that the certificate is not required when the drafter is independent of the transferee. Unfortunately, either the client or his or her beneficiaries may incorrectly perceive the attorney to be rendering an opinion that the desired transaction has been properly done and that it is appropriate for the client when in fact the attorney's attention is directed solely to determining whether the transfer is "not the product of fraud, menace, duress or undue influence." To avoid a claim in the future by either the client/transferor or beneficiaries that the attorney failed to identify and point out some flaw in the transaction or plan, the attorney should document the narrow scope of the representation (namely, the preparation of the Certificate of Independent Review) in the engagement letter, making it clear that he or she is assuming no responsibility for the plan itself.

For the statutory basis of limiting the scope of representation for purposes of preparing a Certificate of Independent Review, see Prob C §21351(b).

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§2.32 B. When Does Representation Terminate?

For many attorneys, defining the scope of the representation also includes the duration of the representation. Unlike services rendered in the litigation context, estate planning services are often performed over many years, and it may be difficult to identify when they begin or end. The relationship between the estate planning attorney and client is usually open-ended, and, unless the engagement letter or some other document makes it clear when the relationship will end, the question of ongoing representation can continue until the client's death (and sometimes beyond).

There is no authority in California imposing on the estate planning attorney a duty to keep clients apprised of changes in the law that might affect the client's estate plan. Nonetheless, from time to time, commentators have suggested that such a duty might be imposed, and the cautious estate planning attorney may wish to define in the engagement letter the extent to which the client can expect the attorney to provide ongoing advice about future changes.

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VI. CLIENT WITH DIMINISHED MENTAL CAPACITY

§2.33 A. Estate Planner's Dilemma

The estate planning attorney confronts a difficult problem when faced with a client with apparently impaired or questionable mental capacity. On the one hand, the attorney does not want to stand in the way of a person's effectuating his or her lifetime and testamentary donative desires. In *Moore v Anderson Ziegler Disharoon Gallagher & Gray* (2003) 109 CA4th 1287, 135 CR2d 888, the court held that an estate planning attorney does not owe a duty to takers under an earlier will or trust to ascertain and document a client's competence when the client makes amendments. The court held that imposing such a duty might unjustifiably deny many persons the opportunity to make or amend their wills. In *Boranian v Clark* (2004) 123 CA4th 1012, 20 CR3d 405, the court held that an attorney who drafted a will for a dying testator who was taking morphine and subject to hallucinations did not owe a duty of care to individuals who were to receive the testator's estate under an earlier will. On the other hand, the attorney does not want to assist the client in doing something he or she would not have done with undiminished capacity. This problem is particularly acute when the attorney knows that the client's proposed course of action diverges from past practices, differs widely from that customarily done by people in similar circumstances, or seems suspiciously like the product of undue third party influence. In the companion case of *Featherson v Farwell* (ordered not published Feb. 23, 2005; former opinion at 123 CA4th 1022, 20 CR3d 412), the *Boranian* court held that an attorney for a grantor who did not record or deliver a deed giving a remainder interest in a residence to a specified daughter out of excess caution with respect to the client's wishes did not owe a duty of care to the daughter. For further discussion, see Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide April 2010). See also Assessment of Older Adults With Diminished Capacity: A Handbook for Lawyers (2005), published by the American Bar Association Commission on Law and Aging and the American Psychological Association.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.34 B. Estate Planning Documents

§2.34 B. Estate Planning Documents

California gives both attorneys and courts guidance in assessing capacity in Prob C §§810-813, 6100, and 6100.5. See §28.2. However, if, after considering these sections (and perhaps getting input not only from the client but also from third parties), the attorney has doubts about the client's mental capacity, no controlling California statutory or judicial authority guides the attorney when that client wants to execute estate planning documents. In California, the only authority addressing the estate planning client with questionable capacity is San Diego Bar Ass'n Ethics Opinion No. 1990-3, which advises that an attorney drafting a testamentary document for a client "must be satisfied that the client is competent to make a will and is not acting as a result of fraud or undue influence." The opinion suggests that once an issue of capacity is raised in the attorney's mind, it must be resolved:

> The attorney should schedule an extended interview with the client without any interested parties present and keep a detailed and complete record of the interview. If the attorney is not satisfied that the client has sufficient capacity and is free of undue influence and fraud, no will should be prepared. The attorney may simply decline to act and permit the client to seek other counsel or may recommend the immediate initiation of a conservatorship.

On the other hand, ABA Model Rules of Prof Cond 1.14 and the Comments to it (amended in 2002) deal specifically with the client who has impaired capacity. Rule 1.14 reads, in pertinent part, as follows:

> RULE 1.14: CLIENT WITH DIMINISHED CAPACITY
> (a) When a client's capacity to make adequately considered decisions in connection with a representation is diminished, whether because of… mental impairment or for some other reason, the lawyer shall, as far as reasonably possible, maintain a normal client-lawyer relationship with the client.
> (b) When the lawyer reasonably believes that the client has diminished capacity, is at risk of substantial physical, financial or other harm unless action is taken and cannot adequately act in the client's own interest, the lawyer may take reasonably necessary protective action, including consulting with individuals or entities that have the ability to take action to protect the client and, in appropriate cases, seeking the appointment of a guardian ad litem, conservator or guardian.
> (c) Information relating to the representation of a client with diminished capacity is protected by Rule 1.6 [Confidentiality of Communications]. When taking protective action pursuant to paragraph (b), the lawyer is impliedly authorized under Rule 1.6(a) to reveal information about the client, but only to the extent reasonably necessary to protect the client's interests.

Comment 1 to Rule 1.14 reads as follows:

> The normal client-lawyer relationship is based on the assumption that the client, when properly advised and assisted, is capable of making decisions about important matters. When the client … suffers from a diminished mental capacity disorder or disability, however, maintaining the ordinary client-lawyer relationship may not be possible in all respects. In particular, a severely incapacitated person may have no power to make legally binding decisions. Nevertheless, a client lacking legal competence with diminished capacity often has the ability to understand, deliberate upon, and reach conclusions about matters affecting the client's own well-being.

The ACTEC Commentary on ABA Model Rules of Prof Cond 1.14 exhorts the estate planning lawyer to be cautious in proceeding with modification of the client's estate plan. The ACTEC commentary observes:

> If the testamentary capacity of a client is uncertain, the lawyer should exercise particular caution in assisting the client to modify his or her estate plan. The lawyer generally should not prepare a will, trust agreement, or other dispositive instrument for a client who the lawyer reasonably believes lacks the requisite capacity. On the other hand, because of the importance of testamentary freedom, the lawyer may properly assist clients whose testamentary capacity appears to be borderline. In any such case the lawyer should take steps to preserve evidence regarding the client's testamentary capacity.
> In cases involving clients of doubtful testamentary capacity, the lawyer should consider, if available, procedures for obtaining court supervision of the proposed estate plan, including substituted judgment proceedings.

In California, the law permitting substituted judgment (Prob C §§2580-2586) for individuals who lack the capacity to

make gifts and handle their own estate planning is fully developed and should be considered carefully when the attorney feels constrained not to assist the client in accomplishing his or her goals directly.

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Source: Estate Planning/California Estate Planning/2 Ethical Considerations/§2.35 C. Protecting Client With Diminished Capacity from Elder Abuse or Other Harm

§2.35 C. Protecting Client With Diminished Capacity from Elder Abuse or Other Harm

The attorney who represents a client in his or her estate planning is often among the first persons to detect the client's diminishing capacity. The discussion above addresses only the attorney's role in working with the client when he or she wants to take some action in estate planning matters. During the course of a representation, the attorney may also become concerned either that the client is no longer able to care for personal and financial affairs, or that there are one or more third parties who are a threat to the financial, if not physical, well-being of the client. What does the attorney do? It is one thing to refuse to participate in the preparation of documents to change the client's estate plan. It is another to take affirmative action to protect the client from his or her impairments or from the predations of third parties. How does the attorney reconcile various ethical duties to the client: the duty of loyalty, the duty to maintain the client's confidences, and the duty to avoid conflicts of interest? When these duties are irreconcilable, which duty trumps the others?

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§2.36 1. California Authority

California has no rule that specifically addresses the obligation (or options) of an attorney representing a mentally impaired client. Such California authority that exists on the subject in the form of ethics opinions takes a position contrary to that in a majority of jurisdictions in the United States. Counsel navigating the ethical rules governing the representation of a mentally impaired client should recognize that (1) there is no controlling California authority on the subject, (2) ABA Model Rules of Prof Cond 1.14 is directly on point and is followed by over 40 states, and (3) local probate court practice should be ascertained before proceeding.

There are four California ethics opinions that deal with this subject: California State Bar Standing Committee on Professional Responsibility and Conduct (COPRAC) Formal Opinion No. 1989-112; LA County Bar Ass'n Ethics Opinion No. 1988-450; San Diego Bar Ass'n Ethics Opinion No. 1978-1; and Bar Ass'n of San Francisco Ethics Opinion No. 1999-2. The first three elevate the duty of confidentiality above all others. These opinions place California in a small minority of jurisdictions having ethics opinions purporting to prohibit an attorney from seeking appointment of a guardian or conservator for an apparently impaired client or even seeking the consultation of a physician. What the attorney (or any other objective observer) deems to be in the best interests of the client is irrelevant.

The San Francisco Opinion (the most recent of the four) concludes that the duty of confidentiality should not always trump all other duties to the client, and states the following:

> As a general rule, an attorney recommends actions to clients and the clients decide what course to take. An impaired client presents challenges that are not easily resolved under customary rules, because the rules assume a rational, sober client. An attorney who reasonably believes that a client is substantially unable to manage his or her own financial resources or resist fraud or undue influence, may, but is not required to, take protective action with respect to the client's person and property. Such action may include recommending appointment of a trustee, conservator or guardian ad litem. The attorney has the implied authority to make limited disclosures necessary to achieve the best interests of the client.

All but the San Francisco opinion ignore the possibility that the attorney may limit the disclosures to (1) matters not involving confidential information (*e.g.,* facts about the client disclosed other than in confidential communications), or (2) otherwise confidential information that the client would presumably want disclosed, such that disclosure is impliedly authorized by the client or required by the attorney's duty of loyalty to the client.

At present, the weight of current California authority in this area seems to exalt confidentiality over all other interests of the impaired client, including the interest to be free from financial and physical abuse and predation. Of serious concern, the attorney apparently may choose only between (1) slavishly following the client's directions (even if capacity to give directions is uncertain) regardless of likely detriment to the client, or (2) withdrawing from the representation (as one would do with a competent client), leaving the former client at the mercy of his or her own failings and the possible abuse of third parties. Until further statutory or judicial guidance is propounded, the California attorney who takes affirmative action to protect a client from harm (against the client's wishes) does so at the attorney's own peril.

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§2.37 2. National Authority

Unlike California, the ABA Model Rules do specifically address this situation with ABA Model Rules of Prof Cond 1.14 (see §2.36). The 2002 amendments to this Rule bolster the attorney's right to take protective action on behalf of the client, and the amended Comments clarify how far the attorney may go:

> Taking Protective Action
>
> …
>
> [5] If a lawyer reasonably believes that a client is at risk of substantial physical, financial or other harm unless action is taken, and that a normal client-lawyer relationship cannot be maintained as provided in [Rule 1.14(a)] because the client lacks sufficient capacity to communicate or to make adequately considered decisions in connection with the representation, then paragraph (b) permits the lawyer to take protective measures deemed necessary. Such measures could include: consulting with family members, using a reconsideration period to permit clarification or improvement of circumstances, using voluntary surrogate decisionmaking tools such as durable powers of attorney or consulting with support groups, professional services, adult-protective agencies or other individuals or entities that have the ability to protect the client. In taking any protective action, the lawyer should be guided by such factors as the wishes and values of the client to the extent known, the client's best interests and the goals of intruding into the client's decisionmaking autonomy to the least extent feasible, maximizing client capacities and respecting the client's family and social connections.
>
> [6] In determining the extent of the client's diminished capacity, the lawyer should consider and balance such factors as: the client's ability to articulate reasoning leading to a decision, variability of state of mind and ability to appreciate consequences of a decision; the substantive fairness of a decision; and the consistency of a decision with the known long-term commitments and values of the client. In appropriate circumstances, the lawyer may seek guidance from an appropriate diagnostician.
>
> [7] If a legal representative has not been appointed, the lawyer should consider whether appointment of a guardian ad litem, conservator or guardian is necessary to protect the client's interests. Thus, if a client with diminished capacity has substantial property that should be sold for the client's benefit, effective completion of the transaction may require appointment of a legal representative. In addition, rules of procedure in litigation sometimes provide that minors or persons with diminished capacity must be represented by a guardian or next friend if they do not have a general guardian. In many circumstances, however, appointment of a legal representative may be more expensive or traumatic for the client than circumstances in fact require. Evaluation of such circumstances is a matter entrusted to the professional judgment of the lawyer. In considering alternatives, however, the lawyer should be aware of any law that requires the lawyer to advocate the least restrictive action on behalf of the client.
>
> Disclosure of the Client's Condition
>
> [8] Disclosure of the client's disability could adversely affect the client's interests. For example, raising the question of diminished capacity could, in some circumstances, lead to proceedings for involuntary commitment. Information relating to the representation is protected by Rule 1.6. Therefore, unless authorized to do so, the lawyer may not disclose such information. When taking protective action pursuant to [Rule 1.14(b)], the lawyer is impliedly authorized to make the necessary disclosures, even when the client directs the lawyer to the contrary. Nevertheless, given the risks of disclosure, paragraph (c) limits what the lawyer may disclose in consulting with other individuals or entities or seeking the appointment of a legal representative. At the very least, the lawyer should determine whether it is likely that the person or entity consulted with will act adversely to the client's interests before discussing matters related to the client. The lawyer's position in such cases is an unavoidably difficult one.

Until California clarifies the rules governing attorneys in this area, many attorneys may reasonably be reluctant to follow the lead of the ABA.

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3

Property Transfer Obstacles

Jeffrey A. Dennis-Strathmeyer

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§3.1 I. ESTATE PLANNING AS TRANSFER PLANNING

Despite the advances of modern science, it is still impossible to cheat death. As a result, the probability that a client's property will eventually be transferred is 100 percent. The estate planner's first task is to assist the client in determining his or her objectives, and then to assist the client in planning property transfers in a way that best meets those objectives. Primary client objectives vary greatly, but they commonly reflect the desire to provide financial security for loved ones and/or to promote charitable causes, perhaps in ways intended to perpetuate favorable memories of the client. These primary objectives create secondary objectives. The client wants to be sure that property will pass to the intended transferees. The client may further wish to restrict the transferee's use of the property. Often, the client wants the transfers to lessen the impact of taxes and administration costs.

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§3.2 II. OVERVIEW OF TRANSFER PLANNING OBSTACLES

At first glance, the task of transferring property seems relatively simple, but closer examination reveals an array of problems. This chapter and the following chapter seek to remind planners of the many obstacles they face in designing estate plans. Most of these obstacles, and their possible solutions, are discussed in greater detail elsewhere in this book. Ultimately, estate planning involves the selection and implementation of strategies for overcoming these obstacles.

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§3.3 A. Client Attitudes

The first group of obstacles in estate planning concern a typical client's mixed emotions regarding property transfers. The mere fact that a client appears in a planner's office provides some assurance of client interest in estate planning, but the depth of that interest may be modest.

Many clients do estate planning only because they feel they *should*. Estate planning is viewed as an obligation of civilized people. Not infrequently this sense of obligation has been inspired by an importuning spouse, child, other loved one, or, unfortunately, a predator (see §3.6).

Contrary to the assumptions of beneficiaries who suggest that a parent's failure to take more aggressive action to save taxes arose from faulty professional advice, some clients do think that their estate plans are important, while other clients are unwilling to tolerate the inconvenience required to lower the taxes that will be paid when they are gone.

Despite the tax advantages, many clients are particularly reluctant to adopt transfer strategies involving large gifts. Some are concerned, reasonably or otherwise, about their own financial security. Others merely want to retain control of their hard-earned wealth.

There are, of course, a number of clients who take a considerable interest in estate planning, sometimes to the point of obsession.

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§3.4 B. Cost Challenges

Costs, including professional fees, fiduciary fees, and court fees, can significantly limit property transfer options. Cost issues often first arise in the context of the fee to be charged for basic estate planning. Particularly with clients of modest net worth, their willingness and ability to pay fees may significantly affect the amount of planning that can be accomplished. In addition, the amount of custom drafting and professional supervision of plan implementation may be limited.

Cost may also be a prohibitive factor for a client of modest means if, for example, the client wants to establish a long-term trust with a corporate trustee that will benefit multiple generations of family members or wants to establish a foundation that perpetuates the client's name. Even affluent clients with ample financial means may resist incurring costs, even though the result may be less advantageous to them and their beneficiaries. For example, many clients resist incurring costs for quality appraisals of interests in business entities even when these appraisals are crucial to the success of an arrangement that can significantly lower transfer tax values. For a discussion of business entity valuation strategies, see chap 18.

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§3.5 C. Lack of Future Supervision

Many clients, particularly the less affluent, do not update their estate plans on a regular basis, yet they continue to take estate planning actions, such as buying life insurance, designating pension beneficiaries, establishing brokerage accounts that will pass by beneficiary designation, and buying vacation homes or time shares in states or countries with different laws from those in California. Other clients' circumstances can change, *e.g.,* when property is inherited, when asset values change, or when tax laws change.

It is not uncommon to encounter a will or trust that is elaborately drafted to provide for contingencies related to out-of-order deaths, but fails, for example, to consider the possibility that reduced asset values will permit funding of monetary gifts to less-favored beneficiaries, but leave an empty residue passing to the spouse. Whenever possible, given costs and other constraints, estate plans should be designed to minimize the damage that can be caused by future neglect.

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§3.6 D. Predators

Significant risks to clients (particularly elderly clients) are posed by persons who seek to obtain inheritances by improper means. Devices for separating elders from their money range from a relentless solicitation of gifts, to May-December marriages, to forgery and fraud. These devices include misappropriation of funds by client-chosen fiduciaries, including trustees, agents appointed in power of attorney documents, and (in rare cases) attorneys. Public concern about these risks can actually impose further transfer obstacles. For example, California's "disqualified person" statutes (Prob C §§21350-21356), enacted in response to the highly publicized, widespread, predatory actions of a California estate planning attorney, can invalidate transfers to persons who draft the transfer documents. See §3.8.

Although an estate planner's opportunities to identify and address predator problems are often limited, the risks can be reduced by careful client interviewing, advising the use of cofiduciaries and other arrangements that minimize temptations to "borrow" client funds in times of a fiduciary's personal financial distress, and requiring bonds for fiduciaries.

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III. COMMON RESTRICTIONS ON PROPERTY TRANSFERS

§3.7 A. Overview of Transfer Restrictions

Sometimes the client does not have the legal ability to transfer property or cannot transfer property without the consent of others. This is particularly true of married persons and persons with registered domestic partners (see chap 4), but even single persons often find that they cannot transfer certain types of property, such as pension plan or trust interests. Although the law generally favors free alienation of property, certain restraints are lawful. Both agreements and statutes may limit a person's ability to transfer property without the consent of others who have interests in the same property. Some of the more common transfer limitations are noted in §§3.8-3.18.

The ability to transfer property becomes severely restricted if the client becomes incapacitated. Even if there is legal ability, the client may be unwilling to transfer property in an effective and efficient manner owing to real or imagined needs to retain control of the property until death.

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§3.8 B. Legal Inability to Transfer Property

The most obvious obstacle to accomplishing a desired transfer of property is the risk that the attempted transfer will be attacked, successfully or otherwise, on one of the classic grounds for setting aside a will or other transaction. Among these grounds are lack of compliance with execution formalities (including witness requirements), lack of capacity, or the presence of fraud, duress, or undue influence. See, *e.g.*, Prob C §8252 (in will contest, contestants have burden of proof as to lack of capacity, undue influence, fraud, or mistake). Transfer documents can be attacked under the "disqualified persons" statutes (Prob C §§21350-21356), which invalidate transfers to persons involved in drafting transfer instruments (or persons closely related to such drafters) and transfers to care custodians of dependent adults. See *Rice v Clark* (2002) 28 C4th 89, 120 CR2d 522 (beneficiaries of decedent's will and trust who provided information needed to prepare those documents and who encouraged decedent to execute them were not disqualified persons); *Bernard v Foley* (2006) 39 C4th 794, 47 CR3d 248 (no personal-relationship exception to disqualified-person statute invalidating transfers to care custodians); *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390 (paid live-in caregiver clearly provided "social services" and was therefore disqualified person as care custodian); *Estate of Shinkle* (2002) 97 CA4th 990, 119 CR2d 42 (former long-term care ombudsman remained disqualified person after skilled nursing home facility patient returned home); *Estate of Swettman* (2000) 85 CA4th 807, 102 CR2d 457 (handyman and conservator, respectively, who assisted in execution of instruments were not disqualified persons). Note, however, that, among other exceptions, these provisions do not apply if the transferee is a close relative. See Prob C §21351(a), (g).

In *Estate of Pryor* (2009) 177 CA4th 1466, 99 CR3d 895, the court held that the exemption for spouses applied to a former spouse who became the deceased transferor's care custodian and then remarried the transferor. In a related action, the court held that the deceased transferor's daughter could not maintain an action as the transferor's successor to annul the marriage on grounds of fraud. The court rejected a contention that the enactment of the Elder Abuse and Dependent Adult Civil Protection Act (Welf & I C §§15600-15765) raised new public policy concerns that were not addressed when earlier court decisions held that a nullity action alleging a voidable marriage does not survive the death of a spouse. *Pryor v Pryor* (2009) 177 CA4th 1448, 99 CR3d 853.

An attorney who undertakes to assist a client in transferring property is necessarily assuming a duty to assist the client in making the transfer in a manner that does not unduly expose the transfer to attack. The risk of attack is relatively low if the client is clearly competent, the planner has no conflict of interest, reasonable steps are taken to assure that the client can communicate with the planner without the participation of anyone who might be exercising undue influence, and the planner is reasonably diligent in complying with legal formalities. The formalities are particularly important in the case of transfers to nonrelatives who could be considered care custodians. In *Osornio v Weingarten* (2004) 124 CA4th 304, 21 CR3d 246, the court held that a drafting attorney who failed to advise the testator that a devise to a care custodian would likely fail unless the testator obtained a certificate of independent review breached a duty of care owed to both the testator and the care custodian. It remains uncertain whether the drafting attorney can supply the certificate, but this may be better than nothing given the understandable reluctance of clients to pay additional fees for separate counsel to review the transfer. In cases of transfers to caregivers, rather than in cases involving transfers to drafters or persons related or connected to the drafter, it is often the case that the attorney is independent of the transferee.

PRACTICE TIP: One of the most effective means to ensure the validity of attempted transfers is an initial client interview that establishes the client's knowledge of his or her property and his or her relationships to relatives. See Prob C §6100.5 (defining mental competence to make will). Unfortunately, the utility of this device is greatly diminished if a client is not interviewed alone and others are permitted to answer crucial questions.

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1. Lack of Compliance With Execution and Delivery Formalities

§3.9 a. Formalities Imposed by Statute

In many instances, California statutes impose witness, notary, and delivery requirements. Formal wills must be executed as provided in Prob C §6110. See chap 5. Conveyances must be delivered. See CC §1054. See also chap 8. Disclaimers must be filed within specified time limits with a court or a specified person or fiduciary. Prob C §280. See chap 27. Other transfer documents are typically valid without being witnessed or notarized, but if recording is necessary to protect title or retransfer title, the practical consequence is that the document must be notarized. For a discussion of documents transmuting the property of married persons, see chap 4.

A document executed outside California is usually valid if it accords with the requirements of the state where the document was executed. See Prob C §6113.

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§3.10 b. Formalities Imposed by Documents

The validity of an estate planning action is often subject to formality requirements contained in trusts, contracts, or other documents. For example, trust provisions creating powers of appointment frequently impose formality requirements for documents exercising these powers. The trust may require that the appointment power be exercised in a will or codicil. The trust may require that the document be notarized or that it refer expressly to the instrument that created the appointment power. In addition, the trust may require delivery of the exercising document to a trustee or other specified person during the life of the holder of the power. Such requirements are generally enforceable. See Prob C §§670-674.

Trust documents also frequently impose formality and delivery requirements for documents revoking or amending the trust. These are also enforceable. Prob C §§15401-15402. Written contracts usually require that amendments be in writing. However, at least one court has held that, where the settlor was the trustee, a revocable trust that authorized inter vivos revocation by giving written notice to the trustee could be revoked by execution of a will that manifested an intention to revoke. The court concluded that Prob C §15401(a) does not require an express provision allowing revocation by will. *Gardenhire v Superior Court* (2005) 127 CA4th 882, 26 CR3d 143.

Typically, private formality and delivery requirements apply to property that passes by beneficiary designation, including life insurance proceeds, retirement plan benefits, financial institution accounts, and transfer-on-death registered securities. Some of these requirements are indirectly required by statute, but they are usually enforceable without reference to a statute. See generally chap 7.

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§3.11 c. Express Statement Requirements

In some situations a property-transfer-related action is not valid unless a document contains an express provision of some kind. For example, Prob C §4264 provides that a variety of actions that an attorney-in-fact might take, including the making of gifts, are invalid unless the actions are "expressly authorized." Another provision prevents an attorney-in-fact from amending or revoking a trust without express authorization in the trust instrument. Prob C §15401(c).

In many situations, express statements are required to opt out of default rules if the rules may have a profound impact on the value of the transfer. See, *e.g.*, Prob C §20110(b) on the equitable proration of estate taxes. More default estate tax proration rules are found in federal statutes, including IRC §§2206 (tax liability of life insurance beneficiaries), 2207 (tax liability of appointees of general power of appointment property), 2207A (tax liability of recipients of former qualified terminable interest property included in estate of surviving spouse), and 2207B (tax liability when inter vivos gift property subject to estate tax because of donor-retained interest).

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§3.12 2. Insufficient Capacity

The degree of capacity needed to perform a specific act depends on the act in question. Generally, an individual is not competent to make a will if the individual is under age 18, cannot understand the nature of the testamentary act, cannot understand and recollect the nature and situation of the individual's property, cannot understand his or her relationship to close relatives, or suffers from a mental disorder (such as delusions or hallucinations) that causes a disposition different from the disposition that would be made without the disorder. Prob C §§6100, 6100.5.

With regard to capacity to take other actions, Prob C §812 states:

> Except where otherwise provided by law, including, but not limited to, Section 813 and the statutory and decisional law of testamentary capacity, a person lacks the capacity to make a decision unless the person has the ability to communicate verbally, or by any other means, the decision, and to understand and appreciate, to the extent relevant, all of the following:
>
> (a) The rights, duties, and responsibilities created by, or affected by the decision.
>
> (b) The probable consequences for the decisionmaker and, where appropriate, the persons affected by the decision.
>
> (c) The significant risks, benefits, and reasonable alternatives involved in the decision.

This general statement is supplemented by a patchwork of other statutes and case law. For discussion of these statutes and case law, see Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008) and California Trust and Probate Litigation §§6.2-6.20 (Cal CEB 1999).

For discussion of alternative devices if the transferor lacks competence, see §8.18 (substituted judgment) and chap 28 (durable power of attorney).

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.13 3. Undue Influence

§3.13 3. Undue Influence

A will, trust, or other transfer document is invalid if it was procured by undue influence. CC §1567; Prob C §6104. Civil Code §1575 states:

> Undue influence consists:
> 1. In the use, by one in whom a confidence is reposed by another, or who holds a real or apparent authority over him, of such confidence or authority for the purpose of obtaining an unfair advantage over him;
> 2. In taking an unfair advantage of another's weakness of mind; or,
> 3. In taking a grossly oppressive and unfair advantage of another' s necessities or distress.

As defined in *Rice v Clark* (2002) 28 C4th 89, 96, 120 CR2d 522, "[u]ndue influence is pressure brought to bear directly on the testamentary act, sufficient to overcome the testator's free will, amounting in effect to coercion destroying the testator's free agency." In the context of litigation, a presumption of undue influence can be established by showing that (*Estate of Sarabia* (1990) 221 CA3d 599, 270 CR 560):

- A confidential relationship existed between the testator and the person alleged to have exerted undue influence;
- The person alleged to have exerted undue influence actively participated in actual preparation or execution of the will or trust (but see *David v Hermann* (2005) 129 CA4th 672, 28 CR3d 622 (evidence of procurement not essential to proof of undue influence unless presumption is used)); and
- The person alleged to have exerted undue influence unduly profited by virtue of the will or trust (but see *Estate of Auen* (1994) 30 CA4th 300, 308, 35 CR2d 557 (when there is attorney-client relationship, proof that benefit was undue not required)).

A confidential relationship exists whenever a person places trust and confidence in another person's integrity and fidelity. *Estate of Rugani* (1952) 108 CA2d 624, 239 P2d 500. Undue influence differs from incapacity, but evidence of weakness of mind can facilitate proof of undue influence. In *Estate of Odian* (2006) 145 CA4th 152, 51 CR3d 390, the court of appeal held that substantial evidence supported trial court findings that transfers to a paid live-in caregiver (whom the court determined was a disqualified person in any event) were the result of undue influence, and that the transfers were invalid because the decedent lacked capacity.

California's "disqualified person" statutes (Prob C §§21350-21356) address the same issues as the rules on undue influence, but they impose different burdens of proof. See §§2.21, 2.31, 8.16.

The possibility of undue influence can present thorny problems for planners, particularly when an elderly client wishes to leave a substantial gift to a caretaker, regardless of whether the caretaker is a relative. Several problems arise with such a desire. The first is the difficulty of detecting undue influence, a task that may be virtually impossible if the planner failed to insist on interviewing the client alone. However, there can be various warning signs. If a client announces that his or her children are dishonest and have been stealing property, the planner should be instantly alert to the possibility that these opinions are the direct result of the proposed transferee's influence. A recent change of attorneys is also a warning sign, no matter how believable the explanation.

Assuming that the planner becomes reasonably certain that undue influence is present, new problems arise. Some solutions to these problems may do more harm than good. The planner can withdraw from the engagement, but this may only cause the perpetrator to seek less perceptive counsel or use property transfer devices that do not require an attorney. The planner may attempt to draft documents that better reflect the client's "uninfluenced" wishes, but doing so assumes that the wishes can be ascertained and that they will not be changed once the original proposed transferee sees the actual contents of the documents.

If the planner determines that the client is not subject to undue influence, the planner has the problem of preserving evidence of the client's independence. It may be hard to prove such independence if the planner has ever represented the proposed transferee or otherwise has a conflict of interest. The evidence will also be weaker if the proposed transferee was involved in any way in the interview process.

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.14 4. Fraud, Duress, Menace, and Mistake

§3.14 4. Fraud, Duress, Menace, and Mistake

On rare occasions, a planner may confront a planning situation in which he or she is concerned that a proposed transfer is the result of fraud, duress, menace, or mistake. For a discussion of relevant requirements, see California Trust and Probate Litigation §§6.27-6.31 (Cal CEB 1999).

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§3.14A 5. Prior Agreement Restricting Transfer

Another potential obstacle to accomplishing a desired transfer is the existence of a prior agreement restricting transfer, such as a will contract. The attorney should make every effort to inquire about the existence of any such agreement. In *Stewart v Seward* (2007) 148 CA4th 1513, 56 CR3d 651, for example, the daughter of decedent's predeceased spouse alleged that decedent had entered into an oral agreement with the spouse in the presence of several family witnesses in which the spouse stated that she would not execute a will disposing of her property and would not convert title of their home from joint tenancy to tenancy in common, in exchange for decedent's promise to execute a will leaving 50 percent of the home to the daughter and 50 percent to two grandchildren. In the event, the spouse died intestate and decedent executed a will devising 100 percent of the home to the two grandchildren. On the alleged facts, the decedent did not have the legal ability to transfer the property, although the court held that the daughter's claim was barred by the statute of limitations.

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.15 C. Spendthrift Clauses

§3.15 C. Spendthrift Clauses

Most trusts contain spendthrift clauses prohibiting beneficiaries from transferring or encumbering their rights in the trust. These clauses are generally valid in California and offer some degree of protection from creditors. See Prob C §§15300-15309. Unfortunately, the clauses may limit the beneficiary's ability to take useful tax planning actions. For a general discussion of spendthrift clauses, see California Will Drafting, chap 27 (3d ed Cal CEB 1992).

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§3.16 D. Limitations on Transferring Pension Plans

Usually there are significant limitations on the ability of an employee to transfer any interests in a pension plan, except to the extent that the employee is allowed to name beneficiaries who will succeed to distribution rights on his or her death. 29 USC §1056(d); IRC §401(a)(13). Sometimes these limitations can be circumvented by making authorized withdrawals from the plan, but this usually triggers immediate recognition of income unless there is a rollover to an IRA. See chap 21.

IRAs allow somewhat greater flexibility, but an attempt to transfer ownership out of the name of the participant (except for a rollover to a surviving spouse) will be treated as a withdrawal, causing recognition of income. IRC §408(d). With a Roth IRA, such a transfer results in the loss of the ability to accumulate interest and dividends tax free. See IRC §408A(d).

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.17 E. Limitations on Transferring Nonpublicly Traded Business Interests

§3.17 E. Limitations on Transferring Nonpublicly Traded Business Interests

Most nonpublicly traded business interests, including interests in partnerships, limited liability companies, and corporations, are subject to restrictions on transfer. Some restrictions are imposed by securities laws, particularly in a sale to someone who will not be active in the business. Governing instruments or owner agreements, including shareholder agreements, commonly limit transfers that may be made without the consent of some or all of the other owners. Often, transfers cannot be made without first offering to sell the interests to other participants in the business. Interests in professional corporations are subject to restrictions that require owners to have the relevant professional license. Corp C §13407.

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.18 F. Other Restrictions on Transfers

§3.18 F. Other Restrictions on Transfers

Other restrictions on transfers arise in connection with everything from rights with respect to retirement facilities, to memberships in country clubs, to interests in businesses that involve the use of a liquor license. See Estate Planning for Special Assets (Cal CEB 2004); Transferring Property Without Probate (Cal CEB Action Guide September 2006).

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§3.19 IV. RESTRICTIONS DUE TO TAX CONSIDERATIONS

Some tax statutes, e.g. the gift tax statutes, directly tax the transfer of property. Other tax statutes, such as those imposing taxes on capital gains, make the transfer of property a recognition event. Statutes aimed at restricting newly discovered tax avoidance devices, public policies (*e.g.,* deductions for transfers to charity), political compromises, and accidents of history affect these laws. A significant part of estate planning consists of planning to transfer property in a way that minimizes taxes. Because discussions of tax laws take up a substantial portion of this book (see, *e.g.*, chap 10 (estate and gift taxes), chap 11 (generation-skipping transfer tax), chap 17 (marital deduction strategies), chap 18 (business entity valuation planning strategies), chap 24 (charitable remainder trusts)), it is appropriate here to merely note some of the more significant ways in which tax laws restrict transfers.

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§3.20 A. Gift Tax

On a percentage basis, few clients ever pay gift taxes, primarily because no tax is due until taxable gifts exceed $1 million. IRC §§2010(c), 2505(a). Another reason is the possibility that the estate tax may be permanently repealed. Payment of gift taxes can be a wise move if estate taxes are inevitable, but not if the transfer tax can be avoided entirely.

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B. Estate Taxes

§3.21 1. The Marital Deduction

The IRC §2056 marital deduction is the product of many years of political compromises. In its current form, the statute permits the deferral of estate tax until the death of the surviving spouse if the transferring spouse is willing to make transfers in the very limited ways the statute allows. Qualifying for the marital deduction may result in transfers being made in ways that compromise the client's objectives. For example, transfers to children, including children by a prior marriage (who may be older than the current spouse), are often postponed until the surviving spouse's death. Clients who wish to postpone estate taxes—perhaps until after repeal of the tax—are deprived of the sensible option of establishing family pot trusts that pay benefits to *both* the spouse and descendants as needed. The IRC §§2056(d) and 2056A rules that apply to a noncitizen spouse are even more restrictive.

On noncitizen transactions, see chap 16. On marital deduction strategies, see chap 17.

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§3.22 2. The Charitable Deduction

The IRC §2055 estate tax charitable deduction rules, as well as the somewhat parallel rules for income taxes (IRC §170) and gift taxes (IRC §2522), are among the most complex in the Internal Revenue Code. Indeed, planning mistakes with respect to these statutes are so common that it is necessary for these statutes to permit reformations of transfers in situations in which the transferor wishes to benefit charities but has failed to comply with rules designed to assure that deductions intended to benefit charities do not instead result in benefits to family members. Among other things, these statutes seriously limit the methods that can be used when a transferor wants to make a transfer that will benefit the transferor and loved ones for a specified period, with the charity receiving the assets remaining when the noncharitable beneficiaries have died.

On charitable giving, see chap 23. On charitable lead trusts, see chap 23A. On charitable remainder trusts, see chap 24.

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§3.23 3. Benefits for Small Businesses

For political reasons, estates of small business owners may enjoy certain transfer tax benefits not available to estates of owners of other assets. In some situations, eligibility for these benefits depends on the percentage of the estate that the assets of the small business comprise. The benefits include:

- The right to use special valuation rules for farms and ranches (IRC §2032A);
- The right to pay estate taxes in installments over 10 years (IRC §6166); and
- Special capital gain tax treatment for stock redeemed to pay expenses (IRC §303).

In each instance, a client may be motivated to transfer or not to transfer property in order to create or preserve estate eligibility. But the eligibility rules sometimes disregard transfers made near death. See IRC §2035(c).

These statutes also impose various restrictions on the transfer of property by the transferees. Premature transfer outside the family may trigger a recapture tax or result in acceleration of the payment of estate taxes that were payable in installments. For a discussion of business entity valuation strategies, see chap 18.

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§3.24 4. Valuation

Transfer taxes are based on the value of assets. As a result, transfer plans can be heavily influenced by the desire to minimize the value of transferred assets. For example, transfers may be accelerated in order to accomplish the transfer before an initial public offering (IPO) or other event (*e.g.,* the death of the insured) significantly increases the asset's value. Also, gifts may be made of fractional interests in property, and retained interest trusts may be used despite the need to meet the detailed requirements of IRC §2702 to avoid adverse valuations.

Section 2702 provides an excellent example of rules that exist solely to deter tax planning strategies that were perceived as abusive. It is one of a set of rules that specifically address the possibility of valuation abuses by taxpayers who are related to each other. See IRC §§2701-2704. These rules significantly increase planning complexity when transfers are made between related persons. See chap 25.

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§3.25 C. Income Taxes

Several features of the income tax system have a significant impact on transfer plans and must, therefore, be kept in mind. For example, the compressed schedule for the income taxation of trusts (IRC §1(e); see chap 13) is intended to deter efforts to use trusts to shift income tax liability away from a wealthy high-bracket transferor to a low-bracket trust. The effort has been so successful that income shifting now plays only a minor role in estate planning.

Another significant consideration is the tradeoff between capital gain taxes and transfer taxes that results from the fact that a new income tax basis is generally available for assets owned and transferred at death. IRC §1014. For an extensive discussion of this issue, see chap 12. In contrast, the transferee's income tax basis in property acquired by gift is generally equal to the transferor's basis (carryover basis). IRC §1015.

Nevertheless, capital gain taxes can sometimes be reduced by transferring appreciated assets to a low-bracket individual. For tax years beginning after 2007, in particular, the capital gains tax rate is 0 percent for individuals in the 15-percent ordinary income tax bracket. IRC §1(h). Thus, appreciated assets can be transferred to these individuals and immediately sold without payment of federal tax (although state income tax may be due in California), which has the benefit of establishing a new basis in the assets, so long as the amount of the gain is not itself sufficient to push the individual into the 25-percent bracket and the individual is not subject to the "kiddie tax" under IRC §1(g). See §8.22.

However, any gift of assets must be properly documented to avoid inclusion of the gain in the transferor's taxable income. In *Estate of Frances Elaine Freedman*, TC Memo 2007-61, the court held that capital gain on the sale of stock held in a joint brokerage account was properly taxed entirely to the estate of the joint tenant who contributed the stock to the account. The court held that there was insufficient evidence of an earlier intent to make a gift, noting that the contributing joint tenant reported all of the income on a return filed before death and that the decedent subsequently transferred the proceeds of sale to bank accounts held in her name alone.

Planners must also consider statutes that provide for changed tax consequences in transactions between individuals (and entities created by those individuals) who are closely related by blood or marriage. The most notable of these are the IRC §267 rules that, among other things, delay or prevent the recognition of losses on sales between related parties.

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§3.26 D. Property Taxes

Generally, unless an exclusion applies, California real property is reassessed for property tax purposes when a change of ownership occurs. Rev & T C §§60-62. Some transfers between family members are fully exempt or exempt up to a specified dollar limit. These exclusions may become particularly important when property is likely to remain in a family for an extended period, as may be true for a vacation home, farm, ranch, or rental property. In these situations, special care must be taken to avoid a transfer arrangement that results in an otherwise avoidable reassessment.

On California real property tax considerations, see chap 15.

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V. OBSTACLES RESULTING FROM TRANSFEREE CIRCUMSTANCES

§3.27 A. Transfers to Young Transferees

Frequently a client desires to transfer property in order to benefit a young person. Simple prudence generally demands that transfers for minors be made to trusts or custodianships.

There can be other considerations as well. Typically, laws restrict transfers of dangerous property, including motor vehicles and firearms. At a minimum, the transferor may become legally liable for later use of transferred property. In addition, the client may choose to put restrictions on a transfer that cannot be effectively enforced without incurring trustee fees that are disproportionate to the size of the gift. A useful device for small unrestricted gifts is a custodianship under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). For a discussion of transfers under CUTMA, see §8.26.

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Source: Estate Planning/California Estate Planning/3 Property Transfer Obstacles/§3.28 B. Transfers for Incapacitated Persons

§3.28 B. Transfers for Incapacitated Persons

Clients sometimes wish to make transfers that will benefit someone who is mentally impaired. Normally such transfers are made in trust. If the beneficiary receives any public benefits, the trust may take the form of a special needs trust that limits the trust benefits in a way that will not jeopardize the public benefits. See chap 26A; California Will Drafting, chap 23 (3d ed Cal CEB 1992); Drafting California Irrevocable Trusts, chap 13 (3d ed Cal CEB 1997). Estate planners may also become involved in situations in which the transfer to such a person is involuntary, perhaps the result of intestate succession or a personal injury lawsuit.

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VI. MULTIPLE JURISDICTION ISSUES

§3.29 A. Unexpected Restraints on Alienation

Planners should never assume that a client has the same ability to dispose of property outside California that he or she has in California. Some states have "forced-share" election laws, which may give a surviving spouse unexpected rights. Some foreign countries extend similar rights to children, including adult children.

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§3.30 B. Conflicting Tax Claims or Systems

Different states have different tax systems. Even when the tax systems are similar, however, the tax officials of the involved states may assert conflicting claims. See generally chap 14. Conflicts can sometimes be avoided by converting real property to personal property by, *e.g.,* transferring real property to a business entity.

When multiple nations are involved, the issues become even more complex. If a citizen of one country has property subject to tax in another, taxes may be determined in accordance with a specific treaty between the two nations. When small amounts of property in foreign jurisdictions are involved, the costs of handling the property on death may be more than it is worth. If so, it may be appropriate to sell the property or pass it to the next generation by immediate gift.

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§3.31 C. Burdens of Tax Avoidance Laws

When property is in other countries, the client may be subject to United States statutes intended to assure that United States citizens cannot successfully avoid taxes in this country by transferring property out of the country. For similar reasons, the United States is concerned about property that comes into the country if the recipient claims it is received as a gift but the claim is in reality an effort to conceal taxable income. These concerns result in reporting laws and tax laws that can become a trap for persons who, for nontax reasons, move assets in and out of different countries. See IRC §§643(i) (loans from foreign trusts), 668 (interest charges on accumulation distributions from foreign trusts), 679 (taxation of foreign trusts with United States beneficiaries), 684 (recognition of gain or loss on transfer to foreign trust), 6039F (foreign source gift reporting), 6048 (foreign trust reporting). For a discussion of some of the more common international tax problems, see chap 16.

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VII. COLLATERAL CONSEQUENCES OF PROPERTY TRANSFERS

§3.32 A. Public Benefit Consequences

Property transfers may have an impact on public benefit eligibility for either the transferor or the transferee. Notable consequences for transferors (and sometimes spouses of transferors) include eligibility for Medi-Cal convalescent hospital care coverage, other Medi-Cal benefits, and Supplemental Social Security (SSI). The form and timing of transfers may also establish whether the government will be able to seek reimbursement for the costs of providing benefits. See chap 30.

Lack of care in making gifts may also adversely affect a transferee's public benefits in ways that might be easily avoided by making a transfer to a special needs trust, transferring an exempt asset instead of cash, or providing the use of property in kind.

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§3.33 B. Asset Protection

Either the transferor or a proposed transferee may have current or future creditor problems. The extent to which planners should be concerned about asset protection is a matter of considerable debate among members of the profession. Most planners would agree that an attorney who undertakes the task of drafting a simple living trust is generally not required to give advice about the creditor protection benefit of off-shore foreign trusts or even the benefits of establishing a trust in a state that provides creditor protection for an irrevocable trust that names the settlor as one of a group of discretionary beneficiaries.

The duties of the attorney may be different, however, if he or she is made aware of specific creditor problems that directly concern the undertaking. For example, if the planner is drafting a trust for the support of a beneficiary with creditor problems, an attorney claiming to be an expert in trusts may well have an obligation to consider making distributions discretionary, giving that discretion to someone other than the beneficiary, and making the beneficiary's rights subject to a spendthrift clause.

Such issues are best resolved by express provisions in a retainer agreement. That said, a planner who has a basic understanding of the fundamental asset protection issues that arise in estate planning provides a more valuable service to a client than one who does not.

To the extent that asset protection issues are considered in an estate plan, they can become obstacles to other estate planning objectives. For example, it might be desirable to roll over an ERISA qualified plan account or benefit to an IRA in order to provide distribution options not available under the plan or to gain investment control. This approach, however, may reduce the creditor protection afforded to qualified plans under ERISA's antialienation provision. See 29 USC §1056(d)(1). In most cases, though, the difference is minimal because the transferor retains the option to seek bankruptcy protection. Under 11 USC §522(b)(2)(C), qualified plan assets are exempt from the debtor's bankruptcy estate, while the exemption for IRA assets is limited to $1 million, plus an unlimited amount attributable to rollover contributions. Thus, a rollover of retirement funds to an IRA generally does not reduce bankruptcy protection.

For a discussion of spendthrift clauses, see §3.15. For discussion of asset protection planning, see chap 26.

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4

Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners

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§4.1 I. ESTATE PLANNING ISSUES FOR SPOUSES AND DOMESTIC PARTNERS

This chapter focuses on some of the many transfer obstacles and issues that estate planners face when counseling their married and domestic partner clients and suggests some strategies for coping with these obstacles. While this chapter originally focused only on the practitioner's married clients, the issues raised by the California Domestic Partner Rights and Responsibilities Act of 2003 (Fam C §§297-299.6) require additional discussion relating to registered domestic partners, who are subject to most of the same constraints as married couples. The May 15, 2008, California Supreme Court decision legalizing same-sex marriage (*In re Marriage Cases* (2008) 43 C4th 757, 76 CR3d 683) and the November 4, 2008, passage of Proposition 8 eliminating the right of same-sex couples to marry in California (Cal Const art I, §7.5) create a new classification that includes an estimated 18,000 same-sex couples who married in California after the court decision and before the passage of Proposition 8. The issues affecting these couples are almost identical to the issues affecting registered domestic partners. Married couples are discussed in §§4.2-4.40E. Domestic partners and the issues that impact same-sex married couples differently from opposite-sex married couples are discussed in §§4.41-4.64.

The rights and obligations of same-sex registered domestic partners who have also obtained a California marriage license and performed a wedding ceremony in 2004 should not be any different than the rights of those partners who did not obtain a California marriage license. Although Fam C §299(a)(3), operative until January 1, 2005, provided that a domestic partnership is terminated when one of the domestic partners marries, because the August 12, 2004, California Supreme Court decision ruled that these marriages were void from their inception and a legal nullity, the registered domestic partnerships of these partners were not terminated when they obtained the California marriage license and performed the marriage ceremony. *Lockyer v City & County of San Francisco* (2004) 33 C4th 1055, 17 CR3d 225.

Whether the estate planner separately represents a husband or wife or jointly represents both spouses, the planner must be aware of impediments to achieving married clients' goals and objectives. Some of these issues are obvious, such as characterization of assets as community property, quasi-community property, or separate property. Other impediments are more obscure and unfamiliar even to competent estate planners.

Planning property transfers for married clients presents particular problems. For example, there are legal limits on a married person's ability to transfer property without his or her spouse's consent, and sometimes even with spousal consent. There are a number of tax considerations with varied consequences that may force the married client to choose between a desired plan of disposition and a desired tax result.

The estate planner is often placed in a difficult role as adviser to married clients. Generally, it is advantageous for a person to provide for his or her opposite-sex spouse. These advantages include the marital deduction available for transfers to a spouse, the tax-free rollover of retirement plan benefits if the spouse is named as beneficiary, the exclusion from reassessment of property taxes on transfers to a spouse, and the possibility of a stepped-up basis adjustment on the death of the first spouse to die.

Occasionally, it can be detrimental to transfer a married person's estate solely to an opposite-sex spouse. For example, the ultimate estate tax may be larger at the second spouse's death because of the increase in the size of the estate. Also, real property holdings may be reassessed following the second spouse's death if the first spouse did not use the $1-million reappraisal exemption available for transfer of property other than the family home (see chap 15), and the value of real property in the surviving spouse's estate exceeds $1 million in assessed value. Further, in blended marriages, children of the predeceased spouse may be disinherited by changes made by the surviving spouse to the design of his or her estate plan.

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§4.2 II. GIFTS OF COMMUNITY PROPERTY

The estate planner is often asked to counsel clients on lifetime transfers of property. Leveraged gifts (see §25.2) may be used to minimize death taxes and achieve clients' goals and objectives. The estate planner must have a working knowledge of the statutory requirements for making both lifetime and testamentary gifts to ensure that the transfer will not be set aside.

For a specific discussion of gifts of community property by domestic partners, see §§4.42-4.45. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.3 A. Spousal Consent Required for Gifts

In California, without the written consent of the other spouse, a married person cannot make a gift of community personal property, or dispose of community personal property for less than fair and reasonable value. Fam C §1100(b). Except for short-term leases, community real property cannot be transferred or encumbered without the joinder of the other spouse. Fam C §1102(a). The estate planner's failure to obtain the written consent or joinder of a spouse to a gift of community property can cause the gift to be ineffective, which can have serious tax consequences and lead to litigation and malpractice claims. Because a married person may have acquired a community property interest in the separate property of his or her spouse, it is generally prudent to obtain the written consent or joinder of the nongifting spouse even when making a gift of property understood by the spouses to be separate. For a case in which the estate planner was sued for malpractice for failing to obtain such a consent, see *Sindell v Gibson, Dunn & Crutcher* (1997) 54 CA4th 1457, 63 CR2d 594 (decedent husband's children sued law firm that prepared husband's estate plan for failing to obtain from husband's second wife consent to or acknowledgment of separate character of husband's property, at a time when wife was willing and able to give it).

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.4 B. Exceptions to Spousal Consent

§4.4 B. Exceptions to Spousal Consent

Neither written consent nor joinder is required if both spouses mutually make a gift to a third party, or if one spouse makes a gift of community personal property to the other. Fam C §1100(b). If one spouse gives community personal property to a third party, the gift is not voidable if there is fair and reasonable value received in exchange for the property given to the third party. See Fam C §1100(b).

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C. Effect of Gift Without Consent

§4.5 1. Gift Voidable by Nonconsenting Spouse

A gift made by a married person without the express consent of his or her spouse is a voidable gift, in contrast to a void gift. This means that a gift transaction undertaken unilaterally by a married person may be set aside or declared void on legal action by the nonconsenting spouse or the spouse's successors, but is not void in itself. Gifts of community property may be invalidated in their entirety during the lifetime of the donor-spouse. See *Marriage of Stephenson* (1984) 162 CA3d 1057, 1071, 209 CR 383; *Novo v Hotel Del Rio* (1956) 141 CA2d 304, 308, 295 P2d 576. Following the death of a married person who made a unilateral gift without the consent of his or her spouse, the nonconsenting spouse may void the gift to the extent of the nonconsenting spouse's one-half community interest. See, *e.g.*, *Odone v Marzocchi* (1949) 34 C2d 431, 439, 211 P2d 297 (gift made by wife in contemplation of death); *Ballinger v Ballinger* (1937) 9 C2d 330, 334, 70 P2d 629; *Bank of Cal. v Connolly* (1973) 36 CA3d 350, 377, 111 CR 468.

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§4.6 2. Gifts to Minors

Married people often make gifts to their children, grandchildren, or other relatives under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). In practice, written spousal consent for these gifts is seldom obtained, but the careful estate planner should advise that written consent is required to prevent the setting aside of the gift in a subsequent legal action by the nonconsenting spouse. Although custodial gifts to minors under CUTMA are seemingly "irrevocable" and convey to the minor "indefeasibly vested" title in the custodial property (Prob C §3911(b)), if funded with community personal property, such gifts are vulnerable to attack under Fam C §1100(b) unless made with joint spousal consent. See *Marriage of Stallworth* (1987) 192 CA3d 742, 753, 237 CR 829; *Marriage of Stephenson* (1984) 162 CA3d 1057, 1073, 209 CR 383.

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§4.7 3. Breach of Spousal Fiduciary Duties

In addition to an action to set aside an unauthorized gift, a nonconsenting spouse may seek remedies for breach of spousal fiduciary duties under Fam C §1101. Under this section, a married person has a claim against his or her spouse for breach of a fiduciary duty imposed by Fam C §1100 or §1102 that results in impairment to the married person's present undivided one-half interest in the community estate. A gift made by a married person without a spouse's consent appears to fall squarely within the reach of Fam C §1101 because it involves a transaction or transactions that "have caused or will cause a detrimental impact to the claimant spouse's undivided one-half interest in the community estate." Fam C §1101(a).

Several different remedies are available under Fam C §1101. A court may order an accounting of the property and obligations of the parties to a marriage, and may determine ownership rights as well as beneficial enjoyment of or access to community property. A court may also determine the classification of all property of the parties to a marriage. Fam C §1101(b).

The range of possible remedies also includes an award of attorney fees and costs in addition to the value of the transferred property. If a married person makes a gift without the consent or joinder of the other spouse, Fam C §1101(g) appears to require the court to award the claimant spouse 50 percent, or an amount equal to 50 percent, of any asset transferred in breach of the fiduciary duty, plus attorney fees and court costs. In at least one reported decision, an appellate court has held that the statutory language requiring the fee award is mandatory and unambiguous. Thus, if the court finds a breach of the fiduciary duty imposed by Fam C §721, the court does not have discretion to deny an award of attorney fees and costs. See *Marriage of Hokanson* (1998) 68 CA4th 987, 992, 80 CR2d 699.

PRACTICE TIP: Under Fam C §1101(e), the court may dispense with the spousal consent requirement if the proposed transaction is in the best interest of the community and the consent has been arbitrarily refused or cannot be obtained owing to the physical incapacity, mental incapacity, or prolonged absence of the nonconsenting spouse.

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§4.8 4. Survival of Right to Set Aside Gift

Each spouse has a present interest in community property and the right to dispose of one-half of it by will on death. Prob C §100. Such rights are property rights within the meaning of CCP §17. A legal action for violation of a property right survives the death of the owner of that right. Prob C §§7000, 7001. Therefore, the nonconsenting deceased spouse's legal representative may seek to set aside a gift made without the decedent spouse's consent. See *Harris v Harris* (1962) 57 C2d 367, 370, 19 CR 793. In *Harris*, the executor of a deceased wife's estate recovered one-half of all gifts of community property made by the husband without the wife's consent during the period that the husband was the guardian of the wife and for the period when the wife was under the guardianship of another, when there was no showing that the court approved the gifts, and no showing that the wife would have consented to the gifts had she been competent.

Only a nonconsenting spouse or his or her representative may seek to set aside an invalid gift. Lack of consent by one spouse cannot be used by the transferring spouse to avoid the transaction. The transferring spouse is fully bound as though it were a gift of his or her separate property. See *Dahne v Dahne* (1920) 49 CA 501, 193 P 785.

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§4.9 III. SPOUSAL CONSENT TO NAME BENEFICIARIES OF NONPROBATE COMMUNITY PROPERTY

Although much wealth is passed to beneficiaries through the probate process at the death of a married person, an even greater amount is transferred by various nonprobate devices. The most significant nonprobate transfers include life insurance, IRAs, 401(k) plans, annuity contracts, and living trusts. These and other nonprobate transfers present additional and significant obstacles to the estate planner in planning for married couples because of the requirement of spousal consent and the interplay between state community property laws and federal laws that preempt state laws.

For a specific discussion of domestic partner and same-sex spousal consent to name beneficiaries of nonprobate community property, and a discussion of issues that impact same-sex married couples differently from opposite-sex married couples, see §§4.46-4.50. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.10 A. Nonprobate Transfer Statutes

A special series of statutes governs nonprobate transfers of community property that take effect on death. See Prob C §§5010-5032. These statutes apply to any nonprobate transfer of community property on death executed by a married person (see Prob C §5014(a)) with respect to interests in insurance policies, contracts of employment, bonds, mortgages, promissory notes, certificated or uncertificated securities, account agreements, custodial agreements, deposit agreements, compensation plans, pension plans, individual retirement plans, employee benefit plans (other than ERISA-qualified plans; see §4.18), trusts, conveyances, deeds of gift, marital property agreements, and other written instruments of a similar nature (Prob C §5000(a)).

These statutes have important ramifications for all married clients and must be considered by any estate planning attorney preparing wills or trusts for married clients who have or may have employee pension or benefit plans, life insurance, or similar nonprobate assets. Special will and trust provisions are often necessary to deal with some of the possible effects of these statutes.

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§4.11 1. Requirement of Spousal Consent

Under California community property law as applied to the typical marital situation, retirement benefits, IRAs, life insurance, annuities, and other assets are community property when acquired during marriage, and each spouse has an interest in them. For many of these assets, the spouse who acquired the asset is required to designate a beneficiary of the asset in the event of his or her death. Because the assets are community property, the other spouse must also sign a written consent to the designation for the death beneficiary designation to be valid for that spouse's community property interest in the asset.

PRACTICE TIP: Many clients do not recall (1) the persons they named as beneficiaries of their retirement plans, insurance policies, and other nonprobate transfer vehicles; (2) where the death beneficiary designation forms can be found; or (3) whether they obtained the consent of their spouse to the death beneficiary designated on the life insurance policy, retirement plan, or other nonprobate transfer. The practitioner must be diligent in reminding married clients about the importance of verifying this information and the need for spousal consent to the beneficiary designation.

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§4.12 2. Rules Governing Changes in Death Beneficiary Designation

The general rule concerning spousal consent for nonprobate transfers is set forth in Prob C §5020, which states that:

> [a] provision for a nonprobate transfer of community property on death executed by a married person without the written consent of the person's spouse (1) is not effective as to the nonconsenting spouse's interest in the property and (2) does not affect the nonconsenting spouse's disposition on death of the nonconsenting spouse's interest in the community property by will, intestate succession, or nonprobate transfer.

For purposes of this requirement, a written joinder in a provision for nonprobate transfer of community property on death constitutes a valid consent to the transfer. Prob C §5010. Of particular importance to the estate planner helping clients achieve their planning objectives is the statutory requirement set forth in Prob C §5021(a), under which a nonprobate transfer made without the requisite consent may be set aside with respect to the interest of the nonconsenting spouse. The failure of the estate planning attorney to advise his or her client to obtain that consent can be disastrous.

In *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240, a husband transferred community property funds into nine bank accounts without his wife's consent. These accounts were payable on death (POD) to individuals other than his wife. When the husband died, the wife petitioned the probate court under Prob C §5021(a) for an order setting aside the transfer of one-half of the funds in each account. The court held that the wife could recover her one-half interest in the POD accounts established by her husband without her consent, even though she received more than one-half of the total community estate when her husband died.

PRACTICE TIP: Changes in death beneficiary designations to life insurance policies and IRAs are common. So are changes in the entitlement of benefits in other instruments making nonprobate transfers of community property on death. The statutory rules governing changes in death beneficiary designations are not well understood by most practitioners and even less so by their clients. The rigid application of the statutory rules can lead to results that were likely not intended by many married persons. The estate planner counseling married persons needs to be fully aware of these statutes and when it may be appropriate to advise clients to opt out of the statutory scheme.

Some applications of the nonprobate transfer rules follow ("*H*" refers to the transferring spouse; "*W*" refers to the nontransferring spouse). Under Prob C §5023(b)(1), if *H* executes a provision for a nonprobate transfer of community property on death with the consent of *W* and then subsequently modifies the provision during *W*'s lifetime without her consent, *H*'s modification revokes *W*'s prior consent and the property passes as though *W*'s consent had not been given unless she executes a new written consent. See Prob C §§5032, 5020. If *W* signs a consent to *H*'s beneficiary and after *W*'s death, *H* executes a change in the death beneficiary form, *W*'s previously executed consent is unaffected by *H*'s subsequent modification and *W*'s one-half interest in the community property is subject to a nonprobate transfer on death but only as consented to by *W*. See Prob C §5023(b)(2). In other words, *W*'s consent to the death beneficiary is frozen unless she authorized *H* to execute a modification after *W*'s death in the instrument of nonprobate transfer, the terms of the written consent, or in her will. In such a case, *W*'s one-half interest in the community property is deemed transferred to *H* at the time of *W*'s death, and *H*'s change in the designated death beneficiaries is effective as to both *H* and *W*'s respective interests in their community property. See Prob C §5023(b)(3).

For further discussion of the many questions raised by the nonprobate transfer provisions, see Dennis-Strathmeyer, *Retroactivity Gives Nonprobate Community Property Transfer Law Immediate Importance*, 14 CEB Est Plan Rep 1 (Aug. 1992).

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§4.13 3. Practical Effect of Spousal Consent Requirement

As discussed at §§4.11-4.12, because changes in death beneficiaries made by *H* after *W*'s death are ordinarily ineffective to dispose of *W*'s portion of the community property, *H*'s ability to change beneficiaries of a life insurance policy, IRA, or other similar interest will be substantially restricted under the California nonprobate transfer statutes. *H* can change the beneficiaries of his own one-half community property interest, but he cannot alter the beneficiary last consented to by his deceased spouse of *her* interest, unless *W* specifically allows *H* to change the beneficiary after her death. In many cases, this statutory default scheme may be in accord with the joint estate plan of both *H* and *W*. But in other cases, and in the opinion of this author, the majority of cases, the statutory scheme will conflict with the understandings of both *H* and *W* if they jointly desire that the surviving spouse be free to dispose of the assets at a later time as he or she deems appropriate.

Clients' desires on these significant legal issues will vary. Spouses who have been in a long-term marriage, especially with children, may simply have confidence in the judgment of their surviving spouse and be willing to grant that spouse broad rights to dispose of all the couple's assets. Many clients, however, are in second marriages and have children from prior marriages. Others, even in long-term, first marriages, when specifically asked whether they want to give their spouse the power to change the death beneficiaries following their death, including the power to change the death beneficiary to a new spouse to the exclusion of the couple's children, will say no. Still others may view their jointly acquired marital assets in accord with the community property laws, *i.e.*, that they are community assets and each spouse should have the power to dispose of his or her interest in those assets as he or she sees fit. The estate planner's role is to explore these feelings with the clients and design the estate plan consistent with the clients' objectives.

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§4.14 4. Illustration of the Spousal Consent Requirements

Set forth below is a common situation that illustrates the effect of the nonprobate transfer rules and spousal consent.

EXAMPLE: *H* and *W1* use community property earnings to purchase a single premium "universal" type policy of life insurance insuring *H*'s life. *H* designates *W1* as the primary beneficiary and their minor child, "C," as the contingent beneficiary. The insurance policy has a place for *W1* to sign her consent to the death beneficiaries selected by *H*. *W1* signs her consent. *W1* dies, survived by *H* and C. *W1*'s will leaves her entire estate to C. No mention is made in *W1*'s will of revoking her consent to the beneficiaries designated in the insurance policy on *H*'s life or giving *H* the power to alter any plan of disposition of *W1*'s interest in the policy. A few years later, *H* remarries and changes the beneficiary on "his" life insurance policy to *W2*. Under the statutes, *H*'s subsequent change of the death beneficiary is invalid with respect to *W1*'s interest in the life insurance policy. On *H*'s death, *W2* would receive *H*'s interest in the death benefits of the policy. C would receive *W1*'s interest. This outcome is the result of *W1*'s failure in her will to revoke her consent to any nonprobate transfer of community property on her death in the event that she predeceased *H* and instead to give her community property interest in the insurance policy to *H*.

The estate planning attorney should consider advising the clients in the design stage of the planning process of the benefits and detriments of including a provision under which *W* effectively restores to *H* the absolute power of disposition over nonprobate community property assets. In the absence of such a provision, any consent given by *W1* during her lifetime will continue to govern the disposition of those assets after the death of *H* even if *W1* predeceases *H*.

This result may or may not be in accord with the intentions of the parties in a given case. Many variations of this example involving second marriage can easily be seen.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.15 5. Form: Revocation of Consent to Nonprobate Transfers of Community Property

§4.15 5. Form: Revocation of Consent to Nonprobate Transfers of Community Property

4.15-1 Revocation of consent to nonprobate transfers of community property

If I predecease my spouse, I revoke any consent that I may have given to my spouse as to any nonprobate transfer on the death of any person, to anyone other than my spouse, of all or part of my community property interest in any asset controlled by an instrument described in California Probate Code §5000 (or any successor statute), and instead I give to my spouse my community property interest in any assets affected by this revocation of consent. It is my intention that my spouse shall have full power to dispose of all community property assets to which this provision of my will applies. Notwithstanding the preceding sentences, this revocation of consent shall not apply to any community property included in any revocable living trust in which I am the settlor or a cosettlor, which shall continue to be governed by the terms of the living trust instrument. If my spouse and I die simultaneously, or it cannot be established by clear and convincing evidence whether my spouse or I died first, this provision shall not apply.

Comment: When appropriate to effect a client's wishes, the attorney should add language to the client's will that would essentially provide the surviving spouse with full power of disposition over nonprobate community property assets.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.16 B. Special Issues for Retirement Plans

§4.16 B. Special Issues for Retirement Plans

Special issues can arise for married people in the context of retirement accounts and benefits. For a discussion of retirement plans, generally, in estate planning, see chap 21.

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§4.17 1. Defined Benefit Plans

Under the provision of the Retirement Equity Act of 1984 (REAct) (Pub L 98-397, 98 Stat 1426), most qualified plans (*i.e.*, defined benefit plans; see chap 21 for definition) must provide that benefits be payable in the form of a qualified joint and survivor annuity (QJSA) unless the nonparticipant spouse consents to another arrangement. Similarly, the plan must provide for payment of a qualified preretirement survivor annuity (QPSA) in the event of the participant's death before retirement. IRC §401(a)(11). A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse that is 50 to 100 percent of the amount of the annuity payable during the joint lives of the participant and spouse. IRC §417(b). A QPSA is analogously defined in IRC §417(c). For plan years beginning after December 31, 2007, the plan also must provide for payment of a qualified optional survivor annuity, with a survivor annuity for the life of the spouse that is 75 percent of the joint annuity amount unless the QJSA and QPSA pay 75 percent of the joint annuity amount, in which case the qualified optional survivor annuity must pay 50 percent of the joint annuity amount. See IRC §417(g).

The rights to a QPSA or a QJSA (or a qualified optional survivor annuity) can be waived. The waiver must be in a writing signed by the nonparticipant spouse that is notarized or witnessed and that acknowledges the effect of the waiver, including an affirmative statement of the rights the nonparticipant spouse is relinquishing. See *Lasche v George W. Lasche Basic Retirement Plan* (SD Fla 1994) 870 F Supp 336, aff'd (11th Cir 1997) 111 F3d 863; IRC §417(a)(2). Rights to QJSAs and QPSAs are sometimes waived in prenuptial or similar agreements by providing that a spouse is obligated to execute and deliver the documents required by the statute.

The mandatory provision of QJSAs and QPSAs has the effect of requiring the participant spouse to obtain the consent of the nonparticipant spouse to receive a lump-sum distribution. This may create conflict-of-interest issues for the attorney advising a married couple, because the nonparticipant spouse will give up significant rights if the lump-sum distribution is made. This is true even if the assets are rolled over into an IRA, because there are no comparable spousal protections for IRAs.

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§4.18 2. ERISA-Governed Retirement Accounts

Notwithstanding California's general community property laws, retirement plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) (401(k) plans, 403(b) plans, and the like) are governed by special rules at death. Although the nonparticipant spouse may have a community property interest in such benefits for dissolution purposes, the nonparticipant spouse has no bequeathable interest at death. *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754; *Ablamis v Roper* (9th Cir 1991) 937 F2d 1450. Rather, the predeceasing, nonparticipant's interest passes to the surviving participant spouse at death.

Based on *Boggs,* at least one California court has held that ERISA's preemption and antialienation provisions do not allow a court to make a domestic relations order providing the nonparticipant spouse the right to name a successor in interest (other than as a designated beneficiary or alternate payee under the terms of the plan) to receive his or her share of undistributed pension benefits on death. *Marriage of Shelstead* (1998) 66 CA4th 893, 78 CR2d 365.

It is not clear whether the *Boggs* rule applies to IRAs and other retirement arrangements that are not subject to the antialienation provisions of ERISA. See 29 USC §1056(d). As a practical matter, the majority of nonparticipant spouses do not intentionally try to transfer to third parties their community property interests in pensions and IRAs held in the name of their spouse. The more difficult cases can be avoided by ensuring that the nonparticipant spouse's will cannot be construed as devising the interests to someone other than the participant spouse, as might occur if some share of the residue passes to someone other than the participant spouse. In addition, compliance with California's nonprobate transfer spousal consent requirements will avoid ambiguity about the decedent's intent in making devises. See §§4.9-4.15.

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§4.19 IV. PLANNING ISSUES FOR MARRIED PERSONS UNDER PROBATE ADMINISTRATIONS

Significant wealth is transferred to named beneficiaries outside of formal, court supervised probate administrations. Many practitioners routinely use a revocable living trust as the primary testamentary vehicle for married people to avoid the expense and delays of formal probate. Nonetheless, probate proceedings are needed and useful in many situations. Sometimes, for example, clients (or their attorneys) will fail to transfer all of their assets to their living trust, and a probate may be needed following the death of a married person to clear title to the assets into the name of the successor trustee of the living trust.

Probate court supervision may even be intentional. A younger married client with small children and a modest estate may be best served by a will that creates contingent trusts for minor children in the event that both parents are deceased. In other cases, clients may prefer court supervision because of family dynamics. Occasionally, the attorney may be called on to do a "secret" will for a married person, disinheriting a spouse.

Regardless of the circumstances causing the probate, most estate planners will eventually find themselves handling probate administrations for deceased married clients. The probate process, unlike nonprobate transfers, contains family protection statutes, such as family allowance provisions, probate homestead provisions, and the set aside of exempt property. The practitioner must understand the impact that these family protection statutes may have on any proposed estate plan so that the attorney can counsel his or her client appropriately.

For a specific discussion of planning issues for domestic partners under probate administrations, see §§4.51-4.55. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.20 A. Family Protection Statutes

The family protection statutes (Prob C §§6500-6615) reflect a legislative policy that places the welfare of the decedent's surviving family above that of the decedent's named beneficiaries or creditors. The policy embodied in these statutes is to protect the decedent's spouse and minor children (and, in some cases, adult children and parents) when either the decedent failed to do so or when the decedent's creditors might otherwise exhaust the estate to the disadvantage of the statutorily protected individuals. These statutes can frustrate the married person's estate plan because the "beneficiaries" of the estate may end up being identified by statute and fixed by the court, not by the testator. Hence, these statutes can be significant obstacles to planning and designing a married person's will. The decedent's testamentary intentions are irrelevant in determining the surviving family members' right to a family allowance. Rather, such payments are in addition to and not in lieu of a recipient's interest in the estate. Indeed, a family allowance will not necessarily harmonize with a decedent's estate plan and, in certain instances, may in fact frustrate it.

The practitioner should be thoroughly familiar with these family protection statutes to explain to the client the impact the protective provisions may have on the proposed estate plan. In some cases, it may be appropriate to obtain from a spouse a written waiver of some or all of the statutory protections afforded by the family protection statutes. In other cases, the attorney might suggest a plan design that provides some benefits to a spouse or minor children that would terminate if the spouse or children sought the protection of the family protection statutes.

For a more detailed discussion of these topics, see 2 California Decedent Estate Practice, chap 17 (2d ed Cal CEB 2009).

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1. Family Allowances

§4.21 a. Impact

A probate administration can take a significant period of time. During the administration of the probate estate, the surviving spouse and minor children are entitled to a reasonable allowance paid from the estate for their maintenance. See Prob C §6540(a). In addition, dependent adult children and parents may also be entitled to an allowance. See Prob C §6540(b). These allowances can be significant both in terms of their dollar amount as well as their impact on the decedent's overall estate plan. The longer the estate is administered, the greater the impact of a family allowance on the decedent's beneficiaries. Some local probate rules limit family allowance orders to 1 year and require a further order to continue the payment of the allowance. However, the only statutory limitation to the payment of an allowance is set forth in Prob C §6543, which provides that the family allowance may continue until the entry of order for final distribution, unless the estate is insolvent, in which case the allowance may continue for 1 year after the granting of letters to the personal representative. The estate planner should note that the court has discretion to keep an estate open to continue a family allowance payment in some limited situations. See Prob C §12203(a).

Depending on the size of the probate estate (and maybe the nonprobate estate), an award of a family allowance to a spouse of the decedent and to minor children can be considerable. The estate planning attorney counseling the testator should be careful to remind the client of the impact a family allowance award can have on the client's estate and explore methods that could minimize that impact. The attorney should first explore the possibility of obtaining a written waiver from the client's spouse of his or her entitlement to a family allowance. Written waivers are expressly permitted by Prob C §141(a)(5), provided that they are knowing and voluntary.

A second potential method for minimizing the impact of a family allowance award on the decedent's estate plan is to put the spouse or child to an election. Under this strategy, the decedent intentionally leaves a gift to an otherwise disinherited spouse or child. The gift would be forfeited if the spouse or child sought an award of a family allowance. Like a forced "widow's" election (see California Will Drafting §17.43 (3d ed Cal CEB 1992)), this plan would put the spouse or child to an election, *i.e.,* take the gift under the will and forego a family allowance or forfeit the gift and take a chance with the court's exercise of its discretion in fashioning a family allowance order. This forced election is untested in the courts and possibly may be held to violate the state's public policy of providing support to a protected class.

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§4.22 b. Family Allowances and Revocable Trusts

Family allowances cannot be paid from revocable trust property. *Parson v Parson* (1996) 49 CA4th 537, 541, 56 CR2d 686. Can the statutory protections provided to a spouse and minor children in a probate context nevertheless apply in a living trust context following the death of a married settlor? The answer to this question has not been finally answered by the courts. If a married person dies with a revocable living trust and pour-over will leaving a sizeable separate property estate to beneficiaries who are not the spouse or children of the decedent, can the decedent's spouse open a probate, even if there are no assets to be probated, obtain a family allowance order, and seek to have the trust assets satisfy the family allowance order on the basis that the spouse is now a creditor of the estate? There is no statutory authority to pay a family allowance directly from a revocable trust as there is from an estate. A revocable trust may be liable for payment, however, if there is an estate administration and estate assets are insufficient to pay the allowance. See *Parson v Parson* (1996) 49 CA4th 537, 56 CR2d 686.

PRACTICE TIP: One possibility for obtaining a family allowance from a revocable trust was suggested by the *Parson* court in dictum. If some assets were not funded in the trust before death, and thus required probate using the pour-over will, a true estate would be created. In such a case, a surviving spouse might be entitled to a family allowance from the probate estate, and to the extent that the estate assets were insufficient to pay the family allowance, the trust assets might be held available to fund the allowance under Prob C §§19001(a) (liability of revocable trust for creditors' claims) and 11420 (family allowance listed in priority for payment of debts from a decedent's estate).

An attorney representing a married person who seeks to disinherit a spouse must be aware of the potential impact of the family allowance provisions, even in a trust context. When the drafting attorney uses a typical fully funded revocable living trust as the primary estate plan, supplemented with a pour-over will, it is not unforeseeable that a surviving spouse may seek to have the decedent's pour-over will admitted to probate. There usually are some assets outside the trust (*e.g.,* items of tangible personal property, a few stock certificates, a car) that can be administered even if a summary probate procedure (*e.g.,* collection by affidavit under Prob C §§13100-13116) is an option. Once the probate is opened, the surviving spouse may seek a family allowance order and possibly obtain payment from the trust under Prob C §19001 to the extent that the estate assets are insufficient to pay the award.

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2. Probate Homesteads

§4.23 b. How Probate Homestead Arises

Probate Code §§6520-6528 provide additional protection to the surviving spouse and minor children of a married person in the form of a probate homestead. The probate homestead is designed to protect the family home for the benefit of the decedent's spouse and certain other dependents of the decedent. Additionally, these statutes protect the home from the reach of the decedent's general creditors, nonfamily beneficiaries of the decedent's will, and the decedent's more distant intestate heirs. Probate homesteads are discussed in greater detail in 2 California Decedent Estate Practice, chap 17 (2d ed Cal CEB 2009).

Probate homestead issues are likely to arise if the decedent devised his or her residence to someone other than a spouse or children. A probate homestead may, to a certain extent, override such a devise in favor of the spouse and minor children. In particular, a probate homestead may be sought if the decedent willed property to a second family to the exclusion of his or her minor children from a prior marriage.

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§4.24 b. Overcoming Probate Homestead

In the planning stages, the estate planning attorney must consider the possibility of a court imposing a probate homestead over the decedent's residence (or other real property asset). Although it is impossible to predict a court's exercise of its discretion in advance, a waiver by the surviving spouse and a firm testamentary expression of the decedent's intent may reduce the likelihood of a court-ordered homestead.

As with a valid waiver of a family allowance, a surviving spouse may be disqualified from receiving a probate homestead if he or she knowingly and voluntarily executed a waiver either before marriage in a prenuptial agreement or after marriage. See Prob C §§140, 141(a)(3). As a practical matter, it may be impossible for a married person to obtain a written waiver of a probate homestead if the marital relationship has deteriorated.

The expression of testator's intent as stated in a will may also be useful in avoiding a probate homestead. It may prove helpful at a contested hearing on the probate homestead issue that the decedent had a clause in his or her will clearly stating that no probate homestead should be set aside for the decedent's spouse or minor children. Under Prob C §6523(a), in imposing a probate homestead, a court must consider, among other factors, the decedent's intent with respect to the property in the estate and the decedent's estate plan as expressed in inter vivos and testamentary transfers "or by other means." Although the testator's intent is not determinative, it may prove helpful. A married person seeking to disinherit a spouse or devise a residence to someone other than a spouse should include an appropriate expression of intent in any will or trust.

Presumably, the same limitation against the awarding of a family allowance directly from a revocable trust applies as well with respect to probate homesteads. See §4.22.

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§4.25 3. Small Estate Set Aside to Surviving Spouse or Minor Children

Under Prob C §§6600-6615, estates worth less than $20,000 can be set aside to the decedent's surviving spouse or minor children. Like the family allowance and probate homestead discussed above, these sections are designed to provide money or other property to a spouse or minor children even if the decedent's will provides otherwise. If the statutory requirements are met, this protected class takes the small estate free from the rights of beneficiaries named in the decedent's will or intestate heirs who might have a superior right to the property under the rules of intestate succession. Court approval is required and the maximum amount that the court can set aside is $20,000 of a net estate. See Prob C §6602. Because the set aside is limited to relatively small estates, which are defined to include community property (Prob C §6600(a)), these statutory provisions are rarely used to defeat the interests of the testate beneficiaries. A significantly large estate might still qualify for the set aside to a spouse or children, however, because some assets, such as life insurance, retirement benefits, multiple party accounts, probate homesteads, joint tenancy property, and life estates are excluded when calculating the size of the estate. Prob C §6600(b). Also the value of the property must be "netted out," *i.e.*, determined net of all liens and encumbrances. Prob C §6602.

Consistent with the other family protection provisions of the Probate Code, the court has discretion to determine if any set aside is warranted and who among the eligible parties can receive the set aside, and in what amounts. Among the factors the court can consider is the decedent's intent. Prob C §6609(b). A married person who wishes to leave his or her estate to individuals who are not the spouse or children should have a statement in the will clearly indicating an intent that no small estate set aside should be granted by the court and should set forth any reason for that desire, including provisions the testator has made for the protected individuals from assets outside probate.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.26 4. Setting Aside Exempt Property to Surviving Spouse or Minor Children

§4.26 4. Setting Aside Exempt Property to Surviving Spouse or Minor Children

Under Prob C §6510, the court has discretion during estate administration to set apart for the benefit of a decedent's surviving spouse or minor children all or any part of the decedent's property (other than the family dwelling) that may be exempt from enforcement of a money judgment. A spouse may waive his or her right to have exempt property set aside if he or she executes a voluntary and informed written waiver either before or during marriage. See Prob C §141(a)(4).

Set forth below is a partial list of assets that may be exempt from enforcement of a money judgment and therefore capable of being set aside and paid to the decedent's surviving spouse or minor children. See also chap 26. These provisions are found in CCP §§704.010-704.210. Many of the categories of exempt property are limited by dollar amounts. Some of the categories require a claim of exemption to be filed. Exempt property includes:

- $2550 of equity in a motor vehicle (CCP §704.010);
- Household furnishing, appliances, provisions, wearing apparel, and personal effects (CCP §704.020);
- $2700 of materials for repair or improvement of a principal residence (CCP §704.030);
- $6750 of jewelry, heirlooms, and works of art (CCP §704.040);
- Health aids (including prosthetic and orthopedic appliances) (CCP §704.050);
- $6750 of tools or personal property used in a trade, business, or profession ("tools of trade"), limited to $4850 for a commercial motor vehicle (for spouses in a common trade or business the exemption amount is $13,475 for tools of trade, limited to $9700 for a commercial motor vehicle) (CCP §704.060);
- Recently paid wages and earnings traceable to deposit accounts or in the form of cash or its equivalent (*i.e.,* a check) (CCP §704.070);
- $2700 in deposit accounts containing social security payments directly deposited by the government (CCP §704.080);
- $1350 of a prisoner's funds held in an inmate's trust or similar account (CCP §704.090);
- $10,775 of benefits from unmatured life insurance, annuity, or endowment policies, and benefits from matured policies "to the extent reasonably necessary for support" (CCP §704.100);
- Public retirement and related benefits and contributions (CCP §704.110);
- Public employee vacation credits (CCP §704.113);
- Private retirement and related benefits and contributions (Keogh plans, IRAs) "to the extent necessary for support" (CCP §704.115);
- Unemployment and unemployment disability funds, and strike benefits payable by a labor union (CCP §704.120);
- Disability and health insurance benefits (CCP §704.130);
- Personal injury causes of action and damages awards or settlements (CCP §704.140);
- Wrongful death causes of action and awards or settlements (CCP §704.150);
- Workers' compensation claims, awards, or payments (CCP §704.160);
- Public assistance payments and financial aid from a charity or fraternal benefit society (CCP §704.170);
- Relocation benefits (*i.e.,* for displacement from a dwelling, paid under federal or state law) (CCP §704.180);
- Student aid (financial aid provided by an educational institution for expenses while attending school) (CCP §704.190); and
- Cemetery plots (CCP §704.200).

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§4.27 B. Estate Planning and Family Protection

It is not difficult to see that estate planning for a married person is not as simple as it may look when all of the family protection statutes are intertwined with the intentions of the testator. It is the public policy of the state of California to take care of the surviving spouse and children out of the decedent's estate whenever the decedent fails to provide for them. A court-ordered family allowance, probate homestead, small estate set aside, or exempt property set aside can seriously affect a married person's estate plan. The attorney should consider waivers executed in accordance with the statutory provisions of Prob C §§140-147 whenever advising a client during the negotiations of a prenuptial or postnuptial agreement. At least one court has held that a waiver contained in a premarital agreement was enforceable by the decedent's estate against the surviving spouse, even though it failed to comply with the Family Code requirements for premarital agreements, because it complied with the Probate Code requirements for waivers. *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502. Nevertheless, in the planning stages, until the California Supreme Court opines on this issue, a prudent practitioner involved in drafting a prenuptial agreement will advise clients to obtain waivers that comply with both Fam C §§1610-1617 (applicable to premarital agreements) and Prob C §§140-147 (applicable to waivers).

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§4.28 V. OMITTED SPOUSES AND CHILDREN

The strong public policy favoring spouses and children demonstrated in the family protection statutes (see §§4.20-4.27) is extended to a spouse or child omitted from a married person's will or trust when (1) the spouse married the decedent after the decedent signed the will or trust or (2) the omitted child was born to or adopted by the decedent after the decedent's will or trust was executed.

For a specific discussion of omitted domestic partners and children of domestic partners, see §§4.56-4.57. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.29 A. Statutory Share of Spouse

Under Prob C §21610, if a married person's "testamentary instrument" (*i.e.*, will or trust; Prob C §21601(a)) fails to provide for his or her surviving spouse, who married the decedent after the execution of the testamentary instrument, the omitted spouse is entitled to a share of the decedent's probate estate or trust estate, or both, as the case may be. The surviving spouse is entitled to a statutory share equal to one-half of the community property, one-half of the quasi-community property, and a share of the deceased married person's separate property equal in value to the share that the spouse would have received if the decedent had died intestate, but in no event more than one-half the value of the separate property in the estate. Prob C §21610.

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§4.30 1. Exceptions to Statutory Share

Under Prob C §21611, there are three circumstances in which the statutory share is defeated:

- The deceased married person's failure to provide for the omitted spouse was intentional and that intention is apparent from the relevant testamentary instrument;
- The decedent made transfers to the surviving spouse outside the testamentary instrument intended to be in lieu of a provision in the decedent's will or trust to provide for the spouse, as shown (a) by the decedent's statements, (b) from the amount transferred, or (c) by other evidence; or
- The surviving spouse signed a valid agreement waiving the right to share in the decedent's estate.

In *Estate of Will* (2009) 170 CA4th 902, 88 CR3d 502, when the surviving spouse had executed a prenuptial agreement that did not comply with the 7-day waiting period required by Fam C §1615, the court held that the surviving spouse's waiver of the right to share in the decedent's estate was nonetheless valid because it complied with the Prob C §§140-147 requirements for a waiver of rights that the surviving spouse would otherwise have at death.

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§4.31 2. Effect of Omitted Spouse Statutes on Estate Planning

Attorneys often recommend that a divorcing couple revoke their existing estate plan and revise it in accordance with each spouse's current testamentary objectives. Likewise, when a client remarries, it is imperative that the client be advised to review his or her estate plan and modify it to carry out any new objectives. The statutory share rules described in §§4.29-4.30 create a default rule that may not mirror the intention of the newly married client. The practitioner should be diligent in reminding clients about these rules and, when appropriate, revise the estate plan to clarify the decedent's intention with respect to his or her new spouse.

Particularly when the client is a single person and marriage is anticipated, the client's estate planning documents should state expressly and with clarity the client's intentions with respect to the client's future spouse. This can be accomplished with a provision in the family declarations portion of the will or trust indicating that marriage is anticipated or pending and whether the settlor intends to provide any benefits to his or her fiancé from assets under the settlor's will or trust or from other assets. The estate planner should be especially diligent in determining which assets the client wants to pass to a new spouse outside the client's will or trust. Life insurance, retirement benefits, or joint tenancy property can all figure in postdeath litigation over claims of an omitted spouse.

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§4.32 B. Omitted Children

Similar to the omitted spouse statutory protections discussed in §§4.30-4.31, if the decedent fails to provide by will or trust for a child born to or adopted by the decedent after the execution of the will or trust, the child is considered an "omitted" child, entitled to receive a share of the decedent's will or trust equal in value to what would be the child's intestate share in the absence of a will or trust, unless the decedent's failure to provide for the child is intentional and that intention appears from the instrument. See Prob C §§21620-21621. Similarly, if the child was living at the time the decedent signed his or her will or trust and the decedent failed to provide for that child either because the decedent falsely believed that the child was dead, or was simply unaware of the child's birth, the child is entitled to a statutory share of the decedent's estate. See Prob C §21622.

There are exceptions to the statutory share rule, but the planner should not rely on the exceptions. Careful questioning of the client will in most cases provide the planner with a good description of the client's existing family and anticipated future family. The planner should then clarify the client's intentions with respect to potential heirs and expressly and unambiguously recite the client's intentions in his or her testamentary documents.

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§4.33 VI. QUASI-COMMUNITY PROPERTY

Quasi-community property is one of the most frequently misunderstood and misapplied legal principles affecting estate planning. It is important for the planner to understand the concept and to identify quasi-community property both in the planning stage as well as in the administration of such property following death. Contributing to the difficulty, quasi-community property has differing definitions, depending on whether the doctrine is being applied in a marital dissolution context or a death context.

For a specific discussion of the impact of quasi-community property on planning for domestic partners and same-sex married couples, see §§4.58-4.60. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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A. Definition of Quasi-Community Property

§4.34 1. Family Code Definition

For marital dissolution purposes, quasi-community property is both real and personal property, wherever located, that would have been community property had the spouse been domiciled in California when he or she acquired it, or any property acquired in exchange for such property. See Fam C §125. The concept of quasi-community property was developed to solve the problem of married persons who acquire assets in another state and then move to California and dissolve their marriage or legally separate. The basic definition of community property does not include property acquired by married persons who do not reside in California at the time of the property acquisition. Hence, the concept of quasi-community property became necessary to provide for an equitable division of the married person's property at the time of divorce or separation.

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§4.35 2. Probate Code Definition

For inheritance purposes, Prob C §66 defines quasi-community property as including the following:

- All personal property wherever it is located, and all real property located in California, acquired by a deceased person while he or she was residing (domiciled) elsewhere, when the property would have been the community property of the decedent and the surviving spouse if the decedent had resided in California at the time of its acquisition; and
- All personal property wherever situated, and all real property located in California, that was acquired in exchange for real or personal property, wherever situated, when the property would have been community property of the decedent and the surviving spouse if the decedent had been domiciled in California at the time the property so exchanged was acquired.

Quasi-community property passes like community property under the rules of intestate succession (Prob C §6401) and the surviving spouse's right to take against the deceased spouse's will (see Prob C §101). However, in applying these rules, determining property rights at death for quasi-community property is significantly different from true community property. Quasi-community property rights attach only if the spouse survives, and cannot be enforced by a predeceased spouse's personal representative, unlike true community property. See §4.8. In other words, the division of property ignores any separate property of the surviving spouse that would have been characterized as quasi-community property if the order of death had been reversed. Also, for inheritance purposes, real property situated in another state cannot be quasi-community property.

If the deceased spouse owned quasi-community property, and made a transfer during life of such property without substantial consideration or spousal consent to or joinder in the transfer, the surviving spouse may require the third-party transferee to return one-half of such property to the decedent's estate, or one-half of its proceeds, or half of its value at the time of the transfer. See Prob C §102. However, to enforce this right, the deceased spouse generally must have retained an interest in the transferred property (*e.g.*, power to revoke, right of survivorship, right to income, possession, or enjoyment). Thus, the surviving spouse's right to challenge inter vivos transfers is substantially more limited for quasi-community property than for true community property.

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B. Planning Considerations

§4.36 1. Obtain Consent of Spouse Before Making Lifetime Gifts

When appropriate, the practitioner should advise a married client that a surviving spouse may be able to assert a valid claim to one-half of the client's quasi-community property at death. Although many conditions must be fulfilled under Prob C §102 to assert such claim, it would be prudent to obtain the consent of the married person's spouse before making large lifetime gifts of property that could be characterized as quasi-community property at death.

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§4.36A 2. Waiver of Restoration Right if Charitable Remainder Trust Funded With Quasi-Community Property

Under Rev Proc 2005-24, 2005-1 Cum Bull 909, for charitable remainder trusts (CRTs) created on or after June 28, 2005, if the IRS construes the Prob C §102 restoration right as a state law elective share right, for a CRT funded with property that could be characterized as quasi-community property at the death of the settlor, the failure to obtain a waiver of the Prob C §102 restoration right by the spouse of the settlor will cause the CRT to fail to qualify under IRC §664(d). Thus, when creating or funding a charitable remainder trust the practitioner should determine the character of any property used to fund the trust and, if the property could be characterized as quasi-community property at death, consider drafting a waiver of the Prob C §102 restoration right to be executed by the settlor's spouse. Notice 2006-15, 2006-8 Int Rev Bull 501, postpones the need for a waiver until further guidance is issued by the IRS. See discussion in §4.8A. For further discussion of charitable remainder trusts, see chap 24.

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§4.37 3. Designing the Estate Plan

The numerous married couples who have relocated to California pose special challenges to the estate planner. Initially, the attorney must carefully interview the clients to determine the extent of separate property that may be characterized as quasi-community property at death. Once this property has been identified, the estate planner must clarify the couple's intentions with respect to such property and give effect to those intentions in the estate plan. Failure to do so can have unintended consequences when there is substantial quasi-community property. For instance, in a typical three-trust (A-B-C, or QTIP) estate plan (see chap 17), if the surviving spouse claims a forced share of the deceased spouse's quasi-community property, the surviving spouse's one-half of such quasi-community property will ordinarily be added to the survivor's trust, which is revocable by the surviving spouse. The deceased spouse's one-half will be divided between the bypass trust and the QTIP trust depending on the formula in the instrument and the size of the estate. A QTIP trust is irrevocable and often does not allow the surviving spouse to redirect the eventual transfer of the property in the trust. The instrument should specify what happens to the forced share—is the survivor's one-half of the decedent's quasi-community property allocated to the survivor's trust, or is the surviving spouse waiving any entitlement to the forced share, so that it instead passes to the irrevocable bypass or QTIP trust?

For a discussion of three-trust estate plans, see chap 17.

As with community property, a husband and wife may agree in writing to divide their quasi-community property on the basis of a nonprorata division of the aggregate value of the quasi-community property, or on the basis of a division of each individual item or asset of quasi-community property, or partly on each basis. Prob C §101(b).

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§4.37A VII. TRANSMUTATION

The word "transmutation" is perhaps best understood as synonymous with conversion. Transmutation is the process by which property rights of married persons are changed. The separate property of one spouse can be converted to the community property of both spouses or to the separate property of the other spouse. Likewise, the community property of both spouses can be converted to the separate property of either spouse. See Fam C §850. Agreements transmuting property of either or both of the spouses are used for a variety of estate planning purposes. For example, it may be desirable in a long-term marriage to convert inherited separate property of one spouse to community property to achieve a "stepped-up" basis in the property at the first death of either spouse. IRC §1014(b)(6). See chap 12. By converting property in this manner, the married couple and their beneficiaries avoid unnecessary capital gains by receiving a double step-up in the basis (on both halves) of their newly created community property. Advantages of transmutation are discussed in §4.38. Disadvantages of transmutation are discussed in §4.38A. Requirements for a valid transmutation are discussed in §§4.39-4.39H. Limitations of transmutation are discussed in §4.39I.

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§4.38 A. Advantages of Transmutation

In some situations, if a married person has a substantially larger estate than his or her spouse, it may be advisable to transmute a portion of the married person's separate property to the separate property of the spouse to take full advantage of the applicable exclusion amount, should the married person's spouse predecease him or her. See chap 10.

In other situations, it may be necessary to transmute property so that the actual ownership of the property is consistent with the spouses' mutual understanding, particularly in cases when the spouses have agreed that one spouse should take title to real property in his or her name alone to facilitate financing of the property. In *Marriage of Brooks & Robinson* (2008) 169 CA4th 176, 86 CR3d 624, the real estate agent recommended that title to the marital home be taken solely in the wife's name because this would make it easier to obtain financing. Therefore, the husband consented to wife's taking title in her name alone. The couple used husband's earnings for the downpayment and husband made the payments on loans secured by two deeds of trust. The court held that the act of taking title in the name of one spouse with the consent of the other effectively removed the property from the general community property presumption of Fam C §760 and triggered the Evid C §662 title presumption that the property was the wife's separate property. Although the court explained that this presumption could be overcome by clear and convincing evidence that the title reflected in the deed was not what the parties intended, the evidence that title was taken in this manner to facilitate financing and that the downpayment and subsequent payments on the loans could be traced to the husband's community property earnings was insufficient to overcome the title presumption. (The Fam C §2581 presumption that jointly held property is community property did not apply because the property was not jointly held. See §4.39G.) The court concluded that the home was the wife's separate property. Few, if any, married couple clients would expect that, when they follow a realtor's recommendation to take title to the marital home in the name of one spouse alone to facilitate financing, that spouse would own the home as his or her separate property. A transmutation agreement would provide the clear and convincing evidence needed to overcome the title presumption so that both spouses will own their home in accordance with their expectations, as community property.

In Medi-Cal planning, transmutation of the family residence may be useful in a variety of scenarios to save as much as possible for the family of an incapacitated spouse. See chap 30.

Finally, transmutation agreements may be very useful in preventing postmortem litigation if both parties have expressly agreed to the character of their property.

For a specific discussion of transmutations by registered domestic partners and a discussion of how transmutations impact same-sex married couples differently from opposite-sex married couples, see §§4.61-4.63. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.38A B. Disadvantages of Transmutation

In harmonious and functional families, transmutations of property can achieve a number of advantages for the spouses and their intended beneficiaries. See §4.38. However, care should always be given to determining and documenting the clients' intentions before undertaking any specific transmutation of property. Care should also be taken when merely confirming the character of assets in estate planning documents. What often happens is that in a subsequent marital dissolution action, one spouse will argue that the transmutation is valid and the other will argue that no transmutation was intended. At best, the estate planning attorney will be a percipient witness. At worst, he or she will be a defendant in a malpractice action. Accordingly, the safest course of action for the practitioner may be to refuse to do any transmutation of property for estate planning purposes without requiring both spouses to have the agreement reviewed and approved by separate and independent legal counsel. If merely confirming the character of assets in estate planning documents, the safest course of action for the practitioner may be to inform the clients, in writing, that the practitioner is relying solely on the clients' representations regarding the separate and community characterization of their assets.

These disadvantages cannot be avoided by purporting to transmute property solely for the purpose of disposition on death. A transmutation for the purpose of disposition on death is also a transmutation for the purpose of marital dissolution. In *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385, the estate planning attorney represented both spouses in drafting an agreement "made solely for the purpose of interpreting how property shall be disposed of on the deaths of the parties" that "transmuted" the husband's separate property to community property. 166 CA4th at 1170. In the dissolution action initiated by the wife a year after the agreement was executed, the husband argued that the property remained his separate property for purposes of dissolution. The court disagreed and held that, notwithstanding language in the agreement "that purports to qualify, limit or condition the transfer upon the death of either spouse," there was a *present* transmutation of the husband's separate property to community property. 166 CA4th at 1169. Likewise, in *Marriage of Lund* (2009) 174 CA4th 40, 44, 94 CR3d 84, the estate planning attorney represented both spouses in drafting a property agreement that stated that it was the husband's desire for "estate planning purposes" that all of his separate property be converted to community property. In marital dissolution proceedings, the husband argued that his separate property had not been transmuted for purposes of dissolution, but the court held that a valid transmutation had occurred. Thus, all of the husband's previously separate property was characterized as community property for purposes of dissolution. There is no such thing as a transmutation for estate planning purposes only.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.39 C. Requirements for Valid Transmutation

§4.39 C. Requirements for Valid Transmutation

Regardless of the purpose for which transmutation is undertaken, the well-versed practitioner must ensure that the requirements for a valid transmutation are met. There are two requirements for a valid transmutation:

- The transmutation must comply with specific requirements as to form (see §§4.39A-4.39E).
- The transmutation must comply with the rules governing fiduciary relationships (see §§4.39F-4.39H).

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§4.39A 1. Form of Transmutation

The requirements as to form of transmutation are set forth in Fam C §852. These specific requirements, including the express declaration requirement discussed in §4.39B, apply to all transmutations of property except certain gifts of clothing, wearing apparel, jewelry, or other tangible articles of a personal nature. Fam C §852(c).

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§4.39B a. Express Declaration Requirement

A transmutation made on or after January 1, 1985, is not valid unless it is made in writing, by an express declaration that is made, joined in, consented to, or accepted by the spouse whose interest in the property is adversely affected. See Fam C §852(a). A writing signed by the spouse who is adversely affected is not an "express declaration" unless it contains language that expressly states that the characterization or ownership of property is being changed. In *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153, a wife with a community property interest in her husband's IRA executed a document consenting to his naming his children as the beneficiaries. The wife predeceased her spouse and her estate contended that she had not relinquished her community property interests in the IRA because her consent to the beneficiary designation did not satisfy the requirements of Fam C §852. The California Supreme Court agreed, concluding that a writing does not satisfy the statute "unless it contains language which expressly states that the characterization or ownership of the property is being changed." 51 C3d at 272. The court reasoned that the designation of a beneficiary to an IRA account did not contain any language characterizing the property in question, and further contained no language indicating that the adversely affected spouse was aware that the effect of her signature might be to alter the character of her ownership interest in the account. Thus, there was no "express declaration" that met the statutory requirement for transmutation agreements. For discussion of appellate court decisions interpreting the express declaration requirement, see §4.39C.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.39C b. Court Decisions Interpreting Express Declaration Requirement

§4.39C b. Court Decisions Interpreting Express Declaration Requirement

California appellate courts have provided some guidance as to the specific language that may or may not satisfy the "express declaration" requirement of Fam C §852. One court has held that the term "grant" does satisfy the express declaration requirement while another court has implied in dicta that the phrases "becomes community property" and "is changed into community property" also satisfy the express declaration requirement. On the other hand, one court has held that the term "transfer" does not satisfy the express declaration requirement. Another court has held that where the escrow instructions for the sale of a married couple's house provided "proceeds to be split 50/50" those escrow instructions did not satisfy the express declaration requirement. Another court has held that where a clause in the married couple's trust agreement provided that the property transferred to the trust is community property unless specifically identified as separate property and the separate property was not so identified, the clause does not satisfy the express declaration requirement. A bankruptcy court applying California law has held that a statement in a trust providing that all property listed on Schedule A is the community property of the parties does not satisfy the express declaration requirement.

In *Estate of Bibb* (2001) 87 CA4th 461, 468, 104 CR2d 415, a husband executed a deed purporting to "grant" his separate real property to himself and wife as joint tenants. The court concluded that the deed to the real property satisfied the statute because the word "grant" has the same meaning as the word "give." Accordingly, the "express declaration" requirement of the transmutation statute was met and the real property passed to the wife as a surviving joint tenant. The court also held, however, that a joint DMV title was insufficient to establish joint ownership of a Rolls Royce previously owned by one of the spouses.

In *Marriage of Barneson* (1999) 69 CA4th 583, 591, 81 CR2d 726, the court held that written directions by a husband to transfer stock into his wife's name were insufficient alone to transmute the securities from the husband's separate property to the wife's separate property. The court reasoned that the word "transfer" may reflect a change of ownership, but it does not necessarily do so and is therefore ambiguous. The transfer of title might have been made merely to facilitate management. Therefore, the transfer did not satisfy the "express declaration" requirement for a transmutation.

In *Marriage of Leni* (2006) 144 CA4th 1087, 50 CR3d 886, during a period of separation, husband and wife contracted to sell their house and the escrow instructions provided "proceeds to be split 50/50." 144 CA4th at 1091. Prior to the close of escrow, the parties reconciled but the escrow instructions were not amended. Thus, the proceeds of sale were disbursed in equal shares to each of the parties. Several years later the parties dissolved their marriage, and husband argued that the escrow instructions were a sufficient written declaration to transmute one half of the community proceeds of the sale to husband's separate property. The court held that those escrow instructions did not satisfy the express declaration requirement because they contained no express declaration that the character of the property was being changed. 144 CA4th at 1096.

In *Cecconi v Cecconi (In re Cecconi)* (Bankr ND Cal 2007) 366 BR 83, the court held that the statement, "The Settlors declare… that all property listed on schedule A [description of the Property] is the community property of the parties" did not meet the express declaration requirement of California law. 366 BR at 115. The court reasoned that the statement in the trust did not expressly state that the settlor was effecting a change in the character or ownership of the property. The court stated that it was not possible to tell from the face of the document, either the recitals in the trust or the entire trust document, that the settlor "was aware that the legal effect of her signature might be to alter the character or ownership of her beneficial interest in the property." 366 BR at 116.

In *Marriage of Starkman* (2005) 129 CA4th 659, 28 CR3d 639, where the husband conveyed his separate property into a joint revocable trust, and a clause in the trust provided that the property conveyed to the trust is community property unless identified as separate property, but the husband failed to identify the property conveyed as separate property, the court held that the express declaration requirement had not been met. Thus the husband's separate property had not been transmuted to community property. The court implied in dicta that the express declaration requirement would have been met if instead the clause had specified that any property transferred to the trust by either

spouse "becomes" or "is changed into" the community property of the parties. 129 CA4th at 665.

In *Marriage of Holtemann* (2008) 166 CA4th 1166, 83 CR3d 385, the husband and wife executed a transmutation agreement in which the husband agreed that his property is "hereby transmuted" from his separate property to community property. Distinguishing *Starkman,* where the word "transmutation" was never used, the *Holtemann* court explained that here the word "transmutation" was repeatedly used and held that the express declaration requirement had been met. 166 CA4th at 1173.

Given the uncertainty over whether any specific trial or appellate court will hold that specific language does or does not satisfy the express declaration requirement, when drafting documents in which the intent of both parties is to transmute separate property into community property, it would be best to include either the word "transmutation," as in *Holtemann*, or the phrase "the characterization of the property is being changed," which is nearly identical to the phrase quoted in §4.39B as used by the supreme court in *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153. However, any time the intent of the parties is to transmute separate property to community property, prior to drafting the instrument, the practitioner should consider the ethical issues involved in representing both parties to a transmutation agreement. See chap 2.

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§4.39D c. Exceptions to Statute of Frauds May Not Apply to Express Declaration Requirement

The California Supreme Court has interpreted the writing requirement of Fam C §852(a) more strictly than the writing requirements of some other California statutes. In *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471, finding "no evidence the Legislature intended to incorporate traditional exceptions to the statute of frauds," the court held that the equitable doctrine of partial performance does not provide an exception to the writing requirement of Fam C §852(a). Although the quoted language indicates that other traditional exceptions to the statute of frauds, such as estoppel, are unlikely to provide exceptions to this writing requirement, the court did not foreclose this possibility. The court explained that because the husband conceded that the facts of the case could not support an estoppel theory, the court "need not consider, in this case, whether there are any circumstances that might estop a marital partner from invoking section 852(a)." 36 C4th at 1109.

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§4.39E d. Express Declaration Requirement Not Always Applicable

There are cases in which a spouse has been unsuccessful in his or her attempt to invoke the stringent requirements of Fam C §852(a). For example, in *Hanf v Summers (In re Summers)* (9th Cir 2003) 332 F3d 1240, the court held that Fam C §852(a) did not apply when a married couple used community property funds to purchase a new property as joint tenants, reasoning that there simply was no interspousal transaction requiring application of the transmutation statute. Since this was an acquisition of property rather than a transmutation of property, the acquired property was joint tenancy property, with each spouse owning an undivided one-half interest. See also *Marriage of Brooks & Robinson* (2008) 169 CA4th 176, 86 CR3d 624, in which the court held that, when the wife took title to the marital home in her name alone to facilitate financing with the consent of the husband, the wife's initial acquisition from a third party did not constitute a transmutation and thus was not subject to Fam C §852(a) transmutation requirements. Because the husband could not produce clear and convincing evidence that the couple intended the home to be community property, the court held that the home was the wife's separate property.

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§4.39F 2. Presumption of Undue Influence in Transactions Between Spouses

Even if the transmutation clearly meets all of the requirements as to form set forth in Fam C §852 (see §§4.39A-4.39E)), the transmutation will not be valid if a court finds that one spouse unduly influenced the other spouse. Although often it is difficult to prove that a transaction was the result of undue influence, because spouses are in a confidential relationship with each other, frequently a rebuttable presumption of undue influence arises in transactions between spouses. See §4.39G. It is not easy to rebut this presumption. Therefore, the practitioner drafting a transmutation agreement should take great care that either the presumption does not arise or the presumption can be rebutted. See §4.39H.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.39G a. How Presumption of Undue Influence Arises

§4.39G a. How Presumption of Undue Influence Arises

California has a statutory presumption that spouses are in a confidential relationship with each other. See Fam C §§721, 1100(e). As a consequence, whenever one spouse gains an advantage over the other in an interspousal transaction, a rebuttable presumption arises that the transaction was the result of undue influence. *Marriage of Delaney* (2003) 111 CA4th 991, 996, 4 CR3d 378. There is conflicting authority concerning whether the presumption of undue influence arises when any advantage is obtained by a spouse or whether the spouse must obtain an unfair advantage for the presumption to arise. Many courts have held that one spouse gains an advantage over the other whenever his or her position is improved, or he or she obtains a favorable opportunity, or otherwise gains, benefits, or profits. See, *e.g., Marriage of Balcof* (2006) 141 CA4th 1509, 1519, 47 CR3d 183; *Marriage of Matthews* (2005) 133 CA4th 624, 629, 35 CR3d 1. On the other hand, at least one court has held that the presumption of undue influence does not arise in an interspousal transaction unless one spouse obtains an *unfair* advantage or obtains property for which no or clearly inadequate consideration has been given. *Marriage of Burkle* (2006) 139 CA4th 712, 717, 43 CR3d 181. Until this conflicting authority becomes settled, the prudent practitioner will recognize that the presumption may arise whenever any advantage is obtained by one spouse. Once the presumption of undue influence has arisen, the burden shifts to the advantaged spouse to rebut the presumption. If the advantaged spouse is unable to rebut the presumption, the transmutation is not valid.

Although the California Supreme Court has held that if the spouses elect to deal with each other at arm's length, the fiduciary obligations otherwise imposed by the confidential relationship are terminated (see *Marriage of Connolly* (1979) 23 C3d 590, 600, 153 CR 423), and as recently as 1989, appellate courts have followed this holding (see, *e.g., Marriage of Baltins* (1989) 212 CA3d 66, 88, 260 CR 403), it now appears that even if spouses elect to deal with each other at arm's length, they may not be able to avoid the fiduciary duties associated with confidential relationships.

In *Marriage of Delaney* (2003) 111 CA4th 991, 4 CR3d 378, the husband executed a grant deed conveying his unencumbered separate property residence to himself and his wife as joint tenants, in connection with a loan application, without questioning his wife's instructions that it was necessary to do so. The husband was severely limited in his reading ability and relied on his wife to handle all legal and financial matters. The court held that, when any interspousal transaction advantages one spouse to the disadvantage of the other, the presumption arises that such transaction was the result of undue influence because Fam C §721 subjects spouses to the same standards of disclosure toward each other as are applicable to any confidential fiduciary relationship. This presumption of undue influence prevails over the Evid C §662 presumption in favor of record title and over the Fam C §2581 presumption that property acquired in joint form during marriage is community property. Because the wife was unable to rebut the presumption of undue influence, the transmutation was not valid. Note also that the Evid C §662 record title presumption prevails over the Fam C §760 community property presumption when the presumption of undue influence does not trump both presumptions. See *Hanf v Summers (In re Summers)* (9th Cir 2003) 332 F3d 1240; *Marriage of Brooks & Robinson* (2008) 169 CA4th 176, 86 CR3d 624.

In *Marriage of Burkle* (2006) 139 CA4th 712, 43 CR3d 181, in which the spouses specifically waived their fiduciary responsibilities to each other in their postnuptial agreement, the court noted that it need not consider the question of whether such a waiver is permissible under California law, because the trial court had expressly found that the husband had fulfilled his fiduciary duties to the wife.

PRACTICE TIP: The prudent practitioner might consider drafting a transmutation agreement in which both spouses elect to deal with each other at arm's length and waive their fiduciary duties to each other—at least with respect to negotiation and execution of the transmutation agreement—while at the same time doing everything possible to ensure that the client fulfills his or her fiduciary duties to the other spouse. If a future court, deciding whether the transmutation agreement is enforceable, accepts the waiver of fiduciary duties as permissible under California law, the presumption of undue influence should not arise, but if the future court decides that spousal fiduciary duties cannot be waived, the client will still be able to argue that he or she meets all of the tests enumerated in §4.39H for rebutting the presumption of undue influence.

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§4.39H b. Rebutting the Presumption of Undue Influence

The advantaged spouse must prove all three of the following elements to rebut the presumption of undue influence: (1) the disadvantaged spouse freely and voluntarily entered into the transaction, (2) the disadvantaged spouse had full knowledge of all of the facts, and (3) the disadvantaged spouse had a complete understanding of the legal effect of the transaction. See *Marriage of Delaney* (2003) 111 CA4th 991, 1000, 4 CR3d 378. The first and third elements are more likely to be met if the disadvantaged spouse is represented by independent counsel. The second element requires full disclosure by the advantaged spouse of both the character and the value of the property subject to the transaction. See Fam C §1100(e). If the disadvantaged spouse is not fully informed of the Fam C §2640 right of reimbursement and how that right may or may not be impacted by the transaction, the third element may not be possible to meet.

There is conflicting authority concerning the standard of proof required to rebut the presumption of undue influence. Some older decisions require clear and convincing evidence. See, *e.g., Bank of America v Crawford* (1945) 69 CA2d 697, 701, 160 P2d 169. More recent decisions generally have not specified the standard of proof required to rebut the presumption. However, three decisions have now clearly identified preponderance of the evidence as the standard of proof required to overcome the presumption. See *Marriage of Balcof* (2006) 141 CA4th 1509, 1520, 47 CR3d 183; *Marriage of Burkle* (2006) 139 CA4th 712, 738, 43 CR3d 181; *Marriage of Matthews* (2005) 133 CA4th 624, 631, 35 CR3d 1.

PRACTICE TIP: Because almost all transmutations at least arguably advantage one spouse over the other spouse, with the possible exception of a sale for fair market value, and because by relying on older decisions, it could still be argued that the standard of proof required to rebut the presumption is clear and convincing evidence, it is important to take as many steps as possible toward rebutting the presumption of undue influence when planning a transaction or agreement. If the practitioner represents only one spouse, he or she should at least recommend, or perhaps require, the other spouse to be represented by independent counsel and confirm that the independent counsel has advised the other spouse, in writing, of his or her legal rights prior to the transmutation as well as how those rights are altered by the transmutation. Further, the practitioner should at least recommend, or perhaps require, the client to make full disclosure to the other spouse of both the character and the value of the property subject to the transaction or agreement. If the practitioner represents both spouses, he or she should carefully review the ethical implications of representing both parties to the transaction and seriously consider recommending that both spouses obtain the advice of separate independent counsel prior to executing the transaction documents or agreement. See chap 2.

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§4.39I D. Valid Transmutation May Not Waive Fam C §2640 Right to Reimbursement

Family Code §2640, applicable on dissolution but not at death, provides a stronger right of reimbursement for a spouse's separate property contributions to the community property estate than for a spouse's separate property contributions to the other spouse's separate property estate. On dissolution, a spouse has a right to reimbursement for his or her separate property contributions to the other spouse's separate property estate *unless* there has been (1) a transmutation pursuant to the Family Code *or* (2) a written waiver of the right to reimbursement. Fam C §2640(c). Thus, if the spouses intend to transmute one party's separate property to the other party's separate property, it should not be necessary to also execute a waiver of the right to reimbursement. However, to make it possible to rebut the presumption of undue influence (see §4.39H), the party giving up the separate property should be informed in writing that by transmuting the property he or she is giving up the legal right to reimbursement.

On the other hand, Fam C §2640(b) provides that a spouse has a right to reimbursement for his or her separate property contributions to the community property estate *unless* there has been (1) a written waiver of the right to reimbursement or (2) a signed writing that has the effect of a waiver. There is no mention of a transmutation altering the right to reimbursement. In *Marriage of Holtemann* (2008) 166 CA4th 1166, 1175, 83 CR3d 385, where the transmutation agreement made it clear that the husband transmuted his separate property to community property but made no reference to Fam C §2640, the appellate court agreed with the trial court finding that the transmutation did not affect the husband's §2640(b) right to seek reimbursement.

Courts construing the meaning of a signed writing that has the effect of a waiver have held that a gift deed transferring separate property to the community property estate does not have the effect of a waiver of the right to reimbursement. See, *e.g.*, *Marriage of Perkal* (1988) 203 CA3d 1198, 250 CR 296; *Marriage of Carpenter* (2002) 100 CA4th 424, 429, 122 CR2d 526. See Practice Under the California Family Code: Dissolution, Legal Separation, Nullity §5.95 (Cal CEB Annual). Courts have also held that a waiver must be made in separate writing and cannot be made in the same deed that created a presumption of community property. See *Marriage of Carpenter, supra*; *Marriage of Kahan* (1985) 174 CA3d 63, 71, 219 CR 700. Although it is conceivable that some type of transmutation transaction would also be construed as a waiver of the Fam C §2640(b) right to reimbursement, if the parties to the transmutation desire that the party to whom the separate property belonged is not to be reimbursed for the contribution to the community property estate, the prudent practitioner will have the contributing party execute a written "waiver of the Fam C §2640(b) right to reimbursement" in a separate document from a deed.

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§4.40 E. Drafting Transmutation Agreements

Although no specific words are necessary to meet the statutory requirements set forth in Fam C §852 when drafting transmutation agreements, it is preferable to avoid any ambiguity or uncertainty regarding the parties' intentions. Unlike most contracts, no consideration is required for a valid transmutation agreement. See Fam C §850. The estate planner should always include a statement of transmutation expressly declaring that the character of the property is being changed. For example, if the attorney recommends changing a joint tenancy residence to community property as part of the plan for a married couple, the attorney should have the spouses execute either a new deed to the residence that makes that change or have them sign a separate written transmutation agreement containing recitals explaining that the purpose of the agreement is to transmute the parties' interests in the residence into community property. Similarly, a married couple may wish to transmute all their separate property IRAs to community property and then use an aggregate theory agreement to optimize the funding of subtrusts after the death of the first spouse. See Bilter, *Estate Planning for Community Property Qualified Retirement Benefits*, Estate Planning 1993 (Cal CEB 1993). Likewise, if the estate planner is assisting an elderly couple with Medi-Cal eligibility planning by transmuting community property or separate property of a Medi-Cal beneficiary spouse to the separate property of the other spouse to avoid a risk of later claims (see chap 30), the planner should make certain that the transmutation agreement expressly changes the character of the property and waives and releases any further community or separate property interests.

The best guidance for drafting a transmutation agreement in which the presumption of undue influence is less likely to arise may come from the decision in *Marriage of Burkle* (2006) 139 CA4th 712, 717, 43 CR3d 181, in which the wife challenged the transmutation agreement as unenforceable because of, among other things, the presumption of undue influence. The court concluded that the "presumption does not apply to a postmarital agreement in which [1] both spouses obtain advantages; [2] both are represented by independent and competent legal counsel; [3] the wife is offered full access to the husband's business records relating to the marital assets; and [4] both spouses acknowledge in the agreement that neither has obtained any unfair advantage as a result of the agreement." 139 CA4th at 717.

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§4.40A VIII. ESTATE PLANNING FOR CLIENTS IN THE PROCESS OF DISSOLVING MARRIAGES

Automatic temporary restraining orders (ATROs) impose substantial obstacles on estate planning for clients who are in the process of dissolving their marriages. See Fam C §2040. These ATROs are pre-printed on the second page of the Family Law Summons that is required to be filed and served with any Petition for Dissolution of Marriage. See Judicial Council Form FL-110.

The petitioner is restrained as soon as the petition has been filed and summons issued. Fam C §233(a). The respondent is restrained on personal service of the petition and summons or on waiver and acceptance of service. Fam C §233(a). These ATROs remain in effect until the petition for dissolution is dismissed, a judgment is entered, or the court makes further orders. Fam C §233(a).

Although the summons is not a part of the summary dissolution procedure, only couples with no minor children of the relationship, minimal assets, and no real property, who have been married less than 5 years, are eligible to use the summary procedure. Fam C §2400. Thus, most estate planning clients are not eligible for the summary procedure. The practitioner must be careful not to recommend that the client take any actions that violate the ATROs.

There are four levels of restraint on unilateral actions by one spouse imposed by the ATROs under Fam C §2040: (1) Certain actions are entirely prohibited (see §4.40B); (2) certain actions are prohibited unless the other spouse provides written consent or the court issues an order permitting the action (see §4.40C); (3) certain actions are allowed, but only with prior notice to the other spouse, including revoking a revocable trust or other nonprobate transfer (see §4.40D); and (4) certain actions are allowed even without notice to the other spouse, including revoking a will and creating a new unfunded revocable trust to be funded by a new pourover will (see §4.40E).

For a specific discussion of estate planning for partners in the process of dissolving their domestic partnerships, see §4.64. For a general discussion of how legislation, initiative measures, and court decisions impact planning for domestic partners and same-sex married couples, see §§4.41-4.41B.

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§4.40B A. Actions Prohibited Entirely

The automatic temporary restraining order (ATRO) restrains each spouse from cashing, borrowing against, canceling, transferring, disposing of, or changing the beneficiaries of any insurance or other coverage, including life, health, auto, or disability, held for the benefit of the spouses and their children for whom support may be ordered. Fam C §2040(a)(3).

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.40C B. Actions Prohibited Without Prior Written Consent

§4.40C B. Actions Prohibited Without Prior Written Consent

The automatic temporary restraining order (ATRO) restrains each spouse from taking any of the following actions without the prior written consent of the other spouse or an order of the court:

- Transferring any property, real or personal (whether community property or separate property), except in the usual course of business or for the necessities of life. Fam C §2040(a)(2). Among other things, this means that the client may not make gifts absent consent or a court order.
- Creating or modifying any nonprobate transfer in a manner that affects the disposition of the property subject to the transfer. Fam C §2040(a)(4). Among other things, this means that the client may not change the beneficiary designations of retirement accounts or the dispositive provisions of a revocable trust absent consent or a court order.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.40D C. Actions Permitted With Prior Notice

§4.40D C. Actions Permitted With Prior Notice

Notwithstanding the automatic temporary restraining order (ATRO), each spouse is allowed to take any of the following actions, provided that notice of the change is filed with the court and served on the other spouse before the change takes effect:

- Revoking a revocable trust or other nonprobate transfer, pursuant to the terms of the instrument. Fam C §2040(b)(2).
- Eliminating the right of survivorship to property, such as by severing a joint tenancy. Fam C §2040(b)(3).

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§4.40E D. Actions Permitted Without Notice

Notwithstanding the automatic temporary restraining order (ATRO), each spouse is allowed to take any of the following actions without notice to the other spouse:

- Creating, modifying or revoking a will. Fam C §2040(b)(1).
- Creating an unfunded revocable or irrevocable trust. Fam C §2040(b)(4).
- Modifying a nonprobate transfer, such as a trust, in a manner that does not affect the disposition of the property, for example, by changing the designated successor trustee of a trust. See Fam C §2040(a)(4) and Cal Law Revision Comm'n Comment to Fam C §2040 on the 2001 amendment to §2040(a)(4).

This means that when a client who is in the process of dissolving his or her marriage wants to change his or her estate plan, the client can: (1) revoke the client's current trust and sever any joint tenancy, provided that notice is filed and served on the other spouse before the changes take effect (see §4.40D); (2) without notice to the other spouse, revoke the current will and execute a new pourover will; and (3) without notice to the other spouse, create a new unfunded revocable trust into which the new will pours all of the client's assets. Thus, the client still has the ability to implement a new estate plan with all of the dispositive provisions he or she desires. However, the client will be unable to avoid probate without the consent of the other spouse or a court order allowing funding of the revocable trust.

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§4.41 IX. OVERVIEW OF ESTATE PLANNING FOR DOMESTIC PARTNERS AND SAME-SEX MARRIED COUPLES

Registered domestic partners and same-sex married couples face almost all of the same property transfer obstacles as opposite-sex married couples. However, there are several additional issues, particularly with respect to federal law, that impact planning for domestic partners and same-sex married couples. For the general issues impacting planning for domestic partners, see §4.41A. For the general issues impacting planning for same-sex married couples, see §4.41B. Particular transfer obstacles applicable to domestic partners and same-sex married couples are discussed in §§4.42-4.64.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.41A A. Overview of Issues Impacting Estate Planning for Domestic Partners

§4.41A A. Overview of Issues Impacting Estate Planning for Domestic Partners

Most of the state law rights and responsibilities of married couples also apply to registered domestic partners. Fam C §297.5. When this legislation went into effect on January 1, 2005, there were three major exceptions:

- Registered domestic partners were not permitted to file joint state income tax returns (former Fam C §297.5(g));
- Earned income was not treated as community property for state income tax purposes (former Fam C §297.5(g)); and
- The California Domestic Partner Rights and Responsibilities Act of 2003 (Fam C §§297-299.6) does not amend or modify any provision of the California Constitution or any provision of any California statute that was adopted by initiative. Fam C §297.5(i) (former Fam C §297.5(j)).

All of these initial exceptions have been effectively overridden by further legislation. The exception in Fam C §297.5(i) is usually interpreted to refer to measures relating to the availability of exemptions from property tax reassessment under Proposition 13 and its progeny. Nevertheless, in 2005, the legislature enacted an exemption from reassessment that applied to all transfers of real property on or after January 1, 2006, between registered domestic partners, including transfers in trust and transfers at death. See Stats 2005, ch 416. In 2007, the legislature made this Rev & T C §62(p) exclusion from reassessment effective on January 1, 2000. See Stats 2007, ch 555. In *Strong v State Bd. of Equalization* (2007) 155 CA4th 1182, 66 CR3d 657, the court held that the legislature had the authority to create the exclusion in Rev & T C §62(p) without violating Proposition 13. The *Strong* decision did not consider the 2007 amendment to Rev & T C §62(p), but if the amendment is challenged, it seems likely that, using similar reasoning, the court would hold that the legislature also had the authority for the amendment to the statute.

The legislature has further amended Fam C §297.5 to remove the other two exceptions from the code. The codified legislative explanation indicates that, for tax years beginning on or after January 1, 2007, which generally affects income tax returns filed beginning in 2008, registered domestic partners are required to file California income tax returns jointly or separately on terms similar to those governing spouses, as provided by Rev & T C §18521(d), and the earned income of domestic partners shall be recognized as community property. See Stats 2006, ch 802.

However, the IRS has ruled that California registered domestic partners may not report their earnings as community income for federal income tax purposes, on the basis of its interpretation of the U.S. Supreme Court decision in *Commissioner v Harmon* (1944) 323 US 44, 89 L Ed 60, 65 S Ct 103, in which the Court held that income-splitting was not allowed under a state statute that permitted married couples to elect community property. See IRS Legal Memorandum 200608038, discussed in Denham, *Harmonizing* Harmon: *Taxing Earned Income of California Registered Domestic Partners as Community Property Under Federal Law*, 27 CEB Est Plan Rep 153 (June 2006).

Family Code §297.5(k)(1) imposes most of the California rights and responsibilities of marriage on registered domestic partners *retroactively* to their date of registration with the State of California, which could have been as early as January 1, 2000. The practitioner advising registered domestic partners must be very careful in determining the characterization of property owned by the partners, because any property acquired since the partners registered, including wages, may have converted to community property by operation of law on January 1, 2005. It seems certain that eventually someone will challenge this retroactive application of the law by arguing that it unconstitutionally impairs vested property rights. However, it will not be known whether this retroactivity is constitutional until the California Supreme Court has decided the issue, which may not be for several years.

Whether the California Supreme Court will ultimately hold that the retroactive application of the Act is Constitutional is anyone's guess. Thus, it is very important that practitioners plan for both possibilities (1) that the Act impacts property, including wages, acquired by the partners since their date of registration, which could have been as early as January 1, 2000, or (2) that the Act impacts only property acquired by the partners since the Act went into effect on January 1, 2005. Practitioners must be aware that these issues are very complex and entirely unsettled and approach the issues with great care. For further discussion of some of these issues see Allphin, *New Domestic Partnership Legislation and Its Impact on Estate Planning and Administration*, 10 Cal Trusts & Estates Quarterly 4 (Spring 2004).

There are now many obstacles and impediments to the transfer of property by registered domestic partners. For example, if a domestic partner does not obtain the written consent of his or her partner prior to making a gift of community property, the gift might later be set aside. Also, the family protection statutes may frustrate the domestic partner's estate plan if they are not carefully considered in planning and designing the domestic partner's will. Moreover, if the domestic partner attempts to transmute property without complying with the statutory requirements that previously applied only to married couples, the transmutation will not be valid. In addition, the transmutation of property from one domestic partner to the other is generally a gift taxable transaction under federal law.

It is important to note that the Act only impacts domestic partners who have registered with the California Secretary of State. Most same-sex couples at least 18 years of age, and opposite-sex couples in which at least one partner is over the age of 62, who share a common residence are permitted to register as domestic partners. See Fam C §297. Since many California cities and counties permit registration by domestic partners, in order to plan effectively for domestic partners, the practitioner must make sure that the couple has registered as domestic partners with the Secretary of State, prior to altering any estate planning documents in recognition of the estate planning obstacles for registered domestic partners discussed in this chapter.

The effect of the Act is to change the interpretation of the terms "spouse," "husband," "wife," "widow," "widower," "marriage," and "marital status" to include within their scope the terms "domestic partner" and "domestic partnership." This new interpretation is to be applied to all occurrences of these terms in California statutes, administrative regulations, court rules, government policies, common law, and any other provisions or sources of law, with the exception of the California Constitution and any provision of any California statute that was adopted by initiative. See Fam C §297.5(a)-(d), (i).

In contrast, there will be no new interpretation of these terms under federal law. The federal Defense of Marriage Act (Pub L 104-199, 110 Stat 2419) provides that (1 USC §7):

> In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word "marriage" means only a legal union between one man and one woman as husband and wife, and the word "spouse" refers only to a person of the opposite sex who is a husband or a wife.

On September 15, 2009, legislation was introduced in the House of Representatives by Jerrold Nadler (D-NY) to repeal the federal Defense of Marriage Act. See HR 3567, entitled the Respect for Marriage Act. As of October 13, 2009, the Respect for Marriage Act had gained 101 co-sponsors. Nonetheless, until this legislation is signed into law by President Obama or the constitutionality of the Defense of Marriage Act is tested in the courts, the Defense of Marriage Act will continue to control the interpretation of the terms "marriage" and "spouse" for purposes of federal law.

There are, in effect, two sets of rules of construction: state law rules providing that the term "spouse" must include registered domestic partners and federal rules providing that the term "spouse" must not include same-sex domestic partners. The result is that same-sex domestic partners are extended almost all of the state law rights and responsibilities associated with marriage, but almost none of the federal rights and responsibilities associated with marriage. This dual system introduces enormous complexity to the practitioner's efforts to plan for domestic partners. For an in-depth analysis of all aspects of the enormous complexity of this dual system for domestic partners, see California Domestic Partnerships (Cal CEB 2005).

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.41B B. Overview of Issues Impacting Estate Planning for Same-Sex Married Couples

§4.41B B. Overview of Issues Impacting Estate Planning for Same-Sex Married Couples

On May 15, 2008, the California Supreme Court held that the portions of Fam C §§300 and 308.5 limiting marriage to a union between a man and a woman are unconstitutional and therefore cannot stand. See *In re Marriage Cases* (2008) 43 C4th 757, 76 CR3d 683. When this decision became final on June 16, 2008, same-sex couples began to marry in California. On November 4, 2008, Proposition 8 was passed by the voters and added the following statement to the California Constitution (Cal Const art I, §7.5): "Only marriage between a man and a woman is valid or recognized in California," thereby eliminating the right of same-sex couples to marry in California. The California Supreme Court upheld Proposition 8, holding that it is only the designation of "marriage" for officially recognized same-sex relationships that was removed by this initiative measure, and explaining that the strict scrutiny standard of review continues to apply in all contexts other than the specific subject of the designation of "marriage" to statutes that classify or discriminate on the basis of sexual orientation. See *Strauss v Horton* (2009) 46 C4th 364, 93 CR3d 591. On May 22, 2009, two same-sex couples filed suit in the U.S. District Court for the Northern District of California, arguing that Proposition 8 violates the U.S. Constitution's guarantees of due process and equal protection of the laws. See *Perry v Schwarzenegger* (ND Cal, May 22, 2009, No. 09-CV-2292 VRW). Although trial commenced on January 11, 2010, the case is likely to take several years to work its way to the U.S. Supreme Court. In the meantime, unless voters pass another initiative measure overturning Proposition 8, the measure will remain valid.

It has been estimated that approximately 18,000 same-sex couples were married in California between June 16, 2008, and November 4, 2008. In *Strauss v Horton* (2009) 46 C4th 364, 93 CR3d 591, the California Supreme Court held that those marriages remain valid. The court's reasoning made it clear, however, that if another initiative measure passes that *explicitly* invalidates those marriages, such an initiative could be valid as a permissible constitutional amendment. In addition to the valid marriages contracted in California prior to November 5, 2008, as a result of legislation enacted in 2009, Fam C §308(a) now provides that "a marriage between two persons of the same sex contracted outside this state that would be valid by the laws of the jurisdiction in which the marriage was contracted is valid in this state if the marriage was contracted prior to November 5, 2008." See Stats 2009, ch 625. Thus, although same-sex couples have not been allowed to marry in California since November 4, 2008, and same-sex marriages contracted in other jurisdictions after November 4, 2008, are not recognized by California as valid marriages, California estate planners will continue to see many same-sex married couples in their practices.

PRACTICE TIP: Under California law, a couple may be simultaneously married and registered with the California Secretary of State as domestic partners. See Fam C §297(b)(2). In the event that the proponents of Proposition 8 introduce another measure that attempts to explicitly invalidate these existing same-sex marriages, practitioners should consider advising their same-sex married clients to register as domestic partners with the California Secretary of State, if they have not done so already. Because the rights and responsibilities of registered domestic partners are nearly identical to the rights and responsibilities of same-sex married couples, by also registering as domestic partners, these same-sex married clients can avoid the legal uncertainty associated with a marriage that might later be invalidated by such an initiative, if it were to pass.

The federal Defense of Marriage Act defines the word "spouse" as referring only to a person of the opposite sex. See 1 USC §7. Thus, similarly to domestic partners, same-sex spouses are extended all of the state law rights and responsibilities associated with marriage, but almost none of the federal rights and responsibilities associated with marriage. Similarly to domestic partners, same-sex spouses are denied the benefit of the unlimited federal marital deduction from estate and gift tax. Also similarly to domestic partners, same-sex spouses are likely to be denied the benefit of the step-up in the basis on both halves of the community property for federal income tax purposes at the death of the first spouse under IRC §1014.

There are only two significant legal differences between same-sex marriage and registered domestic partnership. First, a judgment of dissolution of marriage may not be entered unless one of the parties to the marriage has been a California resident for at least 6 months and a resident of the county in which the dissolution proceeding was filed for at

least 3 months prior to when the petition was filed. Fam C §2320. In contrast, a proceeding for dissolution of a California domestic partnership may be filed even if neither party to the domestic partnership is a resident of California. See Fam C §299(d).

The second significant legal difference between same-sex spouses and domestic partners pertains to the federal income tax treatment of community property. Although the IRS has ruled in a Chief Counsel Advice that California registered domestic partners may not report their earnings as community income for federal income tax purposes, portions of the reasoning in that memorandum do not apply to same-sex spouses. IRS Legal Memorandum 200608038. The IRS reasoned that the "case law relating to income-splitting in community property states has always arisen solely in the context of spouses" and asserted that the "relationship between registered domestic partners under the California Act is not marriage under California law." In contrast, individuals in a same-sex marriage are undeniably spouses in a marriage under California law. On the other hand, other aspects of the reasoning in that memorandum do apply to same-sex spouses. The IRS distinguished the *Poe v Seaborn* (1930) 282 US 101, 75 L Ed 239, 51 S Ct 58, decision requiring income-splitting of community property on the basis that it applied to "a husband and wife," explaining that the decision does not apply to "a state's community property law outside the context of a husband and wife." Because a same-sex marriage would not involve a husband and wife, but rather a husband and husband or a wife and wife, the IRS might similarly refuse to apply the *Seaborn* reasoning to same-sex spouses. Thus, unlike domestic partners who may not report their earnings as community income, it is not yet clear whether the IRS will rule that same-sex spouses may not report their earnings as community income.

The dual system of differing federal and state rights makes the practitioner's efforts to plan for same-sex married couples just as complex as planning for domestic partners. For an in-depth analysis of all aspects of the enormous complexity of this dual system for domestic partners, a complexity that is generally equally applicable to same-sex married couples, see California Domestic Partnerships (Cal CEB 2005).

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X. ADDITIONAL PROPERTY TRANSFER OBSTACLES FOR DOMESTIC PARTNERS AND SAME-SEX MARRIED COUPLES

§4.42 A. Gifts of Community Property by Domestic Partners

Family Code §760, relating to community property, should be construed to include the following meaning with regard to registered domestic partners: "Except as otherwise provided by statute, all property, real or personal, wherever situated, acquired by a [person in a domestic partnership] during the [domestic partnership] while domiciled in this state is community property." See Fam C §297.5(a). Because domestic partners thus are able to acquire community property, the California rules pertaining to gifts of community property by spouses will apply equally to gifts of community property by domestic partners. For a detailed discussion of gifts of community property by spouses, see §§4.2-4.8.

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§4.43 1. Consent of Domestic Partner Required for Most Gifts

Because Fam C §§1100-1102 is interpreted to apply to domestic partners as well as spouses, a domestic partner generally cannot make a gift of community personal property, or dispose of community personal property, for less than fair and reasonable value without the written consent of the other domestic partner. Fam C §1100(b). Except for short-term leases, a domestic partner cannot transfer or encumber community real property without the joinder of the other domestic partner. Fam C §1102(a). The estate planner's failure to obtain the written consent or joinder of a domestic partner to a gift of community property can cause the gift to be ineffective, which can lead to litigation and malpractice claims. For exceptions to the requirement that the consent or joinder of the other domestic partner be obtained, see Fam C §1103.

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§4.44 2. Effect of Gift Without Consent of Domestic Partner

Based on the case law applicable to spouses discussed in §4.5, a gift transaction involving community property that is undertaken unilaterally by a registered domestic partner may be set aside or declared void on legal action by the nonconsenting domestic partner or the partner's successors, but is not void in itself. Only the nonconsenting domestic partner or his or her representative may seek to set aside an invalid gift. Lack of consent by one domestic partner cannot be used by the transferring partner to avoid the transaction. The transferring partner is fully bound as though it were a gift of his or her separate property.

Gifts of community property may be invalidated in their entirety during the lifetime of the donor domestic partner. Following the death of a domestic partner who made a unilateral gift without consent, the nonconsenting domestic partner may void the gift to the extent of the nonconsenting domestic partner's one-half community interest.

A legal action for violation of a property right survives the death of the owner of that right. See Prob C §§7000-7001. Therefore, a deceased partner's legal representative may seek to set aside the gift made without the partner's consent.

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§4.45 3. Breach of Domestic Partner's Fiduciary Duties

Because all statutory references to spouses are interpreted to include registered domestic partners, domestic partners are subject to the same fiduciary duties toward one another as spouses. In addition to an action to set aside an unauthorized gift, a nonconsenting domestic partner may seek remedies for breach of domestic partner fiduciary duties under Fam C §1101. Some of the remedies available for breach of fiduciary duties are for the court to order an accounting of the property, determine ownership rights as well as beneficial enjoyment of or access to community property, determine the classification of all property of the parties to a domestic partnership, or award attorney fees and costs in addition to the value of the transferred property. For a detailed discussion of spousal fiduciary duties, see §4.7.

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§4.46 B. Domestic Partner's or Same-Sex Spouse's Consent to Name Beneficiaries of Nonprobate Community Property

The most significant nonprobate transfers include life insurance, IRAs, 401(k) plans, annuity contracts, and revocable trusts. These and other nonprobate transfers will present additional obstacles in planning for registered domestic partners because of the requirement of domestic partner consent. The intertwined nature of federal and state law further complicates planning. In some cases, it will be simpler to plan for domestic partners and same-sex married couples than opposite-sex married couples, because the federal laws that preempt state community property laws with regard to opposite-sex spouses are not applicable to domestic partners and same-sex spouses. However, in other cases it may be even more difficult to plan for domestic partners and same-sex married couples because it may not be clear whether a particular area of law is driven entirely by federal law or by some mixture of federal and state law. See §§4.47-4.50.

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§4.47 1. Nonprobate Transfer Statutes Apply to Domestic Partners

Statutes governing nonprobate transfers of community property that take effect on death apply equally to domestic partners. See Fam C §297.5(c). These statutes apply to any nonprobate transfer of community property with respect to interests in insurance policies, contracts of employment, bonds, mortgages, promissory notes, certificated or uncertificated securities, account agreements, custodial agreements, deposit agreements, compensation plans, pension plans, individual retirement plans, employee benefit plans, trusts, conveyances, deeds of gift, property agreements, and other written instruments of a similar nature. See Prob C §§5010-5032.

Of particular importance to the estate planner helping clients to achieve their planning objectives is the statutory requirement set forth in Prob C §5021(a), under which a nonprobate transfer made without the requisite consent may be set aside with respect to the interest of the nonconsenting domestic partner. The failure of the estate planning attorney to advise his or her client to obtain that consent can be disastrous.

These statutes must be considered by any estate planning attorney preparing wills or trusts for domestic partners, because special will and trust provisions are often necessary to deal with some of the possible effects of these statutes. The impact of these statutes on domestic partners will be similar to their impact on spouses. For a detailed discussion of the impact of nonprobate transfer statutes on spouses, see §§4.10-4.15.

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§4.48 a. Requirement of Domestic Partner's Consent

Probate Code §5020 should be construed to include the following meaning with respect to registered domestic partners: "A provision for a nonprobate transfer of community property on death executed by a [domestic partner] without the written consent of the [other domestic partner] (1) is not effective as to the nonconsenting [domestic partner's] interest in the property and (2) does not affect the nonconsenting [domestic partner's] disposition on death of the nonconsenting [domestic partner's] interest in the community property by will, intestate succession, or nonprobate transfer." For purposes of this requirement, a written joinder in a provision for nonprobate transfer of community property on death constitutes a valid consent to the transfer. Prob C §5010.

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§4.49 b. Practical Effect of Domestic Partner Consent Requirement

Because changes in beneficiaries made by the surviving registered domestic partner after the deceased partner's death are ordinarily ineffective to dispose of the deceased partner's portion of the community property, the surviving domestic partner's ability to change beneficiaries of a life insurance policy, IRA, or other similar interest is substantially restricted under the California nonprobate transfer statutes. The surviving domestic partner can change the beneficiaries of his or her own one-half community property interest, but cannot alter the beneficiary last consented to by the deceased partner of his or her interest, unless the deceased partner specifically allows the surviving domestic partner to change the beneficiary after his or her death. See Prob C §§5010-5032.

Clients' desires on these significant legal issues will vary. A domestic partner in a long-term relationship, especially with children resulting from the relationship, may simply have confidence in the judgment of the other partner and be willing to grant the surviving partner broad rights to dispose of all the partners' assets. On the other hand, even a domestic partner in a long-term relationship may be reluctant to grant the surviving domestic partner such broad rights, because even the concept of community property will be entirely new to many domestic partners.

For example, if a domestic partner accrued employment-related pension benefits during the course of the domestic partnership, those pension benefits previously belonged solely to employee. Employment-related pension benefits accrued since the partners registered their partnership with the State are the community property of both partners by operation of law. Fam C §297.5(k)(1). See §4.50. The employee partner may even express shock that he or she no longer owns 100 percent of his or her pension and no longer has the right to dispose of 100 percent of that pension exactly as he or she pleases, without consent of the other partner. The estate planner's role is to explore these feelings with the client and design an estate plan consistent with the client's objectives. If consistent with the client's objectives, the estate planning attorney should consider advising clients in the design stage of the planning process of the benefits and detriments of including a provision under which one domestic partner effectively restores to the other domestic partner absolute power of disposition over nonprobate community property assets.

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§4.50 2. Special Issues With Retirement Plans for Domestic Partners and Same-Sex Married Couples

Due to the intertwined nature of federal and state law with regard to retirement plans, the issues that arise for domestic partners and same-sex married couples in the context of retirement plan accounts and benefits will be extremely complex. There are, in effect, two sets of rules of construction: state rules providing that the term "spouse" must include registered domestic partners and federal rules providing that the term "spouse" must not include domestic partners. See §4.41A.

The problem presented by these conflicting interpretations is that, in many areas of law, federal and state laws are intertwined, such that it will be very difficult to determine when to follow state rules of construction and treat domestic partners and same-sex spouses exactly like opposite-sex spouses and when to follow federal rules of construction and treat domestic partners and same-sex spouses as unrelated individuals. It is not yet known how these conflicting interpretations of the term "spouse" under federal and state law will impact retirement plans for domestic partners and same-sex spouses. In most cases, domestic partners and same-sex spouses probably will continue to be treated as unrelated individuals for purposes of federal law (when it intersects with state law). However, when treating domestic partners and same-sex spouses like opposite-sex spouses could result in additional revenue for the federal government, the government may argue that due to the intersection of federal and state law in that particular case, domestic partners and same-sex spouses should be treated like opposite-sex spouses.

Under the provisions of the Retirement Equity Act of 1984 (REAct) (Pub L 98-397, 98 Stat 1426), most qualified plans (*i.e.*, defined benefit plans; see chap 21 for definition) must provide that benefits be payable in the form of a qualified joint and survivor annuity (QSJA) unless the nonparticipant spouse consents to another arrangement. Similarly, the plan must provide for payment of a qualified preretirement survivor annuity (QPSA) in the event of the participant's death before retirement. IRC §401(a)(11). The rights to a QPSA or a QJSA can be waived by a writing signed by the nonparticipant spouse that is notarized and witnessed and that acknowledges the effect of the waiver. At the moment, it appears that these federal laws will not apply to domestic partners or same-sex spouses, but this is far from certain as explained above.

Notwithstanding California's general community property laws, retirement plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) (401(k) plans, 403(b) plans, and the like) are governed by special rules at death. Although the nonparticipant spouse may have a community property interest in such benefits for dissolution purposes, the nonparticipant spouse has no devisable interest at death. Again, it appears unlikely that these federal laws will apply to domestic partners or same-sex spouses, but one cannot be certain of this. Although domestic partners and same-sex spouses are not considered spouses by federal law, the rationale for protecting retirement benefits from the claims of a predeceased opposite-sex spouse also would apply to the claims of a predeceased domestic partner and same-sex spouse. For a detailed discussion of how federal laws impact opposite-sex spouses in planning with retirement plans, see §§4.16-4.18.

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§4.51 C. Planning Issues for Domestic Partners in Probate Administration

The probate process, unlike nonprobate transfers, contains family protection statutes, such as family allowance provisions, probate homestead provisions, and the set aside of exempt property. See Prob C §§6500-6615. These statutes can frustrate the domestic partner's estate plan because the "beneficiaries" of the estate may end up being identified by statute and fixed by the court, not by the testator. These family protection statutes are interpreted to apply to surviving domestic partners in the same way as they apply to surviving spouses. Fam C §297.5(c). Hence, these statutes can be significant obstacles to planning and designing a domestic partner's will.

The practitioner should be thoroughly familiar with these family protection statutes in order to explain to the client the impact the protective provisions may have on the proposed estate plan. In some cases, it may be appropriate to obtain from a domestic partner a written waiver of some or all of the statutory protections afforded by the family protection statutes. In other cases, the attorney might suggest a plan design that provides some benefits to a domestic partner or minor children that would terminate if the domestic partner or children sought the protection of the family protection statutes. For a detailed discussion of the impact of the family protection statutes on planning for spouses, see §§4.19-4.27.

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§4.52 1. Family Allowance for Domestic Partner

Probate Code §6540(a)(1), listing the persons for whom a family allowance may be made, includes the surviving domestic partner of the decedent. During the administration of the probate estate, the surviving domestic partner will be entitled to a reasonable allowance paid from the estate for his or her maintenance. This allowance can be significant in terms of both its dollar amount and its impact on the decedent's overall estate plan. The only statutory limitation to the payment of an allowance is set forth in Prob C §6543, which provides that the family allowance may continue until the entry of order for final distribution, unless the estate is insolvent, in which case the allowance may continue for 1 year after granting of letters to the personal representative.

The estate planning attorney counseling the testator should be careful to remind the client of the impact a family allowance award can have on the client's estate and explore methods that could minimize that impact. The attorney should first explore the possibility of obtaining a written waiver from the client's domestic partner of his or her entitlement to a family allowance. See Prob C §141(a)(5).

The attorney should also consider the strategy of a forced election, whereby the decedent intentionally leaves a gift to an otherwise disinherited domestic partner. The gift would be forfeited if the partner sought an award of a family allowance. However, this type of forced election is untested in the courts and possibly may be held to violate the state's public policy of providing support to a protected class.

An attorney representing a domestic partner who seeks to disinherit the other partner should also be aware of the potential impact of the family allowance in a trust context. When the drafting attorney uses a typical fully funded revocable living trust as the primary estate plan, supplemented by a pour-over will, it is not unforeseeable that a surviving domestic partner may seek to have the decedent's pour-over will admitted to probate. There are usually some assets outside the trust (such as a car) that can be administered even if a summary probate procedure is an option. Once the probate is opened, the surviving domestic partner may seek a family allowance order and possibly obtain payment from the trust under Prob C §19001 to the extent that the estate assets are insufficient to pay the award. For a detailed discussion of family allowances, see §§4.21-4.22.

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§4.53 2. Probate Homestead for Domestic Partner

Probate Code §6521(a), listing the persons for whose use a probate homestead may be set apart, includes the surviving domestic partner of the decedent. The probate homestead will protect the family home for the benefit of the surviving domestic partner and certain other dependents of the decedent. The probate homestead also protects the home from the reach of the decedent's general creditors, nonfamily beneficiaries of the decedent's will, and the decedent's more distant intestate heirs. Probate homestead issues are likely to arise if the decedent devised his or her residence to someone other than the surviving domestic partner or the decedent's children. Note that the survivor's children born or adopted during the partnership also may be considered the decedent's children. See §4.57.

In the planning stages, the estate planning attorney must consider the possibility of a court imposing a probate homestead over the decedent's residence (or other real property asset). Although it is impossible to predict a court's exercise of its discretion in advance, a waiver by the surviving domestic partner (see Prob C §141(a)(3)) and a firm testamentary expression of the decedent's intent may reduce the likelihood of a court-ordered homestead. For a detailed discussion of probate homesteads, see §§4.23-4.24.

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§4.54 3. Small Estate Set Aside to Domestic Partner

The surviving domestic partner of the decedent is one of the protected class of persons for whom an estate worth less than $20,000 can be set aside under Prob C §§6600-6615. If the statutory requirements are met, this protected class takes the small estate free from the rights of beneficiaries named in the decedent's will or intestate heirs who might have a superior right to the property under the rules of intestate succession. The court has discretion to determine if any set aside is warranted. Among the factors the court can consider in making this determination is the decedent's intent. A domestic partner may waive his or her right to the small estate set aside if he or she executes a voluntary and informed written waiver either before entering into the domestic partnership or while a domestic partner. See Prob C §141(a)(6).

A domestic partner who wishes to leave his or her estate to individuals other than his or her surviving partner or children should have a statement in the will clearly indicating an intent that no small estate set aside should be granted by the court and should set forth any reason for that desire, including provisions the testator has made for the surviving domestic partner from assets outside probate. For a detailed discussion of small estate set asides, see §4.25.

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§4.55 4. Setting Aside Exempt Property to Domestic Partner

The court has discretion during estate administration to set aside for the benefit of a decedent's surviving domestic partner (as well as minor children) all or any part of the decedent's property, other than the family dwelling, that may be exempt from enforcement of a money judgment. Prob C §§6510-6511. A domestic partner may waive his or her right to have exempt property set aside if he or she executes a voluntary and informed written waiver either before entering into the domestic partnership or while a domestic partner. See Prob C §141(a)(4).

The provisions listing the categories of assets that may be exempt from enforcement of a money judgment, and that are therefore capable of being set aside and paid to the decedent's surviving domestic partner, are found in CCP §§704.010-704.210. Some of the categories require a claim of exemption to be filed. Two examples of the categories are (1) $2550 of equity in a motor vehicle (CCP §704.010) and (2) household furnishings, appliances, provisions, wearing apparel, and other personal effects if ordinarily and reasonably necessary to members of the decedent's family (CCP §704.020). For a detailed discussion of the set-aside of exempt property, and the dollar limitations, see §4.26.

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§4.56 D. Omitted Domestic Partners

Probate Code §21610 is construed to include the following meaning with regard to registered domestic partners: "Except as provided in Section 21611, if a decedent fails to provide in a testamentary instrument for the decedent's surviving [domestic partner], who entered into [a domestic partnership with] the decedent after the execution of all of the decedent's testamentary instruments, the omitted [domestic partner] shall receive a share in the decedent's estate." The surviving domestic partner will be entitled to a statutory share equal to one-half of the community property, plus one-half of the quasi-community property (see §§4.58-4.60), plus a variable share of the decedent's separate property.

The statutory share rules create a default rule that may not mirror the intention of the client who is in a domestic partnership. The practitioner should be diligent in reminding clients about these rules and, when appropriate, revise the estate plan to clarify the decedent's intention with respect to his or her domestic partner. When the client is a single person anticipating entering into a domestic partnership, the client's estate planning documents should state expressly and with clarity the client's intentions with respect to the client's future domestic partner. For a detailed discussion of omitted spouses, whose rights are the same as omitted domestic partners, see §§4.29-4.31.

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§4.57 E. Omitted Children of Domestic Partners

Children born to a domestic partner during the domestic partnership may be considered the children of both domestic partners under the Uniform Parentage Act (UPA) (Fam C §§7600-7730). Under Fam C §297.5(d), the rights and obligations of registered domestic partners with respect to the children of either of them are the same as spouses. Under Fam C §7540, the child of a wife cohabiting with her husband is conclusively presumed to be a child of the marriage. (Despite language in Fam C §§7540-7541 limiting the application of the presumption when there is evidence demonstrating the biological impossibility of the husband's paternity, the California Supreme Court has stated that "the conclusive marital presumption in section 7540 is not really a presumption at all but is instead 'a rule of substantive law.'" *In re Jesusa V.* (2004) 32 C4th 588, 614, 10 CR3d 205, quoting *Kusior v Silver* (1960) 54 C2d 603, 619, 7 CR 129.) This presumption is incorporated by reference in the UPA. See Fam C §7611. Children of unregistered same-sex domestic partners also may be considered the children of both partners under the UPA. In *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46, the court held that the lesbian partner of the biological mother of two children was the presumed mother of the children under Fam C §7611(d) because (1) she received the children into her home and openly held them out as her natural children, (2) she actively participated in causing the children to be conceived with the understanding that she would raise the children as her own together with the birth mother, (3) she voluntarily accepted the rights and obligations of parenthood after the children were born, and (4) there were no competing claims that another person is the children's second parent. In *Charisma R. v Kristina S.* (2009) 175 CA4th 361, 96 CR3d 26, the court followed the reasoning of *Elisa B.* to hold that the same-sex *registered* domestic partner of the biological mother of a child was the child's presumed mother. The parentage presumptions of the UPA are incorporated in the intestate succession provisions of the Probate Code, which are incorporated in the omitted child statute. See Prob C §§26, 6453, 21620-21623. Cautious estate planning attorneys should advise their domestic partner clients to amend their wills and trusts to make clear their intention to provide—or not to provide—for any such children born after the execution of those documents, as discussed in §4.32.

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Source: Estate Planning/California Estate Planning/4 Additional Property Transfer Obstacles for Married Persons and Registered Domestic Partners/§4.58 F. Quasi-Community Property Acquisition by Domestic Partners and Same-Sex Spouses

§4.58 F. Quasi-Community Property Acquisition by Domestic Partners and Same-Sex Spouses

While the rules of statutory construction with regard to quasi-community property require that the term "spouse" be interpreted to include registered domestic partners, because there are currently few other states that provide legal recognition to same-sex relationships similar to California domestic partnerships, and because in order to acquire quasi-community property, a couple must first be domiciled in another state, then move to California, fewer domestic partners than opposite-sex spouses are impacted by the quasi-community property laws. See §§4.59-4.60.

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§4.59 1. Circumstances in Which Domestic Partners Might Acquire Quasi-Community Property

Consider the Prob C §66 definition of quasi-community property as it applies to domestic partners: "All personal property wherever situated, and all real property situated in this state, heretofore or hereafter acquired by a decedent while domiciled elsewhere that would have been the community property of the decedent and the surviving [domestic partner] if the decedent had been domiciled in this state at the time of its acquisition." For domestic partners to have acquired property in another state that meets this definition, the domestic partners must have been in a domestic partnership with each other that California recognizes as equivalent to California domestic partnerships (or have been married to each other) while domiciled in another state, then later move to California.

Family Code §299.2 provides that, "A legal union of two persons of the same sex, other than a marriage, that was validly formed in another jurisdiction, and that is substantially equivalent to a domestic partnership as defined in this part, shall be recognized as a valid domestic partnership in this state regardless of whether it bears the name domestic partnership." The major unknown here is which relationships authorized by other states will be considered substantially equivalent to a California domestic partnerships, so that they will be recognized as valid domestic partnerships by California.

Eight states other than California do not allow same-sex marriage but grant some type of official recognition (called domestic partnerships, civil unions, reciprocal beneficiaries, or designated beneficiaries, depending on the state) to nonmarital, same-sex relationships: Colorado, Hawaii, Maine (following repeal of same-sex marriage by voters there), New Jersey, Nevada, Oregon, Washington, and Wisconsin. Although it seems likely that California will recognize New Jersey, Nevada, Oregon, and Washington civil unions or domestic partnerships as valid domestic partnerships, because those who enter into these civil unions and domestic partnerships are given as many, or almost as many, rights and responsibilities as California domestic partners, that is not certain because the rights granted by these four states are not identical to those granted by California. The Colorado, Hawaii, Maine, and Wisconsin laws provide only limited rights to domestic partners. Because these states give substantially fewer rights to domestic partners than California, it seems less likely that California will recognize domestic partnerships formed in these states as substantially equivalent to California domestic partnerships.

Five states-Connecticut, Iowa, Massachusetts, New Hampshire, and Vermont-and the District of Columbia now allow same-sex couples to marry. On October 11, 2009, Governor Schwarzenegger signed SB 54, which amends Fam C §308(c) to make clear that same-sex couples who legally marry in another jurisdiction are entitled to the same rights and subject to the same responsibilities as California registered domestic partners. See Stats 2009, ch 625. Therefore, quasi-community property rights arise for these same-sex couples who legally marry in another jurisdiction and then move to California.

Because there is no requirement that the couple be domiciled in California for a couple to register with California as domestic partners, another way for domestic partners to acquire quasi-community property is for the couple to become domestic partners in California while domiciled in another state and at some later point in time move to California. In that case, all property acquired by the couple while domiciled in another state that would have been community property, had the couple been domiciled in California when the property was acquired, will become quasi-community property when the couple moves to California.

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§4.60 2. Planning Considerations for Domestic Partners and Same-Sex Spouses Who May Have Acquired Quasi-Community Property

Quasi-community property passes like community property under the rules of intestate succession (Prob C §6401) and the surviving registered domestic partner's right to take against the deceased partner's will (see Prob C §101). However, quasi-community rights attach only if the domestic partner survives, and cannot be enforced by a predeceased domestic partner's personal representative, unlike true community property.

If the deceased domestic partner owned quasi-community property, and made a transfer during life of such property without substantial consideration or domestic partner consent to or joinder in the transfer, the surviving partner may require the third-party transferee to return one-half of such property to the decedent's estate, or one-half of its proceeds, or one-half of its value at the time of the transfer. See Prob C §102. When appropriate, the practitioner should advise a domestic partner client that a surviving partner may be able to assert a valid claim to one-half of the client's quasi-community property at death. Although many conditions must be fulfilled to assert such claim, it would be prudent to obtain the consent of the other domestic partner before making large lifetime gifts of property that could be characterized as quasi-community property at death.

Any practitioner who represents a domestic partner client who fits one of the circumstances described in §4.59, in which quasi-community property might have been acquired before moving to California, or a same-sex spouse who may have acquired quasi-community property, should also review the detailed discussion of quasi-community property in §§4.33-4.37.

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§4.61 G. Transmutation by Domestic Partners and Same-Sex Spouses

Transmutation is a process by which the property rights of domestic partners are changed. The separate property of one domestic partner can be converted to the community property of both domestic partners or to the separate property of the other domestic partner. Similarly, the community property of both domestic partners can be converted to the separate property of either partner. See Fam C §§850-853.

The transmutation rules applicable to registered domestic partners and same-sex spouses are the same as those applicable to opposite-sex married couples. See Fam C §297.5(a)-(c). However, the advantages available to domestic partners and same-sex married couples when they transmute property are fewer than those available to the opposite-sex married couple. For a detailed discussion of the identical requirements for valid transmutations between spouses, see §§4.39-4.39H.

Practitioners should be aware, however, that domestic partners who registered before January 1, 2005, and executed a premarital-type agreement in accordance with Fam C §297.5(k)(2) before July 1, 2005, may have successfully changed their property rights without a transmutation.

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§4.62 1. Limited Advantages and Possible Disadvantages of Transmutations by Domestic Partners and Same-Sex Spouses

Transmutation agreements are just as useful to registered domestic partners and same-sex married couples as to opposite-sex married couples in preventing postmortem litigation if both parties have expressly agreed to the character of their property. However, that is where the similarity to the advantages to opposite-sex married couples ends. The other benefits to opposite-sex married couples for converting property belonging to one spouse to property belonging to the other spouse do not apply to domestic partners and same-sex married couples because these benefits are all related to federal law, which does not apply to domestic partners and same-sex married couples. The domestic partner or same-sex spouse does not get the advantage of the unlimited federal marital deduction for property passed outright to the surviving domestic partner or same-sex spouse. Under IRC §2056, the deduction is only permitted for property passing from the decedent to the surviving "spouse" of the decedent, a term that does not include a same-sex surviving spouse or partner.

Nor is the surviving domestic partner likely to get the step-up in the basis on both halves of the community property for federal income tax purposes at the death of the first domestic partner. The provision that grants the double step-up in basis to community property indicates that it only applies to "the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state." IRC §1014(b)(6). Although the IRS generally relies on state law for its definitions of spouse and community property, the federal Defense of Marriage Act (Pub L 104-199, 110 Stat 2419) prohibits the IRS from relying on California state law for its definition of surviving spouse. See 1 USC §7. On September 15, 2009, legislation was introduced in the U.S. House of Representatives to repeal the Defense of Marriage Act. See HR 3567, entitled the Respect for Marriage Act. Nonetheless, until this legislation is signed into law by President Obama, domestic partners and same-sex spouses will not receive the benefit of the unlimited federal marital deduction from estate and gift taxes and are unlikely to receive the benefit of the double step-up in basis on community property for federal income tax purposes.

However, a surviving domestic partner may be entitled to the full step-up in basis for state income tax purposes. Although IRC §1014(b)(6) is incorporated by reference in Rev & T C §18031, registered domestic partners will be "treated by California law as if federal law recognized a domestic partnership in the same manner as California law." Fam C §297.5(e).

In Medi-Cal planning, transmutation of the family residence may or may not be useful to the domestic partner or same-sex spouse in saving as much as possible for the family of the incapacitated domestic partner, depending on the specific benefits the incapacitated partner wishes to obtain. Medi-Cal is both a federal and a state program; therefore, federally funded Medi-Cal programs treat domestic partners and same-sex married couples as if they are not married when determining eligibility and benefits, but state-only funded Medi-Cal programs treat domestic partners and same-sex married couples similarly to opposite-sex married couples when determining eligibility and benefits. The California Department of Health Care Services (DHCS) provides the guidelines used to determine Medi-Cal eligibility and benefits for domestic partners in All County Welfare Directors (ACWD) Letter No. 09-03 (Feb. 9, 2009). These same guidelines are made applicable to same-sex married couples in ACWD Letter No. 09-04 (Feb. 9, 2009), as discussed in 30 CEB Est Plan R 99 (Feb. 2009). See chap 30.

The most important thing for the practitioner to keep in mind when considering a transmutation agreement for domestic partners is that a transmutation agreement between domestic partners or same-sex spouses will be a taxable event if the gift exceeds the IRC §2503(b) gift tax annual exclusion amount ($13,000 in 2010), because the unlimited federal marital deduction from gift taxes for gift transfers of property between spouses will not be available to domestic partners or same-sex spouses. Under IRC §2523, this deduction is only allowed if the gift is to the donor's "spouse," which does not include a same-sex spouse or domestic partner.

In light of the drawbacks of transmutation agreements by domestic partners and same-sex spouses, the practitioner should carefully consider the advantages and disadvantages of drafting a property characterization agreement before drafting such an agreement for domestic partner or same-sex spouse clients. Because of the presumption of undue

influence, which is just as applicable to domestic partners and same-sex spouses as to opposite-sex spouses, and the ethical issues associated with representing both domestic partners or spouses in a transmutation agreement, when drafting a marital or domestic partner property agreement that transmutes property from separate property to community property, the cautious practitioner should consider whether to recommend that both partners or spouses obtain the advice of independent counsel prior to executing the agreement.

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§4.63 2. Requirements for Transmutations by Domestic Partners and Same-Sex Spouses

There are two requirements for a valid transmutation between domestic partners and same-sex spouses:

- The transmutation must comply with the specific requirements as to form set forth in Fam C §852.
- The transmutation must comply with the rules governing fiduciary relationships.

The requirement as to form that has generated the most litigation is the requirement that to be valid, the transmutation must be made in writing, by an express declaration that is made, joined in, consented to, or accepted by the domestic partner whose interest in the property is adversely affected. Fam C §852(a). A writing signed by the domestic partner who is adversely affected is not an "express declaration" unless it contains language that expressly states that the characterization or ownership of property is being changed. *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153. See §4.39B. For a detailed discussion of appellate court decisions interpreting the "express declaration" requirement, see §4.39C.

As a consequence of the confidential fiduciary relationship occupied by domestic partners, in a transaction between domestic partners, whenever one partner gains an advantage over the other, a rebuttable presumption arises that the transaction was the result of undue influence. *Marriage of Delaney* (2003) 111 CA4th 991, 996, 4 CR3d 378. Once the presumption of undue influence has arisen, the burden shifts to the advantaged domestic partner to rebut the presumption. The advantaged partner must prove all three of the following elements to rebut the presumption of undue influence: (1) the disadvantaged partner freely and voluntarily entered into the transaction, (2) the disadvantaged partner had full knowledge of all of the facts, and (3) the disadvantaged partner had a complete understanding of the legal effect of the transaction. If the advantaged partner is unable to rebut the presumption, the transmutation is not valid. 111 CA4th at 1000. For discussion of the standard of proof required to rebut the presumption of undue influence, see §4.39H.

Even if the transmutation is valid, if it is a transmutation of separate property to community property, most likely the Fam C §2640(b) right of reimbursement will still be available to the partner who owned the separate property, unless that partner has executed a written waiver of the right to reimbursement. See §4.39I.

Any time a practitioner considers a transmutation for domestic partners, care should be given to determining and documenting the clients' intentions before undertaking any specific transmutation of property. What is likely to happen is that in a subsequent domestic partner dissolution action, one partner will argue that the transmutation is valid and the other will argue that no transmutation was intended. At best, the estate planning attorney will be a percipient witness. At worst, he or she will be a defendant in a malpractice action. Therefore, the safest course of action for the practitioner may be to refuse to do any transmutation of property for estate planning purposes without requiring both domestic partners to have the agreement reviewed and approved by separate and independent legal counsel. For further discussion of the requirements for valid transmutations between spouses and suggestions with regard to the drafting of transmutation agreements, see §§4.39-4.40.

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§4.64 H. Estate Planning for Clients in the Process of Dissolving Their Domestic Partnerships

Automatic temporary restraining orders (ATROs) impose substantial obstacles on estate planning for clients who are in the process of dissolving their domestic partnerships. See Fam C §2040. These ATROs are pre-printed on the second page of the Family Law Summons that is required to be filed and served with any Petition for Dissolution of Domestic Partnership. See Judicial Council Form FL-110. Although the summons does not apply when a domestic partner files a Notice of Termination of Domestic Partnership (similar to the summary dissolution procedure for marriages), only couples with no minor children of the relationship, minimal assets, and no real property, who have been registered domestic partners less than 5 years, are eligible to use the Notice of Termination. Fam C §299(a). Thus, most estate planning clients are not eligible for the simpler notice procedure. The practitioner must be careful not to recommend that the client take any actions that violate the ATROs. See §4.40A.

Four levels of restraint on unilateral actions by one domestic partner are imposed by the ATROs under Fam C §2040: (1) Certain actions are entirely prohibited (see §4.40B); (2) certain actions are prohibited unless the other partner provides written consent or the court issues an order permitting the action (see §4.40C); (3) certain actions are allowed, but only with prior notice to the other partner, including revoking a revocable trust or other nonprobate transfer (see §4.40D); and (4) certain actions are allowed even without notice to the other partner, including revoking a will and creating a new unfunded revocable trust to be funded by a new pourover will (see §4.40E).

When a client in the process of dissolving his or her domestic partnership wants to change his or her estate plan, notwithstanding the ATROs, the client can: (1) revoke the client's current trust and sever any joint tenancy, provided that notice is filed and served on the other partner before the changes take effect; (2) without notice to the other partner, revoke the current will and create a new pour-over will; and (3) without notice to the other partner, create a new unfunded revocable trust into which the new will pours all of the client's assets. Thus, the client still has the ability to implement a new estate plan with all of the dispositive provisions he or she desires. However the client will be unable to avoid probate without the consent of the other partner or a court order allowing funding of the revocable trust.

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Wills

Donald R. Travers

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I. INTRODUCTION

§5.1 A. Role of Wills in Estate Planning

For hundreds of years, wills have been the basic device used to direct disposition of an estate after a person's death, and despite a trend in many states to use revocable trusts as will substitutes, wills remain a fundamental tool for the estate planner. On revocable trusts, see chap 6. Because wills are in most cases simpler and shorter documents than revocable trusts, they are generally less time-consuming to prepare and therefore are less costly for the client. A will is ordinarily a better choice than a trust when the estate is small enough to avoid probate administration by means of the various small estate procedures available under Prob C §§6600-6615 and 13000-13660.

It also remains true that all properly prepared estate plans contain a will, if only a pourover will that transfers to the trust assets that were not transferred to the trust during the client's lifetime. On pourover wills, see §6.41. A will may also be used to accomplish things a trust cannot. For example, a will may nominate guardians for minor children, provide funeral or burial instructions, or exercise a power of appointment. A will remains ambulatory; that is, the testator retains the power to alter or revoke the will during his or her lifetime, so until the testator dies, the rights of devisees are inchoate, and devisees have no vested or legally enforceable rights with respect to the will. Of course, the testator's right to amend or revoke the will is conditioned on the testator retaining the capacity to do so, and modification or revocation of a will by an incapacitated testator is invalid.

NOTE: Intestacy need not be a permanent situation with reference to an incapacitated person who has no will. Under the substituted judgment rules (Prob C §§2580-2586), the court may authorize a conservator or other interested person to make a will for a person under conservatorship. Prob C §2580(b)(13). However, if there is a will in existence, the court apparently has no jurisdiction to revoke or modify the will of a conservatee or other incapacitated person.

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§5.2 B. Terminology

A "will" is a written instrument in which a person makes a disposition of his or her property that takes effect after his or her death. A "testator" is a person who makes a will. See Prob C §88 ("will" includes codicil and any testamentary instrument that appoints executor or revokes another will). The words "gift," "bequest," "legacy," and "devise" are frequently used to refer to a transfer of property made by will and formerly carried specific meanings. A legacy or bequest was traditionally a gift by will of personal property. A devise was a testamentary disposition of real property. In modern practice no distinction is made among these terms, and the Probate Code appears to use "devise," "transfer," and "gift" interchangeably. For example, Prob C §32 provides that "devise," used as a noun, means a disposition of real *or* personal property by will. A "codicil" is a supplement or addition to a will and may explain, modify, add to, subtract from, qualify, alter, restrain, or revoke provisions in a will. Black's Law Dictionary (8th ed 2004).

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C. Rules of Construction

§5.3 1. Intention of Testator

A skillfully drafted will should clearly express the testator's intent as to the disposition of his or her property. However, it is not enough simply to prepare an instrument that is clear on its face. A properly drafted will should anticipate possible changes in the testator's estate and changes in the persons who will ultimately receive the estate. A will that fails to anticipate and provide for changes is likely to result in problems for the personal representative after the testator's death.

A number of rules for interpretation or construction of wills have been developed by the courts and the legislature to address situations in which the will fails to provide the personal representative with clear directions for distribution of the estate. Probate Code §§21101-21700 deal with construction of wills, trusts, and other instruments. The underlying or basic principle in determining the legal effect of a disposition directed in a will is the intention of the testator as expressed in the document. Prob C §21102(a). The rules of construction apply when the intention of the transferor is not clear from the will. Prob C §21102(b).

In general, the courts and the legislature prefer an interpretation of a will that favors validity and prevents intestacy, rather than one that results in intestacy. See Prob C §21120. Words are given their ordinary meaning unless the intention to use them in another way is clear and the intended meaning can be ascertained. Prob C §21122. Extrinsic evidence is admissible to determine whether a document constitutes a will or to determine the meaning of a will or a portion of a will if the meaning is unclear. Prob C §6111.5. Devises to a former spouse or registered domestic partner are presumed revoked and pass as if the former spouse or partner were deceased, unless the will expressly provides otherwise. Prob C §§6122, 6122.1. These statutes do not expressly revoke transfers to relatives of a former spouse or partner, but courts have sometimes concluded that the testator did not intend to pass property to such persons in the event the marriage or partnership was terminated. See, *e.g., Estate of Jones* (2004) 122 CA4th 326, 18 CR3d 637.

If it is necessary for the court to construe a provision in the will after the testator's death, the result will be to some extent arbitrary. The need to resort to the rules of construction often results from a lack of forethought on the part of the drafter. A well drafted will should make the testator's intent clear, so that even if there are changes in either the estate or the identity of the beneficiaries, the will provides for those changes, and judicial construction will not be necessary.

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§5.4 2. Incorporation by Reference

A document in existence when the will is executed may be incorporated by reference to interpret the will if the will states the intent to incorporate the document and describes it sufficiently to identify it. Prob C §6130. A testator may incorporate by reference into his or her own will, a will made by another person. A testator may also incorporate nontestamentary papers written by the testator or any third party.

The document incorporated by reference must be in existence when the will is executed. However, a document that does not exist when the will is executed, but that exists later when a codicil is executed, may be validly incorporated into the will by the codicil. *Simon v Grayson* (1940) 15 C2d 531, 533, 102 P2d 1081. The will may not merely refer to the document; rather, the will must clearly show the testator's intent to incorporate the extrinsic document into his or her will.

EXAMPLE: Nontestamentary documents commonly incorporated by reference into wills include funeral and burial contracts, contracts leaving the testator's body for medical research, deeds to real property devised by the will, buy-sell agreements regarding the testator's corporate stocks, and letters of instruction to executors or beneficiaries regarding the testator's wishes as to certain property.

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§5.5 3. Doctrine of Facts of Independent Significance

An attorney may draft a will that disposes of property by referring to "acts and events that have significance apart from their effect upon the dispositions made by the will." Prob C §6131. It is immaterial whether the acts and events occur before or after execution of the will or the testator's death. Execution or revocation of the will of another person is an event with independent significance. Prob C §6131. See generally 1 Scott & Ascher on Trusts §7.1.2 (5th ed 2006); 14 Witkin, Summary of California Law, *Wills and Probate* §169 (10th ed 2005).

The doctrine of facts of independent significance is often used to ascertain beneficiaries whose identities cannot be satisfactorily determined by reference to the will. Thus, devises to "children," "heirs," "next of kin," or "such person or institution as may care for me during my old age or last illness" are not invalid for vagueness, because the beneficiaries' identities can be ascertained from extrinsic facts of independent significance. See, *e.g., Estate of Hollingsworth* (1940) 37 CA2d 432, 99 P2d 599 (devise to persons "in my employ"). The doctrine may also be used to determine particular items of property to be given to identified beneficiaries. Thus, devises of funds in a particular bank account, securities in the testator's safe-deposit box, or furniture in a designated room are usually held valid despite the fact that the property can be ascertained only by reference to extrinsic facts. 1 Scott on Trusts §7.1.2.

A disposition is invalid when the facts from which it can be ascertained have no significance apart from the disposition in the will. Accordingly, devises to persons named in an unattested memorandum not incorporated in the will by reference are invalid on the ground that the memorandum has no significance apart from the will. 1 Scott on Trusts §7.1.2. For this reason, a devise of personal property to "those persons designated in a memorandum that I will prepare and leave in my safe-deposit box" would not be valid.

NOTE: The doctrine of facts of independent significance should not be confused with the doctrine of incorporation by reference. See §5.4. For example, unlike the doctrine of incorporation by reference, the doctrine of facts of independent significance permits reference to events occurring after the date of the will.

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§5.5A 4. Disposition of Tangible Personal Property by Writing

Probate Code §6132 provides that a will may refer to a writing that directs disposition of tangible personal property not otherwise disposed of by the will, except for money that is common coin or currency (*i.e.,* not collectibles) and property used primarily in a trade or business. The writing must be dated and either be in the testator's handwriting or be signed by the testator. Prob C §6132(a). The writing may be written or signed by the testator before or after the execution of the will and need not have significance apart from its effect on the dispositions of property made by the will. Prob C §6132(c). The testator may make subsequent handwritten or signed changes to the writing, and the most recent writing controls the disposition. Prob C §6132(d). If there are inconsistent dispositions, a dated writing will control over an undated writing unless it can be established that the undated writing was created later than the dated writing. Prob C §6132(e). The value of any single item of tangible personal property disposed of by the writing may not exceed $5000 and the total value of tangible personal property identified and disposed of by the writing may not exceed $25,000. Prob C §6132(g).

Inclusion of a provision in a will allowing creation by the testator of a "writing" under Prob C §6132 may be problematic, and may result in litigation or a disposition of personal property that is at odds with the intentions of the testator. The writing is subject to very flexible requirements. Although §6132(a)(2) requires the writing to be dated and either handwritten or signed by the testator, §6132(b) provides that the failure of the writing to conform to these requirements does not preclude the introduction of evidence regarding the testator's intent regarding the disposition of personal property.

There are also potential difficulties with values. The total value of property disposed of by the writing may not exceed $25,000, and if the value of any single item exceeds $5000, the disposition of that item will not be controlled by the writing. But values, especially of collectible items, often change. If the value of property changes after creation of the writing, the writing may fail and the property will be disposed of pursuant to the residue or remainder clause of the will.

Attorneys who wish to include a provision in a will that allows creation of writings that will control disposition of personal property should proceed with caution. One commentator has suggested that the will should require the writing to be subject to the same requirements for disposing of personal property as are applied to all holographic instruments. See Prob C §6111. For further discussion, see Schenone, *New Probate Code Section 6132—An Improvement or Just a Stimulus for Litigation?*, 13 Cal Trusts & Est Q 18 (Spring 2007).

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§5.6 II. TYPES OR KINDS OF WILLS

Although an attorney seldom prepares any type of will other than a witnessed will, the subject of other types of wills is sometimes raised. It is therefore necessary to be familiar with the various types of wills recognized in California. For discussion of these wills, see §§5.7-5.14.

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A. Witnessed Will

§5.7 1. Testator's Signature

The formal requirements of a witnessed will are provided in Prob C §6110. To be valid, a witnessed will must be in writing and signed (Prob C §6110(b)):

- By the testator;
- In the testator's name by some other person in the testator's presence and by the testator's direction; or
- By a conservator pursuant to a court order to make a will under Prob C §2580.

The testator may sign by mark "when the person cannot write, his name being written near it, by a person who writes his own name as a witness…." CC §14. A person "cannot write" if he or she is either illiterate or physically unable to write. See *Estate of Holloway* (1925) 195 C 711, 235 P 1012 (guiding testator's hand because he was physically weak); *Estate of Guilfoyle* (1892) 96 C 598, 31 P 553 (testatrix who knows how to write but is physically unable to do so may sign by making mark at end of will). If the will is to be signed "by some other person in the testator's presence and by the testator's direction," it may be preferable for someone to guide the testator's hand rather than having another person sign the will for the testator because it helps to establish the testator's participation in the creation of the will. In either event, when another person signs the testator's name, it is not necessary for the person signing the testator's name or guiding the testator's hand to sign his or her own name.

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§5.8 2. Number and Signatures of Witnesses

The will must be witnessed by at least two persons, each of whom (Prob C §6110(c)):

- Is present at the same time and witnesses either the signing of the will or the testator's acknowledgment of the signature on the will; and
- Understands that the instrument is the testator's will.

PRACTICE TIP: Although California requires only two witnesses, it is probably better to have three. Witnesses may move away, die, or become incapacitated. Having a greater number of witnesses increases the probability of finding one who is available.

The witnesses must understand that the instrument they sign is the testator's will, although it is not necessary for the testator to declare to the witnesses that the document is his or her will. The witnesses may gain the necessary understanding by, for example, examining the instrument or from the "circumstances surrounding the execution of the will." Comment to Prob C §6110. The will must be signed or acknowledged in the presence of the witnesses, who must be present at the same time. The statute does not require the witnesses to sign the will in the presence of the testator or of each other, although it is strongly advisable.

Although the witnesses may sign the document at some time after the testator has signed, the witnesses must sign the will before the testator's death. See *Estate of Saueressig* (2006) 38 C4th 1045, 44 CR3d 672, specifically disapproving *Estate of Eugene* (2002) 104 CA4th 907, 128 CR2d 622 (will admitted to probate despite witness's inadvertent failure to sign will until after testator's death).

WARNING: Acknowledgment of a witnessed will by a notary has no effect, and a will that is acknowledged and signed by a notary but not otherwise witnessed is not valid. Nonetheless, signature by a notary may constitute a valid attestation if another witness also signs. In *Estate of Saueressig, supra,* the court held that a notarized will was not valid, because the notary's husband, who witnessed the signing of the will, failed to sign the will until after the testator's death.

The rules providing for signature and attestation of wills apply equally to codicils. See Prob C §88 ("will" includes "codicil").

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Source: Estate Planning/California Estate Planning/5 Wills/§5.9 3. Who May Be Witness

§5.9 3. Who May Be Witness

Any person generally competent to be a witness may act as a witness to a will. Prob C §6112(a). It is not required that a witness be 18 years of age or older, although use of minors as witnesses should probably be avoided whenever possible.

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§5.10 a. Interested Witnesses

A will is not invalid because the will is signed by an interested witness, *i.e.,* someone who receives a gift under the will. But unless there are at least two other subscribing witnesses who are disinterested witnesses, the fact that the will makes a gift to a subscribing witness creates a presumption that the witness procured the gift by duress, menace, fraud, or undue influence. Prob C §6112(c). The presumption does not apply when the witness is a person to whom the gift is made solely in a fiduciary capacity. Prob C §6112(c). If a gift in an instrument fails because of the presumption and the witness fails to rebut the presumption, the interested witness may not receive more than the share of the estate he or she would have received if the will had not been admitted to probate. Prob C §6112(d).

WARNING: The presumption against an interested witness does not arise if one witness is interested but there are two other subscribing witnesses who are not interested. Nevertheless, the use of interested witnesses is a dangerous practice and should be avoided if at all possible.

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§5.11 b. Attorney or Hospital Staff as Witness

In most situations, the witnesses to a will signed in the attorney's office are the attorney, other attorneys in the office, or clerical staff. Many attorneys routinely act as witnesses to wills they have drafted, at least in part because they are in a position to know whether the testator possesses testamentary capacity. Also, it is usually not difficult to locate an attorney-witness after the testator's death through the State Bar, so use of attorneys as witnesses may be a valuable service to the client.

If a will is to be signed in a hospital, it may be possible to enlist a nurse or other employee of the hospital as a witness, although many hospitals prohibit staff members from doing so.

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§5.12 B. Holographic Will

A will that does not comply with the requirements for a witnessed will (see §§5.7-5.11) "is valid as a holographic will, whether or not witnessed, if the signature and the material provisions are in the handwriting of the testator." Prob C §6111(a). Because only the "signature and material provisions" of a holographic will must be in the testator's handwriting, a will may be a valid holographic will if immaterial provisions are printed or typed, or even written by another person. Holographic wills are usually prepared without the help of an attorney, so they are often unclear in many respects, but like all wills they are subject to the requirement that they demonstrate testamentary intent—the testator's intention to dispose of his or her property after death. See Prob C §6111(c). Although no formal statement is required, a statement of testamentary intent in a holographic will may be either handwritten by the testator or part of a commercially printed form will. Prob C §6111(c).

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§5.13 C. Statutory Will

The California statutory will is authorized by Prob C §§6200-6243. The will form itself is set out in Prob C §6240. A statutory will may be executed by any person of sound mind over age 18. Prob C §6220. The statutory will must be witnessed by at least two persons, who must observe the testator's signing. Prob C §6221(b).

As the California Law Revision Commission Comment points out, Prob C §6221 is misleading. It states that "[a] California statutory will shall be executed *only* as follows: (a) The testator shall complete the appropriate blanks and shall sign the will." (Emphasis added.) In *Estate of Perry* (1996) 51 CA4th 440, 58 CR2d 797, however, the court held that even though another person filled in the blanks at the testator's direction, the will could be admitted to probate if it was executed in compliance with Prob C §6110. A literal reading of §6221(a) would seem to indicate that a statutory will may be signed only by the testator and not by another person at the testator's direction or by a conservator pursuant to a substituted judgment order under Prob C §2580. Following the rationale of *Estate of Perry*, however, a statutory will signed by any of the methods described in Prob C §6110 would not be invalid because it failed to comply with §6221.

Statutory will forms are available from the State Bar of California or from its website at http://www.calbar.ca.gov and from many stationery stores.

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§5.14 D. Uniform International Will

Under the Uniform International Wills Act (Prob C §§6380-6390), a valid international will may be written by the testator or another person "by hand or by any other means." Prob C §6382(a). The testator must declare in the presence of two witnesses and "a person authorized to act in connection with international wills that the document is the testator's will and that the testator knows the contents thereof." Prob C §6382(b).

Persons authorized to act in connection with international wills include members of the diplomatic and consular service of the United States designated by Foreign Service regulations. Prob C §6380(b). The witnesses and the authorized person must sign the will in the testator's presence. Prob C §6382(e). The authorized person must attach to the will a certificate establishing that the requirements of the Uniform International Wills Act have been fulfilled. Prob C §6384. The certificate by the authorized person is conclusive of the formal validity of the international will. Prob C §6385.

PRACTICE TIP: An international will may be useful for a client who owns property in other countries or who plans to move to another country. Before recommending completion of an international will with the intention that it control the disposition of property in another country, the attorney should verify that the country or countries in question have adopted the Uniform International Wills Act.

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III. WHAT DOES AND DOES NOT PASS UNDER A WILL

§5.15 A. When Will May Be Ineffective

Generally, disposition of a testator's property is determined by his or her will. However, there are a number of situations in which disposition of a decedent's property is controlled by the form of ownership of a particular asset, or by a beneficiary designation that overrides the provisions of a will. Clients often fail to understand the need for a unified and understandable estate plan and may hold property in a variety of ways that undercut the estate plan as stated in the will.

There are a number of situations in which a client's will may be ineffective to transfer particular assets at death. Some of these situations involve:

- **Joint tenancy property.** Property held in joint tenancy will pass to the surviving joint tenant or joint tenants "by right of survivorship." Real property, corporate securities, bank accounts, and motor vehicles may all be held in joint tenancy, and written agreements may be created to hold other forms of personal property in joint tenancy. CC §683. The decedent's interest in a joint tenancy asset will not be subject to testamentary disposition unless the joint tenancy is severed. See §§7.19-7.29.
- **Community property with right of survivorship.** Married couples may hold real property as community property with right of survivorship. CC §682.1. This form of ownership provides the advantage of easy title transfer to the surviving spouse by means of an affidavit, similar to the process for terminating a joint tenancy. At the same time, both halves of the property are entitled to a stepped-up basis for income tax purposes on the death of either spouse. IRC §1014(b)(6). As with property held in joint tenancy, the decedent has no testamentary power over property held in this form. See §§7.30-7.31.
- **Pay-on-death (POD) accounts.** A pay-on-death (POD) account is payable on demand to the "POD payee" after the death of the depositor, or if there are multiple depositors, after the death of the last depositor to die. Prob C §5302. The POD payee has no ownership interest until the death of the depositor, and the arrangement may be terminated at any time by the depositor. See §§7.32, 7.35.
- **Totten trusts.** A Totten trust is an account held by the depositor in trust in a financial institution for a beneficiary or "transferee." Prob C §§80-82. Totten trusts are similar to POD accounts, and are often used in custodial accounts under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925). On the depositor's death, the funds held in the account will be paid to the transferee on demand. See §§7.32, 7.36.
- **Securities registered in beneficiary form.** Under the Uniform TOD Security Registration Act (Prob C §§5501-5512), an individual may own securities for the benefit of another by using the words "transfer on death" (or "TOD") or "pay on death" (or "POD") after the individual's name and before the beneficiary's name in the registration instrument. Prob C §5505. A TOD security is similar to a POD account; TOD securities may be reregistered in the name of the TOD beneficiary after the death of the owner, or in the case of multiple owners, after the death of the last owner to die. See §7.37.
- **Life insurance policies.** Death benefits payable under a life insurance policy pass to the beneficiaries designated by the owner of the policy and are not subject to disposition under the will of the insured. See chap 19.
- **Annuities, pension plans, and retirement plans.** Like life insurance policies, annuities, pension plans, and individual retirement accounts (IRAs) pass to designated beneficiaries and are not subject to testamentary disposition. See chaps 20-21.

PRACTICE TIP: Because of the formality involved in creating a will, most people remember the existence and contents of their will, but they may easily forget about pay-on-death or similar designations, or they may misunderstand the relationship between the will and a pay-on-death agreement. It is important for the attorney to explain these situations to the client, and to try to ensure that the estate plan accurately reflects the client's intentions. In most cases, the attorney should independently verify land titles and determine whether bank accounts or stock

brokerage accounts are held in the client's name alone or jointly, and whether there are pay-on-death or TOD (transfer-on-death) designations on any such accounts.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.16 B. Community Property

§5.16 B. Community Property

Except as otherwise provided by statute, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in California is community property. Fam C §760; Prob C §28. This rule also applies to property acquired by a person with a registered domestic partner during the domestic partnership. Fam C §297.5. "Quasi-community property" is real or personal property, wherever situated, acquired during marriage by either spouse while domiciled elsewhere, that would have been community property if the acquiring spouse had been domiciled in California at the time of acquisition. Quasi-community property also includes property acquired in exchange for property that would have been community property if the spouse who acquired the exchanged property had been domiciled in California at the time of its acquisition. Fam C §125; Prob C §66. Same-sex registered domestic partners may have quasi-community property if they previously acquired property during a legal union that was validly formed in another jurisdiction and recognized as substantially equivalent to a domestic partnership under Fam C §299.2, such as a Vermont civil union or a civil marriage in Massachusetts or Canada. The separate property of a married person or registered domestic partner is defined in Fam C §770. The respective interests of spouses and domestic partners in community property while both are living are present, existing, and equal. Fam C §751. On the death of a married person or registered domestic partner, one-half of the community property belongs to the surviving spouse or partner, and the other half belongs to the decedent. Prob C §100(a).

A married person's will may dispose of his or her separate property and his or her one-half of the community property. Prob C §6101. A married person may not dispose of more than his or her one-half of the community property. An attempt to dispose by will of more than the testator's one-half interest, like a gift during life, is voidable by the surviving spouse but not void. *Harris v Harris* (1962) 57 C2d 367, 19 CR 793. If a spouse attempts to dispose by will of more than his or her half, a "forced election" or "widow's election" is created. The most common application of the doctrine of election is a will that purports to dispose of both halves of the community property by placing all the community property into a testamentary trust for the benefit of the surviving spouse. After the testator's death, the surviving spouse can either go along with the disposition in the will and receive the benefit of the trust, or the survivor may elect to "take against the will" (in other words, refuse to have his or her half placed in the testamentary trust created by the deceased spouse's will), with the deceased spouse's half going to someone other than the surviving spouse. Widow's election provisions were formerly common, but are rarely seen today because of serious tax disadvantages such as reduction of the marital deduction. See California Will Drafting §17.43 (3d ed Cal CEB 1992).

PRACTICE TIP: In drafting a will for a married person, the attorney should be cautious about situations when the client wants to dispose of a specific item to a person other than his or her spouse. If the asset in question is partly or entirely community property, the surviving spouse will be able to void the gift to the extent that it disposes of his or her half of the community property, although doing so may trigger a no-contest clause.

One way to address this problem is for the spouses or partners to agree to apply the "aggregate theory" to their community property. Under the aggregate theory, each spouse or partner is seen to have owned half of all the community property, and the first spouse or partner to die has the right to dispose of his or her half in terms of total value without reference to any particular asset. By contrast, under the "item theory," each spouse or partner can dispose of only an undivided 50-percent interest in each particular asset. Spouses or partners may agree in writing to divide their community property on the basis of a nonprorata division of the aggregate value of the community property, or on the basis of a division of each individual item, or partly on each basis. Prob C §100(b). In the absence of a written agreement, California follows the item theory of community property, so that if the parties wish to use the aggregate theory to dispose of their respective estates on the basis of a nonprorata division, it is necessary to create a written agreement to that effect. See *Estate of Wilson* (1986) 183 CA3d 67, 227 CR 794.

Nontestamentary dispositions by one spouse or partner may create problems if the particular disposition is made without the written consent of the other spouse or partner. In *Estate of Wilson,* the husband created three Totten trusts in favor of his children. The trial court ruled that the surviving spouse was entitled to one-half of each account even though she was already receiving more than one-half of the total community property. In affirming the judgment, the

court of appeal reasoned that "since each Totten trust is an individual community property asset in which the decedent had only a one-half undivided interest at the time he died, he could pass on to third parties only his one-half [of] that asset." 183 CA3d at 73.

In 1992, the legislature enacted Prob C §5021, which provides that in a proceeding to set aside a nonprobate transfer of community property on death, the court shall set aside the transfer as to the surviving spouse's interest in the property unless the surviving spouse has consented in writing to the transfer. In *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240, the court held that in enacting Prob C §5021 the legislature intended to codify the rule in *Estate of Wilson, i.e.,* a surviving spouse who did not consent in writing to transfers of community property by means of a nonprobate transfer may enforce his or her community property interest on an item-by-item basis. This right is not affected by the surviving spouse's previous receipt of more than one-half of the total community property. Therefore, if one spouse or partner intends to create Totten trusts or other nonprobate devices that will be funded with community property, it is clearly necessary that he or she obtain the other spouse or partner's written consent if the transferor wants to eliminate the risk that one-half of the transfer will be ineffective. If the transferor intends to dispose of only the transferor's one-half interest, the transferor can make a nonprobate transfer that expressly transfers one-half of the property to the spouse or partner and transfers the other half to the intended donee. The spouse or partner is not entitled to retain the benefits of being a named beneficiary and also claim community property rights with respect to the same transfer. *Tyre v Aetna Life Ins. Co.* (1960) 54 C2d 399, 6 CR 13.

An additional difficulty is created by the evolution of the domestic partnership laws. Community property for registered domestic partners was established by the enactment of the California Domestic Partner Rights and Responsibilities Act of 2003 (Fam C §§297-299.6). Marital property ownership rules—including the requirement of a transmutation to change the status of property—generally apply retroactively to the date of registration of the domestic partnership. Fam C §297.5(k)(1). For domestic partners who registered before January 1, 2005, however, an agreement between the domestic partners intended to be governed by the requirements of Fam C §§1600-1620 relating to premarital agreements is enforceable if the agreement was executed and in force as of June 30, 2005. Fam C §297.5(k)(2). Therefore, while property acquired by a domestic partner before January 1, 2005, was separate property at the time of acquisition, it may now be considered community property in the absence of a contrary agreement in force by June 30, 2005.

As a consequence, a will executed after registration but before January 1, 2005, in which a specific gift is made to someone other than the testator's registered domestic partner may be voidable if the asset—separate property when the will was executed—is now community property. See §§4.42-4.45.

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§5.17 IV. CONFLICT OF LAWS

It is increasingly common for clients to own property, sometimes complete households, in two or more states or even in other countries. In addition, people often move to other areas when they retire. One of the most common questions any estate planner hears is, "Is my will effective in another state?" Questions concerning the laws of different jurisdictions arise in two general areas: (1) questions concerning the validity of a will or a provision of a will (see §§5.18-5.19); and (2) questions of interpretation of a particular provision (see §5.20).

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§5.18 A. Validity

In general, the validity of a will with respect to personal property is determined by the law of a testator's domicile. See CC §946; Prob C §§8005, 8007. The validity of transfers of real property is usually determined by application of the law of the state where the real property is located. See CC §755.

If the law of more than one state might be applied, some commentators have suggested that the law that validates the will should be applied, rather than the law that invalidates the will and results in intestacy. See Uniform Probate Code §2.506. California law follows this principle, and Prob C §6113 provides that a written will is validly executed if it is executed in accordance with:

- The laws of the place of execution at the time of execution;
- The laws of the place where at the time of execution or the time of death, the testator lives or is a national; or
- The Uniform International Wills Act (Prob C §§6380-6390).

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§5.19 B. Equitable Conversion

If the estate includes real property that the will directs the personal representative to sell and convert into money, the proceeds are considered personal property from the time of the testator's death. Prob C §21107. This is referred to as equitable conversion, and in such a situation, the law of the testator's domicile is applied. CC §946; Prob C §21107. The doctrine of equitable conversion applies only when the will clearly orders sale of the real property; it does not apply if the representative has the discretionary power to sell the property. See 14 Witkin, Summary of California Law, *Wills and Probate* §57 (10th ed 2005).

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§5.20 C. Interpretation

Questions of interpretation are determined similarly to those of validity. See §§5.18-5.19. The law of the testator's domicile controls concerning personal property, and the law of the situs controls concerning real property. However, with respect to interpretation, the courts generally enforce provisions that provide that a will should be construed according to the law of a state selected by the testator. See, *e.g.*, Prob C §21103 (meaning of disposition in will to be determined by local law of state selected by transferor unless that law is contrary to certain California public policy provisions).

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§5.21 D. Advising Client With Out-of-State Property

The attorney should take into account certain general considerations in advising a client who owns out-of-state property:

Disposition under will. The attorney should try to determine whether the law of the state where the property is located affects the will's disposition of the property. For example, if a client wishes to leave real property (presumably the client's separate property) to his or her spouse, would it be subject to expensive or time-consuming probate procedures in the foreign state?

Execution requirements. The attorney should determine whether the California will meets execution requirements in the foreign state. If the will does not comply with the law of the foreign state, it may be difficult to determine whether the foreign state will treat the California will as valid on the basis that it complies with California law. See §5.18. It is therefore prudent to have an attorney who is licensed in the foreign state review the will.

Distribution requirements. In most situations, if the client owns out-of-state real property, it may be necessary to consult a local attorney about the procedures necessary to distribute the asset after the testator's death. If an ancillary probate will be needed, the attorney should determine the estimated cost of the procedure. The attorney should then discuss the required procedures, the cost, and possible ways to reduce the cost with the client. It may also be prudent to contact an attorney in the foreign state and ask that he or she review the California will (or trust) to be certain the document is valid in both states. The out-of-state attorney's comments should be in writing and a copy should be sent to the client.

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§5.22 V. ADMINISTRATION OF DECEDENT'S ESTATE

The most important disadvantage to the use of a will as the central estate planning document is the expense and delay in distribution involved in the probate process. This is the primary reason that revocable trusts are so frequently used as substitutes for wills.

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§5.23 A. Small Estate Administration

When a person dies, his or her property must be identified and transferred to the individuals entitled to it, including the decedent's creditors and the tax authorities. A decedent's property is subject to administration under the Probate Code except as otherwise provided by law, and is subject to the rights of beneficiaries, creditors, and other persons as provided by law. Prob C §7001. The particular method of administration varies depending on the nature and value of the decedent's property. When an attorney is consulted concerning estate planning, he or she must be prepared to discuss whether probate administration will be required for the client's estate, and if so, what the cost is likely to be. There are several procedures available that make probate administration unnecessary. See §§5.24-5.29.

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§5.24 1. Collection of Small Estates by Affidavit

The affidavit procedure provided in Prob C §§13100-13116 can be used to collect the decedent's personal property when the gross value of the decedent's real and personal property in California does not exceed $100,000. Prob C §13100(a). The affidavit procedure cannot be used to transfer real property. Prob C §13115. On transferring real property, see §5.25. The "gross value" of the estate does not include real or personal property located outside California, motor vehicles including cars and trucks, boats, mobile homes, manufactured homes, amounts due the decedent for service in the armed forces, up to $5000 of salary due the decedent (Prob C §13050(b), (c)), and property in which the decedent's interest was terminable at death, such as property held in joint tenancy, life estates, and property passing to a spouse under Prob C §13500.

If the decedent dies testate, the persons named in the will are entitled to use the procedure. If the decedent dies intestate, the persons entitled to use the procedure are limited to the decedent's spouse, issue, parents, grandparents, or the trustee of an inter vivos trust established by the decedent in which a person with any of these relationships is the primary beneficiary, or any other successor as defined in Prob C §13006. See Prob C §13100. To collect property using the affidavit procedure, 40 days must have elapsed since the decedent's death. Prob C §13100. The successor prepares an affidavit that includes the information specified in Prob C §13101 and presents it to the person having custody of the item. If the decedent's estate includes real property, the affidavit must be accompanied by an inventory and appraisal of the real property. Prob C §13103.

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§5.25 2. Real Property

There are two procedures available to transfer real property included in a small estate. Under Prob C §§13150-13158, if there is no probate proceeding in California for the decedent's estate, or if the decedent's personal representative consents in writing to the use of the procedure, and if the gross estate is less than $100,000, the successor may file a petition with the superior court to determine succession to real property. The petition may include an additional request that the court make an order determining that the petitioner has succeeded to personal property. Prob C §13151. An inventory and appraisal of all of the decedent's real and personal property made by a probate referee must be attached to the petition. Prob C §13152(b). The form for the petition is provided on Judicial Council Form DE-310 (Petition to Determine Succession to Real Property).

Under Prob C §§13200-13210, there is also a procedure for obtaining title to real property if the value of all of the decedent's real property in California does not exceed $20,000. The procedure requires 6 months to have elapsed since the decedent's death. Prob C §13200(a). An affidavit is filed with the superior court; an inventory and appraisal must be attached. Prob C §13200(c). On receipt of the affidavit and a fee of $30, the court clerk must file the affidavit and attachments and issue a certified copy of the affidavit. Prob C §§13201-13202; Govt C §70626(b). The affidavit is then recorded in the county in which the real property is located. Prob C §13202.

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§5.26 3. Small Estate Set-Aside

If all of a decedent's personal property wherever located, and all of a decedent's real property in California, does not exceed $20,000, a procedure is available under Prob C §6600-6615 for a summary set-aside of the estate. In this case, the $20,000 is the net value of the estate, which is computed by reducing the gross value of the estate by the amount of liens and encumbrances and by the value of any probate homestead set aside under Prob C §6520. The procedure is available only to the decedent's surviving spouse (even if remarried) and to the decedent's minor children.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.27 4. Passage of Property to Surviving Spouse Without Administration

§5.27 4. Passage of Property to Surviving Spouse Without Administration

If all or part of the decedent's estate passes to his or her surviving spouse, the property may pass without administration. Prob C §§13500-13503.

WARNING: The utility of the procedure under Prob C §§13500-13503 is questionable because title companies and transfer agents are usually reluctant to rely solely on marital status without having some sort of court document to confirm passage of the property to the spouse. On an alternative procedure available involving a court order, see §5.28.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.28 5. Determination or Confirmation of Property Passing or Belonging to Surviving Spouse or Registered Domestic Partner

§5.28 5. Determination or Confirmation of Property Passing or Belonging to Surviving Spouse or Registered Domestic Partner

Under Prob C §§13650-13660, a surviving spouse or registered domestic partner, the personal representative, or certain other persons may file a petition with the superior court for an order that administration of all or part of the estate is not necessary, because all or part of the estate passes to the surviving spouse or domestic partner. If a petition for probate or for letters of administration is also filed, the petition for spousal or domestic partner property determination or confirmation must be filed separately even if the petitions are filed at the same time. Cal Rules of Ct 7.301. However, both petitions must be filed under the same case number. Cal Rules of Ct 7.301. The petition is filed on Judicial Council Form DE-221 (Spousal or Domestic Partner Property Petition).

Notice must be served on any nonpetitioning representative of the estate, all heirs, devisees, and legatees of the decedent, and all beneficiaries of a trust that is a devisee, as well as on all persons who have requested special notice, all persons who have given notice of appearance, and the Attorney General if the decedent's will involves a charitable bequest or devise. Prob C §13655. The order is made on Judicial Council Form DE-226 (Ex Parte Petition for Authority To Sell Securities and Order).

NOTE: No inventory and appraisal is required under this procedure, although having the probate referee prepare an inventory and appraisal may be worthwhile to establish basis for income tax purposes.

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§5.29 6. Cost of Procedures

All of the procedures described in §§5.24-5.28 are relatively simple, and the cost to the decedent's successors is usually modest. In discussing estate planning with a client, if it appears that the client's estate can be transferred after his or her death by means of one of these procedures, it is usually appropriate to prepare a will rather than a revocable trust simply because the combined cost of preparing the will and completing the summary procedure after the client's death will ordinarily be less than the cost of preparing a revocable trust. On the advantages and disadvantages of revocable trusts, see chap 6.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.30 B. Probate Administration

§5.30 B. Probate Administration

When a client consults an attorney about estate planning, the client's concern with the probate process is likely to be the time and cost involved. Many people have had unfortunate experiences or have heard stories about probate procedures that were quite lengthy and expensive. In practice, probate administration can seldom be completed in fewer than 6 months. Although administration of a simple trust when no federal estate tax return is required may be somewhat shorter, in most situations the time for completion of the two procedures is similar. Probate administration often lasts longer than 6 months because of delays caused by the need to sell real property or prepare estate tax returns; the same problems within a trust administration often result in similar delays.

However, the cost of probate administration versus trust administration may be quite different with larger estates. The most substantial cost of probate is personal representative fees and attorney fees. The personal representative receives compensation (the "statutory fee") based on the gross value of the estate, as follows (Prob C §10800):

- Four percent on the first $100,000;
- Three percent on the next $100,000;
- Two percent on the next $800,000;
- One percent on the next $9,000,000;
- One-half of 1 percent on the next $15,000,000; and
- Above $25,000,000, a reasonable amount to be determined by the court.

The attorney is compensated for ordinary services on the same schedule. See Prob C §10810. Based on these percentages, statutory fees can be considerable.

EXAMPLE: The combined representative's fee and attorney's fee for probate of an estate valued at $400,000 would be $22,000. Costs of publication and filing fees would raise the cost by several hundred dollars. Termination and distribution of a fairly simple trust with assets of $400,000, on the other hand, should cost much less.

In addition to compensation for ordinary services, the personal representative and the attorney may be compensated for extraordinary services. See Prob C §§10801, 10811. Extraordinary services are not defined in the Probate Code, but, in general, extraordinary fees are allowed for services that ordinarily are not required in estate administration. However, the court cannot approve in advance an arrangement providing for variable fees that is not a contingent fee agreement within the meaning of Prob C §10811(c). See *Estate of Stevenson* (2006) 141 CA4th 1074, 46 CR3d 573 (court order approving agreement to pay variable fees for handling claims for and against insolvent estate was invalid).

EXAMPLE: Extraordinary services include litigation services by the attorney, legal services defending the estate against claimants, sales of real property, preparation of tax returns, and defense of will contests.

Although the cost of administration of a small trust may be somewhat less than that of a probate administration, the fact that there is a cost at all is sometimes misrepresented by attorneys and others who are hoping to be hired to prepare the trust. Many clients have the impression that if they have a revocable trust, the process of termination and distribution after the settlor's death will involve little or no cost. Unfortunately, this is usually not true, and the attorney should try to educate the client about the likely cost of trust administration.

When a client is trying to decide whether he or she should have a will or a trust, the attorney should explain the advantages and disadvantages of each, the cost of preparing each, and the cost of postmortem administration. If this is done, clients with estates valued at less than $100,000 usually elect to have a will because of the availability of the various summary procedures for small estates discussed in §§5.24-5.29. Individuals with large estates usually elect a trust due to the benefits of avoiding a costly probate process.

For more discussion of revocable trusts, see chap 6. For a full discussion of probate administration, see California Decedent Estate Practice (2d ed Cal CEB 2009).

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C. Problems With Dispositions

§5.31 1. Types of Gifts

Traditionally, a testamentary gift of an interest in real property is termed a "devise," and gifts of personal property are called "bequests" or "legacies." These terms, which have been used interchangeably by the courts, have had little legal significance. See, *e.g., Estate of Gracey* (1927) 200 C 482, 491, 253 P 921. The Probate Code now recognizes the interchangeability of these terms. When used as a noun, "devise" means "a disposition of real or personal property by will"; when used as a verb, "devise" means "to dispose of real or personal property by will." Prob C §32. Because "devise" is now defined by the Probate Code, the will drafter should exercise caution when using that word in a will.

Probate Code §21117 recognizes six categories of gifts. The classification of a particular gift is important primarily for the purpose of determining which gifts are subject to abatement. See §5.32. The six categories of gifts are (Prob C §21117):

(1) A *specific gift* is a gift of a particular thing; *e.g*., "I give my wedding ring to *A*."

(2) A *general gift* is a gift from the general estate that does not give specific property. For example, a gift of "300 shares of common stock of General Motors Corporation" is a general gift, particularly if the will instructs the executor to buy GMC stock on the open market for the beneficiary if the estate stock is insufficient at the testator's death. In contrast, a gift of "*my* 300 shares of General Motors Corporation stock" is a specific gift.

(3) A *demonstrative gift* designates a particular fund or asset from which the gift is to be made; *e.g.,* "I give the sum of $5000 to *B* to be paid from my credit union savings account."

(4) A *general pecuniary gift* is a gift that is expressly stated either as a fixed dollar amount or as a dollar amount determinable by the provisions of the will. For example, "I give the sum of $25,000 to *C,*" and a gift to a surviving spouse of an amount determined by a pecuniary amount marital deduction formula clause, are general pecuniary gifts.

(5) An *annuity gift* is a general pecuniary gift that is payable periodically; *e.g.,* "I give the sum of $500 per month to *D* for the rest of her life."

(6) A *residuary gift* is a gift of all that remains after all specific and general gifts are discharged; *e.g.,* "I give the residue of my estate to *E.*"

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Source: Estate Planning/California Estate Planning/5 Wills/§5.32 2. Abatement

§5.32 2. Abatement

"Abatement" refers to a reduction or diminution of testamentary gifts. In the typical situation, residuary gifts are abated because residuary assets are used to discharge the decedent's debts and expenses of administration or to satisfy gifts. Abatement becomes a problem when the residue is insufficient to pay all debts, expenses, and gifts in full.

Probate Code §§21400-21406 set forth the order in which testamentary gifts abate. These rules apply for all payment of debts, expenses, and other charges and satisfaction of gifts, but they do not apply to payment and apportionment of estate taxes. Prob C §21401.

Testamentary gifts abate in the following order (Prob C §21402(a)):

- Property disposed of by the laws of intestate succession;
- Residuary gifts;
- General gifts to persons other than the testator's relatives;
- General gifts to the testator's relatives;
- Specific gifts to persons other than the testator's relatives; and
- Specific gifts to the testator's relatives.

Annuities and demonstrative gifts are considered to be specific gifts to the extent they are satisfied out of the fund or asset specified in the will, and general gifts to the extent they are satisfied out of other property. Prob C §21403(b). All gifts within a particular class abate pro rata. Prob C §21403(a).

PRACTICE TIP: The attorney should discuss with the client how the statutory rules of abatement apply to the client's dispositive scheme. If the client does not wish the statutory rules to apply to his or her will, the attorney should draft abatement provisions in the will to effectuate the client's preferences. Provisions in a will that provide for abatement supersede the statutory abatement provisions. Prob C §21400.

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§5.33 3. Ademption

If the testator makes a specific gift of property that does not exist or is not in the testator's estate at the time of the testator's death, the gift may be considered adeemed (extinguished). This may occur when property has been exchanged, sold, lost, destroyed, or given away during the testator's lifetime. When ademption occurs, the personal representative may not substitute other assets in place of the specific devise.

Whether ademption occurs depends primarily on what can be inferred about the testator's intent. There is no ademption without sufficient proof that the testator intended the gift to fail. *Estate of Austin* (1980) 113 CA3d 167, 173, 169 CR 648.

The Probate Code provides statutory provisions specifying to what devisees are entitled when property that was specifically devised is no longer in the testator's estate at death. See Prob C §§21132-21135. These statutory provisions resemble the provisions concerning ademption in the Uniform Probate Code and reject to some extent the common law rules on ademption. These statutory provisions include the following rules:

Securities. If the testator intended a specific gift of securities (rather than a general gift of the equivalent value), the devisee is entitled to additional securities owned by the transferor at death that are acquired by the transferor after execution of the instrument as a result of the transferor's ownership of the described securities, provided that the securities are (a) securities of the same organization acquired by action initiated by the organization, or any successor organization, excluding any acquired by exercise of purchase options; (b) securities of another organization acquired as a result of merger, consolidation, or reorganization; or (c) securities of the same organization acquired as a result of a plan of reinvestment. Prob C §21132.

Specifically devised property. A devisee is entitled to the remainder of the specifically devised property, the balance of the purchase price owed to the testator by the buyer at the time the gift takes effect (ordinarily the time of the testator's death), any eminent domain award unpaid at the time the gift takes effect, and any insurance proceeds resulting from fire or casualty insurance on the property or other recovery for injury to the property. Also, the recipient of a gift is entitled to property owned by the transferor at the time the gift takes effect if the gift is acquired as a result of foreclosure or obtained in lieu of foreclosure of the security interest for a specifically given obligation. Prob C §21133.

Specifically devised property sold or mortgaged by conservator or agent. If, after execution of the instrument, specifically devised property is sold or mortgaged by a conservator or agent under a durable power of attorney for an incapacitated principal, the devisee is entitled to a general pecuniary gift equal to the net sale price of, or the amount of the unpaid loan on, the specifically devised property. Also, if an eminent domain award for the taking of specifically devised property or insurance proceeds is paid to a conservator or agent, the devisee is entitled to a general pecuniary gift equal to the amount of the award or proceeds. Prob C §21134.

These provisions address issues frequently faced by courts and practitioners. Following the growing judicial trend against finding ademption, Prob C §21139 provides that the ademption rules should not be construed to increase the incidence of ademption under California law. Rather, the rules apply only when the testator's intention is not indicated in the will. Prob C §21102(b).

In *Brown v Labow* (2007) 157 CA4th 795, 69 CR3d 417, the court held that dissolution of a corporation by the successor trustee of an incapacitated settlor's revocable trust did not cause ademption of a specific gift of stock that was to be distributed from the trust on the settlor's death. The court rejected the contention that California case law concerning ademption of property of incapacitated persons by conservators should not apply because of the subsequent enactment of Prob C §21134. See *Estate of Mason* (1965) 62 C2d 213, 42 CR 13; *Estate of Ehrenfels* (1966) 241 CA2d 215, 50 CR 358; *Estate of Packham* (1965) 232 CA2d 847, 43 CR 318.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.34 4. Exoneration

§5.34 4. Exoneration

Unless the will provides otherwise, a specific gift of encumbered real property passes the property to the beneficiary subject to the encumbrance, without right of exoneration. Prob C §§21102, 21131.

PRACTICE TIP: Because a testator is free to determine whether encumbrances on devised property should be exonerated, it is important for the will drafter to specify in the will the testator's desires regarding payment of encumbrances from other estate assets. If the testator desires exoneration of encumbered specific gifts, he or she must further decide whether specific gifts of other property should abate for the purpose of exonerating the encumbered property. A testator who does not provide for such abatement will be presumed not to have desired it. Prob C §21404.

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§5.35 5. Gifts to Drafters

With certain exceptions, an attorney or other person who drafts the will is disqualified from taking under the will, and any provision in the will that makes a donative transfer to such a person is invalid. Prob C §21350(a)(1). For a full discussion of limitations on gifts to drafters, see chap 2.

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§5.36 VI. COMMON DRAFTING ISSUES

A well drafted will must be grounded on a thorough understanding of the law of wills. Most experienced and knowledgeable lawyers have developed forms that serve not only as a framework for the instrument, but also as a checklist or reminder of the various issues that must be addressed in every will. Good forms are available from a number of sources (see California Will Drafting (3d ed Cal CEB 1992)) and can provide a starting point for the less experienced attorney, but no form can take the place of an attorney's thoughtful planning.

A will is ambulatory, *i.e.*, it can be changed at any time before the testator's death, so it speaks only at the time the testator dies, not when it is executed. Frequently a client may have an attorney prepare a will and may never review it even though many years have passed. Between the execution of the will and the testator's death many things can change, including the value of the testator's estate and the particular property included in it, whether beneficiaries named in the will are still alive, or whether new family members have been born. A well drafted will should anticipate these changes as much as possible. A will that fails to anticipate changes in the estate or the beneficiaries may result in partial intestacy or the need to ask a court to construe it.

The general considerations in §§5.37-5.53 may help to draft a will that expresses the testator's intent even after significant changes have occurred in the testator's estate or to the beneficiaries or family members. See Featherston, *Back to Basics—Will and Trust Construction and Drafting: Selected Non-Tax Issues*, Estate Planning 1999 (Cal CEB 1999).

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§5.37 A. Definition of Intended Beneficiaries

The will should define terms like "children," "descendants," and "issue." Are stepchildren, nonmarital children, adopted children, or foster children to be included within those terms? If class gifts are made in the will, the will should define who is included in or excluded from the class.

EXAMPLE: The will states "I give $10,000 to each of my grandchildren who survives me." Does this include only persons living at the date the will was executed or all members of the class living at the death of the testator? It is good practice to define what the testator means by such terms.

Sample will language might read:

The terms "grandchild" or "grandchildren" will include all persons born to or adopted by a child of mine who are living at the time of my death but will not include persons adopted as adults.

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§5.38 B. Survivorship and Alternate Disposition

The will should provide a survivorship period, *e.g.,* 120 days, 3 days, or similar language, but not longer than 6 months in the case of a devise to the testator's spouse (see §17.14), and it should clearly provide what happens if the beneficiary does not survive the testator. A typical survivorship provision might read:

I give $5000 to my brother, James Jones, if he survives me by _ _[*number*]_ _ days, and if he does not, the gift will lapse and become part of the residue of my estate.

Note that careless use of the phrase "survives" in place of "survives me" could render this clause ambiguous as to whether the beneficiary must survive the testator or the execution of the will. See *Burkett v Cappovilla* (2003) 112 CA4th 1444, 5 CR3d 817 (ambiguous trust survivorship clause required distributees to survive 60 days after settlor's death).

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§5.39 C. Gift to Minors

If a gift may be made to a minor, the will should provide for the gift to be distributed to a custodian under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) or to a testamentary trust. For discussion of CUTMA, see California Will Drafting §§22.13-22.15 (3d ed Cal CEB 1992).

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§5.40 D. Testator's Attempt to Dispose of Property That Does Not Belong to Him or Her

The will should clearly indicate what property the testator intends to dispose of under the will. Ordinarily the will disposes of the testator's probate assets and not assets over which the testator lacks the power of testamentary disposition. If the settlor is married, the will should provide that the testator intends to dispose of only his or her separate property and his or her half of the community property unless the testator intends to put his or her spouse to a "forced election." See §5.16.

Assets that the testator cannot dispose of by will should not be mentioned unless the testator wishes to clarify the gift. For example, if the testator holds certain property in joint tenancy with another person, leaving it to some third party in the will is likely to cause serious problems between the surviving joint tenant and the named beneficiary. For discussion of nonprobate property, see chap 7. To overcome such problems, a provision in the will relating to joint tenancy property could be worded as follows:

I hold my checking account at Big Sky Bank in Chico, California, as a joint account with my son, William Smith, and it is my intention that the funds remaining in that account at the time of my death will belong to him.

Such a provision may clarify the testator's interest and avoid potential unpleasantness in the family over whether the decedent actually intended that William would receive the checking account.

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§5.41 E. Powers of Appointment

The will should clearly indicate whether the testator intends to exercise any power of appointment. A power of appointment is a power to dispose of property. General and special powers of appointment are defined in and governed by Prob C §§600-695. For a full discussion of creation and exercise of powers of appointment, see chap 9.

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§5.42 F. Possible Death of Beneficiaries

The will should anticipate the possibility that a beneficiary may die before the testator and provide an alternate disposition of the gift if that should occur. Sample language might read:

I give $10,000 to my nephew, James Brown, if he survives me, and if he does not this gift will lapse and become part of the residue of my estate.

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§5.43 G. Residuary Clause

The will should always include a residuary clause and provide for alternate dispositions to avoid intestacy. A sample will provision for gifts of the residue in equal shares might read:

I give the residue of my estate in equal shares to those of the following three persons who survive me: Susan Brown, Nancy Smith Jones, and Sharon Ann Davis.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.44 H. Anti-Lapse Statute

§5.44 H. Anti-Lapse Statute

When drafting the residuary clause in particular (see §5.57), the attorney must be aware of the anti-lapse statute, Prob C §21110. The statute provides an alternate disposition of a gift to the issue of a deceased beneficiary when (Prob C §21110):

- The beneficiary does not survive the testator and so does not take under the will (Prob C §21109);
- The beneficiary is kindred of the testator, or of the testator's surviving, deceased, or former spouse; and
- The will does not express a contrary intent (including that the beneficiary survive for a specified period of time after the death of the testator) or a substitute disposition.

See *Estate of Lensch* (2009) 177 CA4th 667, 99 CR3d 246, in which the court held that the executor of the beneficiary's will had the burden of proving by clear and convincing evidence that the beneficiary (whose body was discovered shortly after the testator's death) survived the testator under Prob C §220; otherwise, the court held that the beneficiary's sons were entitled to the lapsing gift when the beneficiary was the testator's son and no substitute disposition was provided in the testator's will.

EXAMPLE: The will provides "I give $25,000 to my grandchild George Smith," and George predeceases the testator. The anti-lapse statute causes the gift to be distributed to George's issue.

It is poor practice to rely on the anti-lapse statute (or on any other rule of construction or interpretation) to carry out the testator's wishes. The anti-lapse statute may seem clear to the attorney, but it is not necessarily clear to laypersons.

EXAMPLE: "I give $5000 to my nephew Tom Jones" is subject to the anti-lapse statute if Tom does not survive the testator, because Tom is kindred and because no contrary intent or substitute disposition is made. But a gift "to my nephew Tom Jones if he survives me" will lapse if Tom does not survive the testator because "if he survives me" expresses a contrary intent that voids the anti-lapse statute. See Prob C §21110(b).

Good drafting practice should state the gift and provide an alternate disposition in terms a layperson can readily understand. A sample alternative disposition might read:

I give $25,000 to my grandchild, George Smith, if he survives me, and if he does not, to his issue who survive me in the manner provided in Probate Code §246.

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§5.45 I. Possible Changes in Assets

The will should anticipate changes in property that is specifically given. If certain property is the subject of a specific gift, the will should indicate whether the property passes subject to or free of encumbrances. If an item may be sold by the settlor before death, the will should indicate if the beneficiary is entitled to any part of the sale price that remains unpaid at the testator's death.

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§5.46 J. Individual Retirement Accounts

If the testator's spouse has an individual retirement account (IRA) that is community property, the will should indicate whether the testator intends to dispose of his or her community property share of the IRA. This is not a problem if the testator leaves all of his or her estate or the residue of his or her estate to the surviving spouse, but a gift of the residue or all of the testator's estate to someone other than the surviving spouse carries the possibility that the testator means to give his or her community property interest in the spouse's IRA to the beneficiary named in the will. For further discussion of estate planning considerations with respect to IRAs, see chap 21. For discussion of nonprobate transfers of community property, see §§7.12-7.18.

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§5.47 K. Tax Apportionment

If the will does not contain a tax apportionment clause, estate taxes must be paid pro rata by the recipients of the estate, including persons who receive gifts of nonprobate property. Prob C §§20110-20111.

EXAMPLE: A testator provides for a gift of $10,000 to a close friend and leaves the residue of the estate to the testator's children. If the estate is taxable, the friend pays a prorata share of the estate taxes unless the will provides to the contrary.

If the client chooses to deviate from the statutory apportionment of estate taxes, the attorney must draft provisions that are clear and unambiguous. Failure to do so may lead not only to costly litigation but also to a result inconsistent with the testator's wishes.

WARNING: The attorney should avoid boilerplate tax clauses that charge all taxes to the residue without apportionment. When a portion of the residue passes to the spouse, the clause may result in a lower net amount passing to the spouse, a lower marital deduction, and an increase in estate tax. See *Estate of Betty Pace Miller*, TC Memo 1998-416, aff'd (5th Cir 2000) 209 F3d 720 (unpublished opinion). See also *Lurie v Commissioner* (7th Cir 2005) 425 F3d 1021 (revocable trust apportionment clause requiring payment of estate taxes from residue of trust resulted in depletion of trust when trusts previously established by other persons were unexpectedly included in the decedent's estate for estate tax purposes).

The attorney also must ensure that the will clause apportioning the estate's tax burden clearly states which taxes are subject to its provisions. The clause should specify whether it is intended to include, *e.g.*, federal estate taxes, California and other state estate or inheritance taxes, federal and state generation-skipping transfer (GST) taxes, and the recapture tax under IRC §§2032A and 2057. A general reference to "all taxes due as a result of my death" is not adequate. For example, IRC §2603(b) permits a will to direct apportionment of the GST tax in a manner other than that called for by statute as long as the will makes "specific reference" to the GST tax.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.48 L. Distribution Formulas for Class Gifts

§5.48 L. Distribution Formulas for Class Gifts

If the testator makes a gift to a class or provides for alternate gifts to a class such as a predeceased beneficiary's issue or descendants, the will should specify how the gift is to be shared among the class. Probate Code §§240-247 provide different division formulas, and many practitioners prefer simply to refer to one of these sections rather than reproducing the formula.

The general rule is that the testator's intent determines the manner of distribution. *Lombardi v Blois* (1964) 230 CA2d 191, 40 CR 899. If the testator's intent is unknown, the members of the class take per capita (equally), even when a gift is made to an individual and a group of persons ("to *A* and the children of *B*") or when a gift is made to several groups constituting the class ("to the children of *A*, *B*, and *C"*). 14 Witkin, Summary of California Law, *Wills and Probate* §221 (10th ed 2005). However, Prob C §245 modifies the above common law rule when the class involved consists of issue or descendants. When the will does not specify the manner in which issue or descendants are to take, the distribution pattern described in Prob C §240 is employed. Prob C §245.

The statutes present three alternative distributive schemes that the attorney should discuss with the client:

(1) Under Prob C §240 (distribution by representation based on nearest generation with living members) the property is divided

> into as many equal shares as there are living members of the nearest generation of issue then living and deceased members of that generation who leave issue then living, each living member of the nearest generation of issue then living receiving one share and the share of each deceased member of that generation who leaves issue then living being divided in the same manner among his or her then living issue.

(2) Under Prob C §246, the property subject to the class gift is divided

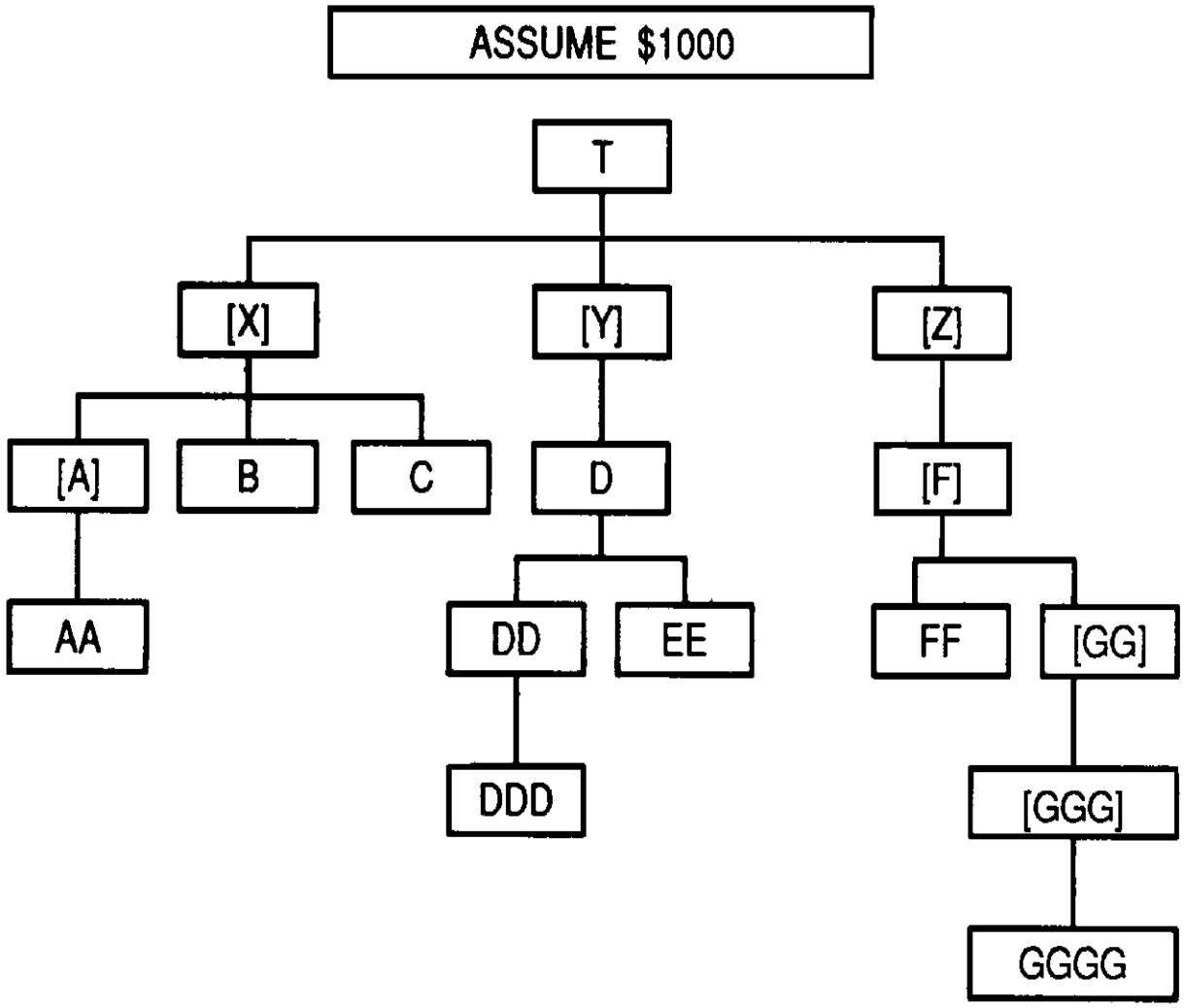
> into as many equal shares as there are living children of the designated ancestor, if any, and deceased children who leave issue then living. Each living child of the designated ancestor is allocated one share, and the share of each deceased child who leaves issue then living is divided in the same manner.

(3) Under Prob C §247, the property is divided in a "per capita at each generation" disposition scheme

> into as many equal shares as there are living members of the nearest generation of issue then living and deceased members of that generation who leave issue then living. Each living member of the nearest generation of issue then living is allocated one share, and the remaining shares, if any, are combined and then divided and allocated in the same manner among the remaining issue as if the issue already allocated a share and their descendants were then deceased.



Distribution Under Probate Code §§240–247



By Representation (§246)	*§240*	*"Per Capita" at Each Generation (§247(a))*
B–1/9 = $111.11	B–1/5 = $200	B–1/5 = $200
C–1/9 = $111.11	C–1/5 = $200	C–1/5 = $200
AA–1/9 = $111.11	D–1/5 = $200	D–1/5 = $200
D–1/3 = $333.33	AA–1/5 = $200	AA–2/15 = $133.33
FF–1/6 = $166.67	FF–1/10 = $100	FF–2/15 = $133.33
GGGG–1/6 = $166.67	GGGG–1/10 = $100	GGGG–2/15 = $133.33

If the testator prefers the distribution scheme outlined in Prob C §240, the will should call for the gift to be distributed "in the manner provided in Section 240 of the Probate Code." Prob C §245(a). If the testator prefers the distribution

scheme outlined in Prob C §246, the will should call for the gift to be either (1) distributed "in the manner provided in Probate Code §246" or (2) distributed "per stirpes," "by representation," or "by right of representation." Prob C §246(a), (b). If the testator prefers the distribution scheme described in Prob C §247, the will should call for the property to be taken either (1) "in the manner provided in Section 247 of the Probate Code" (Prob C §247(a)) or (2) distributed "per capita at each generation" (Prob C §247(b)).

Thus, to provide an alternate gift to a class, the testator might include the following provision in the will:

I give $10,000 to my nephew, John Smith, if he survives me, and if he does not, to his issue who survive me, in the manner provided in Probate Code §246.

NOTE: The attorney should keep in mind that different states define "by right of representation" and other distributive phrases in different ways.

For more on different schemes for distribution of class gifts, see California Will Drafting §§12.32-12.34 (3d ed Cal CEB 1992).

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§5.49 M. Choice of Law Provision

A choice of law clause provides that the laws of a particular state will be applied in matters of interpretation or construction. A typical choice of law clause might read:

The validity, interpretation, and construction of any provision of this will shall be governed by the laws of the State of California in effect on the date of execution.

Including a choice of law clause can avoid an unexpected construction of a will provision if the client moves to another state.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.50 N. Disinheritance

§5.50 N. Disinheritance

If the testator intends to make no gift to a spouse or child, the will should include language specifically disinheriting that person. The same is true if the testator intends not to provide for a stepchild or foster child.

The following heirs must be specifically omitted from the will or they may be able to claim intestate shares as omitted heirs:

- A child of the testator born or adopted after the will was executed (Prob C §§21620-21621);
- A child omitted because the testator mistakenly believed the child to be deceased (Prob C §21622);
- A child of whose birth the testator was unaware (Prob C §21622); or
- A spouse who married the testator after the execution of the will (Prob C §21610).

It is unclear whether stepchildren or foster children may claim as omitted children under Prob C §21620. "Child" is defined in Prob C §26 as a person who can claim from a parent by intestate succession. Probate Code §6454, which describes the parent-child relationship for purposes of intestate succession, gives inheritance rights to some stepchildren and foster children. See *Estate of Joseph* (1998) 17 C4th 203, 70 CR2d 619 (court held statute did not apply when there was no legal barrier to adoption after claimant attained age of majority). Probate Code §6455 also preserves the judicial doctrine of equitable adoption. See *Estate of Ford* (2004) 32 C4th 160, 8 CR3d 541 (claimant must demonstrate some direct expression, on decedent's part, of attempt to adopt claimant). A child adopted before the parent's will or trust was executed does not take a share of the estate, but this rule may not prevent a lawsuit if the child is omitted without explanation. See, *e.g., Estate of Mowry* (2003) 107 CA4th 338, 131 CR2d 855.

Therefore, it is prudent for a testator who wishes not to provide for a spouse, child, stepchild, or foster child to do so explicitly. Although it may appear that certain persons—*e.g.,* a child of the testator born before execution of the will and clearly known to the testator—have no arguable right to the estate if they are not mentioned in the will, failure to inherit from a parent or spouse often causes a powerful emotional reaction and may well result in litigation. If it is clear from the document that the disinheritance was intentional, there is a better chance of forestalling trouble. Although clients often tell the attorney why they wish to disinherit a particular person, it is better not to recite in the will the reason for disinheriting someone. The disinherited person may be angered by the statement or may wish to contest the will in order to prove the testator to be mistaken.

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§5.51 O. Perpetuities Savings Clause

The common-law rule against perpetuities is being reformed or abolished in many states. California has adopted the Uniform Statutory Rule Against Perpetuities (USRAP) (Prob C §§21200-21231). Under USRAP, a nonvested interest is invalid unless it vests or terminates either (Prob C §21205):

- Within 21 years after the death of an individual alive when the interest was created; or
- Within 90 years after the interest was created.

To avoid pitfalls, the will should include a perpetuities savings clause if the will creates a testamentary trust or any other future interests. A perpetuities savings clause in a testamentary trust operates by terminating the trust and all its original interests at the end of the allowable period if the trust actually lasts that long. The clause also sets forth an alternative distribution for the trust property in that event. See California Will Drafting, chap 34 (3d ed Cal CEB 1992).

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§5.52 P. Debts of Beneficiaries

If any devisee is indebted to the testator, whether or not the debt is enforceable, the will should direct the representative on whether to take the debt into consideration in determining the gift to the debtor.

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§5.53 Q. Contracts to Make Will

If the testator has not entered into a will contract, the will should include a statement to that effect. On will contracts and alternatives to them, see California Will Drafting §§1.8-1.16 (3d ed Cal CEB 1992).

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VII. FORM: SIMPLE (NON-TRUST) WILL

§5.54 A. Form: Title; Testator's Declaration

5.54-1 Title; revocation of prior wills

WILL OF
_ _[*testator's name*]_ _

I, _ _[*name*]_ _, a resident of _ _[*name of county*]_ _ County, California, declare that this is my will. I hereby revoke all wills and codicils that I have previously made.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.55 B. Form: Introductory Provisions: Spouse, Children, Definition of Children, and Community Property

§5.55 B. Form: Introductory Provisions: Spouse, Children, Definition of Children, and Community Property

5.55-1 Introductory provisions

ARTICLE ONE

INTRODUCTORY PROVISIONS

1. Marital Status. I am married to _ _[*name*]_ _ and all references in this will to my _ _[*husband/wife*]_ _ are to _ _[*him/her*]_ _.

2. Children. I have _ _[*number*]_ _ living children whose names are _ _[*names*]_ _.

[*If applicable, add one or more of the following options*]

[*Option 1: Stepchildren*]

I have _ _[*number*]_ _ stepchildren whose names are _ _[*names*]_ _.

[*Option 2: Foster children*]

I have no foster children.

[*Option 3: Deceased children*]

I have _ _[*number*]_ _ deceased children whose names are _ _[*names*]_ _.

[*Continue*]

3. Definitions of "Child" and "Issue." As used in this will, the term "child" will have the meaning provided in California Probate Code §26 in effect on the date this will is executed. The word "issue" will have the meaning provided in California Probate Code §50 in effect on the date this will is executed.

4. Property to be Disposed of. It is my intention in making this will to dispose of my separate property and my half interest in the community property of my marriage to _ _[*name*]_ _. I confirm to _ _[*him/her*]_ _ _ _[*his/her*]_ _ interest in the community property of our marriage.

5. No Contract to Make Will. I have not entered into a contract to make a will or testamentary gift or a contract not to revoke wills.

6. No Exercise of Power of Appointment. I intentionally do not exercise any power of appointment which I have at the time of my death.

Comment: On the definition of intended beneficiaries, see §5.37. On powers of appointment, see chap 9.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.56 C. Form: Gifts of Money and Property

§5.56 C. Form: Gifts of Money and Property

5.56-1 Gifts of money and property

ARTICLE TWO

GIFTS OF MONEY AND PROPERTY

1. Gift to [*name*]. **I give the sum of** [*dollar amount*] **to** [*name*] **if** [*he/she*] **survives me, and if not,** [*to* [*his/her*] *issue who survive me, their identity and their respective shares to be determined in the manner provided in California Probate Code §246 in effect on the date this will is executed/ this gift will lapse and be distributed with the residue of my estate*] **.**

2. Gift of Real Property. I give my interest in the real property commonly known as [*address*] **, together with my interest in any insurance on the property,** [*describe gift of real property, including survivorship provisions, e.g., in equal shares to my daughters* [*name*] *and* [*name*] *. If either of my daughters does not survive me, and if she leaves children who survive me, the share of this gift that otherwise would have been distributed to my deceased daughter will instead be distributed, in equal shares, to her children who survive me. If either of my daughters does not survive me and leaves no children who survive me, the share of this gift that otherwise would have been distributed to that deceased person will be added to the share distributed to my other daughter if she survives me, or to her children who survive me if she does not. If neither of my daughters survives me and if neither of them leaves children who survive me, this gift will lapse and become part of the residue of my estate*] *.* **If neither the real property commonly known as** [*address*] **, nor any interest in it, is included in my estate at the time of my death, this gift will lapse. The real property will pass subject to any liens and/or encumbrances on it, without exoneration. The property is more fully described as:** [*legal description of real property*] **.**

3. Gift of Tangible Personal Property. I give all of my clothing, jewelry, furniture and furnishings, motor vehicles, and other items of a personal nature not otherwise disposed of by this will or in any other manner, [*describe gift of personal property, e.g., to my children who survive me for thirty (30) days, as they shall agree among themselves, or as my executor shall in my executor's discretion determine to be in accordance with my wishes if they do not agree*] **.**

Comment: On survivorship provisions, see §5.39. On the various distributive schemes for gifts to a class, see §5.48.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.57 D. Form: Gift of Residue

§5.57 D. Form: Gift of Residue

5.57-1 Residuary gift

ARTICLE THREE

GIFT OF RESIDUE

1. Gift to ___[*name*]___. I give the rest, residue, and remainder of my estate to _ _[*name*]_ _, my _ _[*husband/wife*]_ _ if _ _[*he/she*]_ _ survives me. If not, I give the residue of my estate to my children who survive me; provided, however, that if any child of mine does not survive me, and if he or she leaves issue who survive me, the share of the residue of my estate that otherwise would have been distributed to that deceased child will instead be distributed to his or her issue, their identities and their respective shares to be determined as provided in California Probate Code §247 in effect at the date of my death.

Comment: On residuary clauses, see §5.43.

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§5.58 E. Form: Executor and Bond

5.58-1 Executor and bond

ARTICLE FOUR

NOMINATION OF EXECUTOR

1. Nomination of Executor. I nominate the persons listed below, in the order indicated, as executor or successor executor of my will:

First: _ _[*name*]_ _

Second: _ _[*name*]_ _

The term "my executor" shall include any personal representative of my estate.

[*Add one of the following alternatives*]

[*Alternative 1: No bond required*]

2. Bond. I request that no bond be required of any executor nominated in my will.

[*Alternative 2: Bond required*]

2. Bond. I request that the court require bond of any personal representative of my estate.

[*Continue*]

Comment: It has become almost automatic for wills to waive bond. This may be a reasonable economy, but it may also subject the estate to an uncompensated loss if the personal representative errs or goes astray. The subject should be discussed with the client so that he or she can make an informed and prudent decision on the subject. If the representative is the testator's only child and sole beneficiary, bond would be unnecessary. If the executor is a friend or neighbor with no family connection, bond would probably be advisable.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.59 F. Form: Powers of Executor

§5.59 F. Form: Powers of Executor

5.59-1 Executor's powers

ARTICLE FIVE

POWERS OF EXECUTOR

1. General Powers. My executor may administer my estate under the California Independent Administration of Estates Act (Probate Code §§10400-10592). My executor shall have all powers conferred on executors by law at the date of my death, including any powers provided in this will, except as otherwise provided in this will.

2. Specific Powers. In addition to the powers conferred on my executor under Article Five, paragraph 1, above, my executor shall have the following powers:

A. Power to Sell Estate Assets. My executor may sell, with or without notice, at either public or private sale, for cash or terms, any property of my estate that my executor considers necessary for the estate's proper administration and distribution.

B. Power to Lease Estate Assets. My executor may lease all or any part of the real or personal property of my estate on terms that my executor considers proper.

C. Power to Retain Estate Assets. My executor may retain any asset of my estate (including unproductive, speculative, or fluctuating assets) for as long as the executor considers proper. My executor will not be liable for any resulting losses unless the executor acts in bad faith, is grossly negligent, or engages in willful misconduct.

D. Power to Distribute Gifts to Incompetent Adults. My executor may distribute a gift made in my will to any beneficiary who is under any legal disability, or who is unable in the executor's judgment to use or manage the property properly by reason of mental or physical illness or disability, to the beneficiary's conservator of the estate. My executor may distribute the property to the beneficiary directly if, in the executor's judgment, the beneficiary has the capacity to use and manage the gift appropriately. The receipt of any of the above-described distributees will suffice for the executor's discharge with regard to the property.

E. Power to Allocate Property to Distributive Shares. In selecting estate property to be distributed in fulfillment of any nonspecific devise made in my will, my executor may determine which property to allocate to the portions to be distributed.

F. Power to Distribute Property Non-Prorata. My executor may distribute estate property prorata or nonprorata when fulfilling devises of shares of my estate.

G. Power to Consider Basis And Make Adjustments When Making Distributions. My executor may consider the income tax basis of estate assets when allocating property to fulfill devises. My executor may make adjustments to share or gifts to compensate for the tax consequences of any distribution that my executor believes may directly or indirectly prefer one beneficiary or group over another; my executor's decisions in this regard will be final. My executor may allocate property to fulfill devises without regard to the income tax basis of estate assets and will not be liable for failure to exercise the powers to consider tax basis or to make compensatory adjustments provided above.

H. Power to Satisfy Pecuniary Devise In Kind. Except when my will specifically provides otherwise, my executor may satisfy any general pecuniary devise by cash, by in-kind property valued as of the date of distribution, or partially by each.

I. Power to Purchase Estate Assets. My executor may purchase, or exchange assets for, assets of my estate or any fractional interests in it for adequate consideration.

Comment: The powers specifically listed above are for purposes of illustration, and, although they may be appropriate in some cases, individual provisions should be reviewed and retained or deleted as appropriate. For a complete list of powers, see California Will Drafting, chap 33 (3d ed Cal CEB 1992).

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Source: Estate Planning/California Estate Planning/5 Wills/§5.60 G. Form: Guardians of Person and Estate

§5.60 G. Form: Guardians of Person and Estate

5.60-1 Nomination of guardians

ARTICLE SIX

NOMINATION OF GUARDIANS

1. Nomination of Guardian of Person. If my spouse does not survive me, and if at the time of my death any of my children are minors, I nominate _ _[*name*]_ _ as guardian of the person of my minor child or children.

2. Nomination of Guardian of Estate. If my spouse does not survive me, and if at the time of my death any of my children are minors, I nominate _ _[*name*]_ _ as guardian of the estate of my minor child or children.

Comment: On guardians for the person and estate of minor children, see California Guardianship Practice (Cal CEB Annual).

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§5.61 H. Form: Funeral Instructions

5.61-1 Funeral and burial instructions

ARTICLE SEVEN

FUNERAL AND BURIAL INSTRUCTIONS

1. Funeral and Burial Instructions. I direct that _ _[*specify testator's instructions for funeral and burial*]_ _. I authorize _ _[*name*]_ _ to carry out all these directions and wishes, particularly those for disposition of my remains.

Comment: If the client feels strongly about funeral and burial instructions, they may be included in the will. If so, they must be carried out. Health & S C §7100.1(a). If this is done, the person nominated as personal representative should be made aware of the directions before the client's death. If the will is kept in a safe deposit box, the directions may otherwise not be discovered until some time after other arrangements have been made and carried out. It is prudent to also include identical instructions in a durable power of attorney for health care. On health care directives, see chap 29. On instructions concerning the decedent's remains, see chap 31.

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§5.62 I. Form: Concluding Provisions: Gifts to Minors, Choice of Law, Payment of Taxes, Interest, Survivorship, and No-Contest Clauses

5.62-1 Concluding provisions

ARTICLE EIGHT

CONCLUDING PROVISIONS

1. Gift to Minors. If any beneficiary of this will is, at the time of my death, under the age of twenty-five (25) years, my executor will, in my executor's discretion, make an irrevocable transfer of that beneficiary's gift to a custodian selected by my executor for the minor, under the California Uniform Transfers to Minors Act (CUTMA) (Probate Code §§3900-3925) until the beneficiary reaches the age of twenty-five (25) years.

2. Choice of Laws. The validity, interpretation, and construction of any provision of this will shall be governed by the laws of the State of California in effect on the date of execution.

3. Payment of Taxes. I direct my executor to pay all death taxes, both state and federal, including any tax due on property not included in my probate estate, from the residue of my estate, without apportionment among the residuary beneficiaries.

4. Interest on Gifts. No gift in my will or in any codicil to it will bear interest, whether or not it is distributed within the period provided by law.

5. Survivorship Period. For purposes of this will, a beneficiary will not be deemed to have survived me if the beneficiary dies within thirty (30) days after the date of my death.

6. No-Contest Clause. If any beneficiary under my will in any manner, directly or indirectly, contests my will or any of its provisions in any legal proceeding that is designed to thwart my wishes as expressed in my will, any share or interest in my estate given to that contesting beneficiary under my will is revoked and will be disposed of under the terms of my will as if that contesting beneficiary had predeceased me without issue.

[*If applicable, add the following option*]

[*Option: Intentional disinheritance*]

7. Disinheritance Clause. I have intentionally omitted to provide in this will for _ _[*relationship, e.g., my stepson, my daughter*]_ _, _ _[*name*]_ _, if _ _[*he/she*]_ _ survives me, and if not, for _ _[*his/her*]_ _ issue, if any, who survive me.

[*Continue*]

[8.] Severability. If any provision contained in this will is invalid or unenforceable, that provision will be treated as void and the remaining provisions will remain in effect as if the invalid or unenforceable provisions were not included in this instrument.

Comment: On tax allocation provisions, see §5.47. On intentional disinheritance of a spouse or child, see §5.50. For discussion of no-contest provisions, see §6.21.

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Source: Estate Planning/California Estate Planning/5 Wills/§5.63 J. Form: Execution and Attestation Clauses

§5.63 J. Form: Execution and Attestation Clauses

5.63-1 Execution and attestation

Executed on _ _[*date*]_ _, at _ _[*name of city*]_ _ , California.

__[*Signature of testator*]__
_ _[*Typed name*]_ _

On the date written below, the testator, _ _[*name*]_ _, declared to us that this instrument, consisting of _ _[*number*]_ _ pages including this page, was the testator's will and asked us to witness it. The testator then signed this will in our presence, all of us being present at the same time. At the testator's request, in the testator's presence, and in the presence of one another, we subscribe our names as witnesses. We believe that the testator is over age 18, is of sound mind, and is under no constraint or undue influence.

We declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed on _ _[*date*]_ _, at _ _[*name of city*]_ _, California.

_ _[*Name of Witness*]_ _ __[*Signature*]__
_ _[*Address*]_ _

_ _[*Name of Witness*]_ _ __[*Signature*]__
_ _[*Address*]_ _

_ _[*Name of Witness*]_ _ __[*Signature*]__
_ _[*Address*]_ _

Comment: On testator and witness signature requirements, see §§5.7-5.8.

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6

Revocable Trusts

Kenneth G. Petrulis

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§6.1 I. INTRODUCTION TO REVOCABLE TRUSTS

A revocable trust is a popular estate planning tool that can serve useful property management functions during a client's lifetime, but is primarily used as a convenient and efficient means to distribute a client's assets on his or her death. This chapter discusses the advantages and disadvantages of using a revocable trust instead of a will or other will substitute. On wills, see chap 5. On other devices for transferring property at death, see chap 7. This chapter also discusses the use of revocable trusts as alternatives to other devices for transferring property (see §§6.6-6.9). In addition, it covers legal requirements for trusts (see §§6.10-6.13), typical issues that arise in drafting trusts (see §§6.14-6.28), choice of trustee (see §§6.29-6.40), funding issues (see §§6.41-6.49), third party rights (see §§6.50-6.53), taxation of trusts (see §§6.54-6.57), management of trust assets (see §§6.58-6.61), construction of trust instruments and terms (see §6.62), and termination of trusts (see §§6.63-6.68). The chapter does not discuss resulting trusts that are implied trusts.

A trust is revocable by the settlor or settlors unless expressly made irrevocable by the trust instrument. Prob C §15400. Irrevocable trusts involve a permanent relinquishment of control or enjoyment by the settlor that inevitably has gift and other tax consequences. A revocable trust usually does not have such substantive tax effects because it may be revoked by the settlor at any time. Nevertheless, it does have other substantive effects that impact legal and beneficial rights.

WARNING: Unless the method of revocation specified in the trust is designated as exclusive, the trust may nevertheless be terminated by other methods allowed by law, without notice to co-trustees. See §6.68.

California follows common law trust rules as modified by statute. Prob C §15002. The common law doctrine of merger (terminating a trust when the legal and equitable titles are held by the same person) is abrogated by statute. Prob C §15209. This allows for the establishment of self-settled, self-administered trusts with very little formality and no need to vest rights in third parties such as trustees or potential beneficiaries to establish the efficacy of the trust.

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§6.2 II. ADVANTAGES AND DISADVANTAGES

The revocable trust has become the primary testamentary transfer device used by professional estate planners in California. A combination of factors makes the use of a trust particularly advantageous in California. Nevertheless, it does have its limitations and will not be suitable for all.

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A. Advantages of Revocable Trust

§6.3 1. Probate Avoidance

The primary advantage of a revocable trust is that assets transferred to the revocable trust before the settlor's death are not part of the settlor's probate estate and are not subject to probate proceedings. California retains a more formal probate procedure with greater monetary and time costs than the procedure encouraged by the Uniform Probate Code. In general, probate proceedings require notices (*e.g.*, for initial petition, petitions for instructions, and petition for final distribution) and court hearings that increase attorney time and costs. Sales of property and the handling of creditor claims are examples of such proceedings. Probate fees in California can be substantial, and include statutory fees as well as extraordinary fees that are commonly granted by the probate court. See Prob C §§10800-10801. See also 3 California Decedent Estate Practice, chap 30 (2d ed Cal CEB 2009).

Avoiding probate:

- May save significant administrative costs. The attorney should, however, do a comparative analysis of the costs (see Drafting California Revocable Trusts §§1.10-1.18 (4th ed Cal CEB 2003)).
- Allows the trustee to act more quickly than an executor can to administer and distribute the estate independent of probate court supervision. The initial petition to administer the estate, a petition to confirm sales of property, petitions for instructions, and the petition for final distribution all have required notice periods that contribute to the time delays of a typical probate. Except for the filing of the estate tax return, a typical trust often can be administered in a few months, whereas a typical California probate estate lasts a minimum of a year to 18 months.

NOTE: There is a common misconception that little or no postdeath administration is required if the living trust is fully funded. Obviously, administration of a living trust involves many of the same tasks that are required in a probate proceeding, *e.g.,* collecting information, valuing assets, selling assets, settling debts and claims, preparing and filing tax returns, paying taxes, and transferring assets, albeit without the requirement of filing court forms and trying to clear probate notes. See generally California Trust Administration (2d ed Cal CEB 2001).

- May eliminate the need for multiple probate proceedings if assets are located in other states.
- Maintains greater (but not complete) confidentiality of the settlor's estate plan and the family's privacy. Because of the notice requirements of Prob C §16061.7, the trust loses some of the confidentiality a settlor may desire. Even if a settlor wishes to keep the terms of the trust private, he or she is not allowed to do so.

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§6.4 2. Ease of Management

A revocable trust is a useful device that serves property management functions during a settlor's lifetime and after death. A revocable trust:

- Avoids the costs and inconvenience of formal conservatorship proceedings in the event of the lifetime disability or incapacity of the settlor (see §6.7); and
- Provides for long-term continuity of management of the settlor's assets, uninterrupted by the settlor's incapacity or death.

California institutions such as banks, lenders, and title companies have become so accustomed to dealing with trusts that the administration of a revocable trust during the settlor's lifetime is relatively easy. Formerly, banks and other institutions were wary of dealing with trusts because of uncertainty over the powers of the trustees. California, however, has established a statutory form of certification of trust that provides protection for any institution relying on the certification. See Prob C §18100.5. The statutory form is widely accepted and has led to standardization even among institutions that retain their own certificate of trust forms. The certification of trust provides a financial institution with documentation of the trustee's powers. It also preserves the confidentiality of the dispositive terms of the trust that need not be disclosed in the certification. A certification of trust that relates to an interest in real property may be recorded in the office of the county recorder in the county in which the property is located. A successor trustee may execute and record an affidavit of change of trustee if title to an interest in property is affected by the change of trustee. The recordation establishes a presumption concerning the identity of the successor trustee. See Prob C §§18105-18108.

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§6.5 B. Disadvantages of Revocable Trust

Although the advantages of a revocable living trust in most cases significantly outweigh its potential disadvantages, in certain situations a revocable living trust may not be appropriate. Potential disadvantages include:

- The initial start-up costs of planning, drafting, and funding a revocable living trust generally are higher than the cost of drafting a will or a testamentary trust, and implementation costs are incurred sooner.
- Funding a revocable living trust, *i.e.*, transferring legal title of the assets to the trust (see §§6.41-6.49), can involve a significant amount of time, effort, and expense because assets must be re-titled in the name of the trustee. This can require executing and recording real property deeds; assigning stock, notes, partnership interests, and leases; and changing bank accounts and life insurance and retirement beneficiary designations.
- Trust formalities must be observed. The trustee must maintain bank accounts that are properly titled and must keep careful records.
- If the settlor is not the trustee, there normally will be ongoing trustee fees.
- Trust beneficiaries, unless they request it, do not have the protection of court supervision. Court supervision can be helpful in administrations involving antagonistic heirs and beneficiaries or financial difficulties.
- Creditors' claims may not be cut off unless the trustee elects to file, publish, and serve notice on all classes of potential creditors (see §6.53).
- A revocable living trust does not receive the same income tax treatment as does a probate estate unless the trustee makes an election under IRC §645 (see §6.55).

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III. REVOCABLE TRUST AS ALTERNATIVE TO OTHER DEVICES

§6.6 A. Substitute for Durable Power of Attorney

A durable power of attorney is one alternative to the use of a trust. See Prob C §§4000-4545. A durable power of attorney allows management of property even while the principal is not competent. Because the power of attorney terminates at death (Prob C §4152(a)(4)), however, it does not provide for continuous administration of the property. Use of a power of attorney alone requires a probate.

A power of attorney is riskier and more difficult to use than a living trust. Although the power holder is a fiduciary with traditional fiduciary obligations to the principal, unless specifically provided in the power of attorney, the typical agent does not have the broad range of obligations imposed by statutory and case law on trustees. Most importantly, although the power of attorney agent may act on behalf of the principal, there is no clear duty to do so. Prob C §4230. A trustee of a revocable trust, on the other hand, has an affirmative obligation to manage and invest trust assets for the benefit of the settlor. Prob C §§16000-16105.

The trustee of a living trust also has an obligation to account on a regular basis. Prob C §§16060, 16061. See §6.51. Statutory power of attorney forms and most attorney-drafted powers of attorney do not include such a requirement. Generally, an attorney-in-fact is not required by statute to account except on demand by the principal or by court order. Prob C §4236(b). This is a reflection of the lack of an affirmative obligation by the power holder to take control of and manage assets subject to the power of attorney. An accounting is required only to the extent of actions actually undertaken under the power of attorney by the attorney-in-fact. Prob C §4236(a).

Another advantage trust administration has over a durable power of attorney is that assets are titled in the name of the trustee of the trust. Because property managed by an agent under a durable power of attorney remains in the name of the principal, many asset holders, including banks, may refuse to accept the power of attorney or may require the client and the attorney-in-fact to use the institution's form of power of attorney. Although the laws relating to certifications of trust and durable powers of attorney both provide for sanctions when an institution or asset holder does not recognize the certification or power of attorney (see Prob C §§4306(a), 18100.5(h)), the confusion and reluctance to comply with the power of attorney is much greater.

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§6.7 B. Substitute for Conservatorship

If the settlor becomes incompetent or incapacitated, the terms of a revocable living trust can provide a method for determining incapacity or incompetency relating to trust estate management. See §6.19. By providing explicit procedures such as identifying the decisionmakers and the criteria, the costs and embarrassment of conservatorship court proceedings can be avoided. A smooth transition of administration can occur because the trust estate will be managed by a successor trustee selected by the settlor. The trust also can assure that the incapacitated person is properly provided for in accordance with a standard of care designated in the trust. In this situation, it is also important to have an advance health care directive (see chap 28) to avoid a conservatorship of the person. On conservatorships, see California Conservatorship Practice (Cal CEB 2005).

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§6.8 C. Will Substitute

Property transferred to a revocable trust during the settlor's lifetime is not part of the settlor's probate estate. When the settlor dies, equitable title to trust property passes to a new beneficiary, but the transfer is not considered a testamentary disposition subject to probate. *Estate of Heigho* (1960) 186 CA2d 360, 364, 9 CR 196. The trust functions in effect like a will, disposing of the decedent's property without court interference (unless requested by an interested party, including the trustee). Trust assets are administered and distributed by the trustee in accordance with the terms of the trust. On trust administration, see California Trust Administration (2d ed Cal CEB 2001). The death of a trustee does not require a probate proceeding, because even if the trust instrument does not provide for a successor trustee, the vacancy will be filled under Prob C §15660. Courts arguably also have more power to reform revocable trusts than wills, in the event that ambiguous drafting of the document could produce adverse tax consequences. See *Ike v Doolittle* (1998) 61 CA4th 51, 70 CR2d 887 (court reformed ambiguous trust in manner that would avoid inclusion of bypass trust in survivor's estate for federal estate tax purposes).

Trusts avoid probate court supervision, the requirement to file an inventory and appraisal, and the requirement of a formal accounting (although any provision in the trust document limiting trustee liability must include a 180-day notice requirement as set forth in Prob C §16461, and some form of accounting is required to begin running the statute of limitations for the trustee's acts; see Prob C §16460(a)). There is also less likelihood that a bond will be required under Prob C §15602 or that the details of the trust or inventory and appraisal will become public.

Compared to a probate administration in which all aspects of the estate are open to the public, a revocable living trust maintains a high degree of privacy. Even when the settlor fears that the terms of the revocable trust may be disclosed to beneficiaries or other persons in a court proceeding, the settlor may provide in the trust instrument that in such an event only portions of the trust directly relevant to an inquiry be divulged and that any judicial review be conducted in a closed proceeding.

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§6.9 D. Substitute for Beneficiary Designation or Deed

Nonprobate transfers of property at death are authorized, among other means, by conveyance, deed of gift, agreement, or similar instrument. Prob C §5000. The most common forms of nonprobate transfers include joint tenancy deeds (see chap 7), other deeds with remainder interests (see chap 7), beneficiary designations on insurance contracts (see chap 19), annuities (see chap 20), IRA accounts (see chap 21), and pension plans (see chap 21). Some states also have a revocable transfer on death deed (revocable TOD deed) or beneficiary deed. The revocable TOD deed transfers real property to the named beneficiary on the death of the owner without probate and is revocable until that time.

There is a significant problem with nonprobate transfers: the form of deed or beneficiary designation may not provide for contingent beneficiaries. If a beneficiary dies before the transfer, the transferor's distribution plan will be thwarted because the gift to that beneficiary will fail. The typical form of beneficiary designation allows, at most, for designation of one secondary or contingent beneficiary. More complex beneficiary designations are discouraged. By contrast, a trust can include a specifically tailored plan of distribution that allows for most contingencies.

WARNING: Beneficiary designations for IRAs and pension plans should take into account minimum required distribution rules. See chap 21.

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IV. LEGAL REQUIREMENTS FOR TRUSTS

§6.10 A. Elements of Trust

A revocable trust is created by a settlor or by married settlors who manifest the intent to create a trust. It must have assets and a beneficiary. See Prob C §§15200-15205. The trust itself can last for no more than a life in being plus 21 years, or 90 years, whichever is specified in the trust instrument. Prob C §21205. Unless restricted by the trust instrument, the trustee has all the duties and powers provided by Prob C §§16000-16105 and 16200-16249, respectively.

For discussion of statutory powers and issues involved in drafting custom trustee powers, see Drafting California Revocable Trusts, chap 17 (4th ed Cal CEB 2003).

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§6.11 B. Trust Creation

In California, a trust may be express or implied. See Prob C §15200. Express trusts may or may not be in writing. See Prob C §§15206, 15207. Express trusts in writing need not be funded. See Prob C §6300 (permitting pour-over by will into unfunded trust). If the trust is not funded, however, the advantages of probate and conservatorship avoidance may be lost (see §§6.3, 6.7), although alternate methods of funding, such as a durable power of attorney (see §6.6) or a *Heggstad* petition under Prob C §850(a)(3) (see §6.49), may be available.

A trust may be created by declaration or by an agreement. See Prob C §15200. If necessary, a conservator may be appointed to petition a court to create a trust by exercise of the substituted-judgment power. Prob C §2580(b)(5). See *Conservatorship of McElroy* (2002) 104 CA4th 536, 552, 128 CR2d 485. California statutory provisions relating to the powers and duties of the trustee, and the rights of the settlor, beneficiaries, and creditors may be modified by the terms of the trust instrument. See Prob C §§16000, 16200(a). The express terms of the trust, however, may not violate California public policy. Prob C §15203; *Estate of Ferber* (1998) 66 CA4th 244, 253, 77 CR2d 774. Any trust created by the trust instrument must have a definite purpose that can be determined with reasonable certainty. See Prob C §§15204, 15212 (pet trust).

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C. Administration of Trust

§6.12 1. By Settlor/Trustee

Most revocable trusts are administered initially by the settlor. In this situation, trust administration is often so informal as to be almost nonexistent.

NOTE: The informality of administration should not lull the trustee and the trustee's attorney into assuming that there are no differences between ownership of property as a trustee and ownership as an individual. These differences are encountered most frequently when a trust is being funded. Transfer agents have various requirements for changing title to the property from the settlor's name to that of the trustee. Real property deeds, for example, raise issues concerning title insurance, due-on-sale clauses, and real property taxes. On funding procedures, see §§6.41-6.49. The attorney must address these issues as part of the trust creation process.

As long as the trust is treated as though it were owned by the grantor, no fiduciary income tax return is required. All trust income is reported on the settlor's personal income tax return. See Treas Reg §§1.671-4(b)(2), 301.6109-1(a)(2). While the settlor is a trustee, no other person has a right to make any demand on the settlor as trustee, including a demand for an accounting, a demand for a disclosure of trust terms, or a demand that the trustee be required to take or refrain from taking any particular action. Prob C §15800.

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§6.13 2. By Third Party Trustee

When a third party is trustee of a revocable trust, formalities of trust administration must be observed. See Prob C §§16000-16105. See also §§6.59-6.61. The trustee is bound to comply with the terms of the trust unless the settlor presents a contrary amendment, demand, or instruction. Prob C §§16000-16001. Usually, the trust provides that any such amendment, demand, or instruction be in writing and be delivered to and accepted by the trustee. Because of the revocable nature of the trust, however, unless otherwise provided in the agreement, if the trustee does not accept and agree to the amendment, demand, or instruction, the trustee's remedy is to resign and permit a successor trustee to be appointed. See §6.17.

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V. COMMON DRAFTING ISSUES

§6.14 A. Community Property and Separate Property

Transferring property to a trust does not and cannot in and of itself transmute the character of the property interest. Under Fam C §852, any agreement to transmute the character of the property must be made in writing by express declaration. Typical trust language does not and should not as a routine matter deal with transmutation issues.

Although not required, it is helpful to include a statement in the trust to the effect that the character of the property is not being changed merely because it has been transferred to the trust, *e.g.*,

***Property Retains Character*. Except as expressly provided in this document, all property becoming subject to this trust shall retain its character as community property, quasi-community property, or separate property after becoming trust property.**

See Drafting California Revocable Trusts §5.23 (4th ed Cal CEB 2003).

To preserve the community property character of property contributed to the trust, the trust should also include a provision stating that rights in the community property may be modified only with the joinder and consent of both spouses. See Fam C §761(a).

When separate trusts are used for a husband and wife, the question arises of how to fund community property into the trusts. Community property interests are indivisible. Therefore, if a husband and wife establish separate trusts, and each trust contains that spouse's separate property and his or her "half" of the community property, the one-half of the community property in each trust belongs one-half to each spouse. This is true even though one spouse has primary control over the assets in his or her trust. All of the aspects of community property apply, including fiduciary obligations and transfer requirements. See Fam C §§1100-1103. Thus, to transfer community property contained in the husband's trust, it is necessary to obtain the consent and signature of the wife, even though the property is held in the name of the husband as trustee of the husband's trust. See Fam C §1102(a).

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§6.15 B. Joint Trust Provisions

In order to avoid the complex problems inherent with a "his and hers" trust plan involving community property (see §6.14), a one-trust plan for the separate property of each spouse and his or her community property is commonly used. A three-trust plan is typically used when there is significant separate property held by one or both spouses and the spouses wish to segregate the property. In a three-trust scheme, two trusts hold the spouses' respective separate property, and the third holds the community property.

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§6.16 C. Joint Tenancy Property

There is some question as to application of rules concerning joint tenancy property that has been transferred to a trust. If assets held by the settlors in joint tenancy are true joint interests (as defined in CC §683) rather than community property interests, transfer of the property to a trust will not ordinarily sever the joint tenancy if the joint tenants do not intend to do so. See *County of Fresno v Kahn* (1962) 207 CA2d 213, 24 CR 394, and *Estate of Louise H. May,* TC Memo 1978-20, which suggest that property held in joint tenancy form may retain the right of survivorship. But see *Black v Commissioner* (9th Cir 1985) 765 F2d 862 (specifically disapproved reasoning in *Estate of May*). *County of Fresno* is distinguishable because it did not deal with an explicit trust or with transferring a deed into a trust, and because legal title to the subject property always remained in joint tenancy.

When property held in joint tenancy form will be transferred to the trust, the joint tenancy should be terminated to make it clear that the trust document will control disposition of the settlor's interest. This can be done by:

- A joint tenant transferring property to the trust, unilaterally terminating the joint tenancy (CC §683.2(a) (real property); Prob C §5303 (multi-party accounts); see *Estate of Propst* (1990) 50 C3d 448, 268 CR 114 (in absence of prior contrary agreement, joint tenancy in personal property may be unilaterally severed));
- A written agreement executed by all the joint tenants that severs the joint tenancy (CC §683.2(d)), followed by a deed transferring the property to the trust; but see *Estate of Powell* (2000) 83 CA4th 1434, 100 CR2d 501 (written agreement can be settlors' declaration that property held in trust);
- A deed executed by all the joint tenants transferring the property held in joint tenancy form to the trustee. A joint tenancy interest in property transferred to a revocable trust may be severed by implication if the terms of the trust are inconsistent with the continued existence of the joint tenancy. See *Black v Commissioner* (9th Cir 1985) 765 F2d 862 (terms of trust inconsistent with right of survivorship, which is distinguishing feature of joint tenancy; applying Arizona law). See also *McDonald v Morley* (1940) 15 C2d 409, 101 P2d 690; *Wardlow v Pozzi* (1959) 170 CA2d 208, 338 P2d 564.

NOTE: The cautious drafter will expressly state that the addition to the trust of property held in joint tenancy form severs the joint tenancy. In addition, the trust instrument should specifically state that such property transferred to the trust will thereafter be community property to the extent that the settlors' interests in the property are equal, *e.g.,*

***Exception: Joint Tenancy Property*. No property now or hereafter subject to this trust is joint tenancy property or community property with right of survivorship. Any property that was joint tenancy property or community property with right of survivorship before becoming trust property shall become community property as a result of becoming trust property to the extent that the settlors' interests in the property were previously equal.**

See Drafting California Revocable Trusts §5.23 (4th ed Cal CEB 2003). The "exception" language refers to language in §6.14, providing that property transferred to the trust retains its character.

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§6.17 D. Amendments

A trust is revocable unless it provides otherwise. Prob C §15400. The power to revoke a trust includes the power to modify it. See Prob C §15402. To avoid any uncertainty about whether amendments are permitted and how they should be made, the trust instrument should include an express power to amend and should describe the amendment procedure. A trust provision regarding amendments might read:

The settlors may at any time during their joint lifetimes alter, amend, or revoke this trust by a written instrument signed by both settlors and personally delivered by either of them or sent by certified mail to the trustee. Either of the settlors acting alone may alter, amend, or revoke this trust insofar as it affects all or any portion of the trust estate which is derived from the separate or community property of that settlor by written instrument executed by the settlor and delivered to the trustee from time to time during the settlors' joint lifetimes. No amendment substantially increasing the trustee's duties or liabilities or changing the trustee's compensation will be valid without the trustee's written consent. The trustee will not be obligated to act under any amendment unless the trustee accepts it. If the trustee is removed for refusal to accept an amendment, the settlors will pay to the trustee any fees due and will indemnify the trustee against all liabilities that the trustee has incurred in administering the trust.

For additional revocation and amendment provisions, see Drafting California Revocable Trusts, chap 20 (4th ed Cal CEB 2003).

The trust usually provides that an amendment must be delivered to and accepted by the trustee, although the trustee is not bound to comply with the terms of an amendment. See §6.13. An amendment to a trust need not be witnessed or notarized. See Prob C §§15200, 15206.

PRACTICE TIP: The cautious drafter will specify whether the method of amendment provided in the trust is the exclusive method and whether alterations, amendments, or revocations must include notice to all settlors or trustees. See §6.68.

As a practical matter, the trustee should be concerned with amendments to administrative provisions that affect the trustee's duties and potential liability. In addition, provisions regarding distributions and beneficiaries may be of concern to the trustee. Finally, certain types of provisions (*e.g.*, "good citizen" provisions, which require the trustee to make or withhold distributions based on whether a beneficiary meets "good citizen" standards) may be difficult for some trustees to administer or, if not properly drawn, may expose the trustee unnecessarily to liability.

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§6.18 E. Gifts During Settlor's Lifetime

Gifts made by the trustee of a revocable trust are treated as made directly by the settlor and are not treated as a relinquishment of the power of revocation by the settlor that would cause inclusion of a gift made within 3 years before the settlor's death in the settlor's estate under IRC §2035(a). See IRC §§2035(e), 2038. However, any gift tax paid on gifts made by the trust within 3 years before the settlor's death is included in the settlor's estate. IRC §2035(b).

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§6.19 F. Incapacity

To avoid problems with trustee succession, estate management, and distributions by a settlor during his or her lifetime, revocable trusts often include provisions defining incapacity for one or more of these purposes. These provisions may permit the trustee to use his or her own judgment or may require the settlor's physician to determine incapacity. If there is no single physician who occupies a position of trust with the settlor, the trust may provide that the determination of two independent physicians is required to establish that incapacity exists. However, the medical privacy requirements of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (Pub L 104-191, 110 Stat 1936) and HIPAA Privacy Rule (42 USC §1320d-2; 45 CFR pts 160, 164) and California's Confidentiality of Medical Information Act (CMIA) (CC §§56-56.37) may prevent a physician from giving an opinion concerning the trustee's incapacity unless (1) the trustee has designated a health care agent in an advance health care directive who can authorize the physician to disclose medical information about the trustee (see Prob C §4678), or (2) the trustee has signed a written authorization allowing the trustee to disclose that information. For sample forms of authorization, see Basile, *HIPAA Privacy Rules: What's an Estate Planner to Do?*, 9 Cal Tr & Est Q 13 (Winter 2003); Soskin, *How to Be a HIPAA Lawyer*, 26 CEB Est Plan Rep 125 (Apr. 2005). For further discussion, see California Powers of Attorney and Health Care Directives §§7.76-7.84 (Cal CEB 2008). Other common incapacity provisions use family members, friends, or a combination of them to determine incapacity. Legal incapacity is seldom the proper criterion for use in a trust. Legal incapacity requires an adjudication under Prob C §1872 that the proposed conservatee lacks the legal capacity to enter into binding transactions. A determination of legal incapacity leads to the appointment of a conservator of the settlor's estate. Avoidance of a conservatorship is usually one of the desired goals in establishing a revocable trust. See §6.7. Typical language regarding incapacity might read:

For purposes of trust distributions during a settlor's lifetime, a settlor is not competent to direct distributions if the settlor is a person for whom a conservator of the estate could be appointed under California law. The trustee is not required to obtain a court adjudication of incompetence and may rely on the trustee's personal judgment based on the trustee's observations. The trustee will not be liable for any such determination that is not made in bad faith and for an improper purpose.

For additional incapacity form provisions, see Drafting California Revocable Trusts §6.12 (4th ed Cal CEB 2003). The trust might also include similar language defining incapacity with respect to successor trustees.

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§6.20 G. Spendthrift Provisions

Spendthrift provisions are a form of restraint on transfer commonly included in revocable trusts. They are included to provide protection for trusts that are established for third party beneficiaries, after the trust has become irrevocable. In a trust that contains a spendthrift provision, a beneficiary's interest in income, principal, or both is not subject to voluntary or involuntary transfer, nor is it subject to enforcement of a money judgment, until it is paid to the beneficiary, although a court may order the trustee to satisfy a money judgment out of principal that has become due and payable to the beneficiary. Prob C §§15300-15301.

WARNING: The drafter should not use a spendthrift clause indiscriminately, because such a clause will prevent the beneficiary from assigning his or her interest for estate planning or other desirable purposes.

When the settlor is the beneficiary, trust assets remain subject to the claims of the settlor's creditors. Prob C §§15304, 18200. (Some states, notably Alaska, Rhode Island, Nevada, and Delaware, have abrogated this rule. See chap 26.) As long as the trust is revocable, the settlor's creditors are able to reach the assets of the trust.

A short form of spendthrift clause might read:

No interest in the income or principal of any trust created under this instrument may be voluntarily or involuntarily anticipated, assigned, encumbered, or subjected to creditor's claim or legal process before actual receipt by the beneficiary.

PRACTICE TIP: The spendthrift clause may include limitations that make it inapplicable to the surviving spouse. See Drafting California Revocable Trusts §§19.12-19.13 (4th ed Cal CEB 2003).

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Source: Estate Planning/California Estate Planning/6 Revocable Trusts/§6.21 H. No-Contest Clauses

§6.21 H. No-Contest Clauses

No-contest clauses are used to discourage contests of trusts by providing that any beneficiary who contests the trust forfeits what he or she would have received under the trust. Prob C §21310(b). No-contest clauses in trust documents or amendments drafted now or in the future are governed by a new statute enacted by Stats 2008, ch 174, effective January 1, 2010. Prob C §§21310-21315. However, the new law also applies to "any instrument, whenever executed, that became irrevocable on or after January 1, 2001." Prob C §21315(a). For a detailed discussion of the new law, see *California's New No-Contest Clause Enforceability Statute*, 30 CEB Est Plan Rep 41 (Oct. 2008). Under the new law, no-contest clauses are enforceable only against three types of contests:

- Direct contests of protected instruments brought without probable cause;
- Pleadings challenging "a transfer of property on the grounds that it was not the transferor's property at the time of the transfer"; and
- Creditors' claims or actions based on a creditor's claim.

Prob C §21311(a).

Although the new law repeals former Prob C §§21300-21332, it appears that the legislature may have intended those statutes to continue to govern pre-2001 instruments. See the California Law Revision Commission (CLRC) Comment to Prob C §21315, which makes clear that the CLRC expects that the repealed statutes will continue to govern instruments that became irrevocable before 2001: "An instrument that is not governed by this chapter would be governed by the law that applied to the instrument prior to the operative date of this chapter." This would appear to include the repealed provisions, with the exception of former Prob C §21305, which did not apply to instruments that became irrevocable before January 1, 2001. Arguably, however, on the face of the statute, the old law is repealed; one might argue that pre-2001 instruments are governed solely by the common law.

WARNING: The following discussion relates to former law, which is now repealed. There is some dispute as to whether this law or the common law would apply to irrevocable pre-2001 instruments.

Under former law applicable to instruments that became irrevocable on or after January 1, 2001, the following actions do not constitute a contest unless the drafter specifically identifies them in the no-contest clause (former Prob C §21305(a)):

- Filing a creditor's claim (but see *Colburn v Northern Trust Co.* (2007) 151 CA4th 439, 59 CR3d 828 (trust's no-contest clause resulted in valid forced election in which former spouse's filing of creditor's claim for spousal or child support under marital dissolution judgment would be deemed contest));
- Action or proceeding to determine the character of property (but see *McKenzie v Vanderpoel* (2007) 151 CA4th 1442, 61 CR3d 129 (income beneficiary's proposed petition to compel trustee to exercise Prob C §16336 power to adjust between principal and income would violate trust's no-contest clause)); and
- Challenge to the validity of an instrument other than the instrument containing the no-contest clause (see *Cory v Toscano* (2009) 174 CA4th 1039, 94 CR3d 841 (no-contest clause in trust instrument does not apply to handwritten changes to that instrument made after original execution of that instrument)).

For a list of proceedings that do not violate a no-contest clause as a matter of public policy under former law applicable to instruments that became irrevocable on or after January 1, 2001 (or January 1, 2003), see former Prob C §21305(b). See also Drafting California Revocable Trusts §§19.1-19.3 (4th ed Cal CEB 2003); California Trust and Probate Litigation, chap 5 (Cal CEB 1999). These include a pleading regarding the reformation of a trust instrument to carry out the intentions of the settlor. Former Prob C §21305(b)(11). See, *e.g.*, *Balian v Balian* (2009) 179 CA4th 1505, 102 CR3d 470 (petition to delete special needs restrictions from trust).

In *Tunstall v Wells* (2006) 144 CA4th 554, 50 CR3d 468, the court held that a no-contest clause providing that one beneficiary's contest voids gifts to other beneficiaries did not violate public policy. While the court noted that the common law continues to govern enforcement of no-contest clauses to the extent not covered by statute (former Prob

C §21301; *Estate of Ferber* (1998) 66 CA4th 244, 252, 77 CR2d 774), the court stated that the clause in question did not violate any statutorily or judicially established public policies in California.

NOTE: In *McIndoe v Olivos* (2005) 132 CA4th 483, 33 CR3d 689, the court held that a contest of amendments to the survivor's trust made by the surviving settlor was not a contest of the bypass trust. Had the settlors intended that a contest to a particular subtrust result in a contest to all subtrusts, they could have so stated under former Prob C §21305(a). Although the *McIndoe* decision suggests that settlors can provide that a trust no-contest clause will apply to later amendments, no-contest clauses contained in instruments that became irrevocable on or after January 1, 2001, are not enforceable in California with respect to contests of documents not already in existence at the time of execution of the document containing the clause.

Despite the injunction of former Prob C §21304 that a no-contest clause shall be strictly construed, courts have found violations in a wide variety of proposed actions involving acts of fiduciaries implicating the decedent's larger estate plan. See, *e.g.*, *Hearst v Ganzi* (2006) 145 CA4th 1195, 52 CR3d 473 (petition seeking to compel trustee to pay greater income to trust income beneficiaries would violate no-contest clause when decedent's will gave trustees power to retain trust assets and determine what was principal and what was income). In *Cook v Cook* (2009) 177 CA4th 1436, 99 CR3d 913, the court held that a beneficiary violated a trust's no-contest clause by attempting to obtain a court decree that his indebtedness was not subject to a provision charging a beneficiary's indebtedness to the settlors against the beneficiary's distributive share because it was barred by the statute of limitations.

An attempt to assert interests in a decedent's assets will violate a no-contest clause only if the decedent's intentions with respect to those assets are clear. See *Estate of Strader* (2003) 107 CA4th 996, 132 CR2d 649. See also *Betts v Bank of America* (2007) 156 CA4th 222, 67 CR3d 152 (proposed petition for order surcharging corporate trustee for distributing funds to bank account not controlled by settlor did not violate no-contest clause as attempt to nullify exculpation clause in trust, which provided that trustee would be liable only for willful misconduct or breach of good faith). Beneficiaries seeking to determine in advance of filing whether a particular action might violate a no-contest clause contained in an instrument that became irrevocable before January 1, 2001, may bring an action for declaratory relief under former Prob C §21320. For discussion of declaratory relief actions, see Trust & Prob Litig §§17.36-17.40.

On a practical level, many no-contest clauses do not discourage litigation as they were intended to do. The heir who is entirely excluded from the estate plan has nothing to lose if the no-contest clause is invoked. An overbroad no-contest clause is more likely to unexpectedly affect the beneficiary who receives a significant portion of the estate.

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§6.22 I. Definition of Issue

Including a definition of "issue" in the trust can clarify family relationships and eliminate the possibility that the estate will go to unintended heirs. California law, including the intestacy statutes (Prob C §§6400-6455) and the anti-lapse statute (Prob C §21110), may control disposition of property when named beneficiaries have predeceased the decedent. Unless the trust document provides to the contrary, a gift to a beneficiary without a mention of issue will lapse if the beneficiary is not within the group of family members protected by the anti-lapse statute. Prob C §21110(c). For example, the statutory definition of issue includes all lineal descendants using statutory definitions of parent and child. See Prob C §50. An appropriate trust provision can either narrow or broaden this definition to carry out the settlor's intent. The trust also may include a requirement that issue need to have been acknowledged in some way, that they include only adopted persons under a certain age at the time of adoption, or that certain individuals are excluded. A typical trust provision defining issue might read:

As used in this instrument, the terms "grandchild," "grandchildren," "descendants," and "issue" include natural born and legally adopted lineal descendants of all degrees, but exclude (a) stepchildren; (b) foster children; (c) a person born out of wedlock to a male descendant unless the male descendant openly holds out the child as his natural child; and (d) an adopted person over the age of eighteen (18) at the date of adoption.

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§6.23 J. Contingencies

Trust provisions should be flexible enough to allow the trust to function well even in the face of contingent or unexpected events. These events might include the death or incapacity of a child or even of a significant part of the family. A child may be subject to substance abuse, be attacked by creditors, be subject to fraud or undue influence, or have the need to qualify for public benefits.

Provisions can be included in the trust to provide flexibility in dealing with such issues. For example, the trust may include a provision giving the trustee the ability to withhold distributions to a beneficiary for enumerated reasons. Such a provision might read:

Despite anything to the contrary contained in this instrument except with respect to the exercise of a power of appointment and the applicable rule against perpetuities, the trustee shall postpone the distribution of the trust estate, or any portion of it, if the beneficiary is less than age twenty-five (25), or if the trustee determines, in the trustee's discretion, that any of the following conditions exist:

(a) The beneficiary is under legal disability;

(b) There is a compelling reason to postpone the distribution, such as a serious physical or mental disability, a propensity to substance or alcohol abuse, a pending divorce, a potential financial difficulty, or a serious tax disadvantage in making the distribution;

(c) The beneficiary has clearly manifested an inability to manage financial affairs; or

(d) The property to be distributed is subject to conflicting claims, to tax deficiencies, or to liabilities contingent or otherwise.

The trust should also include a means for the beneficiary to obtain review of the trustee's decision and to subject the trustee's decision to periodic approval by the court. These provisions provide protection for the trustee, as well as for the beneficiary.

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§6.24 K. Special Needs

Special needs provisions can preserve the trust assets for the supplemental needs of a beneficiary, such as travel, entertainment, and special medical care, that are not covered by public benefits. A properly designed and administered special needs trust settled by a person other than the applicant for public benefits, *e.g.,* by parents for a disabled child, is not subject to Medicaid liens or prohibitions on transfers. Medicaid, known as Medi-Cal in California, is concerned solely with transfers to self-settled trusts. See chap 26A. An example of a special needs provision is as follows:

It is the settlors' intent that the trustee, in exercising discretion to distribute income and/or principal to or for the benefit of Susan Johnson, shall consider whether (1) any governmental or private assistance programs exist for which Susan Johnson may be eligible, and (2) whether the distribution by the trustee of such income and/or principal will reduce or eliminate any benefits for which Susan Johnson may be eligible or that she may be receiving from government or private assistance programs. Furthermore, it is the settlors' intent that the trustee in exercising discretion to distribute income and/or principal to or for the benefit of Susan Johnson shall, to the extent possible, collect and expend all benefits from government or private assistance programs for which Susan Johnson may be eligible before expending any amounts from the net income and/or principal of this trust.

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§6.25 L. Support, Maintenance, and Other Discretionary Distribution Powers

The trustee of a revocable trust needs to be informed about the powers of distribution and powers relating to support and maintenance of various beneficiaries. Often the trust will have different standards depending on the identity of the beneficiary. The broadest standard is reserved for the settlor. After the settlor's death, however, for creditor protection as well as for tax purposes, it is preferable to have either an ascertainable standard for distribution, an independent trustee, or both. For tax purposes, the ascertainable standard is limited to health, education, maintenance, and support (HEMS). IRC §2041(b)(1)(A); Treas Reg §20.2041-1(c)(2). The trustee may be instructed whether or not to take other resources of the beneficiary into consideration and whether or not to limit the level of support to the one in effect at the death of the settlor or at some other time. An example of such a provision might read (see Drafting California Revocable Trusts §§7.62, 7.68 (4th ed Cal CEB 2003)):

The trustee shall pay to or apply for the benefit of each of the settlor's children, and to the issue of any deceased child of the settlor, as much of the trust property as the trustee determines is appropriate for each child's health, education, maintenance, and support. In exercising its discretion to determine the amount appropriate for each child's health, education, maintenance, and support, the trustee shall take into account distributions from other trusts established by the settlor, other sources of beneficiary income known to the trustee, other resources of the beneficiary readily available for those purposes, and, to the extent appropriate, the beneficiary's ability to earn income.

If subtrusts that will be created at the death of the settlor (see chap 17) are intended to provide asset protection for a beneficiary or to avoid inclusion of the trust assets in the beneficiary's estate, the discretion of the trustee to make distributions to himself or herself as a beneficiary must be limited to the ascertainable standard. If a broader standard is used, these benefits will be lost unless discretionary distributions not limited to an ascertainable standard are vested in an independent third party trustee.

The settlor can indicate ahead of time the level of his or her own support. For example, for some settlors, being maintained in the home is of primary importance even if it is extremely expensive and even if it affects the residue that may be available for beneficiaries. If these are the settlors' wishes, a trust provision might read:

It is the settlors' very strong precatory desire that neither of them ever be placed into a nursing home or similar environment but, instead, that they be maintained in their residence with live-in nurses, companions, and similar helpers as may be necessary to accomplish this goal.

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Source: Estate Planning/California Estate Planning/6 Revocable Trusts/§6.26 M. Savings Clauses and Savings Statutes

§6.26 M. Savings Clauses and Savings Statutes

Several popular goals of revocable trusts may be defeated if certain technical requirements are not met. Often the failure to meet these technical requirements is the result of a clerical error or an unintended interaction of provisions in the trust instrument. In an attempt to assist settlors of revocable trusts, statutory savings provisions have been enacted in Prob C §§21500-21541 that relate to preservation of the marital and charitable deductions.

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§6.27 N. Payment of Taxes

Absent a revocable trust, decedent's unpaid expenses, including income taxes, are the responsibility of his or her probate estate. See Prob C §11401. Estate, gift, and generation-skipping transfer taxes, on the other hand, are chargeable pro rata among the persons receiving assets from the decedent, including assets such as proceeds of insurance, IRAs and retirement plans, and property passing to a surviving joint tenant. Prob C §20110. It is common to provide by either will or trust for variations in the rules concerning responsibility for taxes. See §5.47.

PRACTICE TIP: Perhaps contemplating that all assets will pass by way of will or trust, many trusts include a provision requiring expenses and taxes to be paid from the residue of the estate. However, if a large proportion of a decedent's estate is contained in an IRA or retirement plan, and the beneficiary of the IRA or retirement plan is different from the residuary beneficiary of the estate, the result can be disastrous. By carefully drafting the clause in the revocable trust providing for payment of taxes and expenses, the settlor can provide that assets passing outside the trust bear their proportionate share of taxes. If it is desired that minor gifts, including those passing outside the trust, not bear taxes, this can be expressed as well. A sample trust provision might read:

On the death of the settlor, the special bequests hereinafter set forth shall be distributed as provided below, free of all estate taxes, to the individuals hereinafter named who survive the settlor.

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§6.28 O. Choice of Law/Situs

For settlors with property in more than one state or for settlors who change residences frequently, the trust may include a provision specifying the law under which the trust is to be interpreted. A California revocable trust may be used to retain the community property character of marital assets even if the owners move to a non-community-property state. See Drafting California Revocable Trusts §§18.9-18.11 (4th ed Cal CEB 2003). For purposes of establishing jurisdiction and venue, however, local law applies. See Prob C §§17002, 17005. The principal place for administration of the trust is the usual place where day-to-day activity of the trust is carried on by the trustee or person primarily responsible for the administration of the trust. Prob C §17002(a). If the principal place of administration cannot be determined under this rule, and if the trust has a single trustee, the principal place of administration is the trustee's residence or usual place of business. Prob C §17002(b)(1).

NOTE: In California, the only trusts subject to continuing court jurisdiction are those created by will executed before July 1, 1977, or trusts that specifically provide that they are subject to continuing jurisdiction of the superior court. Prob C §17300.

Irrevocable trusts may be transferred from one jurisdiction to another without the need for a court order. Prob C §§17400-17401.

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§6.29 VI. CHOICE OF TRUSTEE

The selection of an appropriate trustee is one of the most important decisions the client will confront in the estate planning process. A key factor in the selection is the proposed trustee's ability to discharge fiduciary duties competently.

The selection of a trustee involves competing considerations. On the one hand, the trustor generally desires that the trustee be sensitive to the needs of beneficiaries. This sensitivity often requires a personal relationship with the beneficiary. The trustee must be especially sensitive when a trust includes part or all of an interest in a closely held business. On the other hand, the trustor should expect fiscal competence and a certain degree of financial sophistication from the selected trustee. Overlaid on these considerations is the ability of the trust to afford any trustee's fees that may be charged.

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§6.30 A. Settlor as Trustee

The choice of the settlor or settlors as trustees for the large majority of revocable trusts is usually treated as a foregone conclusion. This is appropriate when the trust is intended primarily as a conservatorship substitute or will substitute. See §§6.7-6.8. Even though substantive changes affecting title and liability occur with the creation of the trust, most revocable trusts are designed to be transparent until the need arises. As long as the trust is in its dormant stage, the trust is treated as though it were the grantor. As a result, filing a separate fiduciary income tax return, obtaining a separate tax ID number, and encountering title or liability problems sometimes can be avoided. See Treas Reg §§1.671-4(b)(2), 301.6109-1(a)(2). On funding issues, see §§6.41-6.49.

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§6.31 B. Third Party as Trustee

In some instances it is desirable to have a third party trustee or co-trustee. The settlor, because of illness or other incapacity, may need a third party trustee. In general, third party trustees are selected from four sources: family members, corporate trustees, private professional fiduciaries, and trusted friends or professionals.

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1. Sources of Third Party Trustees

§6.32 a. Family Members

The most common choice for a third party trustee is a family member who is sensitive to the needs of the beneficiary; however, a degree of financial sophistication is also required. Although the trustor may expect a family member to serve with little of no compensation, the liability to which a trustee is exposed and the time involved in managing trust assets may be a considerable imposition for which it may be appropriate for a family member to charge a fee. For example, to ensure diligent administration, it may be necessary to provide compensation if administration of the trust prevents other employment, or to satisfy family sensibilities on the subject.

Some families will include individuals who are accorded the highest degree of trust, and who possess understanding of and familiarity with the needs and desires of the beneficiaries. In other families there may be no such individual. The person selected also needs to have the skill and awareness to carry out the fiduciary duties of a trustee, including delegating appropriate functions to professionals when necessary. This combination of characteristics and skills is challenging to find, but it is possible to do so in many families.

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§6.33 b. Corporate Trustees

A corporate trustee generally possesses fiscal competence and the ability to manage assets. Although corporate trustees, as a group, provide the highest level of trust and competence, it is important to verify the reputation and qualifications of a particular corporate trustee.

Cost is a significant factor in deciding whether or not to use a corporate trustee. Because the fees charged by corporate trustees may be substantial, the size of the trust estate is a factor to assess in choosing a corporate trustee. For trusts with substantial assets, however, the Uniform Prudent Investor Act (Prob C §§16045-16054), has greatly lessened the importance of cost. In addition to trust administration, many corporate trustees provide investment services as part of their basic fees. Because most private individuals are not qualified to manage investments under the Uniform Prudent Investor Act, they may need to hire a professional investment advisor, which could cost as much or more than a corporate trustee's all-inclusive fee.

Some corporate trustees will decline to accept trusts that include provisions that are ambiguous or that require monitoring the good citizenship of beneficiaries. In those instances it may be necessary to give a co-trustee who is a family member or other individual the power to exercise the objectionable distribution provisions.

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§6.34 c. Private Professional Fiduciaries

Private professional fiduciaries come from a number of backgrounds. They may have a combination of skills including social work, bookkeeping, accounting, institutional trust administration, and the like. Although they can be bonded, they need not be. Private professional fiduciaries must meet certain state requirements to operate under the Professional Fiduciaries Act (Bus & P C §§6500-6592). See Prob C §2340. Because trust and competence vary widely among private professional fiduciaries, it is important to investigate their qualifications. As with other noncorporate trustees, the private professional fiduciary can be expected to retain a professional investment advisor to handle trust investments. A listing of qualified, licensed private professional fiduciaries can be found on the website of the Professional Fiduciary Association of California (PFAC) at http://www.pfac-pro.org.

The ability and willingness of a private professional fiduciary to comply with complex or sensitive trust distribution terms may be expected to exceed those of a corporate trustee, particularly when the private professional fiduciary has background or training suited to these issues. On the other hand, private professional fiduciaries will usually need to retain a professional investment adviser at an additional cost to the estate.

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§6.35 d. Trusted Professional Acquaintances

Although often considered as a primary candidate to be the trustee when friends and family members are not available, a trusted person such as a stockbroker, accountant, or attorney is often the least desirable choice. The bulk of trustee services are not generally compensated at a rate equivalent to a professional's normal billing rate. Unless the person is willing to accept a reduced rate or has staff that can provide some of the trustee services, there will be a mismatch between the person's expectations and the settlor's or beneficiaries' expectations. This should be anticipated and addressed in the trust document. To induce a professional to act, the settlor may need to specify that all services as trustee will be compensated at the professional's standard billing rates.

A professional should also be concerned about liability for acting as trustee because the person's normal business standards and obligations are increased by those attendant to his or her duties as trustee. Prob C §16014; *Estate of Beach* (1975) 15 C3d 623, 635, 125 CR 570 (bank as trustee); *Estate of Collins* (1977) 72 CA3d 663, 673, 139 CR 644 (decedent's business partner and lawyer as trustees). In addition, most malpractice policies do not cover errors and omissions for an attorney or accountant acting as trustee.

Despite the problems of an individual acting as trustee, someone who is trusted by the family and is familiar with family dynamics may be the proper choice. However, today's increased complexities and substantial liability problems often militate against such a choice.

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§6.36 2. Special and Independent Trustees

Certain administrative powers held by a trustee may have adverse tax consequences. A trustee who is a beneficiary or who has a dependent who is a beneficiary may be considered to have a general power of appointment under IRC §2041 if the trustee has a power that allows the trustee to make adjustments among beneficiaries without being limited by an ascertainable standard. If the settlor wants the trustee to have the power to make unlimited adjustments among beneficiaries, the settlor may designate an independent third party as a co-trustee, or designate a special trustee who is entrusted with the authority, acting alone, to exercise the tax-sensitive power. On tax-sensitive trustees and possible adverse tax consequences, see Drafting California Revocable Trusts, chap 16 (4th ed Cal CEB 2003).

Special trustees are independent trustees appointed to act only while certain "special" circumstances exist. If no one person or organization is available who meets all of the trustee criteria, the solution may be found in providing for special trustees, co-trustees, or trust protectors. For example, with respect to the corporate trustee that may not want to deal with sensitive family issues, a family member, friend, or trusted professional advisor may be willing to do so. Conversely, the family member who has all of the skills necessary to act as trustee but lacks the time or resources to perform accounting and investment functions may do well paired with a corporate trustee. Trust provisions can provide whether one or both of the co-trustees can act in a given situation or whether the power of the special trustee supersedes that of the permanent trustee.

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§6.37 3. Trust Protector

A trust protector is a person designated by the settlor to make certain decisions regarding appointment or removal of trustees or regarding distributions or termination of a trust, but who does not have the duties and powers of a trustee. Many times a person, including a professional advisor, is reluctant to act as trustee because of potential liability or ongoing obligations. However, the same person may be willing to act as a trust protector. Trust protector provisions are designed to avoid imposing fiduciary liability on the protector and, at the same time, to allow an independent third party to make decisions about removal or appointment of a successor trustee, the invocation of special needs provisions, or the amendment or termination of a trust for tax or other reasons.

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C. Co-Trustees

§6.38 1. Unanimous Consent

Trust provisions should anticipate any special rules for interaction between co-trustees. In the absence of a special provision, the unanimous consent of all trustees is required for any action. Prob C §15620. In the absence of unanimous consent, a court petition for instructions under Prob C §17200 may be required. On Prob C §17200 petitions, see California Trust Administration, chap 15 (2d ed Cal CEB 2001). For example, it may be convenient to provide that if one of the co-trustees is an original settlor of the trust, that trustee acting alone may bind the trust or that, with respect to a corporate trustee, that co-trustee acting alone may bind the trust on any sale or investment of trust property.

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§6.39 2. Ethical Issues in Representing Co-Trustees

Representing co-trustees presents the same ethical issues as representing any other clients jointly. One or more of the co-trustees may have had a previous relationship with the attorney, a co-trustee may expect to reveal information in confidence to the attorney, or one co-trustee may need protection from a breach of trust committed by the other. As with representing any clients jointly, the attorney must be careful to disclose any potential conflicts of interest and to advise one or more of the co-trustees when an actual conflict of interest arises, to seek new or special counsel to deal with the conflict. If a waiver of the conflict is requested, the client should be encouraged to consult with separate counsel before signing a waiver.

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D. Successor Trustees

§6.40 1. Providing for Successor Trustees

Because the suitability of a particular trustee or style of trustee for office may vary depending on the circumstances of the trustee or the circumstances of the trust, it is important to provide for flexible successor trustee provisions. At all times, there should be some person with the ability to remove a trustee and appoint a successor trustee. These provisions not only encourage trustees to act in the best interests of trust beneficiaries, but also provide security to the trustee who wishes to know that if, for some reason, he or she wishes to resign, a successor can easily be appointed. Persons with powers to appoint or remove trustees may include the settlors, a designated trust protector, all of the beneficiaries or some majority, the acting trustee, or named trustees.

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§6.40A 2. Attorney-Client Privilege for Successor Trustees

Several cases, including *Moeller v Superior Court* (1997) 16 C4th 1124, 69 CR2d 317, and *Wells Fargo Bank v Superior Court* (2000) 22 C4th 201, 91 CR2d 716, have raised questions concerning the attorney-client privilege for trustees. The attorney-client privilege relating to some, but not all, communications between trustee and attorney attaches to the office of trustee, allowing successor trustees to obtain attorney-client privileged information on matters of trust administration. *Moeller*, 16 C4th at 1131; *Eddy v Fields* (2004) 121 CA4th 1543, 18 CR3d 487. The predecessor retains the privilege for advice sought for its own protection. *Wells Fargo Bank*, 22 C4th at 209. As a practical matter, the distinction between trust administration advice and defensive advice is not always easy to draw, and this information can be damaging to a former trustee or attorney whose acts are being scrutinized or attacked by a successor.

Moeller places the burden squarely on the trustee to "scrupulously and painstakingly" distinguish its interests from those of the beneficiaries. 16 C4th at 1135. A trustee who wishes to maintain the confidentiality of defensive advice would be wise to use the safe harbor adopted in *Moeller*. If the trustee seeks legal advice in its personal capacity because of genuine concern about possible future charges of breach of fiduciary duty, it "may be able to avoid disclosing the advice to a successor trustee by hiring a separate lawyer and paying for the advice out of its personal funds." 16 C4th at 1134. With this type of arrangement, the advice will not be subject to discovery by successor trustees. See *Wells Fargo Bank v Superior Court, supra* (trust beneficiaries have no right to obtain disclosure of attorney-client communications, whether regarding trust administration or potential trustee liability).

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VII. TRUST FUNDING

§6.41 A. Pourover Will

A pour-over will is commonly used to make a transfer by will to the trustee of a living trust. The assets transferred are added to and administered as part of the trust along with its existing assets. In this way, the will "pours over" into the trust. The Uniform Testamentary Additions to Trusts Act (Prob C §§6300-6303) provides that a pour-over is valid if the trust is identified in the will and the trust's terms exist either in a nontestamentary written instrument executed before or at the same time as the will or in the will of a person who has predeceased the testator. Prob C §6300.

When a revocable trust is funded during the settlor's lifetime by a transfer of assets to the trustee, a pour-over will may be used to protect against a possible failure to transfer later-acquired assets to the trust. If a pour-over will is used in conjunction with a living trust, the settlor need not be concerned about funding every minor asset into the trust because such assets will be covered by the pour-over provisions. If the value of assets not transferred to the trust does not exceed $100,000, the trustee may be able to collect the assets without probate under Prob C §13100. On the affidavit procedure for transfer of personal property without probate, see §5.24.

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B. Standard Funding Procedures

§6.42 1. Tangible Personal Effects and Untitled Property

Despite the ability to transfer unfunded assets into a living trust using a pour-over will (see §6.41), the probate avoidance feature of living trusts depends on re-titling assets so that transfer agents and others have a sound legal basis from which to determine title. This becomes problematic for untitled assets that may pass by personal delivery. In many situations, because of nominal value and relative lack of dispute, tangible personal property is handled very informally, even if there is a probate. However, to avoid problems with the devolution of personal property, potential issues should be anticipated. Allowing personal property to be controlled, *e.g.*, by the provisions of the will, may require an unnecessary probate. These kinds of problems can be avoided by using a general assignment form that provides for the transfer of tangible personal property and gives assurance to any third party who is involved in the transfer process that the trustee has title and the right to possession. The form, if drafted broadly enough and notarized, can also resolve formal transfer requirements for titled property. Prob C §850; *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433. See §§6.48-6.49. For a general assignment form, see Drafting California Revocable Trusts §21.16 (4th ed Cal CEB 2003). Funding tangible personal property into the trust in this manner allows for distribution of the property pursuant to a trust provision.

By putting a provision for distribution of tangible personal property into the trust, it is a simple matter to coordinate the provision with a trust amendment specifically designed for gifts of tangible personal property. Because an amendment to a trust need not be witnessed or notarized (see §6.17), when the settlor wishes to have the power to make amendments regarding the disposition of items of tangible personal property, making and changing the amendments will be a more simple process than the formal process required for a codicil to a will. See Funding a Revocable Trust, steps 19, 49 (Cal CEB Action Guide October 2009).

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§6.43 2. Deposit Accounts

Although deposit accounts should cause no more problem than other titled assets, settlors may be reluctant to allow the name of the trustee to be placed on the account. Settlors sometimes either add alternate signators who are not trustees or beneficiary designations to a trust account. The attorney should stress to the settlor the importance of avoiding such missteps.

The proper way for the trustee to hold title to a deposit account is as follows:

_ _[*Name*]_ _**, trustee of the** _ _[*name of trust*]_ _ **Trust, dated** _ _[*date*]_ _.

For convenience reasons, most institutions allow printing on the checks to reflect only the individual trustee's name and address and do not reveal the existence of the trust. Typical trust provisions provide for a trustee to hold property in the trustee's own name or in the name of a nominee. Trust language may also provide that when there is more than one trustee, only a single signature is required to write checks or withdraw funds. In these situations, funding institutions need to determine the number of signatures required. They should also make settlors aware of provisions in account terms that may permit transfer to a surviving account holder, contrary to the provisions of the trust instrument. See Funding a Revocable Trust, steps 20, 34 (Cal CEB Action Guide October 2009).

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§6.44 3. Securities

Because of specific securities requirements, transfer agents require much more than a certificate of trust (see §6.4) to transfer securities into the name of the trustee. They may require additional documents such as an affidavit of domicile and a signature guarantee as well as an endorsement to any share certificate. For a form of affidavit of domicile, see 3 California Decedent Estate Practice §32.36 (2d ed Cal CEB 2009). These additional requirements can cause significant logistical problems when the settlor holds share certificates in his or her own name.

The attorney may want to discuss with the settlor the relative risks of holding certificates in a brokerage account in a street name versus individually held certificates. Before depositing securities into a brokerage, the attorney should determine the financial viability of the brokerage firm and the adequacy of insurance coverage. This is to be compared with the problems associated with individual ownership of certificates, including lost certificates, failure to give notice to the issuer or transfer agent of a change of address, and the like. It is the author's experience that securities held in individual names are much more likely to be lost or mishandled than those held in a brokerage account. The broker can also provide valuable information to help in identifying a particular security, providing market prices, and making transfers. See Funding a Revocable Trust, step 35 (Cal CEB Action Guide October 2009).

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§6.45 4. Real Property

Transferring real property into the trust name involves choosing the appropriate deed form. The two primary choices are:

(1) A *trust transfer deed*, which is a grant deed with all its warranties that may render the settlor or the settlor's estate liable to the trust for defects in the settlor's title. It may also provide the trust with title to after-acquired property.

(2) A *quitclaim deed*, which has no warranties, transfers only the title that the settlor may have to the property, and does not effectively transfer after-acquired title. *Klamath Land & Cattle Co. v Roemer* (1970) 12 CA3d 613, 618, 91 CR 112.

Given these choices, most attorneys advise their clients to use trust transfer deeds when transferring real estate into a revocable trust in which the settlor is the sole beneficiary.

Transfer of title may also affect liability and title insurance, real property assessment, and due-on-sale clauses. The attorney should review these issues with the client as part of the funding process. If properly addressed, there should be no adverse consequences. Usually there is a nominal charge for adding the trustee as a named insured on any insurance policy relating to title, loss, or liability. The Garn-St. Germain Depository Institutions Act of 1982 (12 USC §1701j-3) preempts due-on-sale clauses for certain residential real property. See California Mortgage and Deed of Trust Practice, chap 8 (3d ed Cal CEB 2000). In addition, a transfer of property to a revocable trust of which the settlor or the settlor's spouse are the only beneficiaries is exempt from reassessment. Rev & T C §63(a).

To transfer real property, see Funding a Revocable Trust, steps 25-26, 42-46 (Cal CEB Action Guide October 2009).

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§6.46 5. Partnership Interests

Partnership agreements often contain provisions restricting transfer of partnership interests and/or requiring approval of the managing partner or some majority of partners before allowing transfer of partnership interests. However, some agreements approve, in advance, transfers to family members or to a revocable trust. To transfer partnership interests, the attorney should contact the managing partner to obtain details about the required procedures and then compare these procedures to the partnership agreement to ensure that all necessary requirements are being met. If the attorney cannot obtain the necessary approvals, it may be necessary to effect an assignment of the income interest only. This leaves the trust without a partnership voice, but with the settlor's share of income under the partnership. In some cases this may be advantageous, *e.g.*, when the partnership is managing property that may have hazardous waste problems or is involved in litigation.

For further discussion of funding procedures, see California Trust Administration, chap 6 (2d ed Cal CEB 2001); Funding a Revocable Trust, steps 21, 38 (Cal CEB Action Guide October 2009).

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C. Alternative Funding Procedures

§6.47 1. Professional Practices

Only a qualified professional may be a shareholder in a professional corporation such as a law, accounting, or medical practice. Corp C §13407. Although a partnership interest itself may not be transferable, the rights on withdrawal or dissolution of the partnership are still assignable so that at the death or withdrawal of the professional partner, the trustee may enforce rights for sale of partnership interests or dissolution of the partnership. See Funding a Revocable Trust, step 21 (Cal CEB Action Guide October 2009). Section 13407 allows the sale of shares in a professional corporation by the trustee to a professional licensed in California. Likewise, if a dissolution of the partnership is contemplated, it can be carried out by a surviving partner. However, in the case of a practice wholly owned by a decedent, it appears that the trustee may not carry out the dissolution. Corporations Code §1900(a) provides that a dissolution can be carried out only by shareholders. Shareholders must be qualified professionals. Corp C §13406(a). Presumably, this restriction is intended to ensure proper handling and disposition of client files of the dissolved professional practice. On planning for the disposition of a sole practitioner law practice, see Estate Planning for Special Assets, chap 11 (Cal CEB 2004).

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§6.48 2. General Assignment

A general assignment form is useful in funding a trust and avoiding probate. If it complies with transfer requirements, such as those for personal property or real property (see §§6.42, 6.45), the form can perfect title in a trustee when delivered to a transfer agent or when recorded. If necessary, it can be used as the basis for a *Heggstad* petition. See §6.49. In using a general assignment form, however, the attorney must be careful that assets not intended to be covered by the assignment, such as those with specific beneficiaries, survivorship rights, or other special handling, are exempted from its operation. For a general assignment form, see Drafting California Revocable Trusts §21.17 (4th ed Cal CEB 2003).

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§6.49 3. The *Heggstad* Solution

In *Estate of Heggstad* (1993) 16 CA4th 943, 20 CR2d 433, the court held that a written declaration of trust by the owner of real property indicating an intent to include the property in the trust was sufficient to fund the property into the trust. However, such a declaration may not be accepted or recognized by title companies or transfer agents unless a court order confirming the transfer is obtained. See Prob C §§850-859, 17200.1 (trustee may file petition requesting court order confirming transfer). It is therefore advisable to transfer each asset individually to the trustees of the trust. It is also advisable to include a legal description of any real property transferred into the trust. See *Osswald v Anderson* (1996) 49 CA4th 812, 57 CR2d 23. For further discussion of *Heggstad* issues, see Drafting California Revocable Trusts, chap 21 (4th ed Cal CEB 2003).

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VIII. THIRD PARTY RIGHTS

A. Beneficiaries

§6.50 1. Vested and Contingent Interests

A beneficiary is defined as a person who has any present or future interest, vested or contingent, in a trust. Prob C §24(c). The concept of a beneficiary of a revocable document has caused considerable problems for courts attempting to determine who has enforceable rights under a trust. It has also resulted in several Probate Code sections attempting to deal with beneficiaries who have only contingent interests in the trust. See, *e.g.*, Prob C §§15800-15805. Because a will is transitory in its nature and effect and only comes into effect on the death of the testator, the beneficiaries named in a will indisputably have no rights. Unfortunately, because the Probate Code definition of "beneficiary" fails to distinguish between beneficiaries with currently enforceable rights and those whose rights are not currently enforceable, there will always be some confusion in the use of the term.

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§6.51 2. Rights During Settlor's Lifetime

Under Prob C §15800(a), the person holding the power to revoke the trust, and not the beneficiary, has the rights afforded to beneficiaries. Similarly, Prob C §15801(a) gives the person holding the power to revoke, while that person is competent, the power to consent or withhold consent. This section, however, does not apply when the joint consent of the settlor and all beneficiaries is required by statute. Prob C §15801(b).

NOTE: Despite Prob C §15801(b), the settlor of a revocable trust may revoke the trust at any time with or without the consent of the beneficiaries. Prob C §15400.

Notice to a beneficiary of a revocable trust must be given to the person holding the power to revoke. Prob C §15802. Notice need only be given to a living person who holds the power to revoke. Prob C §15804(a)(2).

A beneficiary has the rights provided in Prob C §§16060-16063 (trustee's duty to report and account to beneficiaries). Under Probate Code §16062, the trustee is required to account at least annually to each current beneficiary. In *Esslinger v Cummins* (2006) 144 CA4th 517, 50 CR3d 538, the court held that a remainder beneficiary has standing to petition for a court order compelling the trustee to provide annual accountings for prior years. However, under Prob C §§15800 and 16064(b), except to the extent the trust instrument provides otherwise, during the time that the trust is revocable and the settlor is competent, the trustee does not have a statutory duty to report information to or account to beneficiaries other than the settlor. *Johnson v Kotyck* (1999) 76 CA4th 83, 90 CR2d 99. When the settlor dies or becomes incompetent (unless a conservator is appointed who still has the power to revoke the trust), a beneficiary may have the right to demand that the trustee provide an accounting, even for the time when the trust was revocable. *Evangelho v Presoto* (1998) 67 CA4th 615, 79 CR2d 146.

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§6.52 3. Rights After Death

Although beneficiaries may not have had a right to an accounting during the settlor's lifetime, after the settlor's death, beneficiaries may have a right to an accounting for a period prior to death. See, *e.g.*, *Johnson v Kotyck* (1999) 76 CA4th 83, 90 CR2d 99; *Evangelho v Presoto* (1998) 67 CA4th 615, 79 CR2d 146.

Beneficiaries and heirs are entitled to receive a statutory notification that the trustee must serve on them when a settlor dies and the trust becomes irrevocable. Prob C §16061.7(a)(1). In addition, heirs and beneficiaries have the right to receive a copy of the terms of the trust if they request it. Prob C §16061.7(g)(5). Beneficiaries who receive notification, whether or not they request a copy of the terms of the trust, have 120 days from the date of the notice or 60 days from the date they receive a copy of the terms of the trust, if requested, whichever is later, in which to file a trust contest. Prob C §16061.7(h). The 120-day period also applies to beneficiaries who receive a copy of the trust, whether or not the notification states that they are entitled to request a copy of the trust. *Germino v Hillyer* (2003) 107 CA4th 951, 132 CR2d 478. When the trustee fails to give notification to a beneficiary, the trustee is responsible for all damages, attorney fees, and costs caused by the failure unless the trustee has made a reasonably diligent effort to comply with the notification requirements. Prob C §16061.9(a). The trustee is also responsible for all damages if the failure affects an heir whose identity is known to the trustee. Prob C §16061.9(b).

When the trustee has not given the notification required by Prob C §16061.7, an attack on the validity of the trust will be governed by normal statutes of limitations, which vary depending on the facts alleged. See California Trust and Probate Litigation §4.18 (Cal CEB 1999).

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§6.53 B. Creditors

On the settlor's death, if the estate has significant existing or potential creditors, the trustee may elect the creditors' notice proceeding under Prob C §19003. Under that procedure, the trustee must publish notice to creditors in a newspaper of general circulation. Prob C §§19003(a), 19040(a). If the trustee has knowledge of a specific creditor, the trustee must also give the creditor actual notice. Prob C §19050(a). The trustee must give notice to creditors no later than the later of 4 months after first publication of notice under Prob C §19040 or 30 days after the trustee first has knowledge of the creditor. Prob C §19051. The creditor must file a claim within 60 days after notice is mailed or personally delivered to the creditor. Prob C §19100(a)(2). A trustee who knows or has reason to believe that the deceased settlor was the surviving spouse of a person who received health care, as defined, must give notice to the State Director of Health Care Services. Prob C §19202. See also Prob C §19201, which lists additional public entities that may require notice. For further discussion, see California Trust Administration §§10.18-10.22 (2d ed Cal CEB 2001). If the trust claims procedure is not used, creditors must file an action on a liability of the deceased settlor within 1 year after the date of death CCP §366.2. See also *Stoltenberg v Newman* (2009) 179 CA4th 287, 101 CR3d 606, in which the court held that a suit against a successor trustee in her fiduciary capacity that was based on alleged fraud committed by the deceased predecessor trustee while acting as trustee was subject to the 1-year limitations period. The decision cited *Wagner v Wagner* (2008) 162 CA4th 249, 75 CR3d 511, in which the court applied the 1-year limitations period of CCP §366.2 to a suit against a successor trustee of a formerly revocable trust in which the plaintiff claimed compensation for personal services allegedly provided to the deceased settlor.

The limitations period for an unknown creditor to file a claim after the publication of notice is generally 4 months. Prob C §19100(a)(1). However, a creditor may file a late claim if the creditor did not have knowledge of the facts giving rise to the existence of the claim more than 30 days prior to filing the claim, and the claim is filed within 60 days after the creditor has actual knowledge of both the facts giving rise to the claim and the administration of the trust. Prob C §19103.

The time periods for filing a claim generally conform to the equivalent probate proceeding time periods. In certain situations, the trust creditor claims procedure may, in fact, have some benefits over that of the probate claims procedure. See Trust Admin, chap 10.

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IX. TAXATION ISSUES

§6.54 A. Trust Tax Returns

A trust is generally considered a separate taxable entity for federal income tax purposes. As such, unless some exception applies, the trust must have its own taxpayer identification number. The primary exception to this rule is when all of the trust is treated as owned by the settlor or another person under IRC §§671-678. Treas Reg §§1.671-4(b)(2), 301.6109-1(a)(2). A revocable trust is treated as owned by the settlor under IRC §676.

If no exemption applies, the trustee must file a return on Form 1041 for the trust if the trust has any taxable income or gross income of $600 or more for the tax year or if any beneficiary of the trust is a nonresident alien. IRC §6012(a)(4). A state income tax return must be filed on Form 541 when the trust has more than $100 in net income under Rev & T C §18505(e). See California Trust Administration, chap 11 (2d ed Cal CEB 2001).

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§6.55 B. Taxation of Trust Income

For revocable trusts, all income is reportable on the settlor's income tax return during the settlor's lifetime. IRC §671. On the settlor's death, revocable trusts are sometimes treated differently than a probate estate for income tax purposes unless the trustee makes an election to treat the revocable trust as part of the settlor's estate for income tax purposes. IRC §645; Treas Reg §1.645-1(c). Such an election is generally desirable. In the absence of a §645 election:

- An estate can use a fiscal year, but a trust cannot. IRC §644(a).
- An estate is exempt from paying estimated taxes for the first 2 years, but a trust is not. IRC §6654(*l*)(2)(A).
- An estate can take a charitable deduction for income permanently set aside for charity, whereas a trust cannot claim the deduction unless the income is actually paid. IRC §642(c)(2).
- An estate can deduct up to $25,000 of real estate passive activity losses for each of the first 2 years. IRC §469(i)(4).
- An estate is always an eligible S corporation shareholder, but a revocable trust may cease to be eligible after 2 years unless it meets restrictive requirements. IRC §1361(b)(1)(B), (c)(2).
- A decedent's medical expenses that are paid by the decedent's estate (but not trust) can be deducted on the decedent's final income tax return. IRC §213(c)(1).
- An estate is allowed a $600 personal exemption each tax year. A trust is ordinarily allowed only a $100 exemption ($300 if the trust must distribute all income annually, but this often makes the exemption useless). IRC §642(b).

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§6.56 C. Gift Taxes

Gifts from revocable trusts during the settlor's lifetime are treated as gifts made directly by the settlor. IRC §2035(e). See §6.18.

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§6.57 D. Generation-Skipping Transfer Tax

Because of the power to revoke, assets in a revocable trust are considered the property of the settlor for generation-skipping transfer (GST) tax purposes. See IRC §§2611-2612. On the death of the settlor, if other beneficiaries are more than one generation younger than the settlor, the trust becomes a generation-skipping trust, subject to the generation-skipping tax imposed by IRC §§2601-2663. On the GST tax, see chap 11.

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X. MANAGEMENT OF TRUST ASSETS

§6.58 A. Settlor as Trustee

As long as the settlor is acting as the trustee, it might be assumed that the settlor is free to invest trust funds as he or she wishes. However, beneficiaries may have rights to demand an accounting and potentially make a claim against the decedent's estate after the decedent's death for a period before the decedent's death. See §6.52. Although the author questions whether this is a proper application of law, this potential problem can be avoided by including in the trust a provision specifically excepting the settlor from investment duties that apply to other trustees, *e.g*.,

During such time as a settlor is acting as trustee or co-trustee, the diversification requirements of the Uniform Prudent Investor Act (Probate Code §§16045-16054) will not apply.

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§6.59 B. Third Party Trustee

A third party acting as trustee of a revocable trust is held to the investment and management standards set forth in the Uniform Prudent Investor Act (Prob C §§16045-16054) (see §6.60) and the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) (see §6.61). The provisions of these acts may be varied by the trust instrument. Prob C §§16046(b), 16339. The settlor may desire that certain investments be retained or certain others be avoided even if doing so would run contrary to applicable law for investment of trust assets. The settlor may also affect the trustee's choice of investments by specifying how depreciation and capital receipts affect distributions.

The trustee of a revocable trust is not liable when the agent's act is performed or omitted pursuant to the written instructions of the person having the power to revoke the trust. Prob C §16462. Similarly, the trustee of a revocable trust is not liable for hiring an agent when the trustee is directed to do so in writing by the person having the power to revoke. Comment to Prob C §16401. A trustee also may protect itself from liability by using the notice of proposed action procedure in Prob C §§16500-16504. Under those provisions, beneficiaries must object to the proposed action within 45 days of the notice. Prob C §16502(d).

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§6.60 1. Uniform Prudent Investor Act

The Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) requires trustees to create a diversified portfolio and to consider the appropriateness of each investment asset, not as an isolated asset, but in relationship to the entire portfolio. See Prob C §16047(b). However, the terms of the trust may allow variance from the provisions of the UPIA. Prob C §16046(b).

The UPIA is intended to allow trustees to provide for the needs of both the income beneficiary and the remainder beneficiaries, as well to encourage an overall return. More specifically, the trustee has the following duties and powers under the UPIA:

- *Duty to diversify*. Unless the trust provides otherwise, the trustee has a duty to diversify trust assets. Prob C §16048.
- *Duty to incur only reasonable costs*. In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, overall investment strategy, purposes, and other circumstances of the trust. Prob C §16050.
- *Power to delegate*. A trustee may delegate investment and management functions as is prudent under the circumstances. Prudence must be exercised in (1) selecting an agent; (2) establishing the scope and terms of the delegation; and (3) periodically reviewing the agent's overall performance and compliance with the terms of the delegation. Prob C §16052(a).

A trustee who complies with these requirements is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated, unless other breaches of fiduciary duty specified in Prob C §16401(b) (applicable to agents generally) occur with regard to the delegation. See Prob C §16052(c).

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§6.61 2. Uniform Principal and Income Act

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) gives the trustee discretion to look at factors such as overall return, and to allocate capital gains and unrealized growth to income. The intent of the UPAIA is to allow investment for overall growth while still satisfying the needs of the income beneficiary.

The UPAIA governs allocation of income and expense items between principal and income accounts. If the trust instrument does not give the trustee discretion to allocate receipts and expenditures, the allocation must be made in accordance with the UPAIA. Prob C §16335(a)(3).

Generally, the trustee may make an adjustment between principal and income to the extent the trustee considers necessary based on the nature and purpose of the trust, the intent of the settlor, the identity and circumstances of the beneficiaries, the nature of trust assets, and the extent to which the trust instrument gives the trustee the power to accumulate income or invade principal, among other factors. Prob C §16336(a). This adjustment power allows the trustee to invest trust assets in a manner that will produce the best total return without the need to consider whether the desired investment portfolio will produce the balance between trust income yield and principal preservation that was originally contemplated by the settlor or required by the trustee's duty of impartiality. Alternatively, the trustee usually can administer the trust as a unitrust and pay a unitrust amount of 4 percent of the net fair market value of trust assets averaged over the lesser of the 3 preceding years or the life of the trust to the income beneficiary in lieu of income, if no beneficiary objects after notification by the trustee. Prob C §§16328, 16336.4-16336.7. See chap 24A. For a detailed discussion of the UPAIA, see Drafting California Revocable Trusts, chap 17 (4th ed Cal CEB 2003).

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§6.62 XI. CONSTRUCTION OF TRUST INSTRUMENTS AND TERMS

In proceedings to construe trust provisions, the same principles of interpretation apply that also apply to wills and other donative written instruments. See Prob C §§45, 21101-21140. The same rules that apply to restrict gifts to drafters of wills also apply to drafters of trusts. See Prob C §21350(a). Likewise, the rules for trust contests relating to fraud and undue influence are generally the same as those for wills. For grounds for setting aside a will or trust, *i.e.*, attacking its validity, see California Trust and Probate Litigation, chap 6 (Cal CEB 1999).

However, in at least one area, *i.e.*, capacity, there still exists a theoretical difference between wills and trusts. The standard for competence to execute a will is set forth in Prob C §6100.5. On the other hand, the standard for capacity to execute a trust (because it is essentially a contract) is found at CC §§39 and 1556-1557. See Prob C §§810-813 (proof of incapacity).

Because the standard for capacity to execute a will may be lower than the standard required for capacity to execute a trust instrument, in some instances it may appear preferable to use a will instead of a trust to carry out testamentary intent. In practice, little difference is seen between the two standards. Circumstances that might lead to a trust contest would not be ameliorated by the use of a will instead of a trust. For discussion of capacity, see Trust & Prob Litig, chap 6. When in doubt as to the construction or meaning of trust terms, the trustee may, of course, consult with the settlor. If the settlor is unavailable or incapacitated, the trustee may seek instructions from the court under Prob C §17200. On petitions for instruction under Prob C §17200, see California Trust Administration, chap 15 (2d ed Cal CEB 2001).

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XII. TERMINATION OF REVOCABLE TRUSTS

§6.63 A. By Withdrawal/Distribution

Although unfunded trusts are allowed in California (see §6.11), as a practical matter, removing assets from a trust terminates the trustee's control. See *Estate of Coleman* (2005) 129 CA4th 380, 28 CR3d 282 (trust was revoked when all trust property was transferred to the individual settlors pursuant to a marital settlement agreement). As a result, if all trust assets have been withdrawn or distributed, the trust contract might be considered terminated by full performance (subject only to the rights of the beneficiaries to have the trustee account for its acts).

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§6.64 B. Distribution Provisions of Trusts for Married Couples

The following brief description of typical distributive provisions of a revocable living trust for a married couple is offered for illustrative purposes only. For a complete discussion, see Drafting California Revocable Trusts, chaps 9-14 (4th ed Cal CEB 2003).

A revocable living trust established by a married couple typically provides for distribution of all its income currently to the settlors during their joint lifetimes. Both or either of the spouses may serve as trustees, and the surviving spouse may serve as successor trustee after the death of one spouse. See Revocable Trusts, App A.

To preserve the stepped-up basis at death on both halves of community property for capital gains purposes (see IRC §1014(b)(6)), the trust should provide that community property transferred to the trust will retain its character as such. To achieve this result, the trust should provide that the property will remain community property while in the trust and after any subsequent withdrawal and that the trust may be amended during the spouses' joint lifetimes only with their joint consent. Fam C §761.

On the death of either spouse, the trust often will be divided into three trusts:

- A "survivor's trust" to hold the community property share and separate property of the surviving spouse;
- A "marital trust" to contain that portion of the deceased spouse's community property share and separate property qualifying for the estate tax marital deduction under a formula provided in the trust instrument; and
- A trust known variously among practitioners as a "bypass," "credit shelter," "exemption," or "family" trust (called a bypass trust in this book), which contains that portion of the deceased spouse's estate equal to the exemption equivalent of the federal estate tax unified credit, which is intended to escape estate tax on the death of the surviving spouse. See the discussion of bypass trusts in Revocable Trusts, chap 14.

The survivor's trust remains revocable by the surviving spouse during his or her life.

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§6.65 1. Marital Trusts

The terms of the marital trust can qualify its assets for the marital deduction authorizing (or directing) the executor of the pour-over will to make a qualified terminable interest property (QTIP) election. See §6.41. Under IRC §2056(b)(7)(B), a QTIP trust will qualify as such if it pays all its income to the surviving spouse, no person (including the surviving spouse) has the power to appoint property of the trust to anyone other than the surviving spouse, and the executor elects on the estate tax return to treat the trust as a QTIP trust. See chap 17.

Alternative methods of qualifying for the marital deduction are either to give the surviving spouse a lifetime or testamentary general power of appointment over the marital trust assets, or to provide that those assets will pass to the surviving spouse's estate on his or her death. These latter methods are less attractive to many clients than the QTIP method because they enable the surviving spouse to divert assets from the children (*e.g.,* on remarriage) after the first spouse's death.

Regardless of which method of qualifying the marital trust is used, the trust usually provides for payment of all its income currently to the surviving spouse. The surviving spouse's power to control disposition of the marital trust's principal will depend on whether the trust is a QTIP trust. Because the purpose of the QTIP arrangement is to ensure that assets of the deceased spouse will ultimately go to recipients designated by him or her, a QTIP trust's provisions for invasion of principal are often strictly limited, *e.g.,* by an ascertainable standard in the same manner as an exemption trust.

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§6.66 2. Bypass Trusts

The bypass trust is irrevocable after the death of the first spouse and normally pays all its income to the surviving spouse. To avoid taxation of assets of the trust in the survivor's estate, if the surviving spouse serves as trustee, the trust allows the trustee to invade its principal only for the survivor's health, maintenance, education, and support needs (an "ascertainable standard"). See §6.25. The trust also may provide that such power of invasion is to be exercised only after exhaustion of the survivor's trust for these purposes.

When a trust becomes irrevocable, the trustee must provide notice to the beneficiaries and heirs. Prob C §16061.7(a)(1). See §6.52.

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§6.67 3. Distributions on Death of Second Spouse

On the death of the second spouse to die, if the trust so provides, the assets in the survivor's trust, as well as in the marital trust, could be appointed under the provisions of the surviving spouse's will. In default of appointment, typical trust provisions would normally add such assets to the bypass trust to be administered according to its terms.

Dispositive patterns after the death of the surviving spouse are many and varied. Typical provisions allow for retention of property in trust either until specified ages for distribution or for the lifetime of the beneficiaries. Gifts in trust for beneficiaries may be desirable to provide asset protection or tax avoidance, or to provide for the special needs of a beneficiary.

PRACTICE TIP: A properly drafted beneficiary's trust is often preferable to an outright distribution. Even capable, sophisticated beneficiaries will see the advantages of asset protection and tax reduction or avoidance that can be achieved when their gift is retained in an irrevocable trust. See chap 6A.

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§6.68 C. Express Revocation

The settlor may expressly revoke a revocable trust by complying with any method of revocation set forth in the trust instrument, or by a writing (other than a will) signed by the settlor and delivered to the trustee during the settlor's lifetime. Prob C §15401(a). But see *Gardenhire v Superior Court* (2005) 127 CA4th 882, 26 CR3d 143, in which the court held that a will may revoke a previously executed trust where the will unambiguously manifests the settlor's intent to revoke the trust and the settlor delivers the will to the trustee (or the settlor is the trustee) and the trust authorizes revocation by giving written notice to the trustee. See also *Masry v Masry* (2008) 166 CA4th 738, 82 CR3d 915, in which the court held that a husband's unilateral revocation of a joint revocable trust (by delivering notice to himself as trustee) was valid even though notice was not given to the wife until after his death, where the trust document did not state that the revocation method described in the document was the exclusive revocation method. Practitioners should be cautious in providing an exclusive method of revocation. Such provisions are usually unnecessary and may work to defeat the settlor's intentions. See, *e.g.*, *Austin v City of Alexandria* (Va 2003) 574 SE2d 289 (conveyance from revocable trust to charitable remainder trust did not transfer real property because it failed to comply with trust requirements for revoking trust). As long as the trust is amendable and revocable (Prob C §15402), the consent of any named beneficiaries need not be obtained. Prob C §15801.

However, the settlor must have the capacity required to revoke the trust. In *Rands v Rands* (2009) 178 CA4th 907, 100 CR3d 632, the court held that a settlor lacked capacity to revoke his revocable trust when two physicians had previously determined that the settlor lacked capacity to manage his personal and financial affairs. An unusual trust clause provided that incapacity thus determined continued until a court determined otherwise, and the court held that a subsequent determination by two other physicians that the settlor had capacity did not overcome the initial determination of incapacity because the new physicians were unaware of the prior determinations. In *Johnson v Greenelsh* (2009) 47 C4th 598, 100 CR3d 622, the court held that a claim that a surviving spouse did not have capacity to revoke a survivor's trust or appoint a successor trustee of a QTIP trust and a bypass trust did not constitute a contest of any of the trusts. See §6.21. The court noted that the claimant sought no revision of trust terms and made no claim that the trust did not authorize the surviving spouse to appoint a successor trustee or withdraw assets from the survivor's trust. The claimant asserted only that the survivor had become incompetent to perform those actions, so that the purported appointment and withdrawal were ineffective.

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6A

Irrevocable Trusts

CEB Staff

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§6A.1 I. INTRODUCTION

This chapter discusses various kinds of irrevocable trusts. Because tax factors play a major role in irrevocable trusts, this chapter briefly discusses estate and gift taxes (see §§6A.9-6A.10), income taxes (see §6A.11), and generation-skipping transfer (GST) taxes (see §6A.17) as they relate to irrevocable trusts. Although the irrevocable trusts discussed in this chapter are generally unique, independent documents, some planning and drafting considerations are relevant to most kinds of irrevocable trusts. This chapter discusses such factors as trust planning (see §§6A.12-6A.28) and trust instrument structuring (see §§6A.29-6A.35). For a complete discussion of irrevocable trusts, see Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

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§6A.2 A. Types of Irrevocable Trusts

There are many types of irrevocable trusts, and they are used for a variety of purposes.

- *Permanent trusts*. The so-called permanent trust is a trust designed for the prolonged management of permanently and irrevocably transferred assets. The trust objectives include immediate removal of the transferred property from a settlor's estate for estate tax purposes (accomplished at the price of making an immediate gift for gift tax purposes). The trust terms are also designed to ensure that the income from the trust corpus will no longer be includable in the settlor's taxable income for income tax purposes, although irrevocable trusts are sometimes drawn intentionally to cause the trust income to be taxed to the grantor. See chap 13.
- *Life insurance trusts*. An irrevocable life insurance trust is typically used to remove the proceeds of life insurance from the insured's gross estate, while making those proceeds available as a source of liquid funds for the payment of estate taxes and other obligations. See chap 19.
- *Trusts for minors.* Trusts for minors are specialized forms of permanent trusts that more narrowly focus on the specialized circumstances and requirements of minors. See Drafting California Irrevocable Trusts, chap 12 (3d ed Cal CEB 1997).
- *Grantor retained interest trusts*. A grantor retained interest trust allows the settlor to retain an interest in trust assets for a limited period of time, with the remainder interest passing to another person. These trusts, carefully drafted to avoid the valuation restrictions imposed by IRC §2702, are designed to minimize taxes by incurring a gift tax only for the remainder interest that follows the settlor's retained interest. See chap 25.
- *Charitable remainder trusts*. A charitable remainder trust is designed to provide benefits to named individuals for a specified period of time, with the remainder interest passing to charity. To obtain desired tax benefits, including an income tax deduction for the gift to charity, the drafter must ensure that these trusts meet specific requirements. See chap 24.
- *Special needs trusts*. The principal purpose of a special needs trust is to preserve government benefits for a disabled or aged beneficiary. Although the terms of the other kinds of irrevocable trusts discussed in this book are frequently influenced by the tax laws, the terms of a special needs trust are principally controlled by the public benefit laws. See chap 26A.
- *Estate balancing trusts*. If one member of a married couple is wealthy and the other has few assets, an inter vivos qualified terminable interest property (QTIP) trust can be used to provide the less wealthy spouse with a taxable estate, thereby making it possible to take advantage of that spouse's unified credit on his or her death. See §17.65.
- *Surviving-spouse-created qualified domestic trust* (QDOT). Generally, no estate tax deduction is allowed for transfers to a surviving spouse who is not a citizen of the United States. IRC §2056(d). A variation of the marital deduction can be obtained if the transferred property is put in a qualified domestic trust (QDOT). See §§17.74-17.78.

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§6A.3 B. Relationship Between Revocable and Irrevocable Trusts

Revocable trusts and irrevocable trusts have many similarities. Both types of trusts provide for the transfer of property to a trustee who administers and eventually distributes the property as provided in the trust instrument. Most revocable trusts become irrevocable on the death of a settlor or cosettlor. Not surprisingly, many trust clauses used in drafting revocable trusts are also appropriate for various types of irrevocable trusts. See chap 6.

Despite these similarities, there are fundamental differences between revocable and irrevocable trusts. Most notably, the creation of an irrevocable trust has more immediate consequences in terms of property rights and taxes. Thus, for example, a settlor who transfers property to an irrevocable trust for children almost invariably relinquishes most rights to control the property.

The transfer may also result in an immediate gift for gift tax purposes, and may result in a different person being taxable on the income generated by the transferred property. Because they typically have immediate and significant tax consequences, irrevocable trusts involve major planning and drafting issues that do not commonly exist for revocable trusts. Thus, for example, it is often inappropriate for a settlor to serve as trustee of an irrevocable trust, whereas this would be common in the case of a revocable trust.

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§6A.4 II. OBJECTIVES IN CREATING IRREVOCABLE TRUSTS

Clients generally desire one or more of the tax benefits described in §§6A.6-6A.7 without giving up control of the property placed in trust. The tax law will not permit the client to escape estate and income taxes, however, if the client refuses to part with the economic benefit or absolute control of the trust corpus. Thus, trust drafting frequently becomes an attempt to reconcile the client's tax objectives with the client's other wishes. Before permitting the client to part irrevocably with a portion of the client's property, the attorney must ensure that the client will be economically secure and emotionally comfortable after the transfer and that the client has thoroughly considered the nontax effects of irrevocability. When a client doubts whether the tax benefits are worth the consequences of establishing the trust, the trust should not be implemented until the client has thoroughly considered the matter.

The impact on the personal relationship between the settlors and the beneficiaries of a trust, such as parents and children, should also be carefully considered. A trust that creates marital discord or destroys a child's incentive to strive for success in a career does not serve the settlors' best interests, no matter how much tax is saved. However, an irrevocable trust may solve family problems by assuring the settlors that children of a prior marriage will be provided for after a second spouse's death or that assets set aside to care for a disabled child or aged relative will not be squandered by the beneficiary or others.

The drafter and client should also consider the tangible and intangible costs of a more complicated plan using irrevocable trusts. For example, by establishing several trusts for different combinations of beneficiaries, the income tax savings may be greater than with a single trust for the same beneficiaries. Before adopting such a plan, however, the parties should consider whether administrative costs and the difficulty of working with several trusts will offset the tax savings. Tax savings notwithstanding, a client may feel trapped by a successful tax plan.

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§6A.5 A. Reconciling Beneficiary Needs With Management Concerns

Although many gift-giving objectives (and tax objectives) can be satisfied by outright gifts, an outright gift to a young or irresponsible person may risk mismanagement or waste. Further, outright gifts are frequently ill suited to the commonly held desire to provide financial security for a group of persons whose financial needs may be different at different times. Thus, for example, outright gifts may not be suitable for a settlor who wishes to provide security to an older person during that person's lifetime and to provide benefits to others after that person dies. Similarly, an outright gift might not be suitable for a settlor who wishes to preserve funds for the college education of a grandchild years in the future. See §§8.1-8.7.

In many cases, a settlor may be unwilling to make gifts of property because of concerns about the future management of the property. This can be particularly true regarding transfers of interests in family businesses to persons with little business experience. Tax considerations significantly limit a settlor's ability to control property transferred to a trust, but there are modest exceptions to this rule. See analysis of these exceptions in the discussions of transfer and income taxes in §§6A.9-6A.11. In addition, a settlor's concerns can often be satisfied by the selection of a trustee whom the settlor trusts and whose relationship to the grantors and powers over the trust do not create unintended tax consequences.

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B. Obtaining Tax Savings

§6A.6 1. Transfer Tax Savings

The transfer tax system comprises the estate and gift tax and the generation-skipping transfer (GST) tax, which are discussed at length in chaps 10-11. These taxes operate in a manner that highly favors transfers by gift (regardless of whether the gift is made to a trust) rather than transfers at death. Generally, the earlier the gifts are made, the better.

The potential advantages of gifts—particularly early gifts—include the following:

- *Valuation freezing*. The term "valuation freezing" is used to describe any strategy (including outright gifts) that avoids transfer tax on future increases in the value of an asset. See §25.2.
- *Greater use of gift tax annual exclusion.* Failure to make annual exclusion gifts each year results in the permanent loss of a tax-saving opportunity. See §§10.96-10.114.
- *Tax-inclusive/exclusive calculation.* If a donor makes substantial taxable gifts, the gift tax will be significantly lower than the estate tax because the money used to pay the gift tax is not included in the tax base. See §§10.8-10.11.

For a variety of practical or emotional reasons, including those described in §6A.5, the client may be unwilling to make substantial outright gifts. In such cases, an irrevocable trust may provide tax savings by enabling the client to make a gift to a trust rather than an outright gift. Less commonly, irrevocable trusts are used in tax-savings strategies that are not necessarily directly related to the simple facilitation of early gifts. This is particularly the case with qualified personal residence trusts (QPRTs) and grantor retained annuity trusts (GRATs), which satisfy detailed IRC §2702 requirements for avoiding otherwise harsh gift tax valuation rules. See §§25.29-25.40.

The transfer tax consequences of irrevocable trusts are not always favorable. A notable risk for such trusts arises from the fact that allocation of a taxpayer's GST exemption is not necessarily automatic if, *e.g.,* the trust has both skip and nonskip beneficiaries such as children and grandchildren. If a gift is made to such a trust, a gift tax return must be filed to allocate the exemption unless the trust is a GST trust or the grantor has elected to have automatic allocation apply to the trust. See §§11.14-11.25.

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§6A.7 2. Income Tax Savings

For income tax purposes, the income from trust assets may be taxable to the settlor, the beneficiaries, or the trust itself. In general, the income will be taxable to the settlor as long as a settlor or the settlor's spouse retains any rights to receive economic benefits from the trust or retains significant ability to control the trust. IRC §§671-677. See §6A.11. If that is not the case, the trust income may be taxable to the beneficiary if the beneficiary has significant control over the trust. IRC §678. If neither the settlor nor the beneficiary has the required benefits or control, the trust income will be taxable to the trust except to the extent that the income is distributed (or should have been distributed) to the beneficiary in accordance with the terms of the trust instrument. IRC §§641, 643, 651-664.

Thus, trusts can provide income tax savings if the terms of the trust and the distribution decisions of the trustee result in income being taxed to a taxpayer in a lower tax bracket. The opportunity to save taxes by causing income to be taxed to the trust itself is severely limited by the income tax rates applicable to trusts. These rates not only limit tax-savings opportunities but also result in the risk that trust income will be taxed at punitive rates. The drafter should design and administer irrevocable trusts in such a way that substantial income is not taxed to the trust itself, either by giving an appropriate trustee discretion to distribute additional income or by intentionally making the trust a grantor trust. See chap 13.

The use of trusts to shift income to low-bracket taxpayers is also limited by the "kiddie" tax, essentially taxing the investment income of a minor child at the tax rate of the child's parents. See §8.22.

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§6A.8 C. Asset Protection

An asset-protection trust is designed to allow the settlor to retain a beneficial interest in the trust while protecting trust assets from the claims of the settlor's creditors. In some states, such as Alaska and Delaware, the fact that a settlor is a beneficiary of an irrevocable trust does not necessarily result in the creditors' being able to reach trust assets in attempts to satisfy a judgment against the settlor. In contrast, Prob C §15304 provides that the assets of a trust are subject to the claims of the settlor's creditors to the extent that the settlor is a permissible beneficiary of the trust. It is possible, however, to create trusts that are not subject to the claims of creditors of either the settlor or beneficiaries who may receive discretionary distributions, as long as the settlor is not a beneficiary of the trust. Prob C §15303. As a rule, trusts for children or other natural objects of the settlor's bounty can satisfy the legitimate needs of the settlor. See chap 26.

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III. BASIC TAX PRINCIPLES

§6A.9 A. Estate Tax Principles

A settlor's gross estate includes not only a trust from which the income is payable to the settlor for life, but also a trust from which the settlor may demand the income at any time. IRC §2036(a)(1). A settlor's gross estate also includes a trust in which the settlor has the right to designate the person who shall "possess or enjoy" the property or its income. IRC §2036(a)(2). This power is equivalent to a power to amend the trust, which causes the imposition of estate tax under IRC §2038(a)(1). A settlor's uncontrolled power to cause distribution of property at any time to particular persons, even though restricted in identity, is also a power to amend the trust. Any of these powers causes adverse estate tax consequences if it exists at the time of a settlor's death, even though the power was retained for another period (*e.g.,* 25 years), which did not end before a settlor's death.

Under IRC §§2036 and 2038, trust property is included in a settlor's gross estate for federal estate tax purposes if the settlor has retained the prohibited rights or powers, either alone or in conjunction with any person (even an adverse party). See §§10.16-10.26. The powers of a spouse are usually irrelevant for estate tax purposes; IRC §672(e) applies only for income tax purposes. If a settlor acts as trustee or cotrustee, and the trustee or trustees are given unlimited discretionary power to accumulate or distribute income or to distribute principal, or both, the trust property is included in the settlor's gross estate for federal estate tax purposes to the extent of the settlor's contribution to the trust (*e.g.,* one half), even though the settlor is not a beneficiary. *U.S. v O'Malley* (1966) 383 US 627, 16 L Ed 2d 145, 86 S Ct 1123; *Industrial Trust Co. v Commissioner* (1st Cir 1947) 165 F2d 142; *Biscoe v U.S.* (D Mass 1957) 148 F Supp 224. Even if the remainder beneficiary is the same as the income beneficiary, the settlor's retained right to determine *when* the beneficiary receives principal causes trust principal to be included in the settlor's gross estate. IRC §2038(a)(1); *Lober v U.S.* (1953) 346 US 335, 98 L Ed 15, 74 S Ct 98. If the powers to accumulate or distribute income or principal are limited by a sufficiently ascertainable standard, the property of the trust is not included, at least when the trust beneficiaries are nondependent beneficiaries. *Estate of Ralph Budd* (1968) 49 TC 468, acq 1973-2 Cum Bull 1.

Retention of these interests, rights, and powers is only briefly discussed in this chapter because, ordinarily, retention of any such explicit interests, rights, and powers is not intended, and careful drafting can guard against their inadvertent retention.

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§6A.10 B. Gift Tax Principles

A settlor makes a completed gift only after placing the property beyond his or her own control. IRC §2511; Treas Reg §25.2511-2. The settlor may do so by transferring title to another person or to an entity that the settlor does not control. If a third party is named trustee of the trust, and the settlors do not retain the power to reacquire the trust property or to appoint who will receive the property on their deaths, a completed gift will have occurred because the settlors will have given up control over who will receive the property. Either power is enough to prevent a completed gift. Treas Reg §25.2511-2(c). Vesting a third-party trustee with the power to distribute the property to the settlors does not by itself avoid the imposition of the gift tax. Treas Reg §25.2511-2(b). Moreover, a completed gift can occur even though the trust is subject to estate tax at one settlor's death and the settlors will be subject to income tax on trust income.

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§6A.11 C. Income Tax Principles

A settlor is treated as the owner of a trust for income tax purposes and taxed on trust income when the trust instrument includes any of the following provisions:

- The settlor has a reversionary interest in either income or principal if, at the inception of the trust, the value of this interest exceeds 5 percent (for either income or principal). IRC §673.
- The settlor or a nonadverse party may appoint income or principal, unless a statutory exception applies. IRC §674. The statutory language is couched in terms of retention of a power to designate beneficial enjoyment; limited powers may be fatal, and the statutory exceptions are some of the most intricate in the tax law.
- The settlor or a nonadverse party has a power to revoke, to the extent of that power. IRC §676. The settlors' unrestrained right to help themselves to both principal and income constitutes a power to revoke for tax purposes. Treas Reg §1.676(a)-1.
- Income may be distributed, in the discretion of a settlor or a nonadverse party, to the settlor or the settlor's spouse or be applied to pay life insurance premiums on policies covering a settlor or his or her spouse. IRC §677.

Under IRC §§674(a) and 675-677, the settlor is treated as the owner of the trust not merely when the settlor acts as the trustee or as one of several trustees. These sections also apply when any person acts as the trustee who is not an adverse party or whose acts are not subject to an adverse party's approval or consent. Exceptions to the apparent broad scope of IRC §674(a) are set out in IRC §674(c)-(d), but these exceptions do not apply when the settlor acts as a trustee. For a discussion of the exceptions, see chap 13.

The most significant rule relating to powers to designate beneficial enjoyment is IRC §674. This section's guiding principle is that the more independent the trustee, the more flexibility is permitted; conversely, the less independent the trustee, the greater rigidity is required. For tax problems involving transfers of property to a trust in exchange for a private annuity, see *Stern v Commissioner* (9th Cir 1984) 747 F2d 555; *LaFargue v Commissioner* (9th Cir 1982) 689 F2d 845. See also §10.22.

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IV. TRUST PLANNING

§6A.12 A. Permanent Trusts Distinguished From Other Trusts

The term "permanent trusts," as used in this chapter, refers to all trusts that are not revocable and that are designed and used to avoid estate taxes on a settlor's death and to shift the income tax burden to the trust beneficiaries. The permanent trust is designed for the following purposes:

- Prolonged management of permanently and irrevocably transferred assets;
- Immediate removal of the transferred property from a settlor's estate for estate tax purposes (accomplished at the price of making an immediate gift for gift tax purposes); and
- To ensure that the income from the trust corpus will no longer be includable in the settlor's taxable income for income tax purposes.

However, irrevocable trusts are sometimes drawn intentionally to cause the trust income to be taxed to the settlor. See chap 13 on income taxation of irrevocable trusts.

Permanent trusts are to be distinguished from:

- Revocable trusts, in that permanent trusts are not revocable and often the income is not payable or taxable to a settlor;
- Trusts for minors, in that permanent trusts are not ordinarily drafted to meet the peculiar problems posed by the legal disability of minors—and the relationship between this legal disability and the settlor's desire to take advantage of the annual gift tax exclusion for gifts of present interests; and
- Specialized trusts, such as irrevocable life insurance trusts, charitable remainder trusts, and grantor retained interest trusts (see chaps 19, 24-25), which are designed to accomplish specific estate and gift tax objectives.

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§6A.13 B. Balancing Personal and Tax Objectives

Often, clients, such as parents, want a trust to meet conflicting purposes. If they are completely candid, they will mention reasons like the following:

- They want a gift that helps their children and saves taxes.
- They also want a chance to use the property themselves in case of adversity.
- They desire management power over the trust estate.
- They wish to decide later when the children will receive the property.

Clients who wish to save transfer taxes cannot retain any beneficial interest in the trust for themselves. See §6A.9. A beneficial interest includes both the direct benefit of payments from the trust and the indirect benefit of discharging the settlors' legal obligations to their creditors or to their minor children. See §6A.21. If the clients persist in the hope of retaining an interest in the trust for their own security, the planner should recommend a revocable trust.

In the counseling process, the attorney's major goal is to help the clients evaluate the tax benefits and economic or emotional disadvantages of any plan. Although the following are not questions of law, they provide the planner with information that is essential when preparing a satisfactory individual family trust.

- Will the clients feel economically secure after the gift?
- Will the children's incentive to achieve be impaired?
- Is it better to distribute principal outright at an early age to make a child "sink or swim," or is it better to protect the child from possible indiscretion?
- Should children be protected from the indiscretion or undue influence of future spouses by retaining their capital in trust for life?
- Should all children be treated equally?

The attorney also performs a valuable service by formulating compromises between the settlors' conflicting aims. This requires a thorough understanding of the tax implications of various possibilities and a sensitivity to possible future developments in the law.

CAVEAT: Although the possibilities are unlimited, the planner must carefully consider the estate tax, gift tax, generation-skipping transfer tax, and income tax consequences of any proposal.

The clients must choose whether they want flexibility, with decision making left to others, or rigidity, retaining the right to make decisions. The attorney, more frequently than the clients, must decide whether a single trust or several trusts will accomplish the clients' objectives. See §§6A.26-6A.28.

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§6A.14 C. Purposes Served by Permanent Trusts

The basic purpose of a permanent trust is to transfer the legal ownership and management of property to one or more trustees for the beneficial purposes set forth in the trust instrument. Specific trust purposes are discussed in §§6A.15-6A.19. To the extent the trust continues after the settlors' deaths, it becomes a substitute for a will with respect to the trust principal. Often, a permanent trust provides for more than one generation.

To mitigate the potential disadvantage of rigid long-term arrangements frequently encountered in permanent trusts, the trustee may be given discretionary powers that:

- Allow payment of income and principal for support, health, education, maintenance and other desirable purposes;
- Allow payments to one or more beneficiaries to the exclusion of other beneficiaries;
- Permit termination of the trust; and
- Provide for the care of minors and other incompetents.

Additional flexibility may be achieved through limited powers of appointment. See chap 9. For forms of discretionary clauses, see Drafting California Irrevocable Trusts, chap 9 (3d ed Cal CEB 1997).

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§6A.15 1. Reducing Settlor's Estate Tax

In general, property of a properly drafted permanent trust will not be included for federal estate tax purposes in a settlor's gross estate, regardless of the time of a settlor's death. As a corollary, a completed gift for gift tax purposes will have been made when the trust was created. If the settlor retains some rights, however, all or part of the trust property may be subject to estate tax on the settlor's death. Moreover, even though the principal of a permanent trust will not become subject to federal estate tax, a federal gift tax may still be imposed at the time of the trust's creation. A double tax is avoided by means of a credit without interest for the gift tax paid against the estate tax later imposed. Retention of these and other types of interests, rights, and powers may also cause the settlor to be taxed on the income of the trust. See §6A.11.

If the settlor intends that the trust property be subject to estate tax, the planner usually should not use a permanent trust. In this circumstance, a revocable trust is generally more desirable because the settlor can retain absolute control. On the use and drafting of revocable trusts, see Drafting California Revocable Trusts (4th ed Cal CEB 2003). If the sole purpose of the trust, however, is to protect a spendthrift settlor against his or her own indiscretion, an irrevocable trust providing lifetime benefits to the settlor, but no tax advantages, is a suitable vehicle. With such an irrevocable trust, the drafter should be careful to avoid the imposition of gift tax for the actuarial present value of the remainder interest. This can be accomplished by giving the settlor a limited testamentary power of appointment. See chap 9.

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§6A.16 2. Postponing Beneficiaries' Estate Tax

Property of a permanent trust usually is not subject to federal estate tax on a beneficiary's death unless:

- The beneficiary has a vested interest in the trust principal that is not subject to divestment;
- The beneficiary is given a general power of appointment; or
- The property is distributable to the beneficiary's estate.

Property may be subject to the generation-skipping transfer (GST) tax when it is not subject to the estate tax. Because each grantor of a trust can shield an amount equal to the IRC §2010(c) estate tax applicable exclusion amount from the GST tax (IRC §2631), it is possible to postpone federal estate taxes otherwise payable by the beneficiaries for several generations, by preventing each beneficiary from receiving any interest that would subject the trust property to inclusion in his or her estate. See chap 10.

For property potentially within the GST exemption, the question may arise whether certain property should be given outright to a child at a given age, or whether the property should be retained in trust during the child's lifetime to save estate tax otherwise payable on the child's death. The settlors may wish to give the trustee, or another person, the power to terminate the trust, thus giving the beneficiary full management powers and possession if the settlors' tax objectives are thwarted. Giving the beneficiary a limited power of appointment also provides a means to deal with future changes in the law without adverse gift tax consequences. See chap 9.

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§6A.17 3. Planning for Generation-Skipping Transfer Tax

Although estate tax may be avoided on a beneficiary's death, the generation-skipping transfer (GST) tax may be imposed on property not sheltered by the GST exemption. See IRC §2631. The GST tax is imposed, with certain exceptions, if the child is given income for life and, at his or her death, the trust assets are distributed to or held in further trust for beneficiaries one or more generations younger than the child (*i.e.,* grandchildren or great-grandchildren). These are called skip persons. IRC §2613(a).

Subject to several exceptions, a GST tax is imposed on taxable terminations, taxable distributions, and direct skips. See chap 11.

- A taxable termination occurs when the present interest in a trust of a nonskip person terminates and thereafter only skip persons have present interests in the trust. IRC §2612(a).
- A taxable distribution is any distribution from a trust to a skip person other than a taxable termination. IRC §2612(b).
- A direct skip is any transfer subject to the estate or gift tax to a skip person or to a trust in which only skip persons have present interests. IRC §§2612(c), 2613(a).

If all or a portion of each grantor's GST exemption will be allocated to the trust (currently or in the future), and the entire trust will not be sheltered from the imposition of the generation-skipping transfer tax because of this allocation, the drafter should create two separate trusts under the trust instrument: one with an inclusion ratio of one, and one with an inclusion ratio of zero.

CAVEAT: To have different inclusion ratios, the drafter must divide the original trust into two or more trusts *before* the grantor's GST exemption is allocated. Then the drafter can allocate the exemption entirely to the resulting trust or trusts, which will be shielded from the imposition of a GST tax.

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§6A.18 4. Reducing Settlor's Income Tax

Unless otherwise expressly indicated, this chapter assumes that the settlor does not want to be taxed on trust income. However, some clients may desire to be taxed personally on trust income. See §6A.19. The creation and taxation of grantor trusts, in which trust income may be taxed to the settlors, are discussed in chap 13.

Explicit retention of an income interest by the settlor causes that income to be taxed to the settlor. In addition, retention of certain rights and powers by the settlor or by other related parties (IRC §672) and inclusion of certain discretionary and administrative provisions in the trust instrument cause the income of the trust to be taxed to the settlor. Retention of these interests, rights, and powers may also cause the property to be subject to estate tax, but the rules governing these two taxes differ substantially. See chap 10.

CAVEAT: The drafter must avoid inadvertently including in permanent trusts those provisions (*e.g.,* support provisions and trustees' powers) that may cause unexpected adverse estate and income tax consequences to persons other than the settlor (*e.g.,* the beneficiaries). See §6A.21.

Under IRC §672(e), any power held by a settlor's spouse is treated as being held by the settlor in determining the income tax consequences of the trust. When community property is used to fund a permanent trust, the husband and wife are each considered to be the creator of one half of the trust. Giving either spouse prohibited interests, rights, or powers over a trust funded with community property causes each spouse to be subject to income tax on the entire trust. IRC §672(e). Similarly, if one spouse's separate property is used to fund a trust over which the other spouse has prohibited interests, rights, or powers, the spouse who has relinquished control over his or her property will still be subject to income tax.

For most settlors, a trust is no longer valuable from a purely income tax perspective because the available savings are small and are offset by added administrative burdens. Nonetheless, a properly drafted irrevocable trust can shift taxable income to the beneficiaries if nontax considerations permit (*e.g.,* no spendthrift adult beneficiary). The settlor can retain the taxable incidences if the settlor is willing to pay the tax with the settlor's own funds and the current law relating to a lack of gift tax consequences remains unchanged.

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§6A.19 5. Achieving Grantor Trust Status

A settlor may want to be taxed on the income of an irrevocable trust, without risking inclusion of the trust in the settlor's estate for estate tax purposes. This can be accomplished by granting a power that is treated differently under the income and estate tax regimes. For example, a settlor's brother may be designated a special trustee with the power to add beneficiaries of a named class to the trust. This causes the settlor to be treated as the owner of the trust under IRC §674 (see IRC §672) for income tax purposes, but not for estate tax purposes, because there is no analog in the estate tax law for inclusion of property in a decedent's estate because of powers exercised by another person over that property.

PRACTICE TIP: Some practitioners believe that the use of a grantor trust for a long-term permanent trust is inappropriate because it raises serious issues of estate tax inclusion. Such trusts are believed more appropriate for short-term trust vehicles, such as grantor retained annuity trusts (GRATs). See chap 26.

The power to add beneficiaries creates a grantor trust, no matter by whom held. See IRC §674(c). Other powers, such as the power to have the settlor borrow from a trust without adequate interest or security, are defective only if held by a nonadverse party. See IRC §675(2). The fact that there are two settlors in respect to community property transferred to the trust is not a problem as long as the required relationship exists in respect to one spouse. IRC §672(e).

If the power to add beneficiaries (or a similar power) is released, the settlor ceases to be treated as owner of the trust unless other provisions of the trust instrument produce this result. The cessation of grantor trust status may have other undesirable income tax consequences from the point of view of the IRS, such as the acceleration of an installment obligation, or the realization of gain from the negative basis of property held in the trust. See chap 13.

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§6A.20 D. Avoiding Reciprocal Trusts

Community property is often split into separate property in connection with life insurance trusts to achieve various income and estate tax benefits. Community property can be divided into equal shares of separate property of the husband and wife respectively without adverse tax consequences. See IRC §1041. If the husband acts as trustee of the wife's trust, however, or the wife acts as trustee of the husband's trust, there will be no *income tax* advantages to such a split, because of IRC §672(e). Additionally, when the trusts contain reciprocal beneficial provisions or powers that would have adverse tax consequences if retained by the settlor-spouse, no *estate tax* purposes will be achieved, because each spouse will be considered the creator of the trust established by the other for tax purposes. *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730.

In *Estate of Bruno Bischoff* (1977) 69 TC 32, the Tax Court applied the reciprocal-trusts doctrine to trusts created by a husband and wife for their grandchildren with each spouse as trustee of the other spouse's trust. Although neither spouse had any beneficial interest in the trust property, each had the power to control the beneficial enjoyment of trust income. Therefore, the reciprocal trust created by the other settlor was included in the deceased settlor's estate. In *Estate of Green v U.S.* (6th Cir 1995) 68 F3d 151, however, the court did not apply the reciprocal-trusts doctrine to two trusts created by a husband and wife for the benefit of their two grandchildren with each spouse as trustee of the other spouse's trust. See §§10.18, 19.55.

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§6A.21 E. Support of Dependents and Payment of Legal Obligations

To a limited extent, it may be possible for settlors to discharge their legal obligations, especially their legal obligations to support others, by using a trust, without being taxed on its income and without having the trust property included in their estates. Retention of the right to have the principal of a trust applied to discharge a settlor's legal obligation is tantamount to retention of the right to "possession or enjoyment" of the property, as those terms are used in IRC §2036, and causes the property of the trust to be subject to estate tax. IRC §2036; Treas Reg §20.2036-1(b)(2). A trustee who has the power to apply the principal of the trust to discharge his or her own legal obligations is considered to have a general power of appointment over the trust property. Treas Reg §20.2041-1(c). This power subjects the property of the trust to estate tax on the trustee's death. IRC §2041.

However, estate taxes are avoided if a third party merely has discretion to make payments that will discharge a settlor's support obligations. *Commissioner v Douglass Estate* (3d Cir 1944) 143 F2d 961. When an independent trustee has the power to use trust funds or income to discharge the settlor's legal obligations, the drafter must ensure that this power is totally discretionary and that there is no express or implied obligation that the trust funds will be so used. See *Estate of Joseph G. Gokey* (1979) 72 TC 721.

Payments made to discharge the legal obligation to support a dependent are not gifts to the extent of the legal obligation. *Crittenden Trust v U.S.* (ED Wis 1952) 52-2 USTC ¶10,870, 44 AFTR 1208. This rule applies both to minor children and to indigent parents. Although adverse estate tax consequences may result from the mere power to discharge a taxpayer's obligation of support, adverse income tax consequences occur only to the extent that the income of a trust is actually used for this purpose.

Trust income is not considered taxable to a settlor merely because that income may be applied or distributed for support or maintenance of a beneficiary (other than the settlor's spouse) whom a settlor is legally obligated to support, except to the extent that income is so applied or distributed. IRC §677(b). See §13.128. Similar rules apply when a person other than the settlor, in the capacity of trustee or cotrustee, has a power to apply trust income for the support of the trustee's dependents. IRC §678(c). See §§13.129, 13.133.

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§6A.22 1. Support of Minor Children

Family Code §§3900-4203 sets out the duty of support as follows:

- The parents of a minor child have a duty to support the child in the manner suitable to the child's circumstances. Fam C §3900.
- The parents have a duty to support a child after age 18 if the child is unmarried, is a full-time high school student, and is not self-supporting, until the child attains the age of 19 years. Fam C §3901(a).
- The parents have a duty to maintain, to the extent of their ability, a child of whatever age who is incapacitated from earning a living and without sufficient means. Fam C §3910(a).

It is often prudent to give the trustee discretion to pay the income and principal of the trust for the beneficiary's support and education because it is not predictable that there will be a person who has a duty to support (and the means to discharge the duty) at all times before a child attains the age of 18. If mandatory payments are prescribed, however, or if a settlor is the trustee, a trust provision should specifically prohibit the trustee from discharging his or her obligation of support by making distributions from the trust.

Several cases in the estate tax field have considered trusts containing support elements. The critical question in each case is whether the settlors have retained an enforceable right to have the trust property, either income or principal, applied to discharge their legal obligation of support. See, *e.g., Commissioner v Dwight's Estate* (2d Cir 1953) 205 F2d 298, cert denied (1953) 346 US 871; *Estate of Jack F. Chrysler* (1965) 44 TC 55, rev'd on other grounds (2d Cir 1966) 361 F2d 508; *Estate of William H. Lee* (1960) 33 TC 1064. As long as there are minor children, if the settlor has retained an enforceable right to have the trust property applied to discharge the settlor's legal obligation of support, estate taxes are incurred on the settlor's death, even though no trust property was in fact so applied before the settlor's death, and regardless of who acted as trustee.

There is no duty to support a grandchild. Fam C §3930. Payments from a trust to support a grandchild, however, may have consequences to the grandchild's parents. Because under California law the obligation to support a spouse or registered domestic partner and minor children is not affected by adequacy of the spouse's or partner's or the minor children's resources (see Fam C §§297.5, 3900, 4300), the income of a trust used for support is includable in the income of the supporting spouse or partner, or parent, regardless of the settlor's or the trustee's identity. See Treas Reg §1.662(a)-4; *Agnes K. May* (1947) 8 TC 860, acq 1947-2 Cum Bull 3.

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Source: Estate Planning/California Estate Planning/6A Irrevocable Trusts/§6A.23 2. Payment of Education Expenses

§6A.23 2. Payment of Education Expenses

The Family Code seems to permit children to be sent to college with expenses paid by a trust created by their parents without resulting in tax consequences for the parents, on the assumption that the parents generally have no obligation to provide a college education for their children or to support adult children. See Fam C §§150, 3901(a). Courts in other jurisdictions have from time to time cast doubt on this assumption on the basis of their local law. See, *e.g., Frederick C. Braun, Jr.,* TC Memo 1984-285.

CAVEAT: When trust funds are to be used for a child's education, the settlors (or the child's parents, if they are not the settlors) should not enter into any contracts or arrangements with the educational institution to pay tuition, fees, or other costs. Otherwise, the trust income will be taxable to the settlors under IRC §677 or will be taxed to the parents under IRC §662, because the contract creates a legal obligation to pay these educational costs. See Treas Reg §1.662(a)-4.

In *Jones v Jones* (1986) 179 CA3d 1011, 1017, 225 CR 95, the court held that "to the extent that an obligation devolves upon a parent to provide education to an *adult* child, it is limited to the completion of a high school education." Therefore, under current law, absent an obligation imposed by a contract, a property settlement agreement, or a court decree on dissolution of marriage to pay these expenses, parents seem not to have an obligation to pay for private school. However, the law is unclear. See Fam C §§150, 3900, 3901.

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§6A.24 3. Support of Parents and Adult Children

Any amount that, under the terms of the trust instrument, is used to fully or partially satisfy a legal obligation of any person is included in that person's gross income. Treas Reg §1.662(a)-4. For tax purposes, however, "legal obligation" includes the obligation of support only if that obligation, as determined under applicable state law, is not affected by the adequacy of the dependent's own resources. Trusts for the support of parents and adult children should not have adverse income tax consequences to the settlor, because under California law, support is due to parents and adult children only if their own resources are inadequate. Fam C §§3910, 4400. If the settlor should move to another state, however, the settlor's duty of support might be enlarged by the laws of the settlor's new domicile.

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§6A.25 F. Flexibility Versus Control

Many clients desire flexibility in a trust to meet changing conditions, *e.g.,* family illness, family members' financial ability, or the beneficiaries' maturity. The settlor's hope is to retain control as well as flexibility. As indicated in §6A.9, a settlor's power to designate new beneficiaries, to change the respective interests of existing beneficiaries, or to amend the trust causes adverse estate tax consequences. Thus, the client's wish for complete flexibility can be realized only if the client will trust a third person to exercise the powers that create the flexibility. Some clients will choose rigidity rather than trust a third party. Income tax provisions frequently limit even the powers certain third parties may be given. See §6A.11. Several of the options available under IRC §674 (see chap 13) often severely limit the degree of control the settlors may retain even indirectly by reason of certain relationships (*e.g.,* a brother or an employee of a controlled corporation). See IRC §672(c)(2). The settlor's lawyer, accountant, doctor, and partner are excluded from these prohibited categories with few exceptions, even though they often may be as amenable to the client's wishes as the client's siblings or employees.

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§6A.26 G. Single Versus Multiple Trusts

When drafting a trust it often becomes necessary, at the outset or at a later time, to divide the trust property into separate portions or shares. The question then arises whether each share constitutes a portion of one trust or each constitutes a separate trust. When determining the proper way to proceed, the drafter should consider the factors discussed in §§6A.27-6A.28, among others.

For generation-skipping transfer (GST) tax purposes, if a separate trust is used to benefit each child and his or her issue, the result will be a taxable termination for the separate trust at that child's death. If one trust is used to benefit all children and their issue, and the trust does not establish separate and independent shares for each child, the imposition of the GST tax will be postponed because the taxable termination will not occur until the last child dies. The postponement, however, does not necessarily produce a tax benefit. See §6A.17.

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§6A.27 1. Considerations Favoring One Trust

With one trust, only one fiduciary income tax return need be filed, and accounting will be simplified. Trustees often charge a smaller fee to administer one trust divided into several shares than to administer several trusts. Sometimes, it may be wise not even to divide the trust into shares. Not dividing the trust allows the trustee to apportion the income and principal according to each individual beneficiary's needs. This alternative cannot be used when a settlor acts as a trustee.

The compaction of trust income tax rates makes income tax considerations fairly academic. A single trust for a group of beneficiaries, one of whom has become dissolute, facilitates the distribution of all trust income to the other beneficiaries, avoiding the high trust-tax bracket.

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§6A.28 2. Considerations Favoring Multiple Trusts

The compaction of trust income tax rates makes accumulation of some income in a trust uneconomic, after considering the added administrative cost. Multiple trusts aid in family squabbles by limiting distributions to a particular beneficiary to his or her share of the family's wealth. Multiple trusts inhibit clearing out trust income when the beneficiary is young or irresponsible. Moreover, a separate trust for each beneficiary permits the trustee to tailor investment policies to fit each beneficiary's needs.

Multiple trusts may make it easier to avoid making distributions in ways that result in unfair income tax results. For example, when two beneficiaries of a single trust receive the same sum of money in two separate years, the first beneficiary may receive only ordinary income, while the second beneficiary may receive only tax-free funds. Use of separate trusts causes each beneficiary to be taxed on his or her own share of trust income, regardless of the year in which he or she receives distribution.

However, the creation of separate trusts destroys the flexibility of providing from a common fund for each of several beneficiaries, according to their respective needs. A settlor who wishes to act as trustee may not retain the power to allocate between several different beneficiaries. See §6A.9. Thus, such a settlor must continue to choose separate trusts for each beneficiary with limited discretion in himself or herself as trustee.

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§6A.29 V. STRUCTURING TRUST INSTRUMENT

This part addresses basic questions users may have concerning the general overall organization of irrevocable trust instruments. It is appropriate to begin that discussion by emphasizing that there is no single "right" way to draft these documents. There are few statutory requirements for a valid trust, and drafting practices vary considerably by locality, practitioner taste and philosophy, demands of the practitioner's drafting system, and the demands of the practitioner's firm. Nevertheless, it is appropriate to make some general recommendations concerning trust design.

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§6A.30 A. The Audience

At the risk of stating the obvious, it is helpful to remember that the purpose of a trust instrument is to convey information to the various members of an intended audience. That audience potentially includes the settlor, the trustee, the beneficiaries, the family CPA, the Internal Revenue Service, the local Superior Court judge, and various third parties who may conduct business with the trustee. This is typically a very disparate group in terms of education in general and knowledge of trusts and taxes in particular. Writing a document that can be understood by all of these persons can be a challenging task. Indeed, it is not rare to encounter an experienced practitioner who claims to have abandoned much of the task in favor of simply making sure the document will not be misinterpreted by the IRS or the courts, reasoning that other interested parties can be educated by use of separately stated explanations.

For those not yet willing to abandon the effort of drafting an understandable document, the following suggestions may be helpful:

- Keep the document short. This not only helps the reader, but it helps the drafter.
- Organize the document by logical topics.
- Put the most important information near the beginning of the document.
- Include one or more clauses near the beginning of the document that state the purpose of the trust and any special intended tax consequences.
- Use informative headings (and do not nullify them with a boilerplate provision that says to ignore them).
- Separate less substantive boilerplate from the more substantive clauses. Remember that the user of an automobile should be able to find out how to turn the headlights on and off without having to read wiring diagrams. The same applies to a trust.
- Avoid overly subtle cross-references with respect to provisions determining rights to receive distributions. Particularly in the case of more lengthy documents, the common drafting technique of putting all definitions in one place, usually amidst boilerplate at the end of the document, is burdensome for the reader and creates uncertainty about whether the settlor (or even the drafter) was fully aware of the definition each time the word was used.
- Do not hide important provisions in the boilerplate. For example, a distribution power should not be located in the middle of a list of routine administration powers.

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§6A.31 B. Required Formalities

A trust may take the form of a conveyance signed by the settlor or the settlor's authorized agent, or a declaration signed by the trustee. Prob C §§15200, 15206. In the case of an irrevocable trust, it is imperative that the trust state that it cannot be amended or revoked. Prob C §15400. No other formality is required, although acknowledgment before a notary is customary.

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§6A.32 C. Clauses Mandated by Tax Laws

In many cases a trust will not qualify for desired tax treatment unless it contains certain express provisions mandated by the Internal Revenue Code or Treasury Regulations. Trusts subject to such requirements include charitable trusts subject to IRC §664, qualified personal residence trusts (QPRTs), other trusts involving retained interests and therefore subject to the special valuation rules of IRC §2702, and qualified domestic trusts (QDOTs), which are used to obtain a marital deduction for a transfer to a surviving spouse who is not a citizen of the United States. IRC §§2056(d), 2056A.

In some cases, particularly those involving charitable trusts, the IRS has published prototype language, and even complete forms, that may be used to satisfy the regulatory requirements. In such situations, it may be desirable to include all mandatory language at a single location in the trust instrument, thereby making it easier to demonstrate compliance.

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§6A.33 D. Narrow Focus—Comparison With Revocable Trusts

In one significant way, it is often much easier to draft an irrevocable trust than a revocable one. The typical revocable trust will often remain in effect for many years before the majority of its provisions have much significance; and the assets of the trust typically are not well-managed assets suitable for a trust, but rather the odd and ever-changing accumulations of persons going about daily life. Also, revocable trusts have multiple beneficiaries by their nature (a minimum of a settlor and someone else).

In contrast, many irrevocable trusts have very short terms, are funded with very specific assets, and may benefit only a single beneficiary. Further, the most significant tax event is often the gift that occurs on initial transfer.

As a result of these and similar comparisons, it is often possible to draft an irrevocable trust that is far shorter and more narrowly focused on a specific task than is the case with a revocable trust.

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§6A.34 E. Sensitive Powers

One of the most challenging tasks involved in drafting an irrevocable trust is to be sure that the trust results in desired tax treatment for income tax and transfer tax purposes.

- If it is undesirable that a trust be deemed owned by the settlor for income tax purposes, considerable care must be exercised to avoid giving the settlor or specified other persons any powers that will trigger application of the grantor trust rules. See §6A.18.
- For estate tax purposes, it is generally important that the settlor not have a power that will result in the inclusion of trust property in the settlor's estate or, in the case of retained interest trusts, that any such power terminate on expiration of the retained interest. See §6A.15.
- When generation-skipping transfer tax is a consideration, it is not only important that the trust not be includable in the estate of the settlor at the time of the settlor's death (except during the intentionally retained term of a retained-interest trust), but it is also important to avoid periods before death during which the trust estate would have been included in the estate of the settlor or the spouse of the settlor if either had died at the time. See the discussions of the estate tax inclusion period (ETIP) rule at §§11.23-11.25.
- Finally, it is often the case that tax objectives will be defeated if a beneficiary or the settlor's spouse is given a general power of appointment under IRC §2041. This typically requires imposing limitations on the distribution powers of such persons. See §§9.13-9.24.

In each case, the risk that the drafter will inadvertently provide the settlor or some other person with an undesirable power can be reduced by using a short document with logical organization.

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§6A.35 F. California Trust Law

The California Trust Law (Prob C §§15000-19403) was enacted in 1986. Particularly in cases where there is little likelihood that the trust will be involved in out-of-state transactions, documents can be shortened considerably by simply relying on the statute, preferably with an express reference to the applicable provisions of the statute. This can be particularly helpful in reducing the list of trustee powers.

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7

Nonprobate and Nontrust Transfers at Death

Sandra J. Chan

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§7.1 I. INTRODUCTION TO PROPERTY TRANSFERS

California law provides many ways to transfer property on death other than by will or by trust. Before incorporating any of these methods into a client's estate plan, practitioners must be fully aware of their limitations and even drawbacks. This chapter describes these methods of transferring property on death and reviews some of the problems one may face with their use. Generally, although all the methods permit the transfer of property without probate, they also are more limited than are wills or trusts in providing for alternative beneficiaries, for managing assets for beneficiaries after a decedent's death, for protecting assets from creditors of beneficiaries, and for coordinating allocation and payment of death tax. Therefore, use of these devices may not be appropriate except in limited circumstances.

Outright transfers of property by will or intestacy to a decedent's surviving spouse or registered domestic partner, which may include the surviving spouse of a same-sex marriage in California after June 16, 2008, and before November 4, 2008 (see *Strauss v Horton* (2009) 46 C4th 364, 93 CR3d 591), may be consummated without formal probate proceedings. In addition, personal and real property in a small estate may pass to a decedent's beneficiaries under a will or the decedent's intestate heirs by affidavit or by court order obtained through informal probate proceedings. See 1 California Decedent Estate Practice, chap 3 (2d ed Cal CEB 2009).

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II. ASSETS PASSING TO SURVIVING SPOUSE OR DOMESTIC PARTNER

§7.2 A. Election to Receive Property Without Probate Administration

When a person dies intestate, leaving property that passes to his or her surviving spouse or registered domestic partner under Prob C §6401, or dies testate and devises all or a part of his or her property to the surviving spouse or partner, the surviving spouse or partner or the personal representative, guardian of the estate, or conservator of the estate of the surviving spouse or partner may elect to receive the property without probate administration. Prob C §§13500, 13502; Fam C §297.5(c). In such cases, the surviving spouse or partner may file a spousal property petition for an order confirming that the decedent's property passes or belongs to the surviving spouse or partner. Prob C §§13650-13660. See §7.3.

In *Estate of McDaniel* (2008) 161 CA4th 458, 73 CR3d 907, the court held that a person who "was a party to a valid proceeding concluded by an order purporting to terminate all marital property rights" is not a surviving spouse for intestate succession purposes. The court concluded that the intestate heirs of the decedent were his parents rather than the spouse of a marriage subject to a stipulated judgment dissolving the marriage that had been entered before the decedent's date of death but that had not become effective on the date of the decedent's death.

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§7.3 B. Spousal or Domestic Partner Property Petition

Use of the spousal property petition may be appropriate when the surviving spouse wishes to settle questions about title or ownership. For example, a surviving spouse may wish to file the petition to obtain a decree that property held by the decedent and the surviving spouse in joint tenancy form is actually community property. Such a decree will not necessarily be honored by the IRS for tax purposes. In *Commissioner v Estate of Bosch* (1967) 387 US 456, 18 L Ed 2d 886, 87 S Ct 1776, the Supreme Court held that while federal authorities are bound to apply state law as explained by the state's highest court, they need only give "proper regard" to the interpretation of state law by lower state courts. Until 2010 (and perhaps afterwards; see chap 12), obtaining such a ruling would permit the surviving spouse to enjoy a stepped-up basis (assuming that the property has appreciated) for the entire property. However, unless the spouses have a written agreement stating that joint tenancy property is community property, only the decedent's half interest in the property is entitled to the stepped-up basis. See Fam C §852; IRC §1014(b)(9).

NOTE: These considerations also may apply to same-sex married couples and registered domestic partners because a step-up in basis for the partner's share of community property may be available for California income tax purposes even though it is not available for federal income tax purposes (see 1 USC §7). While IRC §1014 is incorporated by reference in Rev & T C §18031, registered domestic partners are generally treated as if federal law recognized domestic partnerships in the same manner as California law when federal provisions are referred to or relied on by provisions of California law. Fam C §297.5(e). See §4.62.

A spousal or domestic partner property petition also may be used to decide whether the surviving spouse or partner has a community property interest in inter vivos gifts that the decedent made without the surviving spouse or partner's consent, or in testamentary gifts that the decedent made to anyone other than the surviving spouse or partner. Prob C §§100, 5020-5021, 13650; Fam C §§297.5, 1100(b), 1101(f). Likewise, the petition may be used to determine whether the decedent has separate property that passes to a third person under the laws of intestate succession. Prob C §13656.

If a probate proceeding has commenced, a surviving spouse who has benefitted from the proceeding may be estopped from filing a spousal property petition for assets found to be distributable to him or her in the proceeding. See *Estate of Bonanno* (2008) 165 CA4th 7, 80 CR3d 560.

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§7.4 C. Formal Administration of Part of Estate

Even if a decedent's entire estate passes to the decedent's surviving spouse or registered domestic partner, the surviving spouse or partner (or the personal representative, guardian of the estate, or conservator of the estate of the surviving spouse or partner) may choose to subject some of the decedent's estate to formal administration. Prob C §13502; Fam C §297.5(c). This is because the surviving spouse or partner is personally liable for any debts of the decedent that are chargeable against property that is confirmed to the surviving spouse or partner under a spousal property petition. Prob C §13550; Fam C §297.5(c). If any part of a decedent's estate is formally administered, however, the decedent's creditors will be required to file formal claims after receiving proper notice under Prob C §§9000-9054. A creditor's claim is barred unless (1) the creditor commences judicial proceedings for enforcement of the debt and serves the surviving spouse or partner with the complaint before the time for filing claims expires, (2) the surviving spouse or partner gives the creditor a written acknowledgment of liability for the debt, or (3) the creditor files a timely claim in the formal estate proceedings. Prob C §13552; Fam C §297.5(c). Conversely, formal administration will not clear creditors' claims against the surviving spouse or partner's half of the community property assets unless all of the decedent's separate property estate and all of the decedent and surviving spouse or partner's community property estate are subject to formal administration. Prob C §13553; Fam C §297.5(c).

The surviving spouse or partner may assert the 1-year limitation period of CCP §366.2 for any debt of the decedent sought to be enforced against the survivor under Prob C §13550.

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Source: Estate Planning/California Estate Planning/7 Nonprobate and Nontrust Transfers at Death/§7.5 D. Other Special Statutory Procedures Available to Surviving Spouse or Domestic Partner

§7.5 D. Other Special Statutory Procedures Available to Surviving Spouse or Domestic Partner

In addition to the spousal property petition, a surviving spouse or registered domestic partner may receive or take action on certain of the decedent's assets through special statutory procedures. A surviving spouse or partner (or the personal representative, guardian of the estate, or conservator of the estate of the surviving spouse or partner) can immediately collect up to $5000 (plus cost-of-living adjustments) owed to a decedent for personal services by presenting an affidavit. Prob C §§13600-13606; Fam C §297.5(c). The dollar limitation does not apply to the surviving spouse or partner or the guardian or conservator of the estate of the surviving spouse or partner of a firefighter or peace officer. Prob C §13600(d). A surviving spouse or partner may sell or lease community or quasi-community real property free and clear of any unrecorded claims on the 41st day after the decedent's death. Prob C §§13540-13542; Fam C §297.5(c). Finally, a surviving spouse or partner can take advantage of the small estate transfer procedures. See §§7.6-7.11.

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III. TRANSFERS OF SMALL ESTATE ASSETS

§7.6 A. "Small Estates" Defined

Assets in a small estate may pass without formal administration, either to intestate heirs or testamentary beneficiaries. An heir or a beneficiary may obtain his or her interest in the decedent's personal property by affidavit or declaration (Prob C §§13100-13102) and in the decedent's real property by court order (Prob C §§13150-13158) or by affidavit (Prob C §§13200-13210).

An estate is a "small estate" when the gross value of property in California, after statutory exclusions, does not exceed $100,000. Prob C §13100; see Prob C §13050 for statutory exclusions. For purposes of calculating the value of a decedent's estate, "property" includes money owed to the decedent; any particular item of the decedent's tangible personal property; any debt, obligation, interest, right, security, or "chose in action" belonging to the decedent, even if secured by a lien on real property; and real property. Prob C §13100. Although the value of real property must be calculated to ascertain whether the gross value of the estate is within the "small estate" value, the procedures for transferring small estate personal property may not be used to transfer real property included in the small estate. See Prob C §§13004(a), 13100.

Assets that are statutorily excluded in determining whether a decedent's estate is a small estate include (Prob C §13050):

- All items of property not subject to formal probate administration, including assets held in joint tenancy and multiple-party accounts;
- Property transferable to a surviving spouse;
- Any registered vehicle, vessel, manufactured home, mobilehome, commercial coach, truck, camper, or floating home; and
- Any amounts owed to the decedent for services in the United States armed forces, or any other compensation under $5000 in value (including compensation for unused vacation time).

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§7.7 B. Personal Property Transfers

After finding that a decedent's estate is a "small estate," the affidavit or declaration procedure may be used for all estate transfers except real property transfers and transfers of automobiles, mobilehomes, and any other property registered with the Department of Motor Vehicles (DMV) or the Department of Housing and Community Development. Prob C §§13050, 13100. The affidavit or declaration must contain all the elements (*e.g.,* property not exceeding $100,000) set forth in Prob C §13101. Detailed guidelines for preparing the affidavit or declaration are in Transferring Property Without Probate (Cal CEB Action Guide September 2008). If no proceeding for administration of the decedent's estate is pending, beginning on the 41st day after the decedent's death, the affidavit or declaration may be presented to the holder of the property. See Prob C §13100(c). The property holder is required to transfer the property to the affiant or declarant on presentation of the affidavit or declaration and all supporting documents, including the decedent's death certificate, proof of the affiant or declarant's identity, and evidence of the decedent's ownership of the property. Prob C §§13100-13105. If the property holder refuses to transfer the property, the affiant or declarant may bring an action to recover the property or to compel payment. If the court finds that the holder acted unreasonably in refusing to pay, deliver, or transfer the property to the affiant or declarant, the court may award attorney fees against the holder. Prob C §13105(b). If a probate proceeding is being or has been conducted, the affidavit procedure may be used if the personal representative consents to the transfer in writing. Prob C §13108(a)(2).

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§7.8 C. Real Property Transfers

If a decedent's small estate consists of an interest in real property, the property may be transferred to the decedent's heirs or beneficiaries by either filing a petition for a court order determining succession to real property (Prob C §§13150-13158) or by an affidavit procedure (Prob C §§13200-13210). An heir or a beneficiary must use the court procedure if the decedent's California real property has an appraised gross value (without deduction for liens or encumbrances) of more than $20,000. Prob C §13200(a)(5).

The required contents of the petition for an order determining succession to real property are in Prob C §13152. Detailed guidelines for preparing and filing the petition are in Transferring Property Without Probate (Cal CEB Action Guide September 2008). The required elements of the affidavit for real property of small value are in Prob C §13200.

The affidavit procedure has several advantages over the court procedure: It is less expensive, and the inventory and appraisal that must be attached to the affidavit involves only the real property subject to the affidavit. In contrast, the court procedure requires an inventory and appraisal of both the real property and any personal property to be determined as passing to the heir or beneficiary.

The court procedure has certain advantages over the affidavit procedure: A client can obtain faster results in that the petition for the court order may be filed on the 41st day after the decedent's death, while the affidavit procedure requires a 6-month waiting period; the court procedure yields a final and conclusive court order that the real (and personal) property is passing to the decedent's heirs or beneficiaries; and disputes over the petitioner's rights to the property may be resolved under court supervision.

If a probate proceeding is being or has been conducted, both the affidavit procedure and the court procedure may be used if the personal representative consents in writing to the use of the procedure. Prob C §§13150(b), 13210(b). One should note, however, that if a probate proceeding is commenced, whether or not the personal representative has consented to the affidavit procedure, the personal representative may within 3 years of the court's issuance of a certified copy of the affidavit request that the property subject to the affidavit or, if sold, assets having a value equal to the property's fair market value be restored to the decedent's estate. Prob C §13206.

If the decedent was a beneficiary of a deed of trust or had some other lien on the real property in question, the decedent's interest is not "real property" for purposes of the court procedure or the affidavit procedure. See Prob C §13100(c). The procedure for transferring a debt or obligation that is part of a small estate and that is secured by a lien on real property is set forth in Prob C §13106.5.

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Source: Estate Planning/California Estate Planning/7 Nonprobate and Nontrust Transfers at Death/ D. Motor Vehicles, Mobilehomes, and Other State-Registered Property Transfers/§7.9 1. Vehicles and Other Property Subject to Transfer

D. Motor Vehicles, Mobilehomes, and Other State-Registered Property Transfers

§7.9 1. Vehicles and Other Property Subject to Transfer

A decedent's heirs or beneficiaries can informally obtain title to state-registered property, which includes (see Prob C §13050(b)):

- Vehicles registered under Division 3 of the Vehicle Code (Veh C §§4000-5500), such as cars, motor homes, trailers, and miscellaneous equipment used on public highways;
- Off-road vehicles titled under Division 16.5 of the Vehicle Code (Veh C §§38000-38500), such as all-terrain vehicles, motorcycles, snowmobiles, sand or dune buggies, and jeeps;
- Vessels numbered under Division 3.5 of the Vehicle Code (Veh C §§9840-9900), such as seaplanes and most small watercraft not documented or numbered under federal law, excluding sailboats and rowboats of eight feet in length or less; and
- Vehicles registered under Division 13 of the Health & Safety Code (Health & S C §§18000-19997), including manufactured homes, mobilehomes, commercial coaches, truck campers, and floating homes.

Transfers and registrations of vehicles with a vehicle identification number (*e.g.,* cars) are usually handled by the Department of Motor Vehicles. Transfers and registrations of vehicles with a Housing and Urban Development or Department of Housing number (*e.g.,* manufactured homes) are usually handled by the Department of Housing and Community Development.

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Source: Estate Planning/California Estate Planning/7 Nonprobate and Nontrust Transfers at Death/§7.10 2. Property Owned in Joint Tenancy

§7.10 2. Property Owned in Joint Tenancy

If a decedent owned property in joint tenancy with another person and all unsecured claims against the decedent have been paid or discharged, the surviving joint tenant may submit to the Department of Motor Vehicles the following documents to obtain sole title to the property (see Veh C §4150.5(a)):

- The Certificate of Title on which odometer mileage is reported if the vehicle is less than 10 years old;
- A certified copy of the decedent's death certificate;
- Current registration or certificate number (vessels);
- Statement of Fact (Use Tax Exemption) Form REG 256 to determine whether the surviving joint tenant can avoid use tax imposed on a transfer;
- Vehicle/Vessel Transfer and Reassignment Form REG 262, if an odometer mileage report is required and there is no place to report it on the Certificate of Title;
- The $15 transfer fee; and
- A smog certificate, unless (Veh C §4000.1(d)):
- The initial application for transfer is submitted within the 90-day validity period of a smog certificate, as specified in Health & S C §44015;
- The decedent was the parent, grandparent, sibling, child, grandchild, spouse, or registered domestic partner (Fam C §297.5) of the surviving joint tenant; or
- The vehicle is otherwise exempt from the smog certificate requirement (*e.g.,* because it is a motorcycle).

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§7.11 3. Procedure; Required Documents

The transfer of a vehicle registered with the Department of Motor Vehicles (DMV) can be immediate if a surviving spouse or registered domestic partner (see Fam C §297.5(c)) takes a decedent's interest in the property by will or intestate succession, all unsecured claims against the decedent have been paid or discharged, and there is no other property for which formal probate proceedings are necessary. Any other beneficiary or heir must wait until the 41st day after the decedent's death to transfer a vehicle registered with the DMV. The documents required to transfer non-joint tenancy vehicles and vessels through the DMV include (see Veh C §5910 (vehicles); Veh C §9916 (vessels)):

- The Certificate of Title on which odometer mileage is reported if the vehicle is less than 10 years old;
- Current registration or certificate of number (vessels);
- Statement of Fact (Use Tax Exemption) Form REG 256 to determine whether the heir or beneficiary can avoid use tax imposed on a transfer;
- The $15 transfer fee;
- A smog certificate, unless any of the exceptions in §7.10 applies;
- Affidavit for Transfer Without Probate, Form REG 5; and
- Vehicle/Vessel Transfer and Reassignment Form REG 262, if an odometer mileage report is required and there is no place to report it on the Certificate of Title.

There is no use tax when the transfer is between family members, *i.e.*, the transferor is a parent, grandparent, child, grandchild, spouse, or registered domestic partner of the transferee, or both the transferor and transferee are siblings and minors. Rev & T C §6285(a).

If a surviving joint tenant, heir, or beneficiary will be the sole owner of a vehicle and wants to sell it immediately to a third party, he or she can do so by simultaneously presenting to the DMV the papers establishing his or her rights to the vehicle and the sale documents. In addition, the surviving joint tenant, heir, or beneficiary should complete the reverse side of the certificate of ownership to reflect the new owner.

Detailed guidelines for transferring motor vehicles and other state-registered property are in Transferring Property Without Probate (Cal CEB Action Guide September 2008).

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IV. NONPROBATE TRANSFERS OF COMMUNITY PROPERTY

§7.12 A. General Principles

The alternative methods of transferring property on death are sometimes known as "nonprobate transfers," which include transfers made under (Prob C §5000):

- A written provision that money or other benefits owed to, controlled by, or owned by a decedent before death will be paid after the decedent's death to a person whom the decedent designates either in the instrument or in a separate writing.
- A written provision that money that is owed or will be owed to the decedent under the instrument will cease to be payable if the promisee or promisor dies before payment or demand is made.
- A written provision that any property controlled or owned by the decedent before death that is the subject of the instrument will pass to a person whom the decedent designates either in the instrument or in a separate writing.

Common forms of nonprobate transfers are life insurance policies, employment contracts, and retirement benefit plans. This chapter does not discuss the transfer of life insurance benefits or retirement assets. For a discussion of life insurance, see chap 19. For a discussion of pensions and IRA distributions, see chap 21. Nonprobate transfers also include deposit agreements such as payable-on-death, and Totten trust accounts, gift deeds, and written instruments of a similar nature.

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§7.13 B. Written Consent of Surviving Spouse or Domestic Partner to Transfer of Community Property

If the property subject to the nonprobate transfer on death is community property of a person with a spouse or registered domestic partner, to carry out the person's wishes on death for both halves of the community property, the person must usually obtain (1) a written consent of his or her spouse or partner to the transfer or (2) a written waiver of that spouse or partner's community property rights in the assets subject to the transfer. See Prob C §§141, 5013, 5020; Fam C §297.5(c). If consent or a waiver is not given, the provision for the nonprobate transfer of community property on death is ineffective as to the nonconsenting spouse or partner's interest in the property. The nonconsenting spouse or partner retains the right to dispose on death his or her interest in the community property by will, intestate succession, or nonprobate transfer. Prob C §5020. A judicial proceeding must be brought, however, to set aside the ineffective transfer. Prob C §5021(a). The court having jurisdiction over the proceeding may then set aside the transfer as to the nonconsenting spouse or partner's interest in the property, subject to such terms and conditions or other remedies that appear equitable in the circumstances. Prob C §5021(a). On spousal and domestic partner consent generally, see chap 4.

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§7.14 C. Consent Not a Transmutation

A consent to a nonprobate transfer of community property on death by the spouse or registered domestic partner of the transferor is not a transmutation of the consenting spouse or partner's interest in the property unless that spouse or partner also expresses a clear intent to transmute property. *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153; Prob C §5022; Fam C §§297.5, 852, 853(c). In *Marriage of Benson* (2005) 36 C4th 1096, 32 CR3d 471, relying on *MacDonald*, the court held that the requirement of a writing to transmute property is not subject to the "part performance" exception that may apply under the CC §1624 statute of frauds. The husband had claimed that the wife had promised to relinquish her interest in his retirement plan in consideration of his transfer of an interest in a residence to a trust benefiting the wife. In *Marriage of Starkman* (2005) 129 CA4th 659, 28 CR3d 639, the court held that separate property transferred to a revocable trust was not transmuted into community property by a trust provision stating that property transferred to the trust was community property unless identified as the separate property of either settlor. See chap 4 for a detailed discussion of transmutation issues.

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§7.15 D. Consent to Modification of Provision for Nonprobate Transfer

If a person with a spouse or registered domestic partner, with the written consent of his or her spouse or partner, executes a provision for a nonprobate transfer of community property on death, but later modifies that provision without again obtaining the spouse or partner's consent, the modification is effective only on the modifier's interest in the community property. Prob C §5023(b); Fam C §297.5(c). If the modification occurs during the spouse or partner's lifetime, the modification revokes the spouse or partner's prior consent to the nonprobate transfer. Prob C §5023(b)(1). If the modification occurs after the spouse or partner's death, the modification does not affect the deceased spouse or partner's prior consent to the nonprobate transfer. The deceased spouse or partner's interest in the community property is subject to the nonprobate transfer to which the deceased spouse or partner consented before his or her death. Prob C §5023(b)(2). A spouse or partner may indicate in his or her initial consent to a nonprobate transfer that modifications may be made subsequent to the spouse or partner's death. In that event, the spouse or partner's interest in the community property is deemed transferred to the transferor on the spouse or partner's death, and any modification made after that death is effective as to both halves of the community property. Prob C §5023(b)(3).

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Source: Estate Planning/California Estate Planning/7 Nonprobate and Nontrust Transfers at Death/§7.16 E. Revocability of Spouse or Partner's Consent

§7.16 E. Revocability of Spouse or Partner's Consent

A written consent by a person's spouse or registered domestic partner to a nonprobate transfer of community property by the person on death is revocable during the marriage or domestic partnership. Prob C §5030(a); Fam C §297.5(a). If the marriage or domestic partnership is dissolved, the asset subject to the nonprobate transfer is subject to division by the family law court having jurisdiction over the dissolution proceedings. Prob C §5030(b); Fam C §297.5(b). A written consent becomes irrevocable on the death of either spouse or partner. Prob C §5030(c); Fam C §297.5(c). The spouse or partner revoking the consent must identify the provision for transfer of the property being revoked and must serve the revocation on the person making the transfer before that person's death. Prob C §5031(a). A revocation of a spouse or partner's written consent to a nonprobate transfer of community property results in the property being distributed as if the consent had not been given. Prob C §5032.

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§7.17 F. Nonprobate Transfer of Quasi-Community Property

If a California domiciliary made a transfer on death of quasi-community property to someone other than his or her surviving spouse without substantial consideration and without the surviving spouse's consent, the surviving spouse has a right to compel restoration of one-half of the property by the transferee to the estate. Prob C §102(a). However, Prob C §102 does not require a transferee to restore to the decedent's estate any life or accident insurance, joint annuity, or pension payable to anyone other than the surviving spouse. Prob C §102(b). Any property restored to the decedent's estate under Prob C §102 belongs to the surviving spouse under Prob C §101. Prob C §102(c). These rules also apply to registered domestic partners under Fam C §297.5(c) if they previously acquired property in another jurisdiction while in a legal union substantially equivalent to a domestic partnership, which may include a civil union. See Fam C §299.2. Jurisdictions in addition to California that offer domestic partnerships or civil unions include the District of Columbia, Nevada, New Jersey, Oregon, and Washington. Jurisdictions that allow same sex-marriages include Connecticut, Iowa, Massachusetts, New Hampshire, and Vermont. Colorado, Hawaii, Maine, and Wisconsin provide more limited rights to domestic partners or reciprocal beneficiaries. See §4.59.

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Source: Estate Planning/California Estate Planning/7 Nonprobate and Nontrust Transfers at Death/§7.18 G. Nonprobate Transfer to Former Spouse or Domestic Partner

§7.18 G. Nonprobate Transfer to Former Spouse or Domestic Partner

Subject to certain exceptions, a nonprobate transfer to a former spouse or registered domestic partner of the transferor fails if, at the time of the transferor's death, the former spouse or partner is not the transferor's surviving spouse or partner because of the dissolution or annulment of the marriage or domestic partnership. Prob C §5600(a); Fam C §297.5(b). In *Estate of McDaniel* (2008) 161 CA4th 458, 73 CR3d 907, the court held that a person who "was a party to a valid proceeding concluded by an order purporting to terminate all marital property rights" was not a surviving spouse for intestate succession purposes. A legal separation that does not terminate the marriage or domestic partnership does not constitute a dissolution for purposes of Prob C §5600. Prob C §5600(a). When a nonprobate transfer to a former spouse or registered domestic partner fails, the actual transfer is made as if the former spouse or partner had not survived the transferor. Prob C §5600(c).

A nonprobate transfer to a former spouse or registered domestic partner of the transferor is not subject to revocation under Prob C §5600(a) in any of the following circumstances (Prob C §5600(b)):

- The nonprobate transfer is not subject to revocation at the time of the transferor's death;
- There is clear and convincing evidence that the transferor intended to preserve the nonprobate transfer to the former spouse or partner; or
- There is a court order that the nonprobate transfer be maintained on behalf of the former spouse or partner.

With respect to employer-provided benefits to spouses, the general rule in Prob C §5600(a) may be preempted. In *Egelhoff v Egelhoff* (2001) 532 US 141, 149 L Ed 2d 264, 121 S Ct 1322, the Supreme Court held that the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) preempts a Washington state statute that automatically revoked the status of a former spouse as the designated beneficiary of a benefits plan on divorce. ERISA provides in 29 USC §1144(a) that it "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan" covered by ERISA. See also *Carmona v Carmona* (9th Cir 2008) 544 F3d 988 (ERISA preempts state court orders directing pension plans to change beneficiaries; former spouse's interest in surviving spouse benefits vested at participant's retirement). Thus, insofar as Prob C §5600(a) applies to ERISA-mandated employee benefits, it cannot be relied on. On a dissolution or annulment of marriage, the beneficiary designation for such benefits must be reviewed and appropriately changed. However, same-sex spouses and registered domestic partners are not treated as spouses for purposes of ERISA. See 1 USC §7.

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V. JOINT TENANCY PROPERTY

§7.19 A. Overview of Joint Tenancy

Joint tenancy is a form of co-ownership in which two or more persons own property in equal undivided interests. CC §683. The right of survivorship is a key feature of joint tenancy. Unless the joint tenancy is severed by any of the methods described in CC §683.2, a deceased joint tenant's interest vests in the surviving joint tenant or tenants at the moment of death without requiring probate administration. CC §683.2(c). Except with the simultaneous death of joint tenants, the interest is also not subject to disposition by the deceased joint tenant's will. If property is held by two joint tenants and there is no clear and convincing evidence that one survived the other, the property held in joint tenancy will be administered, distributed, or otherwise dealt with, half as if one joint tenant had survived the other, and half as if the other joint tenant had survived. Prob C §223(b). A similar rule applies to joint tenancies of more than two joint tenants. Prob C §223(c).

The usual way to declare a joint tenancy expressly in a conveyance is to designate the grantees as joint tenants with a right of survivorship. See CC §683. The right of survivorship will be effectively created by stating in the conveyance: "To A and B as joint tenants, with right of survivorship."

For joint tenancies in real property, any joint tenant may sever his or her interest without the joinder or consent of the other joint tenants. CC §683.2(a). Severance can be accomplished by conveyance to a "straw person" or by a written instrument showing the intent to sever the joint tenancy. CC §683.2(a). For example, a joint tenant may sever his or her interest in a joint tenancy by conveying his or her undivided interest to himself or herself. Such a unilateral severance is not effective unless (1) before the death of the severing joint tenant, the written instrument is recorded in the county in which the property is located or (2) such written instrument is executed no earlier than 3 days before the death of the severing joint tenant and recorded within 7 days after that joint tenant's death. CC §683.2(c).

Subject to the two exceptions discussed below, a joint tenancy between a decedent and the decedent's former spouse or registered domestic partner is severed if, at the time of the decedent's death, the former spouse or partner is not the decedent's surviving spouse or partner because of the dissolution or annulment of their marriage or domestic partnership. Prob C §5601(a); Fam C §297.5(b). A legal separation that does not terminate the marriage or domestic partnership does not constitute a dissolution under Prob C §5601. Prob C §5601(a). Probate Code §5601(a) effectively reversed the common law rule that dissolution or annulment of marriage does not sever a joint tenancy between spouses. See, *e.g., Estate of Layton* (1996) 44 CA4th 1337, 52 CR2d 251.

Under Prob C §5601(b), a joint tenancy is not severed if:

- The joint tenancy is not subject to severance by the decedent at the time of the decedent's death (*e.g.,* because severance is prohibited by court order or binding agreement); or
- There is clear and convincing evidence that the decedent intended to preserve the joint tenancy in favor of the former spouse or domestic partner.

For purposes of Prob C §5601, the term "joint tenancy" includes property held as community property with right of survivorship, as described in CC §682.1. Prob C §5601(d). On community property with a right of survivorship, see §7.30.

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B. Tax Aspects of Joint Tenancy

§7.20 1. Effect of EGTRRA

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) repeals the estate and generation-skipping transfer (GST) taxes for decedents dying after December 31, 2009. See IRC §2210(a). This repeal is itself repealed, and the estate and GST taxes are reinstated on January 1, 2011. For a discussion of EGTRRA-2001, see chap 10.

NOTE: Legislative action regarding the 1-year repeal of estate and GST tax appears likely. Whether that action will permanently repeal the estate and GST tax, eliminate temporary repeal, or follow a different path altogether is unclear. Nevertheless, the estate and gift tax planning discussed here and in other sections of this chapter is important during the period before the repeal scheduled under EGTRRA-2001 and after 2010.

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§7.21 2. Gift Tax on Creation

A gift tax may apply on the creation of a joint tenancy with a right of survivorship. A completed transfer into a joint tenancy arrangement is a prerequisite for imposing the gift tax. If a joint tenant who has furnished all the consideration in creating the joint tenancy is permitted to unilaterally terminate the joint ownership and to retrieve the entire property, the transfer is not complete for gift tax purposes and is, therefore, not subject to gift tax. This is usually true for joint tenancy financial institution accounts. See Treas Reg §25.2511-1(h)(4). A gift to the noncontributor does not occur unless and until he or she withdraws funds from the account with no obligation to account for the proceeds to the contributor. Treas Reg §25.2511-1(h)(4); Rev Rul 69-148, 1969-1 Cum Bull 226.

When the transfer into the joint tenancy cannot be completely reversed by the transferor, as with a creation of a joint tenancy in real property, a gift will have been made on the transfer. If any joint tenant can sever the joint tenancy, the value of each tenant's property interest is considered to be pro rata, as determined by the number of joint tenants. See Treas Reg §25.2511-1(h)(5) (gift equal to one-half of value of property on purchase of property followed by creation of joint tenancy with one other owner). See also Treas Reg §25.2515-2(b)(1) (gift equal to one-half of value of property when donor spouse elects to treat creation of joint tenancy (or tenancy by the entirety) between husband and wife as a gift). A gift occurring on the creation of a joint tenancy may qualify for the annual exclusion, the gift tax marital deduction, and the application of some or all of the gift tax applicable exclusion amount.

Ordinarily, no immediate gift tax consequences arise on the creation of a spousal joint tenancy because of the unlimited marital deduction for the transfer to a spouse. See IRC §2523(a). Note that same-sex spouses and registered domestic partners holding property in joint tenancy are not treated as spouses for these purposes. See 1 USC §7. Note further that if the donee spouse is not a United States citizen, the transfer may be subject to gift tax because the marital deduction is not available to noncitizens. IRC §2523(i). In such situations, some relief from gift tax is available under IRC §2523(i)(2), which permits a $133,000 (in 2009) annual gift tax exclusion for gifts to a noncitizen spouse. This more generous annual exclusion is limited to present interest gifts that would be eligible for the marital deduction were it not for the general rule disallowing the deduction for gifts to noncitizen spouses. On the marital deduction generally, see chap 17.

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§7.22 3. Gift Tax on Termination

A joint tenancy can terminate by operation of law (*e.g.,* on dissolution or annulment of marriage), by a consensual act of the joint tenants (*e.g.,* a transfer that results in severance of the joint tenancy), or by the death of one joint tenant. As a rule, the termination of a joint tenancy will result in a gift from one joint tenant to the other to the extent that one joint tenant receives, as a result of the termination, property that is greater in value than the value of that tenant's interest in the joint property. Rev Rul 55-278, 1955-1 Cum Bull 471. In general, if the joint tenants' interests are severable, each tenant is entitled to a prorata share of the property, and the termination thus avoids any gift tax consequences. The gift tax, if due, would then presumably have been paid on the creation of the joint tenancy. Treas Reg §25.2511-1(h)(5). See also Treas Reg §25.2523(i)-2(b)(4), Example 2. If the joint tenants' interests are not severable, the value of each joint tenant's interest (and thus the amount each tenant must receive at termination to avoid gift tax consequences) may need to be calculated on an actuarial basis. See, *e.g.,* IRS Letter Ruling 8746026.

As on the creation of a joint tenancy between spouses, the termination of a spousal joint tenancy generally results in no gift tax consequences for United States citizen spouses. Different rules apply when the donee spouse is a noncitizen but the $134,000 (in 2010) annual exclusion is available to mitigate the gift tax consequences of the termination. See IRC §2523(i)(2).

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§7.23 4. Estate Tax

On a joint tenant's death, the entire property is included in the decedent's estate unless the estate can prove that a portion of the property originally belonged to the survivor or survivors and was never received or acquired by them from the decedent for less than adequate and full consideration in money or money's worth. IRC §2040(a). If, however, the joint tenancy is a qualified joint interest (*i.e.*, a spousal joint tenancy), then on the first joint tenant's death only half of the interest will be included in the decedent's gross estate. IRC §2040(b)(2). Because the qualified joint interest passes to the surviving spouse, no estate tax is paid on that interest under the unlimited marital deduction. IRC §2056(a).

If property derived from community sources is treated as if held in joint tenancy form for the sake of convenience, or if property is held as community property with a right of survivorship (see §7.30), half the property's value is included in the gross estate of the first spouse to die. IRC §2033. If the property is treated as a qualified joint interest, half of the interest is included in the decedent's gross estate under IRC §2040(b). In neither instance will an estate tax be paid on the half of the property that passes to the survivor. IRC §2056. Note that same-sex domestic partners holding property in joint tenancy are not treated as spouses for these purposes. See 1 USC §7.

These rules on qualified joint interests do not apply to a noncitizen spouse unless the property is placed into a qualified domestic trust. IRC §2056(d)(1)(B), (d)(2). Accordingly, the sources of the consideration for the joint tenancy property must be verified in determining the amount of such transfers includable in the decedent's estate. IRC §2040(a). If only a partial interest in property held in joint tenancy is included in the decedent's gross estate, the partial interest is not eligible for a lack-of-marketability or fractional interest valuation discount. *Estate of Wayne-Chi Young* (1998) 110 TC 297.

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§7.24 5. GST Tax

If the noncontributor in a creation or termination of a joint tenancy that is subject to gift tax is a "skip person" as that term is defined in IRC §2613, the creation or termination of the joint tenancy interest will also be subject to the generation-skipping transfer (GST) tax as a direct skip. IRC §§2611(a), 2612(c)(1). Similarly, a termination of a joint tenancy on the death of one joint tenant that results in a transfer to a surviving joint tenant who is a skip person is subject to GST tax. IRC §§2611(a), 2612(c)(1). See generally chap 11.

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§7.25 6. Income Tax

Income from joint tenancy property is prorated equally among the joint tenants for income tax purposes. *Frederick J. Haynes* (1927) 7 BTA 465, acq 1928-1 Cum Bull 14. However, because of the provisions allowing joint returns between spouses, there is no practical difference in federal or California taxation of income from property held by a married couple in joint tenancy or community property. Note that same-sex domestic partners are not treated as spouses for purposes of filing a federal joint return, but they are required to file either a joint return or separate returns for California tax purposes, applying the federal standards applicable to spouses. See 1 USC §7; IRC §6013; Rev & T C §18521(d).

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§7.26 7. Income Tax Basis at Joint Tenant's Death

Joint tenancy property included in a decedent's estate receives a new basis. IRC §1014(b)(9). Joint tenancy property held only between spouses is considered a qualified joint interest under IRC §2040(b)(2). On the death of the first spouse to die, only half of the joint tenancy property receives a new basis under IRC §1014(b)(9). The basis of the half excluded from the contributing spouse's gross estate for federal estate tax purposes is generally the contributing spouse's basis when the joint tenancy was created. IRC §1015(a).

If one spouse makes a gift to the other spouse of half of certain of his or her separate property by contributing that property to a joint tenancy with the other spouse, on the noncontributing spouse's death, the contributing spouse may be treated as having reacquired half the property and would receive a new basis for the reacquired half under IRC §1014(a)(9). If the joint tenancy was created with appreciated property within 1 year before the noncontributing spouse's death, however, a step-up in basis of the reacquired half of the property would be disallowed. IRC §1014(e).

Under California law, the decedent's share of joint tenancy property receives a new basis on death when there is a new basis under federal law. Rev & T C §18031 (provisions of the Internal Revenue Code relating to gain or loss on disposition of property apply in California). Registered domestic partners also may be treated as spouses for California income tax purposes. See §7.3. For discussion of income tax basis generally, see chap 12.

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§7.27 8. Community Property Versus Joint Tenancy; Effect on Basis

Community property is generally the most advantageous form of ownership for appreciated property and property likely to appreciate in value. Both halves of appreciated property of spouses will receive, for federal and California income tax purposes, a step-up in basis at the death of the first spouse to die. IRC §1014(b)(1), (6); Rev & T C §18031. Both halves of appreciated property of same-sex spouses and registered domestic partners may receive a step-up in basis for California income tax purposes, but will not for federal income tax purposes. See §7.3. Property held in community property form may also escape probate if it passes outright to the surviving spouse or partner under a will or by intestate succession. Prob C §§13650-13660; Fam C §297.5(c). A surviving spouse or partner also may acquire property held as community property with a right of survivorship without probate. See §7.30. Likewise, community property held in a revocable trust will avoid probate. See Prob C §§104, 19001(a).

Both the decedent and the surviving spouse's interest in depreciated community property receive a step-down in basis. IRC §1014(b)(1), (6). The use of joint tenancy or a tenancy in common will limit the step-down in basis to the decedent's interest. As with assets held by spouses or registered domestic partners as tenants in common, only the decedent's interest in the joint tenancy will be stepped down.

Because of the unlimited marital deduction (see IRC §2523(a)) and the elimination of the tracing rules for spousal joint tenancies, the joint tenancy form of ownership is often preferable to a tenancy in common for depreciated property of spouses and, in California, registered domestic partners. Joint tenancy both achieves the equivalent limitation on the basis step down and avoids probate of the depreciated asset. Although a decedent spouse or partner's interest in a tenancy in common may pass to the surviving spouse or partner without probate if the interest passes outright to him or her, usually there is still a summary administration procedure that must be initiated to obtain a court ruling that the interest passes to the surviving spouse or partner. See Prob C §13650; Fam C §297.5(c). Tenancy in common may be the preferable alternative for spouses, even though formal probate will be necessary, if the property is to be placed in a bypass trust, or in a trust qualifying for the marital deduction, on the deceased spouse's death. Of course, tenancy in common property held in a revocable trust will avoid probate and may still be held in further trust on the deceased spouse or partner's death.

For a detailed discussion of the effect of the creation or termination of joint tenancies on real property taxes, see chap 15.

PRACTICE TIP: If in reviewing a client's assets the attorney finds assets held by both spouses in joint tenancy that originated from community property, the circumstances of the acquisition should be investigated. Title to a home or stocks and bonds acquired with community property assets is often taken automatically in joint tenancy rather than as a result of a well-considered plan. If so, the attorney should carefully consider whether the joint tenancy arrangement is really in the best interests of the client, the client's spouse, and their family. For assets acquired with community earnings and held by same-sex spouses and registered domestic partners, the attorney must consider the gift tax consequences of retaking title as community property. See §7.21.

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C. Nontax Considerations

§7.28 1. Advantages of Joint Tenancy

The principal advantage of joint tenancy over community property is the potential protection of the decedent's interest in joint tenancy assets from claims of creditors on the decedent's separate property obligations. This is because assets that pass to a joint tenant by right of survivorship generally pass without exposure to the decedent's debts. *Grothe v Cortlandt Corp.* (1992) 11 CA4th 1313, 15 CR2d 38; *Zeigler v Bonnell* (1942) 52 CA2d 217, 126 P2d 118 (judgment lien against debtor joint tenant imposed before death does not sever joint tenancy). The court in *Dieden v Schmidt* (2002) 104 CA4th 645, 653, 128 CR2d 365, limited the holding in *Ziegler* to cases in which the judgment lien was created after the right of survivorship had already arisen. Thus, when a lien predates the creation of the joint tenancy, the property is conveyed subject to the lien. When a tax lien is created after the right of survivorship has arisen, the lien is extinguished by the decedent's death. See *U.S. v Craft* (2002) 535 US 274, 152 L Ed 2d 437, 122 S Ct 1414; Notice 2003-60, 2003-2 Cum Bull 643. But see *Paternoster v U.S.* (SD Ohio 2009) 2009-2 USTC ¶50,520, 104 AFTR2d 5530 (tax lien against decedent's interest in survivorship property remains enforceable after death). However, the lien is enforceable against any other "attachable property" of the deceased joint tenant's estate under IRC §6321. See *U.S. v Vitally* (ND Cal 2006) 2007-1 USTC ¶50,295, 99 AFTR2d 342 (lien was partially satisfied from joint tenancy property in settlement with surviving joint tenant).

This protection does not apply to community property that passes by right of survivorship under CC §682.1. See §7.30. On asset protection generally, see chap 26.

The probate avoidance benefit of joint tenancy has been largely eliminated by the optional summary administration procedures and the availability of revocable trusts as probate avoidance devices.

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§7.29 2. Disadvantages of Joint Tenancy

Joint tenancy has potential disadvantages. For example, although joint tenancy may offer some protection against creditors' claims at death, the creator of a joint tenancy during life exposes the property to the joint tenant's creditors. In *Nikirk v U.S.* (D Ariz 2003) 2003-2 USTC ¶50,701, 92 AFTR2d 6486, the court held that a lien for a son's income taxes attached to his joint tenancy interest in real property, even though his mother had paid for the property and created the joint tenancy solely for estate planning purposes. The court followed *Frederick v Shorman* (Iowa 1966) 147 NW2d 478, in which a mother purchased a residence by paying the entire consideration, but took title in joint tenancy with her son. The mother testified that she put the property in both names solely in case something happened to her. The court held that she failed to prove by clear and convincing evidence that she and her son did not hold equal interests in the property, and consequently the son's creditor could levy on the son's interest. Also, no further planning is possible with joint tenancy property, because it vests in the surviving joint tenant at the moment of death. The surviving joint tenant is then free to dispose of the entire property as he or she wishes. If the surviving joint tenant retains the property until death, it is usually included in his or her estate and is subject to death taxes. For married persons, the joint tenancy form of ownership may lead to overfunding the marital deduction gift and underutilizing the deceased joint tenant's applicable exclusion amount. Such overfunding and underutilizing could result in substantial and unnecessary death taxes.

Much more flexibility is possible in estate planning for community property because each spouse or registered domestic partner can dispose of his or her interest in the community property by will or trust. For example, each spouse or partner's will can provide that all or part of his or her half of the community property be placed into a trust, so that the surviving spouse or partner can receive the income from the trust property during his or her lifetime without subjecting that property to death taxes on the survivor's death. Even if the spouses or partners are not concerned with death taxation on the survivor's death, such a trust may still be desirable so that each spouse or partner can be sure that his or her half of the community property will eventually pass to his or her children or other designated beneficiaries if the survivor enters into another marriage or domestic partnership. For a discussion of revocable trusts generally, see chap 6.

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VI. COMMUNITY PROPERTY WITH RIGHT OF SURVIVORSHIP

§7.30 A. Advantages of Community Property With Right of Survivorship

California recognizes community property with a right of survivorship for assets owned by spouses or registered domestic partners other than joint accounts in financial institutions. CC §682.1; Fam C §297.5(c). When expressly declared in the transfer document to be community property with a right of survivorship, on the death of one of the spouses or partners, the community property passes to the survivor without probate administration. Before the death of either spouse or partner, the right of survivorship may be terminated under the same procedures by which a joint tenancy may be severed under CC §683.2. CC §682.1(a). See also Prob C §5601(a), (d), which provides that the survivorship feature of property held as community property with right of survivorship, like property held in joint tenancy, is terminated if, at the time of the decedent's death, the former spouse or partner is not the decedent's surviving spouse or partner, because of the dissolution or annulment of their marriage or domestic partnership.

Although CC §682.1(a) states that the transfer documents "may be accepted in writing on the face of the document by a statement signed or initialed by the grantees," and such language seems permissive, that apparently is not the case. See 22 CEB Est Plan Rep 76 (Dec. 2000). The analysis of the Assembly Committee on Judiciary (Aug. 25, 2000) states:

> It is important to note that this proposal *affirmatively requires* the signature or initials of the parties on the face of the document… to demonstrate the clear intention of the parties to take this property as community property with rights of survivorship [emphasis added].

PRACTICE TIP: Prudent counsel will advise the grantees to sign or initial the face of the document to indicate their acceptance of the community property with right of survivorship form of ownership.

The community property with right of survivorship form of ownership is not available for separate property. Therefore, if spouses or partners wish to create survivorship rights in property that consists of both separate property and community property interests, one of two options is available to accomplish that objective. The owner of the separate property interest could expressly transmute his or her interest into community property and then the spouses or partners could transfer the entire asset to themselves as community property with a right of survivorship. Alternatively, the owner of the separate property portion could transfer his or her separate property to the names of husband and wife as joint tenants with a right of survivorship. The husband and wife would then transfer their community property interest in the asset to themselves as community property with a right of survivorship. However, the transmutation or transfer of separate property interests by same-sex spouses and registered domestic partners may have gift tax consequences because gifts between the spouses or partners are not eligible for the IRC §2523 marital deduction. See 1 USC §7.

With community property with a right of survivorship for spouses, only half the property is included in the decedent's gross estate under IRC §2040, while all of the property gets basis step-up for both federal and California income tax purposes under IRC §1014 and Rev & T C §18031 (at least until 2010), assuming that the property is treated as community property by the IRS. This option permits a married couple to obtain the probate avoidance benefit of a joint tenancy while they enjoy a full basis step-up for appreciated property (or suffer the consequences of full basis step-down for depreciated property) on the death of either of them. For property of same-sex spouses and registered domestic partners, the portion of the property attributable to contributions by the deceased partner will be included in the decedent's gross estate under IRC §2040. While all the property should get basis step-up for California income tax purposes, only the portion included in the decedent's gross estate gets basis step-up for federal income tax purposes under IRC §1014 because the survivor is treated as a surviving spouse to the extent that California law incorporates federal law but is not treated as a surviving spouse under federal law. See §7.3.

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§7.31 B. Disadvantages of Community Property With Right of Survivorship

Community property with a right of survivorship is not a panacea for probate avoidance. This form of ownership has some of the same disadvantages associated with property held in joint tenancy form. See §7.29. As with joint tenancy property, no further planning is possible for community property with right of survivorship, because it vests in the surviving spouse or registered domestic partner at the moment of the decedent's death. The surviving spouse or partner is then free to dispose of the entire property as he or she wishes. If the surviving spouse or partner retains the property until death, it is usually included in the estate and is subject to death taxes. This form of ownership by spouses may also lead to overfunding the marital deduction gift and underutilizing the deceased spouse's IRC §2010 applicable exclusion amount. Such overfunding and underutilizing could result in substantial yet unnecessary death taxes. On marital deduction generally, see chap 17.

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VII. MULTIPLE-PARTY ACCOUNTS; TRANSFER ON DEATH SECURITIES

§7.32 A. Party's Interest in Account; Community Funds

A "multiple-party account" is a joint account, a "pay on death" (POD) account, or a Totten trust account, which permits a nontestamentary transfer of sums deposited in such accounts on the death of a party to such an account. Prob C §§5132, 5304. A party's interest in an account is deemed to be the party's net contribution to the account, which is the sum of the following at any given time: (1) all deposits made by or for the party, less all withdrawals made by or for the party, (2) a prorata share of any interest or dividends earned, and (3) any proceeds of deposit life insurance added to the account because of the death of the party whose net contribution is in issue. Prob C §5134(a), (c). In the lack of proof to the contrary, only parties who have a present right of withdrawal are considered as having a net contribution in an account, and the net contribution of each party having a present right of withdrawal is deemed to be an equal amount. Prob C §5134(b). When the parties to a multiple-party account are married, regardless of whether they are described as such in the deposit agreement, their contributions are presumed to be community property. Prob C §5305(a).

An account belongs, during the lifetime of all the parties, to the parties in proportion to the net contributions by each to the sums on deposit, unless there is clear and convincing evidence of a different intent. Prob C §5301(a). In *Lee v Yang* (2003) 111 CA4th 481, 3 CR3d 819, however, a divided court held that this rule applies only while sums remain on deposit. Thus, an account holder who withdraws more than that owner's share of account contributions has no duty to account to the other owner. The California Law Revision Commission was expected to propose legislation that would have the effect of overruling the decision in *Lee*, but such legislation has not been enacted. See Cal L Revision Comm'n Memorandum 2004-32. With a POD account, the POD payee has no rights to the sums on deposit during the lifetime of any party, unless there is clear and convincing evidence of a different intent. Prob C §5301(b). Likewise, with a Totten trust account, the beneficiary has no rights to the sums on deposit during the lifetime of any party without clear and convincing evidence of a different intent. Prob C §5301(c). However, in an irrevocable trust the account belongs beneficially to the beneficiary. Prob C §5301(c). Further, Prob C §5303 limits the methods by which survivorship rights can be amended. The authorized methods are:

- Closing the account and reopening it;
- Presenting the financial institution a modification agreement that is signed by all parties with a present right of withdrawal; and
- Complying with a modification method stated in the account agreement.

In *Stevens v Tri-Counties Bank* (2009) 177 CA4th 236, 99 CR3d 188, the court held that a financial institution was liable for withdrawals made by an individual who was purportedly added as an additional "party" to an account without the written consent of the original parties and was not protected by Prob C §5201. No method was stated in the account agreement, and the purported account agreement did not comply with any of the statutory methods of amendment.

Community funds may be deposited in an account held jointly by one spouse or registered domestic partner and a third person, with the other spouse or partner not being a party to the account. Community property funds may also be deposited in a Totten trust account by one spouse or partner for a beneficiary who is not the other spouse or partner or in a POD account where the POD payee is not the other spouse or partner. However, on the death of the spouse or partner who is the party to any of these accounts, the survivorship rights of the third person are subject to the nonparty spouse or partner's right to recover his or her one-half interest in the community funds if the transfer of funds to the account was made without the spouse or partner's written consent. Prob C §§100, 5020-5021; Fam C §§297.5, 1100(b), 1101(f). The surviving spouse or partner has the right to recover the funds even if he or she receives more than one-half of the total community property. *Estate of Miramontes-Najera* (2004) 118 CA4th 750, 13 CR3d 240. See also Prob C §102 on the right to compel restoration of quasi-community property, discussed in §4.35. Such rights of recovery may be asserted in a spousal or domestic partner property petition. Prob C §§13650-13660; see §7.3. If the

surviving spouse or partner does not assert such rights, he or she will be deemed to have made a taxable gift to the third party payee of half of the community funds deposited in the account. Treas Reg §25.2511-1(a). If the value of the gift exceeds the IRC §2503(b) annual exclusion amount, the surviving spouse or partner must either pay a gift tax or reduce his or her IRC §2505 gift tax applicable exclusion amount by the value of the gift.

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§7.33 B. Use of Multiple-Party Accounts in Estate Planning

Multiple-party accounts are a convenient alternative to providing for specific cash gifts in a will or trust. Such accounts permit the surviving party, payee, or beneficiary to receive without probate administration the balance of the sums deposited in them immediately on presentation to the financial institution of proof of the decedent's death. When privacy of a client's general estate plan is desired, the provision of cash gifts through the use of multiple-party accounts can be especially attractive in light of Prob C §16061.7. That section gives each heir of a settlor of a trust and each beneficiary of the trust the right on the settlor's death to receive a full copy of the trust instrument and written notice of that right. Prob C §16061.7(g). A client might not want a beneficiary of a cash gift to have access to the entire estate plan.

On the downside, the client must be diligent about maintaining multiple-party accounts for such purposes. In discussing the estate plan, counsel may find it advisable to make the client aware of the following:

- The client will have to monitor throughout his or her lifetime whether the joint account holders, payees, or beneficiaries continue to be objects of the client's dispositive plan. If not, the client must close or change some or all of the accounts.
- The client will also have to make sure that someone (such as the client's attorney) knows about the accounts so that the surviving parties, payees, and beneficiaries can be made aware of the accounts and the procedures for collecting the assets on the client's death.
- The client's records should reflect his or her contribution to each multiple-party account and its current value so that the client's personal representative can accurately account for them in the client's estate tax returns.
- Finally, the client's will or trust should state whether the residue of the client's estate will be responsible for death taxes on the multiple-party accounts or whether the surviving parties, payees, and beneficiaries will be responsible for them.

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§7.34 C. Joint Accounts

A joint tenancy bank account is an account payable on request to one or more of two or more parties, whether or not mention is made of any right of survivorship. Prob C §5130. A "joint account" may take any of the following forms:

- **Joint account with right of survivorship.** Prob C §§5301(a), 5302(a). This type of account is usually created with words to the following effect: "This account or certificate is owned by the named parties. On the death of any of them, ownership passes to the survivor(s)." Prob C §5203(a)(1). A joint account with a right of survivorship can be created between spouses with words to the following effect, and similar words may be used by registered domestic partners: "This account or certificate is owned by the named parties, who are husband and wife, and is presumed to be their community property. On the death of either of them, ownership passes to the survivor." Prob C §5203(a)(4); Fam C §297.5(c).
- **Joint account without right of survivorship.** This is a special type of joint account when there is clear and convincing evidence of an intent not to have survivorship. The terms of the account may include an express statement making clear that there is no survivorship right or the account may be designated as a "tenancy in common" account. See Prob C §§5302, 5306.
- **Joint account held by spouses or domestic partners with right of survivorship that cannot be changed by will.** This is a joint account held by spouses or registered domestic partners that is not specifically designated in the account agreement as a "community property" account and does not specifically state that there be no survivorship right. The statute creates a presumption that if the parties to an account are married to each other or are registered as domestic partners, whether or not they are so described in the deposit agreement, their net contribution to the account is presumed to be and remain their community property. Prob C §5305(a); Fam C §297.5. This presumption is rebuttable. See Prob C §5305(b). The rules in Prob C §§5301(a) and 5302(a) apply to this type of joint account, including the rule that the surviving spouse or partner's right of survivorship cannot be changed by will. Prob C §5305(c). However, if the terms of the deposit agreement or the account clearly show the intent that there be no survivorship right, either spouse or partner can designate one or more "pay on death" payees or Totten trust beneficiaries to take that spouse or partner's share of the account on his or her death. Without such a designation of payees or beneficiaries, the deceased spouse or partner's share becomes part of his or her estate.
- **"Community property" account of spouses or domestic partners.** This is a joint account held by a husband and wife or registered domestic partners that is specifically designated in the account agreement as a "community property" account. This type of account is governed by the rules that apply to community property generally. Prob C §5307. Accordingly, unless the parties have agreed otherwise, the right of survivorship of the surviving spouse or partner can be changed by will. Thus, the half share of a deceased spouse or partner may be left by will to a person other than the surviving spouse or partner. Also, the deposit agreement or the account agreement can include a provision that the half share of one spouse or partner will pass on that spouse or partner's death to one or more "pay on death" payees or Totten trust beneficiaries. Without a contrary agreement or a contrary disposition, the surviving spouse or partner will take the deceased spouse or partner's half share as community property. A community property account of husband and wife may be formed with words to the following effect, and similar words may be used by registered domestic partners (Prob C §5203(a)(5); Fam C §297.5):

This account or certificate is the community property of the named parties who are husband and wife. The ownership during lifetime and after the death of a spouse is determined by the law applicable to community property generally and may be affected by a will.

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§7.35 D. "Pay on Death" Property

A pay-on-death or POD bank account is an account that is (1) payable on request to one person during that person's lifetime, and on that person's death to one or more POD payees; or (2) payable to one or more persons during their lifetimes, and on the death of all of them to one or more POD payees. Prob C §5140. If one of the payees is not then living but is survived by issue and there is no express provision for survivorship among the multiple payees, the surviving issue of the deceased payee receives that deceased payee's share of the account. Prob C §§5302(b), 21110. A POD payee or beneficiary of a trust account becomes a party to the account only on surviving the original payee or trustee. Prob C §5136.

A POD account with a single party may be formed by words to the following effect: "This account or certificate is owned by the named party. On the death of that party, ownership passes to the named pay-on-death payee(s)." Prob C §5203(a)(2). Similarly, a POD account with multiple parties may be formed by words in substantially the following form: "This account or certificate is owned by the named parties. On the death of any of them, ownership passes to the survivor(s). On the death of all of them, ownership passes to the named pay-on-death payee(s)." Prob C §5203(a)(3).

A party to a "tenancy in common" account may designate a POD beneficiary to receive that tenant's share of the account on the tenant's death. Similarly, although the rights during lifetime and on death of the parties to an account expressly described as a "community property" account are governed by the law on community property generally (see §7.34), either spouse or registered domestic partner on the "community property" account can designate a POD beneficiary to receive that spouse or partner's half share of the account on the death of the spouse or partner.

POD property can also include securities (see §7.37), vehicles, and mobilehomes. See Prob C §§5500-5512 (Uniform TOD Security Registration Act); Health & S C §18102.2; Veh C §5910.5.

PRACTICE TIP: A POD bank account may be better than a joint account if the intent of the contributor is not to provide an immediate cash gift to a non-spouse beneficiary. Unlike a joint account, the beneficiary of a POD account has no rights to funds on deposit during the contributor's life. Thus, the contributor's assets in a POD account are not subject to the beneficiary's creditors during the contributor's lifetime. On the other hand, if the contributor wishes the beneficiary to have access to the account during the contributor's lifetime, *e.g.*, to be able to write checks against the account if the contributor becomes unable to do so, a POD account would not accomplish this purpose. A joint account with the beneficiary would provide the desired access. Alternatively, the contributor could give the beneficiary a limited power of appointment over the account during the contributor's lifetime.

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§7.36 E. Totten Trust Accounts

A Totten trust bank account is an account in the name of one or more parties as trustee for one or more beneficiaries. Prob C §80. The account is usually established by the nomenclature of the account and a deposit agreement with the financial institution at which it is established. For example, a bank account titled *Jane Smith, Trustee for John Jones*, is usually sufficient to create a Totten trust account. The assets in the account belong to the beneficiary (*e.g., John Jones*) on the death of the trustee (*Jane Smith*). A trust agreement is not required to create such an account. In fact, a Totten trust account is defined to specifically exclude a regular trust account under a testamentary trust or a trust agreement that has significance apart from the account. Prob C §80. On the death of the sole trustee or the survivor of two or more trustees of a Totten trust account, the person or persons named as beneficiaries receive any sums remaining on deposit in equal shares. Prob C §5302(c). If one of the beneficiaries is not then living but is survived by issue and there is no express provision for survivorship among the multiple beneficiaries, the surviving issue of the deceased beneficiary receive that deceased beneficiary's share of the account. Prob C §§5302(c), 21110.

PRACTICE TIP: A Totten trust bank account generally has the same advantages and disadvantages as a POD bank account. It is the author's belief, however, that if the contributor is concerned about the beneficiary's creditors, the language used to hold funds in a Totten trust would appear to give more rights to the beneficiary, and therefore to the beneficiary's creditors, than would a POD bank account.

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§7.37 F. Transfer on Death Securities

To encourage development of a title form for use by individuals that is effective for a nonprobate transfer of property at death in accordance with the directions of a deceased owner of a security, and to protect financial institutions using such title form, California has adopted the Uniform TOD Security Registration Act (Prob C §§5501-5512). The Act permits an individual to own securities for the benefit of another by using the words "transfer on death" (or "TOD") or "pay on death" (or "POD") after the individual's name and before the beneficiary's name in the registration instrument. Prob C §5505. The designation of a TOD beneficiary has no effect on ownership until the designating owner's death. Prob C §5506.

The provisions on TOD securities are similar to those for multiple-party accounts. But unlike multiple-party accounts, co-owners of a TOD security may not designate a death beneficiary or beneficiaries other than the person or persons who will take on the survival of all co-owners. See Prob C §5502. In other words, tenants in common and spouses owning a security as community property cannot designate different beneficiaries of their undivided interests in the security.

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G. Tax Aspects of Multiple-Party Accounts

§7.38 1. Gift Tax Aspects of Multiple-Party Accounts

If a party creates a multiple-party account for himself and another party, and the contributing party can regain the entire fund without the noncontributing party's consent, no taxable gift occurs on the creation of the account. Treas Reg §25.2511-2(b)-(c). A gift is made to the noncontributing party when that party withdraws funds from the account for his or her own benefit without any obligation to account for the withdrawn funds to the contributing party. Treas Reg §25.2511-1(h)(4). Presumably, if there is "clear and convincing evidence" of an intent to make an irrevocable transfer on the account's creation, a taxable gift would be made when the account was opened.

A noncontributing party's withdrawal of funds from a multiple-party account is not always deemed a taxable gift. If no gift was intended, the contributing party can trace the funds withdrawn into any property acquired by the noncontributing party. *Estate of Drucker* (1984) 152 CA3d 509, 199 CR 345, disapproved on other grounds in *Estate of Propst* (1990) 50 C3d 448, 462, 268 CR 114. This is true even if the noncontributing party would have received the funds in the account on the contributing party's death. See, *e.g., Estate of Tosh* (Wash App 1996) 920 P2d 1230. If no gift was intended by the contributing party, then presumably no gift tax is payable on the withdrawal. However, all or part of the property acquired with the withdrawn funds or, if not spent, the withdrawn funds themselves, are includable in the estate of the contributing party for estate tax purposes.

If the donee of assets from a multiple-party account is the contributing party's spouse, the gift should qualify for the unlimited marital deduction unless the donee is a noncitizen. If the donee is a noncitizen, the $128,000 (in 2008) annual gift exclusion available for present interest gifts to such a donee should mitigate the transfer tax consequences of the gift. IRC §2523(i)(2).

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§7.39 2. Estate Tax Aspects of Multiple-Party Accounts

A deceased party's net contribution in a multiple-party account at the time of death will be includable in that party's gross estate and be subject to estate taxes. IRC §§2033, 2037-2038, 2040. If the surviving tenant, payee, or beneficiary of assets in the multiple-party account is the contributing party's spouse, the transfer on death should qualify for the unlimited marital deduction unless the donee is a noncitizen. In the latter case, the noncitizen spouse can defer the estate tax on the transfer by transferring the funds received to a qualified domestic trust (QDOT). IRC §2056(d)(2)(B).

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§7.40 3. GST Tax Aspects of Multiple-Party Accounts

If the noncontributor in a creation or termination of a multiple-party account that is subject to gift tax is a "skip person" as that term is defined in IRC §2613, the creation or termination will be subject to GST tax as a direct skip. IRC §§2611(a), 2612(c)(1). Similarly, a distribution of all or a portion of a multiple-party account to a surviving party, payee, or beneficiary who is a skip person is also subject to GST tax. IRC §§2611(a), 2612(c)(1). For a discussion of GST tax generally, see chap 11.

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8

Noncharitable Inter Vivos (Lifetime) Gifts

Marshal A. Oldman

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§8.1 I. OVERVIEW OF INTER VIVOS GIFTS

One of the most fundamental estate planning goals is to pass property from its owner to the owner's spouse, if any, and ultimately to younger generation beneficiaries at the lowest possible tax cost. Although structuring property transfers at the owner's death is certainly the focus of most planning vehicles, the thoughtful practitioner should not overlook opportunities presented by various inter vivos gifts.

Inter vivos gifts have potential income tax as well as transfer (estate, gift, and generation-skipping) tax implications. See §§8.2-8.3. Non-tax considerations also play a major role in structuring lifetime gifts for estate planning purposes. See §§8.4-8.7. Accordingly, the estate planner must be alert not only to the tax implications of various transactions but also to the overall non-tax goals and wishes of the client. Too often the tax tail is allowed to wag the non-tax dog in this area, to the ultimate dissatisfaction of the client and his or her beneficiaries.

For some clients, inter vivos gifts will best suit their non-tax objectives. These clients usually have sufficient personal assets to enable them to make lifetime gifts without jeopardizing their own immediate and long-term financial security. Depending on the client's objectives and circumstances, a number of planning options are available. Among these are outright gifts (including gifts to a guardian or conservator) (see §8.25), gifts to a custodian under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) (see §8.26), and gifts in trust (see §8.21). The estate planner must be prepared to advise clients on the selection of the most appropriate gift vehicles, the assets to be given, and the most advantageous timing of the gifts.

Other clients, however, may be financially unable to make an outright gift of the asset. In such instances, a sale at full market value, or at a bargain price (see §§8.33-8.34) to a family member or other intended beneficiary may be appropriate. Such transfers can have both sale and gift elements, and therefore the structure of the transaction can have profound tax implications for both the transferor and the transferee. The practitioner must be aware at all times of these implications, especially because they are not always readily apparent from the face of the transaction.

Before implementing any of the gift mechanisms discussed in this chapter, the estate planner should carefully consider the personal and financial circumstances of both the donor and donee. Ascertaining the nature and character of the assets involved and the overall intentions of the parties entails a highly individualized planning process. Even considering the cost of this planning, inter vivos gifts can be useful for meeting both the tax and the non-tax objectives of a client.

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Source: Estate Planning/California Estate Planning/8 Noncharitable Inter Vivos (Lifetime) Gifts/ A. Tax Considerations for Inter Vivos Gifts/§8.2 1. Tax Advantages

A. Tax Considerations for Inter Vivos Gifts

§8.2 1. Tax Advantages

Lifetime gifts have a number of tax advantages. This is particularly true for older individuals whose estates will likely be subject to federal estate taxation. Gift planning for estates that exceed the applicable estate tax exclusion amount under IRC §2010 ($2 million for decedents dying in 2006-2008, increasing to $3.5 million for decedents dying in 2009) is an important vehicle for shifting wealth to younger generations, especially with the availability of the annual gift tax exclusion.

The first likely tax advantage of making an inter vivos gift is that some or all of the gift may not be subject to transfer tax. An individual may make gifts of $12,000 (in 2008) per year per donee without incurring gift tax liability and without having to file a gift tax return. IRC §2503(b). Over time, such gifts can transfer a significant portion of the donor's estate to the objects of his or her bounty without incurring transfer tax. Moreover, annual exclusion gifts generate no generation-skipping transfer (GST) tax when they are direct skips or gifts in trust for a single beneficiary. See IRC §2642(c). Gifts in the form of direct payments for school tuition and medical services are similarly exempt. See IRC §2503(e). On estate and gift taxes, see chap 10. On GST tax, see chap 11.

Interspousal gifts are a good means of assuring the donee spouse of an adequate estate with which to fully use his or her own annual exclusions, estate and gift tax applicable exclusion amounts, and generation-skipping transfer (GST) tax exemption. The gift tax marital deduction is unlimited when the donee spouse is a United States citizen (see IRC §2523(a)), and there is an inflation-adjusted annual gift tax exclusion ($128,000 in 2008) for gifts to a noncitizen spouse (see IRC §2523(i)(2)). On noncitizen spouses, see chap 16. On marital deduction strategies in general, see chap 17.

Inter vivos gifts can "freeze" the value of the transferred property as of the time of transfer for estate tax purposes. It is generally better to make a present gift of an asset having a current value of $100,000 than to pay estate tax on an asset that has appreciated to $200,000 or has produced income that has similarly increased the value of the transferred property for estate tax purposes. On valuation freezes, see chap 25.

Inter vivos gifts also allow the donor to structure the character of the estate that will comprise the donor's estate at death. Illiquid assets or assets difficult to value may be removed from the donor's estate. In fact, carefully planned inter vivos gifts may enable the donor's estate to take advantage of special use valuation (see IRC §2032A), the installment payment of estate tax (see IRC §6166), and stock redemption provisions (see IRC §303) by removing nonqualifying assets from the estate so that the various percentage tests required by these sections will be met. See chap 10.

An inter vivos gift of life insurance can achieve significant tax benefits because life insurance generally has a relatively low current value in the hands of the insured and for gift tax purposes, but may become a significant asset in the hands of the beneficiaries. Moreover, it is possible to obtain even greater advantages when such a gift is made through the use of an irrevocable insurance trust. See chap 19.

In addition to various transfer tax savings opportunities, inter vivos gifts can offer income tax savings because they generally relieve the donor of income tax liability attributable to the gifted property. Further savings can be achieved by shifting the taxation of income generated by the gifted property to individuals in lower marginal tax brackets.

Finally, although gift tax rates appear to be the same as estate tax rates, gift tax rates are actually much lower. This is because the tax on a gift is generally calculated by multiplying the rate by the net amount received by the donee (a "tax exclusive" calculation), whereas estate taxes are calculated by multiplying the rate by the value of both the net amount received by the donee and also the property required to pay the tax (a "tax inclusive" calculation). However, the IRC §2010(c) estate tax applicable exclusion amount exceeds the $1 million IRC §2505(a) gift tax applicable exclusion amount. Careful calculation will be required to determine whether the present cost of the gift tax on lifetime gifts in excess of that amount and resulting transfer of carryover basis will produce greater combined estate and income tax savings in the years before 2010, when stepped-up basis under IRC §1014 is considered.

WARNING: The primary reason most parents and other donors make annual gifts to children and other heirs is to take advantage of the annual gift tax exclusion and to remove assets, and more importantly, future appreciation in

those assets, from the donor's estate in order to minimize taxes paid at death. After the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), such gifts may continue to be advantageous because of income tax savings created by shifting income to persons in lower brackets. However, gifts made with the estate tax in mind may cease to be an important estate tax planning tool once the estate tax is eliminated by EGTRRA-2001 in 2010. Beyond that date, the "sunset" provision of EGTRRA-2001 may cause the return of the estate tax as if EGTRRA-2001 had never been passed. For discussion of EGTRRA-2001, see chap 10.

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§8.3 2. Tax Disadvantages

The most significant disadvantage of making inter vivos gifts, aside from incurring transfer tax for gifts over $12,000 (see §8.2), is the potential lost opportunity for acquiring a stepped-up cost basis for the gifted property at the donor's death. See chaps 10, 12. Thus, if a client owns property having a value greater than its current income tax basis (either because the value has increased or because the client has claimed depreciation deductions for income tax purposes), careful analysis is necessary before making that property the subject of an inter vivos gift.

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B. Non-Tax Considerations for Inter Vivos Gifts

§8.4 1. Present Transfer of Property

There are advantages to making lifetime gifts besides potential income and transfer tax savings. An inter vivos gift gives the donee immediate possession and enjoyment of the gifted property. Thus, children and other beneficiaries can use and enjoy the property without having to wait until the donor's death. The inconvenience and expense of probating assets of the estate of the donor, or otherwise administering the assets at death, can also be avoided.

Inter vivos gifts also allow a donor to observe how younger generation beneficiaries make use of substantial amounts of property in the future. For example, after making smaller lifetime gifts to a child or grandchild, a donor may be better able to evaluate how future lifetime or testamentary transfers should be made, whether outright or in trust, and what particular terms are appropriate. Inter vivos gifts may also avoid the loss of assets to unforeseen future creditors. But see CC §§3439-3439.12 (generally prohibiting transfers intended to evade creditors or that make the transferor insolvent).

Of course, the major drawback of gifting property is that the donor will be required to relinquish control of the gifted property. The donor also loses the income generated by the property, as well as losing the income from the funds used to pay any gift tax resulting from the gift.

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§8.5 2. Financial Circumstances of Donor

Gift planning must always take into consideration the loss of the present income to the donor and the potential risk to the donor's future financial security. Thus, before making a gift, future emergencies or investment opportunities must be considered, as well as any liquidity problems that may arise after the transfer of property from the donor to the donee.

When the donor has a modest estate, lifetime gifts usually will not play a major role in his or her estate plan. The donor will need the security of the property, its income, and any future appreciation for his or her own needs. Although the donor may want to make gifts to charity, or to children and grandchildren for their education or the purchase of a home, such gifts must be carefully balanced against the donor's needs to maintain his or her accustomed standard of living in the future.

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§8.6 3. Age of Donor

The significance of such factors as the permanent loss of control over property, the loss of present income, and the potential risk to future security is often related to the age of the donor. Generally, changes in family and financial circumstances are greater risks for younger persons than for older donors. Gifts that may be practical for a 60-year-old donor may be entirely inappropriate for a 30-year-old donor. The possibilities of serious financial setbacks or marital dissolution are generally much larger risks for a younger donor. In addition, the overall tax savings are much more speculative for younger clients due to possible changes in the tax laws.

An older person's age may make gifts less attractive, however, if the donor is not financially secure. Health problems and the lack of time to make up any financial losses with future earnings may weigh against gifts for older clients.

In certain circumstances, however, gifts are advisable for the younger client. Even if a younger person has only a moderate income, his or her age might allow partial use of the annual exclusion without jeopardizing financial security. Thus, young parents may wish to consider annual exclusion gifts as a means of accumulating educational funds for their children. Although it is impossible to establish a reliable rule of thumb, the uncertainties facing a young person should always be of paramount concern when considering gifts.

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§8.7 4. Other Considerations

Additional considerations in planning inter vivos gifts include the following:

- **Estate plan of donee**. It is unfortunate when the donee dies before the donor and the property on which gift tax has been paid (or the donor's gift tax applicable exclusion amount used) reverts to the donor. When any substantial gift program is undertaken, the practitioner should be mindful of the estate plan of the donee to avoid this problem.
- **Undesirable donees**. The gifted property may pass ultimately to a person whom the donor would rather not benefit; for example, a donee's spouse.
- **Unequal gifts**. Unequal inter vivos gifts can also create friction among family members and should be carefully planned to avoid family disharmony.
- **Ineligibility for public assistance or scholarships**. With respect to disabled donees or donees who are otherwise eligible for public assistance, gifted property may result in ineligibility for, or a reduction of, future public benefits. On Medi-Cal planning, see chap 30. Also, in a determination of need-based educational scholarships and loans, the criteria used at present will often result in a greater reduction of scholarship or loan amounts if assets are available in the student's own name rather than in the name of his or her parents.

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II. REQUIREMENTS FOR VALID GIFTS

A. Formal Requirements and Problems

§8.8 1. Elements of Valid Gift

In general, a gift is a transfer of property that is made voluntarily and without consideration. The following elements are necessary for a valid gift (*U.S. v Alcaraz-Garcia* (9th Cir 1996) 79 F3d 769; 13 Witkin, Summary of California Law, *Personal Property* §124 (10th ed 2005)):

- There must be an intent on the part of a donor having capacity to contract to make an unconditional gift;
- The donor's intent must be to make a present gift of the property (if the intention is to make a future transfer, there is no gift);
- There must be an actual or symbolic delivery of the gift, *i.e.*, the donor must relinquish control of the property; and
- The donee must accept the gift.

Delivery of the gift is complete when the donor delivers the gift to a third person who is acting on behalf of the donee, as long as the donor parts with dominion and control over the gift. Not only must the donor part with possession of the property, but he or she must also relinquish to the donee all present and future dominion and control over the gift, beyond any power on the part of the donor to recall it. Surrender must be full and complete so that if the donor should resume control over the property without the donee's consent, he or she will then be answerable in damages as a trespasser. *U.S. v Alcaraz-Garcia, supra*.

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§8.9 2. Transfer Without Change of Possession

A transfer of property must be accompanied by transfer of actual possession from transferor to transferee. If change of possession does not occur, the transfer will be considered a fraud. CC §3440. This rule applies to transfers of community property when the goods remain in the same place. *Pfunder v Goodwin* (1927) 83 CA 551, 257 P 119. A transfer of property made with actual intent to defraud is also void. CC §3439.04. On transfers in fraud of creditors, see §8.15.

Certain transactions are exempt from the change of possession requirement, such as sales under the UCC, transfers for the benefit of creditors, personal property not located within the state, and the like. See CC §3440.1 for a complete list.

What constitutes a change of possession is a question of fact, but the change must at least be actual and open. *Sequeira v Collins* (1908) 153 C 426, 95 P 876. Symbolic delivery, such as handing over the keys to a car, is insufficient. *Southern Cal Collection Co. v Napkie* (1951) 106 CA2d 565, 235 P2d 434. Constructive delivery also is usually insufficient. *In re Black & White Cattle Co.* (9th Cir 1986) 783 F2d 1454 (constructive delivery of healthy, ambulatory cattle insufficient to transfer possession).

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§8.10 3. Transfer by Deed or Other Instrument

A transfer by deed is only considered completed once the deed is actually delivered. See CC §1054. Delivery depends on the intention that title will pass irrevocably even though the right of possession and enjoyment is postponed to a future time. It is a question of fact, of evidence of the circumstances, and of the acts and declarations of the grantor. 13 Witkin, Summary of California Law, *Personal Property* §§126-131 (10th ed 2005).

Delivery may be either actual or constructive. Constructive delivery is presumed when (see *Hahn v Hahn* (1954) 123 CA2d 97, 266 P2d 519):

- By agreement of the parties it is understood to be delivered and the grantee is entitled to immediate delivery; or
- When it is delivered by the grantor to a stranger for the benefit of the grantee, and his or her assent is either shown or may be presumed.

To be a valid constructive delivery, delivery to a third person must be with the intent of the grantor to give up control; such delivery may be absolute, passing title at once, or it may be conditional. See 13 Witkin, Summary, *Personal Property* §131.

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§8.11 4. Transfer of Untitled Property

Untitled property includes movable personal property, *e.g.*, jewelry, furniture, personal effects, or any object that does not have documentation as to its title and ownership. The basic requirement of a valid delivery of property without title is that the donor give up dominion over the property; its control must pass to the donee or some third person not subject to the donor's direction. Retention of any control or right to use the property may be fatal to the gift. However, when actual delivery is impossible or impracticable, for example, when the object is not immediately available to the donor, there may be a valid delivery if the donor gives the means of obtaining possession or some symbol in place of the thing. A valid delivery may also be effectuated by delivery of a written instrument of the gift executed by the donor. However, delivery must be as complete as possible, so constructive or symbolical delivery may not be sufficient if actual delivery is practical. 13 Witkin, Summary of California Law, *Personal Property* §§126-131 (10th ed 2005).

The requirements for transferring untitled property are based on the need to protect the property from fraudulent claims of a gift by requiring evidence that the donor intended to part with his or her property. *Gordon v Barr* (1939) 13 C2d 596, 601, 91 P2d 101.

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§8.12 5. Gift in View of Impending Death

A "gift causa mortis" is made in contemplation of impending death, with the intent that it will take effect only in the case of death. It is revocable while the donor is alive. See 13 Witkin, Summary of California Law, *Personal Property* §134 (10th ed 2005). Because it is revocable, a gift is to be presumed causa mortis rather than inter vivos when made by a donor who is ill or in expectation of speedy death. It is not necessary that the donor expressly refer to his or her impending death. A sick person will often avoid such observations, or may hope for recovery in spite of the knowledge that his or her condition is critical. Therefore, "a gift made during the last illness of the giver, or under circumstances which would naturally impress the giver with an expectation of speedy death, is presumed to be a gift in view of impending death." Prob C §5703.

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§8.13 6. Gift in Contemplation of Marriage

Gifts made in contemplation of marriage are revocable if the marriage does not take place. CC §1590. The statute applies to either party to the contemplated marriage, and the gift is revocable when the donee refuses to marry or when the marriage is mutually abandoned. See 13 Witkin, Summary of California Law, *Personal Property* §154 (10th ed 2005). For example, a would-be spouse who had acquired real and personal property in the name of husband and wife under the expectation that he and his fiancée would soon be married was awarded all the property when his former fiancée failed to obtain a divorce from her previous husband and the two separated. *Shaw v Shaw* (1964) 227 CA2d 159, 38 CR 520. The statute also applies to gifts made in contemplation of the formation of a domestic partnership. See Fam C §297.5(a).

Although the statute does not specifically refer to what happens if the *donor* refuses to marry, it seems clear that the donor cannot set aside the gift: "the clear meaning of the quoted statute is that the donee of an engagement ring is entitled to retain possession thereof when the marriage contract is breached by the donor without any fault on the donee's part." See *Simonian v Donoian* (1950) 96 CA2d 259, 262, 215 P2d 119.

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§8.14 7. Community Property Consent

In California, a married person cannot make a gift of community personal property without the written consent of his or her spouse. Fam C §1100(b). In addition, a spouse may not sell, convey, or encumber community property such as the family house, furniture, or furnishings, or the clothing of the other spouse or children which is community property, without the written consent of the other spouse. See Fam C §1100(c). See also chap 4. A gift of community personal property by one spouse, without the consent of the other, is voidable by the non-consenting spouse unless a showing is made of ratification, waiver, or estoppel. See 13 Witkin, Summary of California Law, *Personal Property* §146 (10th ed 2005). The rule does not apply to mutual gifts to third parties or gifts given by one spouse to another. Fam C §1100(b).

WARNING: Community property law applies to property of registered domestic partners. See Fam C §297.5(a). Domestic partnership property acquired after the date of registration (see Fam C §297.5(k)(1)) is treated as marital property for all purposes affecting gifts of such property between domestic partners and third parties. However, a property agreement between domestic partners who registered before January 1, 2005, will be enforced if the agreement meets the requirements for a premarital agreement under Fam C §§1600-1620 and the agreement was fully executed and in force as of June 30, 2005. Fam C §297.5(k)(2).

When husband and wife acquire property by an instrument in which they are described as husband and wife, the presumption is that the property is community property. Fam C §760. See *Marriage of Cademartori* (1981) 119 CA3d 970, 174 CR 292. The community property presumption may be rebutted by tracing the source of the funds used to acquire the property to separate property. Fam C §2640. See *Marriage of Nicholson & Sparks* (2002) 104 CA4th 289, 294, 127 CR2d 882.

PRACTICE TIP: Because it is sometimes possible for a spouse to have acquired a community property interest in separate property, it is frequently prudent to obtain the written consent or joinder of the spouse even when making a gift of separate property.

On property transfer issues for married persons, see chap 4.

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§8.15 8. Transfers in Fraud of Creditors

Transfers made with the intent to defraud creditors are void as against every purchaser or encumbrancer for value of the property or the rent or profit gained from it. See CC §1227. Transfers in fraud of creditors are governed by the Uniform Fraudulent Transfer Act (CC §§3439-3439.11). Certain property is exempt from the Act. See CC §3439.01(a)(2). For a discussion of exempt property, see Debt Collection Practice in California, chap 9 (2d ed Cal CEB 1999).

Even in the absence of intent to defraud, every transfer of property made without fair consideration by which the transferor is or will be rendered insolvent is in fraud of the transferor's creditors. CC §3439.04(a). Insolvency is defined in CC §3439.02. A disclaimer by a beneficiary is not a fraudulent transfer under the Uniform Fraudulent Transfer Act. Prob C §283.

The following factors may be considered in determining actual intent to defraud (CC §3439.04(b)):

- Whether the transfer or obligation was to an insider.
- Whether the debtor retained possession or control of the property transferred after the transfer (see §8.9 regarding the surrender of possession as being a part of a gift).
- Whether the transfer or obligation was disclosed or concealed.
- Whether before the transfer was made or obligation was incurred the debtor had been sued or threatened with suit.
- Whether the transfer was of substantially all the debtor's assets.
- Whether the debtor absconded.
- Whether the debtor removed or concealed assets.
- Whether the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
- Whether the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- Whether the transfer occurred shortly before or shortly after a substantial debt was incurred.
- Whether the debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider of the debtor.

The personal representative of the decedent's estate has a duty to recover property transferred in fraud of creditors. Prob C §9653. This provision applies when the representative has insufficient assets to pay creditors, and the decedent either made a gift of the property in view of death (see §8.12) or made a conveyance of the property or an interest in it that is fraudulent under the Uniform Fraudulent Transfer Act.

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§8.16 9. Transfer to Drafter/Disqualified Person

The Probate Code prescribes strict limits on gifts made to certain individuals. This category includes the person who drafted the instrument or anyone who is related by blood, cohabitates with, or is an employee of the person who drafted the instrument. Prob C §21350. For a complete list of disqualified persons, see Prob C §21350. For a detailed discussion of gifts to drafters, see chap 2.

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§8.17 B. Competence and Freedom from Undue Influence

Problems of coercion and undue influence may exist when a gift is made, and the donative capacity of the donor may be brought into issue by litigation. Such problems are particularly liable to arise if the gift is a deathbed gift. See §8.12. Questions as to the validity of an inter vivos gift may involve allegations of duress (see CC §1569), menace (see CC §1570), fraud (see CC §§1571-1574), or undue influence (see CC §1575). For a detailed discussion of undue influence, see chap 3.

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Source: Estate Planning/California Estate Planning/8 Noncharitable Inter Vivos (Lifetime) Gifts/§8.18 C. Substituted Judgment

§8.18 C. Substituted Judgment

Substituted judgment, as codified under Prob C §§2580-2586, permits a court to authorize the transfer of estate property that a conservatee would have transferred himself had he or she been competent to act. Substituted judgment may be exercised when the purpose is to (Prob C §2580(a)):

- Benefit the conservatee or the estate;
- Minimize current or prospective taxes or expenses of estate administration; or
- Provide gifts to those who would be likely beneficiaries of gifts from the conservatee.

Thus, a conservator, with court authorization, may minimize taxes through such estate planning techniques as making gifts of principal or income from the estate, exercising or releasing a conservatee's powers as donee of a power of appointment, and creating revocable and irrevocable trusts of the property of the estate. Prob C §2580(b)(1), (3), (5). The conservator may make decisions and take actions consistent with the proper management and control of the estate.

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§8.19 III. TYPES OF GIFTS

There are a number of gift mechanisms available depending on the needs, circumstances, and goals of the potential donor and donees involved. Among these are outright gifts, gifts to guardians or custodians under the California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925), gifts in trust, and direct payment of tuition and medical expenses. In each situation, the estate planner must be prepared to advise clients on selecting the most appropriate means, the most suitable assets, and the most advantageous timing of any gift.

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§8.20 A. Outright Gifts

Outright gifts, or gifts that are not made by way of trust, include outright transfers of full ownership of an asset, as well as transfers of partial interests, such as legal life estates, remainders, and other present and future interests. Also included as an outright gift are transfers by a beneficiary of a interest in an existing trust, such as an assignment of an equitable life estate or remainder interest. An outright gift is the most appropriate vehicle when the donor wants the donee to have maximum freedom in controlling the property. For example, the donor may want the donee to invest gifted money in the donee's individual business or to sell or remodel donated residential property.

As with every type of gift, the estate planner must be certain that all of the elements of a gift are satisfied, *i.e.*, intent to make a gift, delivery of the gifted property, and acceptance of the gift. See §8.8. The estate planner should also bear in mind that there are many situations when a trust is a more appropriate vehicle for making substantial gifts. On gifts to trusts, see §8.21. See also chap 6.

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§8.21 B. Gifts in Trust

A trust is an entity that permits a trustor to transfer legal title to, and management of, property to one or more trustees for the beneficial purposes described in the trust instrument. Trust are either inter vivos (lifetime) or testamentary and may be revocable or irrevocable.

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§8.22 1. Tax Aspects

The transfer of income-producing assets to an irrevocable trust may result in net income tax savings, although the "income shifting" benefits of transfers to irrevocable trusts were diminished by the enactment of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085). Trusts are currently taxed at the highest income tax rates on all but a modest amount of income. See IRC §1(e). Additionally, the unearned income of a child under age 19 (24 in the case of a dependent student) in excess of an inflation-adjusted amount ($900 in 2008) is subject to the "kiddie tax" and is generally taxed at the parent's rate. See IRC §1(g).

Transfer taxes may be saved by transferring assets with significant appreciation potential to an irrevocable trust because transfer taxes are generally paid on the present value of the asset. Of course, such savings must be weighed against the benefit of preserving the stepped-up basis gained on appreciated property in the grantor's estate at the grantor's death.

A gift in trust, however, is usually a gift of a future interest and therefore generally fails to qualify for the $12,000 annual exclusion under IRC §2503(b). See Treas Reg §25.2503-4(c). To qualify for the annual exclusion, a gift must be of a "present interest" (IRC §2503(b)(1)), defined as an "unrestricted right to the immediate use, possession or enjoyment of property or the income from the property" (Treas Reg §25.2503-3(b)). Methods of qualifying for the annual exclusion, despite this restriction, include the use of a *Crummey* trust (see §8.27) or an IRC §2503(c) trust (see §8.28).

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§8.23 2. Non-Tax Aspects

A trust may give beneficiaries a large measure of control or enjoyment of wealth, or both, without causing them to be taxed as heavily as the outright owners of that wealth. Under a well drafted trust, beneficiaries may be given substantial control over the trust in various ways, and, thus, may enjoy many of the character-building and practical consequences of such control without incurring the full tax cost of ownership.

Trusts also give the beneficiaries a great variety of interests (present and future, vested and contingent, limited and absolute) without unduly hampering the management of the property transferred, and they provide management of property for beneficiaries who are incapable of doing so themselves. A trust leaves the determination of who will be a beneficiary, as well as the nature and dimensions of each beneficiary's interest, for future determination by persons or institutions who are chosen by the grantor and who are responsive to the grantor's views. This enables the grantor to enjoy the tax benefits of gifting property without losing effective control over the property given.

For a more detailed discussion of gifts in trust, see chap 6.

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§8.24 C. Gifts Benefiting Minors

Gifts to children, grandchildren, nephews, nieces, and other younger generation beneficiaries usually offer more income and transfer tax savings than do interspousal gifts. For example, a married couple's combined estate tax liability can be reduced by making regular inter vivos gifts to their children, rather than making gifts to each other and increasing the assets subject to tax in the donee-spouse's estate.

Inter vivos gifts to children, grandchildren, and others are also frequently made to provide the donees with an education or with professional training, to assist them in starting a business or other enterprise, or to enable them to purchase a new home. Frequently, these needs arise long before younger generation beneficiaries can expect to inherit property at the donor's death. Donors who are in a financial position to help younger generation beneficiaries at such critical times often find lifetime gifts useful for these and similar non-tax reasons.

However, if a donee is very young, he or she may not be mature enough to manage significant amounts of property received outright. The property may consequently be misused, wasted, or lost to the creditors of the minor, and defeat the purpose of the gift. Consequently, trusts and other mechanisms discussed below are typically used in making gifts to young donees to ensure that the donor's purposes are fulfilled.

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§8.25 1. Formal Guardianships

The traditional way to control an outright gift of property to a minor is through formal guardianship proceedings. See Prob C §§1500, 1510-1601. An outright gift to a minor who has a legally appointed guardian of his or her estate, or a gift to the guardian in such capacity, is considered to be a present interest and qualifies for the annual gift tax exclusion under IRC §2503(b). See *Beatrice B. Briggs* (1960) 34 TC 1132. Income generated by property held by a guardian is taxable to the minor. Treas Reg §1.641(b)-2(b). Because of the compressed rates that apply to income taxed to a trust (see IRC §1(e)), this usually provides an acceptable result despite the imposition of the "kiddie tax" (see IRC §1(g)) on investment income of children under age 19 being taxed at the marginal rates of the child's parent. See §8.22.

Legal guardianships, however, have a number of disadvantages. They require formal court supervision (Prob C §2102) and can be costly and unwieldy. Most importantly, a guardianship terminates at age 18 with the assets delivered to the minor at that time. See Prob C §1600. Although a guardianship may be necessary in certain situations (*e.g.,* when a minor has lost both parents and inherits a substantial amount of property outright), there are better planning vehicles (see §§8.26-8.30) for donors who simply wish to make comparatively modest inter vivos gifts to a minor.

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§8.26 2. Gifts Under California Uniform Transfers to Minors Act (CUTMA)

The California Uniform Transfers to Minors Act (CUTMA) (Prob C §§3900-3925) offers a number of planning opportunities for the donor wishing to make a gift to a minor without the imposition of a guardianship or trust. A donor may, under CUTMA, create a custodianship for inter vivos gifts that enables the custodian to pay the custodial property to the minor, or use it for the minor's benefit, without court order and without consideration of any person's duty to support the minor or of any other available income or property of the minor. See Prob C §3914(a).

CUTMA generally provides that the custodial relationship terminates when the child attains age 18, unless the period of custodianship is extended by the donor or unless the minor dies before age 18. See Prob C §3920. If the period is extended by the donor in the document of transfer, inter vivos gifts may be held until the donee attains age 21. Prob C §3920.5(e). Because the donee must receive the property at age 21, the gift will qualify for the $12,000 annual gift tax exclusion. See IRC §2503(b)-(c). See also Rev Rul 56-86, 1956-1 Cum Bull 449 (allowing annual gift tax exclusion under IRC §2503(b)-(c) for transfer to a similar form of custodianship).

A gift resulting from a testamentary gift or an irrevocable exercise of a power of appointment may extend the custodianship until the donee reaches age 25 if the extension is provided for in the document of transfer. Prob C §3920.5(c)-(d). An inter vivos custodial gift extending beyond age 21 would be considered a gift of a future interest and would generally not qualify for the gift tax annual exclusion. The statute creating custodial accounts, however, protects the donor from such a result because the custodianship will be considered to continue only until the minor attains the maximum age allowed by the statute (*i.e.*, an inter vivos custodial gift is valid, but the custodianship terminates at age 21). Prob C §3920.5(h). When the minor attains the applicable termination age, the custodian must deliver the gifted property to him or her. Prob C §3920.

PRACTICE TIP: If the minor dies before the specified termination age, the property is delivered to the minor's estate. Prob C §3920(c). The donor, therefore, should be aware of the donee's estate plan. For example, if the parents are the donors and do not want the property to return to their estates if the child dies prematurely, a trust that provides that the property passes to the minor's siblings may be a preferable alternative to a custodianship arrangement. Alternatively, a similar result could be achieved if the parents simply disclaimed their inheritance from the deceased child.

A custodianship under CUTMA may be created at the same time the property is transferred to the custodian. It may also commence at the occurrence of a future event, *e.g.,* as provided in a will, a trust, an insurance policy, or a pay-on-death account. In all instances, however, the language used in creating the custodianship, or in transferring the custodial property, must carefully follow the statutory requirements. See Prob C §§3903, 3909, 3920.5.

The designated custodian has the same rights, powers, and authority over the custodial property that unmarried adult owners have over their own property. Prob C §3913(a). The duties of the custodian are stated in Prob C §3912. The custodian's fiduciary obligations, including the duty to render an accounting if appropriately requested, are enforceable by the probate court. See Prob C §3919.

The restrictions on who can act as a custodian under CUTMA are generally not burdensome. See Prob C §3909(a). If a donor dies while serving as custodian, however, the transferred property may be included in his or her gross estate for federal estate tax purposes. See IRC §§2036, 2038.

PRACTICE TIP: Probate Code §3914(d), which allows the donor to reserve all distributive powers to the probate court, may well eliminate the potential estate tax problems of a donor-custodian; however, the effect of the section is subject to ongoing IRS and court interpretation. Therefore, if the potential estate tax liability is significant, a suitable third person should probably be chosen as custodian.

Certain custodial gifts may also have generation-skipping transfer (GST) tax implications if the transfer is made to a grandchild or other skip person. See chap 11.

Generally, the income from custodial property is treated as income of the minor for income tax purposes. If the minor

has not attained age 19 by the end of the tax year, some or all of the income may be taxed at the marginal rates of the minor's parent under the "kiddie tax." IRC §1(g). See §8.22. A potential exception to this rule may apply if the income is used to support the minor and discharges a parent's support obligation; in that situation, the income may be taxed to the parent. See Rev Rul 59-357, 1959-2 Cum Bull 212. Probate Code §3914(c) specifically states, however, that any payments by a custodian are in addition to, and not in substitution for, an obligation to support the minor. This provision may be sufficient to ensure that custodianship income is not taxed to the obligated person (and may presumably prevent adverse estate tax consequences). See Treas Reg §20.2041-1(c)(1). See also Drafting California Irrevocable Trusts §12.14 (3d ed Cal CEB 1997).

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§8.27 3. *Crummey* Trusts

Crummey trusts are used to obtain the annual gift tax exclusion while at the same time allowing the trust to continue for the benefit of the minor beyond age 21. See *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. The *Crummey* trust commonly gives the trustee discretion to pay to, or for the benefit of, the minor, amounts of income and principal the trustee considers appropriate until the age of distribution in the trust, but also allows the minor to withdraw specified assets from the trust. This withdrawal power of the minor creates a present interest in the property subject to the power, and, therefore, the transfer of that property qualifies for the annual gift tax exclusion. See IRC §2503(b); Rev Rul 73-405, 1973-2 Cum Bull 321.

Some donors may feel reluctant to give a minor a *Crummey* withdrawal power over trust property because of the risk that the minor will actually exercise the power and defeat the donor's objectives in creating the trust, *i.e.*, obtaining a present tax advantage while at the same time accumulating funds for the minor's future benefit. This risk can be minimized, however, by limiting the time period in which the power can be exercised (*e.g.,* to 60 days) and the amount of trust property subject to the power (*e.g.,* a maximum of $5000 contributed during the calendar year; see IRC §§2041(b)(2), 2514(e)). In addition, a minor will often be reluctant to exercise a withdrawal power out of concern that the donor may be disappointed.

For more detailed discussion of *Crummey* trusts and of requirements for obtaining the annual exclusion, see chap 10.

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§8.28 4. Section 2503(c) Trusts

Another type of trust that is used to obtain the annual exclusion is the IRC §2503(c) trust (often called a minor's trust), an alternative trust for minors that qualifies for the annual exclusion with regard to both corpus and income and allows the trustee discretion either to accumulate or to distribute income. See IRC §2503(c). To qualify for the annual exclusion, the trust must (see Treas Reg §25.2503-4):

- Permit both the trust corpus and income to be expended by the donee (or for the donee's benefit) before he or she becomes 21;
- Require any portion of the corpus or accumulated income not previously distributed to pass to the donee when he or she becomes 21; and
- Require any portion of the corpus or accumulated income not previously distributed to pass either to the donee's estate or as the donee appoints under a general power of appointment if the donee dies before attaining age 21.

If the trustee is given discretion to determine the amounts of income or corpus to be distributed for the minor's benefit and the purpose for which these expenditures are to be made, there is no resulting failure to satisfy the requirements of IRC §2503(c) unless the trust instrument imposes substantial restrictions on the exercise of this discretion. In addition, the annual exclusion is not lost merely because the minor is given the right, on reaching age 21, to extend the trust term. Treas Reg §25.2503-4(b). If by its terms the trust is to continue beyond that age, it will also qualify for the annual exclusion if the minor after reaching age 21 has a continuing right, or a right during a limited period, to compel immediate distribution of the trust corpus. Rev Rul 74-43, 1974-1 Cum Bull 285.

For more discussion of IRC §2503(c) trusts, see chap 10.

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§8.29 5. Sprinkling Trusts

The "sprinkling" or "spray" trust, in which the trustee or trustees are given the power to determine how the trust's income or principal, or both, are to be allocated among a group of specified beneficiaries or within a designated class of beneficiaries, is a popular device used often in regard to minor beneficiaries. The advantages are the flexibility permitted in distributing income or principal to those beneficiaries who need it most. However, the GST tax requires caution in the establishment of sprinkling trusts. The power to establish or alter the beneficial enjoyment of the income or corpus of the trust makes the trustee one of the persons whose death or other relinquishment of power or interest triggers the GST tax, unless the only permissible recipients of the sprinkling power are lineal descendants of the settlor who are of a generation younger than the trustee. See IRC §2612. See also chap 11.

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§8.30 6. State Tuition Programs

Gifts to qualified state tuition programs (QSTPs) receive special tax treatment under IRC §529. Such gifts qualify for the annual gift tax exclusion even though they are generally gifts of future interests. Contributions to a QSTP are not considered qualifying transfers under the rules providing an unlimited annual exclusion for payments of educational and medical expenses. Instead, they are subject to the regular annual gift tax exclusion. IRC §529(c)(2).

A donor making a gift in excess of the annual exclusion limit may elect to have the contribution treated as if it were made over 5 years. IRC §529(c)(2)(B). Thus, the amount that can be claimed in the current year is five times the annual exclusion amount; however, this is an "advance" that results in no annual exclusions being available in subsequent years until, in effect, the advance is repaid. If the donor fails to survive that period of time, the amount of the advance remaining unpaid is included in the donor's estate. IRC §529(c)(4)(C).

Section 529 qualified tuition programs include private institutions under specified circumstances. See IRC §529(e)(5). Gifts to qualified state tuition programs may be coordinated with other educational tax benefits. See IRC §529(c)(3)(B)(v)-(vi).

Under proposed regulations, a donor who establishes an IRC §529 account may select among different investment strategies designed by the program, but only at the time the initial contribution is made. Prop Treas Reg §1.529-2(g). For further discussion, see chap 21A.

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D. Pseudo-Gifts

§8.31 1. Totten Trusts

When a depositor opens a bank account in his or her name in trust for another person, reserving the power to withdraw funds during the depositor's lifetime, a tentative trust is created, which is revocable during the depositor's lifetime, and which at his or her death becomes, presumptively, an absolute trust. Only the depositor has the right to withdraw from the account. The beneficiary is entitled to the balance on deposit at the depositor's death. If the beneficiary dies first, the trust is terminated. See *In re Totten* (1904) 179 NY 112, 71 NE 748. No gift tax is due on creation of a Totten trust; however, the funds in the trust are subject to federal estate tax in the donor's estate. The Totten trust is now generally upheld both as to bank and savings and loan association accounts, either by case law or statute. See Prob C §5302.

Drawbacks to using this type of account include the fact that creditors of the depositor can reach the fund. See Restatement (Third) of Trusts §26 (2003). In addition, a surviving spouse may attack the trust to the extent necessary to protect his or her statutory intestate share in the depositor's estate. But see *Estate of Allen* (1993) 12 CA4th 1762, 1766, 16 CR2d 352 (omitted spouse not entitled to include Totten trust account in computing statutory share because account was not part of testator's estate at time of death). Also, the guardian or conservator of an incompetent depositor must apply to the court for permission to revoke the trust when the funds are necessary for the ward's or conservatee's welfare. See *Katz v Greeninger* (1950) 96 CA2d 245, 215 P2d 121.

For further discussion of Totten trusts, see chap 7.

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§8.32 2. Joint Financial Institution Accounts

The creation or the termination of a joint interest may be considered a completed gift for gift tax purposes. For married joint owners, such transactions are generally free from gift tax consequences due to the unlimited marital deduction for qualifying gifts to the donor's spouse. See §8.2. On marital deduction strategies, see chap 17. Any gift resulting from the termination of a joint tenancy will qualify for the deduction if the spouses become tenants in common or if one spouse becomes the sole owner.

If the joint owners are not married to each other, however, the creation of the interest generally is a completed gift for gift tax purposes unless each of the owners furnishes consideration for the acquisition of the property in proportion to the value of his or her respective interest. See Treas Reg §25.2511-1(h)(5).

EXAMPLE: If *A* and *B* buy stock for $10,000 as joint tenants, each has a one-half interest and should pay $5000 of the total cost. If instead *A* pays $6000 and *B* pays $4000, *A* is making a gift to *B* of $1000 (the difference between the value of *B*'s one-half interest and the amount he paid for the stock). Westfall & Mair, Estate Planning Law and Taxation §3.04 (4th ed 2001).

A donor may not always want to give away the complete ownership of a particular asset, either because he or she wishes to retain some association with or control over the property, or because the whole property is too large to pass without a significant gift tax. Instead, the donor may choose to give away a partial interest in the property by making the donee a concurrent owner of the asset, using a joint bank account, joint ownership of savings bonds or treasury bills, or a tenancy in common. Tax considerations are often important in making such gifts.

Joint bank accounts offer the advantage of allowing the sole depositor of funds to withdraw his or her contributions without the consent of the other joint owners. The creation of such an account is not a completed gift and is not subject to gift tax until the non-contributing joint owner withdraws assets from the account. See Treas Reg §25.2511-1(h)(4).

United States savings bonds and treasury bills may be registered by the buyer in a joint form, such as "*A* and *B* jointly," but the buyer has the right to re-register the bond in his or her name alone. Therefore, an individual who buys a savings bond and takes title to the bond as "*A* and *B* jointly" has not made a completed taxable gift until the bond is re-registered solely in the name of the donee or the proceeds are paid to the donee at redemption. See *U.S. v Chandler* (1973) 410 US 257, 35 L Ed 2d 247, 93 S Ct 880. Similarly, a purported gift or inheritance of an equitable ownership interest in a savings bond is ineffective as against the estate of the registered owner or the surviving co-owner. See *Free v Bland* (1962) 369 US 663, 8 L Ed 2d 180, 82 S Ct 1089; *DeSantis v Prothero* (Pa Super 2007) 916 A2d 671.

Another option is to make a gift of a tenancy-in-common interest, which represents the concurrent ownership of a single asset by two or more persons without any additional rights or benefits not usually associated with sole ownership. See CC §§682, 685-686. Each co-owner of a tenancy in common owns and may transfer an undivided fractional interest in the property, by lifetime gift or sale, or at death, without the consent of the other co-owners. No co-owner has an automatic right of survivorship in another co-owner's interest in a tenancy in common.

For more on joint tenancy accounts, see chap 7.

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3. Indirect Gifts

§8.33 a. Bargain Sales

Sales offer a way to move wealth into the hands of a beneficiary (or into a trust for his or her benefit) without making a gift for purposes of the gift tax. A properly planned outright sale does not result in a taxable gift by the seller because it represents a transfer of property for full and adequate consideration in money or money's worth. A bargain sale, on the other hand, is designed to create a part-sale/part-gift.

A bargain sale involves the transfer of property for less than the property's fair market value. The buyer may pay all cash or give the seller an installment note (in which situation any gain on the sales portion of the bargain sale may be reported under installment sales rules). Bargain sales remove all future appreciation in the value of the property from the seller's taxable estate immediately, freezing the value of the seller's interest at the amount of consideration received on the transfer. Bargain sales also permit the seller to transfer an asset to a buyer who lacks sufficient funds to buy it for its full fair market value, thereby making a partial gift. In addition, a seller who cannot quite afford to part with all of the income produced by the property can replace the income with the income derived from investments made with the limited sales proceeds. The seller will recognize a smaller taxable gain on a bargain sale than on a sale for full and adequate consideration. Of course, a bargain sale may also be a taxable gift, but the seller's gift tax liability may be reduced by the gift tax annual exclusion or marital or charitable deductions, and current tax payment may be avoided through the seller's gift tax applicable exclusion amount.

The following example illustrates a bargain sale as both a taxable gift and a sale.

EXAMPLE: A son wishes to buy $200,000 worth of closely held stock from his father, but the son has only $150,000 to spend. The father agrees to sell the shares to his son for $150,000. Father's adjusted basis in the stock is $50,000. The transfer is a $50,000 taxable gift, determined by the difference between the value of the stock and the amount of consideration paid ($200,000 − $150,000 = $50,000). The transfer is also a sale on which the father recognizes a $100,000 gain, determined by the difference between the purchase price and the father's adjusted basis ($150,000 − $50,000 = $100,000).

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§8.34 b. Below-Market Interest Rate Transactions

For years, estate planners used the interest-free or below-market demand loan as a means of shifting income and wealth from a high-bracket lender to a low-bracket borrower without surrendering control over the loaned funds. The 1984 case of *Dickman v Commissioner* (1984) 465 US 330, 79 L Ed 2d 343, 104 S Ct 1086, however, established the modern estate planning principle that the failure to charge a market rate of interest for the use of money is a taxable gift by the lender to the borrower. Chief Justice Burger noted that "the gift tax was designed to encompass all transfers of property and property rights having significant value"; therefore, the below-market use of money is "a valuable interest in the money lent" and is a taxable gift. 465 US at 337, 79 L Ed 2d at 350. Internal Revenue Code §7872 sets forth rules imputing interest income on these types of loans. Under the statute, the parties to most below-market, intrafamily loans are treated as if the lender had charged a market rate of interest, the borrower had paid it, and the lender had then given it back to the borrower.

Although IRC §7872 frustrates most uses of below-market demand loans to shift income, there is some tax-saving potential. Although the difference between the charged rate and the applicable federal rate will be imputed as a gift to the borrower, two notable exceptions apply:

Loans under $10,000. No interest will be taken into account for either gift or income tax purposes if the aggregate amount of loans outstanding on any day between the same borrower and lender do not total more than $10,000. IRC §7872(c)(2), (3). This is commonly referred to as the "de minimis" exception.

EXAMPLE: If a lender lends $5000 to a borrower on a demand basis on January 1, and another $5000 on July 1, and yet another $5000 on September 1, interest is imputed to the lender from September 1 through December 31.

This exception applies to loans under the California Uniform Transfers to Minors Act (CUTMA) (see §8.26), but not to loans to a trustee of a trust in which a minor child is the sole beneficiary. See Prop Treas Reg §1.7872-8(a)(2).

Intrafamily loans. There is a $100,000 exception for intrafamily or non-investment loans that are not designed to shift taxable income. See IRC §7872(d). Under this exception, if one individual's loans to another individual total less than $100,000, and if tax avoidance was not one of the primary purposes of the loan, the amount of interest imputed to the lender cannot exceed the combined annual net investment income of the borrower and the borrower's spouse. This exception applies only to loans between individuals, and loans entered into by spouses must be aggregated because spouses are treated as one person under IRC §7872(f)(7). Prop Treas Reg §1.7872-11(c). The borrower of a below-market intrafamily loan is deemed for gift tax purposes to have paid interest to the lender, so the borrower may deduct that amount for income tax purposes.

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§8.35 4. Cancellation of Indebtedness

Generally, the cancellation or reduction of indebtedness results in taxable income to the debtor. However, under certain circumstances, a cancellation may be made as a gift, thus allowing the debtor to exclude that amount from his or her income. IRC §61(a)(12). For example, when a shareholder gratuitously cancels a debt owed to him or her by the corporation, the transaction amounts to a contribution of capital to the corporation to the extent of the amount of the principal of the debt. Treas Reg §1.61-12(a). Also, voluntary contributions from a shareholder to a corporation of which the shareholder and his or her family are the sole shareholders are a gift subject to gift tax.

When a corporation cancels a shareholder's debt, the question arises whether the debt forgiveness constitutes compensation for services, a dividend, or a gift. The answer depends on the facts of each case, but ordinarily a discharge of indebtedness results in income in some form rather than a gift. Although the cancellation of indebtedness is ordinarily considered income to the debtor, in the case of a debtor who is insolvent or in bankruptcy proceedings, cancellation of indebtedness income may be excluded from gross income. See IRC §108(a)(1)(A).

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§8.36 E. Interspousal Gifts

The gift tax marital deduction is unlimited and is applied to the full value of all outright interspousal taxable gifts to a spouse who is a United States citizen. IRC §2523(a). If the donee spouse is not a citizen, there is no marital deduction, but the donor receives an annual exclusion, in an amount adjusted annually ($133,000 in 2009), for gifts to the noncitizen spouse. See IRC §2523(i)(2).

While domestic partners are treated substantially as spouses under California law (see Fam C §297.5), the marital deduction will not be available to shelter transfers between domestic partners from either gift or estate tax. Under the federal Defense of Marriage Act (Pub L 104-199, 110 Stat 2419), the term "spouse" as used in the Internal Revenue Code is limited to "a person of the opposite sex who is a husband or wife." 1 USC §7. In addition, community property of domestic partners will not be entitled to a full step-up in basis for federal income tax purposes. Under IRC §1014(b)(6), the step-up in basis applies to "the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any state." Thus, the full step-up in basis applies only to community property held by "spouses" as defined in the Act. However, a surviving domestic partner may be entitled to the full step-up in basis for state income tax purposes. Although IRC §1014(b)(6) is incorporated by reference in Rev & T C §18031, registered domestic partners will be "treated by California law as if federal law recognized a domestic partnership in the same manner as California law." Fam C §297.5(e).

The importance of the gift tax marital deduction is that it assures the donee spouse sufficient assets with which to make his or her own gifts, fully using his or her own gift tax annual exclusion amount, annual exclusions, and GST tax exemption because gifts to the donee spouse may enable him or her at a later date to make separate gifts to the same donees to whom the donor spouse has chosen to make gifts. On various marital deduction gift strategies including gifts to a qualified terminable interest property (QTIP) trust, see chap 17.

No gift tax return is required for an interspousal gift qualifying for the gift tax marital deduction, other than certain gifts in trust when an election is required to qualify the marital gift as a qualifying income interest in trust. See chap 17.

PRACTICE TIP: It is important for spouses to document gifts to each other. As long as there is proper documentation, it is relatively easy to prove that an interspousal lifetime gift took place. Proper documentation of the date of transfer is especially important in deathbed transfers to a spouse.

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§8.37 F. Generation-Skipping Gifts

The generation-skipping transfer (GST) tax is imposed on gifts to persons in a generation at least two generations below that of the donor. See IRC §2613(a), defining "skip" person. For example, the tax is usually imposed on a donor's lifetime gifts to his or her grandchildren or more remote relations, or to trusts for their benefit. The purpose of the tax is to prevent the use of certain long-term trusts and other devices to apportion the benefits of property among members of several generations, while avoiding estate or gift taxes on all but the first and last generations. Lifetime gifts, whether made directly to skip persons or to trusts under which they are beneficiaries, can avoid the GST tax in many of the same ways that lifetime gifts can reduce a donor's ultimate estate taxes.

Each individual has a lifetime GST exemption equal to the IRC §2010 estate tax applicable exclusion amount ($2 million in 2006-2008, $3.5 million in 2009), which may be used to offset the tax on lifetime or testamentary generation-skipping transfers. See IRC §2631. To the extent that the donor does not exhaust the exemption to reduce the taxation of gifts, it is available to reduce his or her GST tax on testamentary transfers.

The GST tax exemption is important in planning gifts to skip persons because it allows donors to make relatively large gifts without paying any current GST tax. Many donors who would otherwise make larger generation-skipping transfers avoid doing so out of concern that they will exhaust their GST tax exemption and increase their future tax liabilities. However, the opposite type of planning is advised.

Generation-skipping transfers enable the donor to remove large amounts of property from his or her GST tax base. The earlier these gifts are made, the larger the potential tax savings because the greater the amount of appreciation that can be shifted. Therefore, a donor who makes a gift to a grandchild of $1 million worth of appreciating assets (the amount exempt from gift tax under IRC §2505) 20 years before his or her death can shift appreciation for 20 years, while a donor who makes such a gift only 2 years before his or her death can shift appreciation for only 2 years.

In addition, a donor may give away virtually any amount of property without incurring a GST tax liability, reducing the available GST tax exemption, or being required to file a GST tax return, as long as the gifts are all within the annual exclusion limitations. For a detailed discussion of the GST tax, see chap 11.

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9

Powers of Appointment

Richard S. Aiello

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§9.1 I. INTRODUCTION

A power of appointment is a power to direct the disposition of property. The power may be created by will, deed, trust, or other instrument. Depending on the nature of the power, the donee of the power may be treated as the owner of the property for income, estate, and gift tax purposes. For the basic rules and definitions, see §§9.2-9.5.

A power of appointment can be used to accomplish many objectives, including the following:

- To enable the donee to make a later decision about the ultimate disposition of the property subject to the power, taking into account the beneficiary circumstances and tax laws as they exist at some time in the future.
- To allow the donee to accomplish his or her own dispositive objectives as opposed to those of the donor.
- To save taxes.

Powers of appointment are particularly helpful in this day of long-term (dynasty) trusts that exploit the generation-skipping transfer (GST) exemption and try to keep property outside of the transfer tax system as long as possible. Powers generally increase flexibility, something that will be important as these trusts age.

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§9.2 A. Basic Rules

With certain exceptions, a general power of appointment is a power over property that is exercisable by the powerholder in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. IRC §§2041(b), 2514(c). A nongeneral or limited power of appointment is a power of appointment that is not a general power. The rules for distinguishing between general and limited powers of appointment are discussed in §§9.6-9.24.

Property subject to a general power of appointment held by the powerholder at death is included in the estate of the powerholder. IRC §2041(a)(2). The exercise or release of a general power of appointment during the powerholder's lifetime is a transfer of the property subject to the power. IRC §2514(b). The exercise or release of a power subject to estate and gift tax also causes the powerholder to become the transferor of the property for generation-skipping transfer (GST) tax purposes. IRC §2652(a).

Property subject to a general power of appointment is generally treated as owned by the powerholder for income tax purposes if the power is held by a single individual who is currently able to vest income or principal in that individual. IRC §678.

Estate and gift taxation of powers is discussed in §§9.25-9.33. Income taxation of powers is discussed in §§9.34-9.36.

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§9.3 B. Powers Created on or Before October 21, 1942

Special rules apply in the case of powers created on or before October 21, 1942, and practitioners must review those rules closely if clients have any such powers. IRC §2041(a)(1). Some of the following discussion applies equally to these powers, but this chapter focuses on powers of appointment created after October 21, 1942. IRC §2041(a)(2).

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§9.4 C. Retained Powers Excluded

This chapter is limited to powers created by a person other than the powerholder, which are governed by IRC §§2041 and 2514. It generally does not address powers that have been retained by a settlor of a trust, which are governed by different rules. See IRC §§2036-2038. Retained powers are not governed by IRC §§2041 and 2514. Treas Reg §§20.2041-1(b)(2), 25.2514-1(b)(2).

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Source: Estate Planning/California Estate Planning/9 Powers of Appointment/§9.5 D. Probate Code Definitions

§9.5 D. Probate Code Definitions

For purposes of this chapter, a power of appointment is a power created by a person other than the holder that enables the holder to dispose of property that is not owned by the holder in an individual capacity. The chapter will use the more or less traditional definitions found in Prob C §§610-613.

- The "donor" is the person who creates a power.
- The "donee" (or "powerholder") is the person who holds the power.
- The "appointive property" is the property subject to the power.
- A "permissible appointee" is a person in whose favor the power can be exercised (also called an "object").
- An "appointee" is one in whose favor the power is exercised.
- A "general power" is one defined as such by nearly identical terms in IRC §§2041(b)(1), 2514(c) (see §9.6).
- A "special power" (or "limited power") is any power that is not a general power.
- A "testamentary power" is a power that is exercisable only by will.

Planners may wish to use less technical terms in documents and client discussions. However, statutorily defined terms generally should not be used in documents to mean something else. For example, "testamentary power" should not be used to describe a power exercisable at death other than by will. Drafting considerations for express powers are discussed in §§9.37-9.49.

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§9.6 II. GENERAL POWER OF APPOINTMENT

Under IRC §§2041(b)(1) and 2514(c), a power to appoint property that may be exercised in favor of the powerholder (or the estate, creditors, or creditors of the estate of the powerholder) is a general power of appointment, unless the power satisfies one of the following conditions:

- The power is limited by an ascertainable standard;
- The power is held jointly with the creator of the power; or
- The power is held jointly with an adverse party.

If a power may be exercised in favor of any one of the four categories of potential beneficiaries, it is a general power of appointment. *Estate of Rebecca Edelman* (1962) 38 TC 972. Except for the powers listed above, jointly held powers are not excluded. Powers held in a fiduciary capacity are also not excluded. Therefore, a general power may be created if a potential beneficiary of a trust is able to exercise trustee powers.

PRACTICE TIP: If an existing document inappropriately includes prohibited beneficiaries among the group of potential appointees, consider the possibility that the inclusion was merely a scrivener's error that can be corrected by a petition to reform the document. See IRS Letter Rulings 200450033, 200024015.

Any power that excludes all four categories of potential beneficiaries is not a general power. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1). Therefore, a power exercisable in favor of the powerholder's issue (unless the powerholder owes them a duty of support) is not a general power. Indeed, a power exercisable in favor of anyone else is not a general power, despite the fact that many clients might consider it exceedingly broad.

Powers that are general powers are further discussed in §§9.7-9.12. Powers in favor of the powerholder that are not general powers are discussed in §§9.13-9.24.

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§9.7 A. Power to Appoint to Creditors

A power to appoint to one's own creditors is a general power because it effectively permits the holder to expend funds for the holder's own purposes without limitation. The mere fact that a potential beneficiary may also be a creditor of the powerholder does not suffice to make a power a general power. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1). However, a spendthrift provision does not suffice to keep a power from being a general power. *Wilson v U.S.* (ED Pa 1966) 254 F Supp 822, rev'd on other grounds (3d Cir 1967) 372 F2d 232.

It may be argued that the creditors of a person's estate are to be distinguished from the creditors of the person. Otherwise, there would be no reason to include both categories in the list. Although the regulations specify that a power exercisable to meet estate taxes or any other taxes, debts, or charges enforceable against an estate is a power exercisable in favor of a person's estate, creditors, or creditors of the estate, they do not give any example of what constitutes solely a creditor of the estate. If creditors of the estate include only those with whom the estate's personal representative incurs debts rather than everyone to whom the decedent owed money at death, it seems possible to draft a power of appointment that is general for tax purposes but practically quite limited. On the other hand, if creditors of the estate include those to whom the powerholder owed money at death and not merely those who advance funds to the estate after the powerholder's death, the power is practically unlimited. See Prob C §682(b).

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§9.8 B. Power to Discharge Support Obligation

Although exclusion of the listed beneficiaries should suffice to avoid creation of a general power, there is some danger that a power could still be considered general if the powerholder owes a duty of support to the potential beneficiary and may exercise the power in order to discharge that duty. A power exercisable for the purpose of discharging a legal obligation of the powerholder constitutes a power exercisable in favor of the powerholder or his or her creditors. Treas Reg §§20.2041-1(c)(1), 25.2514-1(c)(1).

Therefore, in addition to excluding the listed beneficiaries, it may be best to provide expressly that no exercise of the power will discharge any duty of support owed by the powerholder. In other words, drafters may not want to rely exclusively on the saving provision of Prob C §16082. See §§9.9-9.10.

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§9.9 1. Effect of Statutory Saving Provision

California has tried to lessen the danger of an inadvertent general power by providing that, except as otherwise specifically provided in the trust instrument, a powerholder may not use any power to appoint or distribute income or principal to or for the benefit of others to discharge his or her own legal obligations. Prob C §16082. The statute may not prevent the IRS from finding, however, that a parent has a general power of appointment over property held as a custodian. See §9.10.

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§9.10 2. Power Over Property Held as Custodian

The IRS has taken the position that parents who hold property as custodians for their minor children hold general powers of appointment over the property if the property can be used for items generally considered to be within a parent's support obligation. GCM 37299 (Oct. 21, 1977). Probate Code §3914(a) permits use of custodial funds for support, and the optional rule in Prob C §3914(d), requiring court authorization for support payments, is only available when the custodian is the transferor.

NOTE: The protection provided to powers over trust property by Prob C §16082 (see §9.9) would not seem to extend to property held in custodianships, which is governed by a completely separate part of the statute. Prob C §§3900-3925.

It is not clear whether there is a lapse of the general power when the child attains majority and the custodianship ends. However, there do not appear to be any rulings on this question, indicating no desire by the IRS even to consider it.

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§9.11 C. Power to Remove Trustee

A potential beneficiary of a trust may be considered to have a general power of appointment over trust property if the beneficiary has the power to remove the trustee and the trustee has the power that would be a general power if held by the beneficiary. See §§9.22-9.24. Understandably, if a person has power to remove a trustee and take over the job himself or herself, that person is deemed to have the same powers as the trustee. Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1). The IRS has ruled that even the power to remove a trustee and fill the vacancy with someone other than oneself may cause the powers held by the trustee to be attributed to the powerholder unless the vacancy can be filled only by a third party who is not related or subordinate to the powerholder. Rev Rul 95-58, 1995-2 Cum Bull 191; IRS Letter Rulings 9831005, 9607008.

NOTE: The concept of "related or subordinate" comes from the income tax law and is not something with which estate tax lawyers may be familiar. With respect to a trust, the phrase generally means a settlor, his or her spouse, father, mother, issue, brother, sister, or employee, a corporation or any employee of a corporation in which the stock holdings of a settlor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which a settlor is an executive. IRC §672(c).

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§9.12 D. Power Held Jointly With Nonadverse Party

A power held jointly with someone other than its creator or a person with a substantial, adverse interest (see §§9.16-9.21) is a general power, and the powerholders who are permissible beneficiaries will be treated as joint owners of the subject property. Therefore, if only one of the powerholders is a permissible beneficiary, his or her general power applies to all of the property.

PRACTICE TIP: When the client wants an individual to have a general power for tax purposes without giving him or her too much real power, the drafter might consider giving that person and a nonadverse party a joint power (requiring the concurrence of both holders) to appoint in favor of that individual's estate.

If there are multiple powerholders, if the subject property may be appointed in favor of more than one of the powerholders, and if the power does *not* continue after the death of one of them, each of the permissible beneficiaries who is also a powerholder has a general power over his or her aliquot share of the property. Treas Reg §§20.2041-3(c)(3), 25.2514-3(b)(3). If the power continues, the powerholders are adverse parties. See §9.19.

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III. NONGENERAL POWERS

§9.13 A. Power Limited by Ascertainable Standard

A power to consume, invade, or appropriate property for the benefit of the powerholder is not a general power of appointment if it is limited by an ascertainable standard relating to the health, education, support, or maintenance of the powerholder. IRC §§2041(b)(1)(A), 2514(c)(1).

A power is limited by an ascertainable standard if the extent of the powerholder's duty to exercise and not to exercise the power is reasonably measurable in terms of his or her needs for health, education, or support (or any combination thereof), with support and maintenance being synonymous. Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2).

PRACTICE TIP: If an existing document fails to limit the exercise of a power by an ascertainable standard when a general power of appointment would be inconsistent with the general estate plan, either by including prohibited language or by omitting the limitation entirely, consider the possibility that the failure was a scrivener's error that can be corrected by a petition to reform the document. See IRS Letter Rulings 200043036, 200024015, 199942016, 199936029.

The standard allowed by the regulations is quite broad. Support can be in reasonable comfort or in a person's accustomed standard of living and is not limited to the bare necessities of life. Moreover, it is immaterial whether the powerholder is required to exhaust other resources before exercising the power. Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2). Therefore, the better practice is to avoid using words other than those approved in the regulations, although the exercise of broader powers may be limited in any event by Prob C §16081(c). See §§9.14-9.15.

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§9.14 1. Words Not Permitted in Limited Power

The regulations expressly state that a power to use property for the comfort, welfare, and happiness of the powerholder is not limited by an ascertainable standard. Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2). Nonetheless, these words continue to appear in estate plan documents, and they generate much litigation. See *Forsee v U.S.* (D Kan 1999) 76 F Supp 2d 1135, in which "happiness" expanded a power otherwise limited to health, education, support, and maintenance into a general power. See also *Hyde v U.S.* (D NH 1996) 950 F Supp 418 (power to use income and principal as "necessary and desirable" not limited by ascertainable standard).

NOTE: Even a reference to "emergencies" may create a general power. See IRS Letter Ruling 9044081. In *Estate of Sowell v Commissioner* (10th Cir 1983) 708 F2d 1564, however, the court held that language in a trust authorizing invasion of corpus "in case of emergency or illness" was the same as "need" and therefore did not create a general power of appointment.

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§9.15 2. Trustee Powers Limited by Statute

California has tried to help planners by providing that in any case in which the standard governing the exercise of a trustee's power to make discretionary distributions does not clearly indicate by express reference to the statute that a broader power is intended, the powerholder may exercise the power in his or her favor only for his or her health, education, support, or maintenance within the meaning of IRC §§2041, 2514. Prob C §16081(c). The statute does not limit distributions if the power is held by a beneficiary rather than a trustee. If the power to make discretionary distributions is conferred on two or more trustees, the power may be exercised in favor of a trustee by a co-trustee who is not a permissible current beneficiary of the trust, and if there is none a court may appoint a trustee to exercise the power. Prob C §§15620, 16081(c).

The IRS has ruled that similar statutes converted general powers into limited powers. Rev Proc 94-44, 1994-2 Cum Bull 683; IRS Letter Rulings 200104023, 200014002.

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§9.16 B. Power Jointly Held With Creator

A power is not a general power as long as it is held jointly with the creator of the power. IRC §§2041(b)(1)(C)(i), 2514(c)(3)(A). It is irrelevant whether the creator may also be a potential beneficiary of the power. Estate planners rarely create such powers.

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§9.17 C. Power Jointly Held With Adverse Party

A power is not a general power as long as it is held jointly with a person who has a substantial interest in the property subject to the power and that interest is adverse to the exercise of the power by the first powerholder. IRC §§2041(b)(1)(C)(ii), 2514(c)(3)(B). Estate planners rarely create such powers. The key words are "substantial" and "adverse." See §§9.18-9.19.

Of course, if the adverse party predeceases the first powerholder, who continues alone to hold the power, the power may become general. The adverse party may be making a gift if he or she consents to the exercise of the power in a way that reduces his or her benefits from the trust. See §9.27.

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§9.18 1. Substantial: Not Insignificant Actuarially

With a circularity of definition rarely seen outside the tax law, an interest is considered as substantial if its value in relation to the total value of the subject property is not insignificant. Actuarial principles of Treas Reg §20.2031-7 apply for purposes of valuation, so it appears that a remainder beneficiary who is much older than the life beneficiary may have an insignificant (*i.e.,* not substantial) interest. Treas Reg §§20.2041-3(c)(2), 25.2514-3(b)(2).

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§9.19 2. Adverse: Vested Default Beneficiary

Abandoning circularity for definition by example, the regulations state that an interest is adverse if it is held by a default beneficiary or by a person who will hold a general power of appointment after the first powerholder's death. Therefore, a life tenant may have an unlimited power to appoint in favor of himself or herself with the consent of a younger vested remainder beneficiary, without the power being a general power. Treas Reg §§20.2041-3(c)(2), 25.2514-3(b)(2). Interests that are not adverse under this standard are discussed in §§9.20-9.21.

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§9.20 a. Merely Permissible Beneficiary Not Adverse

Mere joint possession, or merely being a permissible beneficiary, of the power does not make a person's interest adverse. Treas Reg §§20.2041-3(c)(2), 25.2514-3(b)(2). Also, a professional trustee is not adverse even though its fees are based on the size of the trust, which might motivate the trustee to oppose any large distributions. See *Miller v U.S.* (3d Cir 1968) 387 F2d 866.

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§9.21 b. Other Beneficiaries Who Are Not Adverse

The IRS has ruled that an unlimited lifetime power that required the consent of a presumptive remainder beneficiary was still a general power when the powerholder had the additional power at death to disinherit the consenter. Rev Rul 76-503, 1976-2 Cum Bull 275, amplified by Rev Rul 77-158, 1977-1 Cum Bull 285. Also, a default beneficiary of a testamentary power is not substantially adverse to a person who also has a lifetime power that does not default to that same beneficiary. Rev Rul 79-63, 1979-1 Cum Bull 302.

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§9.22 D. Merely Administrative Powers

Although powers of appointment held in a fiduciary capacity may be treated as general powers (see §9.6), merely administrative powers (or the power to change them) that do not affect beneficial enjoyment do not constitute powers of appointment. Neither does the mere power of management, investment, custody of assets, or allocation of receipts and disbursements between principal and income, exercisable in a fiduciary capacity, whereby the powerholder has no power to enlarge or shift any beneficial interests except as an incidental consequence of the discharge of fiduciary duties. Treas Reg §§20.2041-1(b)(1), 25.2514-1(b)(1). Administrative powers may become general powers, however, if the fiduciary has a beneficial interest. See §§9.23-9.24.

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Source: Estate Planning/California Estate Planning/9 Powers of Appointment/§9.23 1. Power to Allocate Between Principal and Income

§9.23 1. Power to Allocate Between Principal and Income

Special care should be taken in giving a trustee who is also a beneficiary broad powers to allocate principal and income items because such powers easily cross the line from being merely administrative to giving the trustee the power to change beneficial interests. For this reason, the statutory power to make an adjustment between principal and income does not extend to trustees who are beneficiaries. Prob C §16336(b)(7).

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§9.24 2. Avoiding Inadvertent General Powers

Unless there is a reason to do otherwise, the simplest way to avoid inadvertently giving a fiduciary a general power of appointment is to appoint as a fiduciary someone who is not a potential beneficiary or to limit all dispositive powers held by a fiduciary so that the power is subject to an ascertainable standard (see §9.13).

A somewhat more complex way of avoiding inadvertent general powers is to divide trustee functions so that one trustee handles general administration of the trust and a second "distribution trustee" or "special trustee" exercises distribution discretion. This arrangement often makes it easier to give the distribution discretion to an independent person who is not a beneficiary, because the independent person will not need to be a person who is also willing to accept the burdens and potential liabilities of day-to-day trust administration.

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§9.25 IV. ESTATE AND GIFT TAXATION OF POWERS

The exercise or release of a general power at death results in the inclusion of the subject property in the estate of the powerholder. IRC §2041(a)(2). The exercise or release of a general power during the powerholder's lifetime also results in the inclusion of the subject property in the powerholder's estate if the powerholder has a retained interest in the resulting transfer under IRC §§2036-2038.

PRACTICE TIP: Having property included in an estate for estate tax purposes may be exactly what a planner wants when one spouse is wealthier than the other and the applicable exclusion amount of the less wealthy spouse would not be fully utilized if he or she were to die first. One possible way to help overcome the disparity might be to give the less wealthy spouse a general power over some assets of the wealthier spouse. IRS Letter Rulings 20060428, 200403094. See §17.65.

A powerholder need not exercise or knowingly release a general power for the subject property to be included in his or her estate; mere possession of the power at death will suffice. IRC §2041(a)(2). See §9.26.

The exercise, release, or lapse of a general power of appointment during the lifetime of the powerholder is a transfer subject to gift tax. IRC §2514(b). See §9.27. Of course, exercising the power in favor of oneself should not itself be a gift.

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§9.26 A. Possession of Power Sufficient

Possession of a general power of appointment at death suffices for inclusion of the subject property even if the powerholder lacks capacity to exercise the power. See *Fish v U.S.* (9th Cir 1970) 432 F2d 1278. Ignorance of the existence of the power also does not prevent inclusion. *Estate of James C. Freeman* (1976) 67 TC 202.

A power exists at death even though its exercise is subject to the giving of prior notice or will take effect only after a certain amount of time after its exercise, whether or not such notice has been given or the power exercised on or before the powerholder's death. However, if the power is exercisable only after a condition precedent that did not, in fact, occur before death, the power is not includible in the powerholder's estate. For example, reaching a certain age, surviving another person, or dying without descendants are all conditions precedent that, if not met at death, will keep IRC §2041 from applying to the subject property. Treas Reg §20.2041-3(b).

When the condition precedent is entirely outside the control of the powerholder, it should suffice to prevent application of IRC §2041. The more difficult question is how much the condition can depend on actions of the powerholder. The rule appears to be that a general power exists at death even though it may be exercised only after the occurrence of an event or contingency during the powerholder's lifetime if (1) that event or contingency is within the control of the powerholder, and (2) the event or contingency has no significant nontax consequences independent of the ability to exercise the power. See *Estate of Ethel H. Kurz* (1993) 101 TC 44, aff'd (7th Cir 1995) 68 F3d 1027.

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§9.27 B. Release or Lapse of Power

The lapse of a power is generally considered a release of the power, with certain exceptions. IRC §§2041(b)(2), 2514(e). See §§9.28-9.29.

NOTE: It may be hard to recognize a release when taking action that may affect property subject to a general power. In Rev Rul 86-39, 1986-1 Cum Bull 301, the IRS ruled that a recapitalization of stock that resulted in shifting value from the remainder of one trust, over which the income beneficiary had a general power, to the remainder of another trust, over which the same beneficiary had no power, was effectively a release of the general power to the extent of the shifted value. Also, the exercise of a nongeneral power may cause the release of a related general power. See IRS Letter Ruling 199909016.

A general power subject to a condition precedent that has not yet occurred is known as a "hanging" power. A partial release of a general power, leaving the powerholder with only a nongeneral power, is not a completed gift assuming the powerholder retains control over ultimate disposition of the subject property. Treas Reg §25.2514-3(c)(1). However, a later exercise or complete release of the power will be subject to the gift tax, and retention of the partially released power until death will cause inclusion of the subject property in the powerholder's estate. Treas Reg §§20.2041-3(d)(1), 25.2514-3(c)(3).

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§9.28 1. Lapse by Incompetent Holder

Generally, a lapse of a general power is considered a release of the power. However, there is a difference between a lapse by an incompetent holder for estate tax purposes and one for gift tax purposes. The lapse of a general power by an incompetent powerholder is not considered a release of the power for gift tax purposes if the power may not be exercised on the holder's behalf. Treas Reg §25.2514-3(c)(4). The incompetence exception seldom applies because it is normally the case that a general power containing a lapse provision can be exercised on the holder's behalf by a guardian or conservator.

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§9.29 2. Exception for "5 or 5" Powers

During any one year, a lapse of a general power is not a release to the extent that, at the time of the lapse, the subject property does not exceed the greater of $5000 or 5 percent of the aggregate value of the property from which the exercise of the lapsed power could have been satisfied. IRC §§2041(b)(2), 2514(e). A general power that comes entirely within this safe harbor is often called a "5 or 5" power. Spouses are often given such powers in bypass trusts.

Of course, if the powerholder withdraws the property, it will be in his or her estate for transfer tax purposes. However, if the powerholder lets the power lapse and the amount withdrawable was within the 5 or 5 exception, the former powerholder is not treated as ever having had an interest in the property for transfer tax purposes.

Determining the exact amount covered by the 5 or 5 power is not always easy, and the amount may be less than expected. If a power to withdraw from a trust is a power to withdraw from the income only, the 5-percent limitation is calculated on the value of the income. Rev Rul 66-87, 1966-1 Cum Bull 217. In Rev Rul 85-88, 1985-2 Cum Bull 201, the IRS ruled that when a donee held a right of withdrawal in two identical trusts created by the same grantor, the amounts should have been aggregated for purposes of applying the $5000 limitation.

Although the lapse of a 5 or 5 power does not have tax consequences, the property subject to the power will be included in the powerholder's estate if the powerholder dies during the period in which the power may be exercised. See, *e.g., Estate of Floy M. Christensen,* TC Memo 2000-368.

The entire amount of any transfer may be protected from estate or gift taxation by using many powerholders. If the amount of a transfer will exceed the amount protected by 5 or 5 powers, however, separate trusts should be used for the protected and unprotected amounts.

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§9.30 C. Treatment of Limited Powers Distinguished

Because only property subject to a general power at death is included in the estate of the powerholder (see §9.25), the release or lapse of a limited power is not a taxable gift of the property subject to the power. See Treas Reg §25.2514-3(e), Example 2. The exercise of a limited power may result in a gift, however, if the powerholder also has an income interest in the property (see §9.31), or if the limited power is used to create a general power (see §9.32).

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§9.31 1. Gift of Income Interest

According to the Service, an income beneficiary who exercises a lifetime nongeneral power to appoint principal to a third party makes a gift of the income that the powerholder otherwise would have received from that principal. Rev Rul 79-327, 1979-2 Cum Bull 342; *Estate of Ruth B. Regester* (1984) 83 TC 1. The Service's position seems reasonable, although a contrary result was reached in *Self v U.S.* (Ct Cl 1956) 142 F Supp 939. Therefore, unless the powerholder's beneficial interest is incapable of valuation (*e.g.,* he or she may receive income or principal in the trustee's discretion), the powerholder must be careful in exercising a lifetime power.

PRACTICE TIP: One way to avoid making a gift by exercising a limited power is for the powerholder to have no other interest in the trust that is not itself a limited power. Instead of giving anyone a beneficial interest in income or principal, payable either mandatorily or at the discretion of the trustee, consider giving him or her nothing but the power to withdraw subject to an ascertainable standard and the power to appoint among a limited class of beneficiaries, both during life and at death. Exercise of any of these powers should cause no gift tax problems. See Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 107 (Feb. 1998).

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§9.32 2. Delaware Tax Trap

Under Delaware law, an exercise of nongeneral power of appointment starts a new perpetuities period. Out of concern that this rule would make it possible to keep property out of the transfer tax system forever, Congress enacted IRC §§2041(a)(3) and 2514(d), which provide that the exercise of a power that creates a second power that can be exercised in a way that starts a new perpetuities period will be treated as a transfer by the person exercising the first power.

Although the creation of a second *nongeneral* power in states other than Delaware does not restart the perpetuities period, the creation of a presently exercisable *general* power of appointment does.

Therefore, exercising a nongeneral power by creating a presently exercisable general power effectively turns the initial nongeneral power into a general power for tax purposes. More specifically, the powerholder can cause the conversion by appointing property to a new trust that gives the primary beneficiary an unlimited withdrawal power for a specified time. The conversion can be accomplished on a fractional share basis. The name "Delaware Trap" reflects the concern that such a conversion might occur by accident, but the conversion is now important in generation-skipping transfer (GST) tax planning because it offers a way for the powerholder to cause property to be subject to estate tax in the holder's estate rather than to GST tax. This can be important if the estate tax will be less than the GST tax.

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§9.33 D. Disclaimers of Powers

Rules regarding qualified disclaimers appear in IRC §2518, and provide generally that an interest in property that is properly disclaimed is treated as never having been held by the disclaimant. Although general disclaimer planning is beyond the scope of this chapter, there are certain aspects of the disclaimer rules that directly affect planning with powers of appointment. See chap 27.

A power with respect to property is a separate interest in property, which means that it can be disclaimed even while other interests are retained. IRC §2518(c)(2); Treas Reg §25.2518-3(a)(1)(iii). Therefore, a person may disclaim a general power of appointment over a trust and retain interests in income and principal without having the trust property included in his or her estate merely because of the disclaimed power.

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§9.34 V. INCOME TAXATION OF POWERS

For income tax purposes, a nongrantor powerholder is treated as the owner of any portion of a trust over which he or she has the power currently exercisable solely by himself or herself to vest corpus or income in himself or herself. IRC §678(a)(1). The powerholder also may be treated as the owner if he or she releases the power. IRC §678(a)(2). If the power is held in a trustee capacity, however, and is only for the purpose of applying income to discharge support obligations, income is taxable to the powerholder/trustee only to the extent so distributed. IRC §678(c).

The statute does not mesh well with the estate and gift tax statutes. IRC §§2041, 2514. Powers that are general powers for estate and gift tax purposes may not be treated as IRC §678 powers for income tax purposes, and vice versa, while the lapse of "5 or 5" powers may be treated as a release for income tax purposes even though the lapse is not treated as a release for estate and gift tax purposes. See §§9.35-9.36.

In some cases, these inconsistencies provide planning opportunities, allowing practitioners to some extent to mix and match various income tax results with various transfer tax results. See Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 105 (Feb. 1998).

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§9.35 A. Inconsistent Treatment of Powers

Under IRC §678, the donee of the power is taxed on the income from the subject property during the period in which the donee holds a general power of appointment exercisable solely by the donee. In contrast, with modest exceptions, a general power of appointment remains a general power for estate and gift tax purposes even if it must by exercised in conjunction with another person. IRC §§2041, 2514. See §9.12.

NOTE: It is arguable that a person who can withdraw income for support is a person with the power to vest income in himself or herself to the extent that the standards of the invasion power in fact allow a withdrawal, even though this person certainly does not have a general power of appointment; yet there is a widely held view that an invasion power is not an IRC §678 power if it is limited by an ascertainable standard. Under IRC §674(b)(5), a trust grantor is not taxable if discretionary distributions of principal are limited by a "reasonably definite" standard. It would seem reasonable that a nongrantor powerholder should be held to no higher standard.

If income from a trust may be used to discharge support obligations, only the income actually distributed is taxed to the trustee, although the entire amount of the income is considered property subject to a general power for estate and gift tax purposes, whether distributed or not. See §§9.8, 9.34.

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§9.36 B. Treatment of Lapsed Powers

One of the most significant issues involving IRC §678 and powers of appointment involves the application of the statute after a power has lapsed (and, as is often noted, there is no "5 or 5" lapse protection for income tax purposes). In this area, the ruling history of the IRS appears inconsistent with the language of the statute. On several occasions, the IRS has ruled that when a 5 or 5 power lapses, the donee becomes the owner of the lapse property for IRC §671 purposes, provided the grantor is not the owner and the donee remains a person to whom income can be distributed or for whom it can be accumulated. The condition regarding the grantor is expressly stated in IRC §678(b). The condition regarding income rights is based on IRC §677. Rev Rul 67-241, 1967-2 Cum Bull 225; IRS Letter Rulings 9745010, 9226037. Determining the precise size of a lapsed powerholder's portion under the IRS position should be done in accordance with the procedure set forth in IRS Letter Ruling 200022035.

The rulings rest on shaky ground because, if nothing else, IRC §678(a)(2) requires a release or a modification of a power, not just a lapse, and requires a retention of control, which seems as if it ought to mean more than a mere beneficial interest. If the IRS position seems inappropriate for a client, the practitioner may wish to consider taking a contrary filing position. One advantage to the IRS position in certain cases would be that the lapsed powerholder would be able to pay the income tax on his or her portion of the trust's income without gift tax implications. Also, if the trust includes the powerholder's residence, his or her portion of the trust could benefit from the capital gain exclusion under IRC §121. See IRS Letter Ruling 200104005.

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§9.37 VI. DRAFTING CONSIDERATIONS—POWERS

Powers may be created either expressly or by giving a trustee or other fiduciary certain administrative and dispositive powers. When drafting an express power of appointment, drafters should be as clear as possible with respect to the extent of the power and how it may be exercised. The remainder of this chapter discusses common drafting issues.

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§9.38 A. Procedures for Exercise

The creating instrument should set forth the manner and conditions of exercising any power thereunder. Except as otherwise provided in the statute governing powers of appointment (Prob C §§600-695), if the creating instrument specifies requirements as to the manner, time, and conditions of exercise of a power, the power can be exercised only in compliance with such requirements. Prob C §630(a). For discussion of specific provisions that may be included, see §§9.39-9.54.

A court may excuse failures to satisfy formal requirements if (1) the faulty exercise approximates the manner of appointment described by the donor, and (2) the failure does not defeat a significant purpose of the donor. Prob C §631. However, clarity in the creating instrument gives everyone involved the best chance to avoid any misunderstanding.

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§9.39 1. Require Specific Reference to Power

If nothing else, the power should require that the exercise make specific reference to the power in order to be effective. Such a requirement avoids unintentional exercise of a power, and the requirement cannot be waived by the court. Prob C §632. A general residuary clause in a will does not exercise any power unless there is some indication of an intent to do so. Prob C §641.

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§9.40 2. Must Be in Writing, Signed, and Dated

Another basic requirement should be that the exercise be in writing. Surprising as it may seem, the statute does not require a writing, merely that the powerholder manifest his or her intent to exercise a power. Prob C §640(a). Apparently, any declaration that the power is exercised may suffice. Prob C §640(b)(1).

Given the liberality of the statute, the document creating the power should specify that any writing exercising the power should also be signed by the powerholder. When an exercise does not become irrevocable until the powerholder's death, it would seem to be a good idea to require that the writing be dated in order to determine whether it is the last exercise executed by the powerholder.

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§9.41 3. Specify by Will or Other Than by Will

If the power is exercisable at death, the practitioner should specify whether it must or may be exercised by will or otherwise. Unless the creating instrument provides otherwise, a power exercisable by inter vivos document is also exercisable by will. Prob C §630(b).

Requiring exercise by will may have made sense in those days when almost all estates were administered through the probate court, where wills were admitted and proved. Nowadays, however, with the widespread use of fully funded living trusts, it would seem foolish in most cases to require the probate of a will for the purpose of exercising a power of appointment. For an example of the problems such a requirement can cause, see *Estate of Kouba* (2002) 95 CA4th 1194, 116 CR2d 319.

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§9.42 4. Witnesses or Acknowledgment

Because an exercise of a power of appointment may have as substantial an impact as does a will or a trust instrument, the practitioner may want to require formalities similar to those applicable to such other documents. See Prob C §§6110, 15206. Although relatively rarely used, witnesses lend a solemnity to the exercise, and an attestation clause may dissuade disinherited default beneficiaries from pursuing a contest. Also, notarial acknowledgment may be appropriate if realty is involved.

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§9.43 5. Must Deliver Exercise to Trustee

Requiring delivery of the exercise to the trustee, particularly in the case of a pre-death exercise that is effective at death, facilitates administration of a trust. If the powerholder is also the trustee, he or she could acknowledge receipt by signing the exercise a second time, in his or her fiduciary capacity.

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§9.44 6. Consent of Another Required for Exercise

It may be appropriate to require that the powerholder obtain the consent of another for the effective exercise of a power. Consent may be required for tax purposes (see §9.12), or there may be non-tax reasons for the requirement. If consent is required for whatever reason, the practitioner should take care that the consent requirement is consistent with the other purposes of the trust.

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§9.45 7. May Disregard Exercise Without Capacity

A power of appointment may be exercised only by someone having capacity to transfer the interest in property to which the power relates, with a minor powerholder capable of exercising his or her power only if the creating instrument so provides. Prob C §625. Therefore, it may facilitate administration of a trust if the trustee is given the power to disregard any exercise executed at a time when the powerholder is determined to lack capacity, applying the same procedures for such determination as probably appear already in the trust instrument with respect to the capacity of the settlors or trustee. Such procedures often require merely the declaration by one or two physicians familiar with the case that the person lacks capacity to manage his or her own affairs, thus keeping many questions of capacity out of the courts.

It might also be helpful to specify whether the power may be exercised by a conservator or an agent under a durable power of attorney if the conservatee or principal lacks capacity. See Prob C §§1871-1872, 2351, 4124, 4264.

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§9.46 B. Power Effective During Life and at Death

If a power is to be exercisable both during life and at death, it may be best to create it as two separate powers. Procedures for exercise during life may differ from those at death, and it is best to keep the powers distinct so that there is no confusion as to whether and when an exercise is effective.

NOTE: The tax rules applicable to Qualified Subchapter S Trusts (QSSTs) or marital deduction trusts allow broad powers of appointment effective at death but prohibit any power effective during life that could benefit anyone other than the income beneficiary. IRC §§1361(d)(3)(A), 2056(b)(5), (b)(7)(B)(ii)(II).

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§9.47 C. General or Limited Power Intended

Although not determinative for tax purposes, it helps to refer to each power as either general or limited. Such a statement may give some indication of the creator's intent if there is confusion as to the breadth of the power.

Also, the drafter may want to include certain savings clauses in boilerplate language that prevent any limited power from being treated as general for tax purposes and that prevent any needless or unintended limitations being placed on a general power. For example, it may be worthwhile to provide that no limited power may be exercised to discharge a powerholder's duties to any third parties, such as an obligation of support to a minor child. See §9.8.

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§9.48 D. Outright Disposition or Continuing Trust

Unless provided otherwise in the creating document, a general or nongeneral power can be exercised to create present or future interests or both; to subject the appointed property to conditions or charges, including spendthrift restrictions; to appoint the property in further trust; and to create further powers of appointment. Prob C §§650, 651. Unless otherwise provided, the donee may appoint the property outright or in trust to one or more of the permissible appointees and exclude others. Prob C §652.

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§9.49 E. Limitations on Power to Benefit Spouse

Clients often want their children to be able to benefit spouses, but not in certain situations and not too much. A clear definition of the term "spouse" should help to alleviate some of these fears. For example, the document creating the power could provide that a person's "spouse" means only the lawfully wedded husband or wife of such person who is then, or at the death of the person was (1) permanently residing with such person; (2) not suing or being sued in any jurisdiction for divorce or dissolution of marriage or for separate maintenance or legal separation from the person; and (3) not subject to an interlocutory decree of divorce or dissolution of marriage.

The client may also want to limit any appointment in favor of a spouse to only the income generated during the spouse's lifetime and to specifically preclude any appointment of principal to the spouse. Such a limitation would allow property so appointed to qualify for a marital deduction, if the appointed property were included in the powerholder's estate, but it would keep principal within the blood family or other favored group of beneficiaries.

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VII. DRAFTING EXERCISE DOCUMENTS

§9.50 A. Repeat Granting Clauses

When drafting an exercise of a power, the practitioner should consider repeating the trust provision that grants the power and any relevant boilerplate. There may be certain procedural requirements for exercise that the practitioner might otherwise miss, and by having the provision as part of the exercise, anyone reading it should be able to determine whether the power was validly exercised. Also, if the power is limited in such a way that it cannot be exercised in complete satisfaction of the client's general desires as evidenced by the rest of his or her estate plan, it helps to have the granting language available to show why the exercise is so limited. If the exercise is in continuing trust, however, the drafter may want to incorporate by reference some of the provisions in the creating trust instrument, rather than repeating them all in the exercise itself.

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§9.51 B. Assure Desired Exercise Is Authorized

Care must be taken to assure that the exercise is authorized. For example, all named appointees, including trusts, must be appointees authorized by the power or by state law. An exercise that is more extensive than that authorized by the power is not void solely because of this flaw but remains valid only to the extent permissible under the power. Prob C §670.

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§9.52 C. Assure Required Consent

If a power may be exercised only with the consent of another person, consent may be given either in the instrument exercising the power or in a separate writing, but it must be signed in each case by the consenter. Prob C §633(a). Unless provided otherwise by the instrument creating the power, (1) no consent is needed if the required consenter dies, (2) the conservator or other guardian of an incapacitated consenter may consent in his or her place, and (3) consent may be given before or after the powerholder actually exercises the power. Prob C §633(b).

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Source: Estate Planning/California Estate Planning/9 Powers of Appointment/§9.53 D. Specify Survival Requirements

§9.53 D. Specify Survival Requirements

An exercise should follow all the usual drafting rules generally applicable when making a disposition of property. Above all, it should specify whether survival is required, because the statute otherwise would apply a broad anti-lapse rule, leaving property appointed to a deceased beneficiary to such beneficiary's issue, provided they are permissible beneficiaries under the power. Prob C §673.

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§9.54 E. Include No-Contest Clause

If the client fears any attack on an exercise by disgruntled default beneficiaries or those who may have benefited under a prior superseded exercise, it may be prudent to include a no-contest clause in the exercise document. Of course, if the contesters would receive no benefit under the exercise in question, they may have nothing to lose by contesting it, and all the usual concerns regarding no-contest clauses apply. See §6.21.

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§9.55 F. Condition Exercise on Disclaimer

Some revocable trusts established by married settlors provide that, at the death of the first spouse to die, all of the trust property passes to a continuing survivor's trust except to the extent that the surviving spouse makes a qualified disclaimer, as defined in IRC §2518, with respect to property passing from the decedent. A trust funded by such a disclaimer is known as a disclaimer trust. See Drafting California Revocable Trusts, chap 14 (4th ed Cal CEB 2003).

If the survivor has a power of appointment over the survivor's trust that he or she wishes to exercise before the end of the disclaimer period (usually 9 months after the date of death), there may be circumstances in which it would be desirable to expressly state in the exercise document that the exercise of the power is subject to the condition that neither the survivor nor the survivor's executor makes a qualified disclaimer. This provision will preserve the possibility of making a qualified disclaimer for the full 9-month period. Preserving that possibility may be desirable for tax purposes (particularly if the survivor has a short life expectancy), but the survivor must also consider whether the distribution consequences of a disclaimer are acceptable to the survivor. In the absence of such a provision, an exercise of a power of appointment over property will cut off the ability of a transferee to disclaim the property subject to the power as of the time when the exercise of the power becomes irrevocable. See *Estate of Leona Engelman* (2003) 121 TC 54.

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Source: Estate Planning/California Estate Planning/9 Powers of Appointment/§9.56 G. Execute and Implement Related Documents

§9.56 G. Execute and Implement Related Documents

In certain cases, it may not suffice merely to exercise a power without following through by executing and implementing necessary related documents. For example, in *Estate of Sylvia Gore*, TC Memo 2007-169, decedent effectively exercised her general power of appointment over a marital trust following her husband's death, making an "assignment" of trust assets to a family limited partnership (FLP). However, the trust was not yet funded at the time of the exercise and title to the assets was never transferred to the FLP. Moreover, decedent retained dominion and control over the assets as evidenced by her continued use of all of the income from them. Accordingly, the Tax Court held that the exercise was not sufficient to cause a completed transfer by gift and that, even if it were, the assets would be included in her estate under IRC §2036.

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10

Estate and Gift Taxes

Beth L. Kramer
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§10.1 I. INTRODUCTION TO TRANSFER TAXES

Knowledge of estate and gift tax law is obviously important for preparation of estate and gift tax returns once a gift has been made or a death has occurred. It is equally important for the estate planner to understand the nuances of estate and gift tax law to optimize the tax benefits from an estate plan. To lower the overall transfer taxes, estate planners should have a thorough knowledge of deductions, credits, and exclusions that might be available to a particular client. The planner can then recommend actions that would qualify an estate for the relevant benefits.

The task has become more difficult with enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), which makes temporary changes to the law. While in the past the estate planner had to consider possible changes in the client's economic or family situation, a planner must now also consider the effect of future changes in the law.

LEGISLATION ALERT: As of this writing, Congress has failed to act to extend or amend the estate tax law so that there is, at least temporarily, no estate tax or generation-skipping transfer (GST) tax applicable to decedents dying in 2010. See §10.4.

This chapter summarizes the basic components of estate and gift tax law to identify the methods for determining a taxable estate or a taxable gift, how different types of assets are valued for estate and gift tax purposes, and when tax returns must be filed and payments made. Specific planning techniques are discussed in other chapters, which are cross-referenced in the text.

A brief history of estate and gift taxes is provided in §§10.2-10.6. Tax advantages of lifetime gifts under the current unified system are discussed in §10.7. Calculation of estate and gift taxes is discussed in §§10.8-10.11. The estate tax is discussed in §§10.42-10.78, and the gift tax is discussed in §§10.79-10.128.

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§10.2 A. Brief History of Estate and Gift Taxes

The federal estate tax was originally enacted in 1916. The current estate tax law is codified in Chapter 11 of the Internal Revenue Code (IRC §§2001-2210).

Because the estate tax applied only to transfers at death, it could be avoided by making lifetime gifts. This loophole was closed in 1932 by the federal gift tax, which imposed a tax on lifetime transfers. The current gift tax law is codified in Chapter 12 of the Internal Revenue Code (IRC §§2501-2524).

Until 1976, the estate and gift tax coexisted as separate tax systems with different rate schedules. The generally lower gift tax rate schedule was an incentive to make lifetime transfers rather than transfers at death. Congress sought to remove this tax advantage by enacting legislation in 1976 that unified the two taxes. See §10.3.

In 1986, the estate and gift taxes were supplemented by a generation-skipping transfer (GST) tax that mimics the effect of an estate or gift tax imposed at each generation. The GST tax is codified in Chapter 13 of the Internal Revenue Code (IRC §§2601-2664). See chap 11. In 1990, special valuation rules were added for certain property transfers. These rules are codified in Chapter 14 of the Internal Revenue Code (IRC §§2701-2704). See chaps 18, 21.

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§10.3 1. Unified Estate and Gift Tax System

The unified system applies a combined progressive rate schedule against a cumulative tax base that includes the taxable estate and post-1976 taxable gifts. IRC §§2001, 2502. A unified credit equal to the applicable credit amount applies against the cumulative federal estate and gift tax incurred by an individual on transfers during his or her lifetime and at death. IRC §§2010(c), 2505. The applicable credit amount is the tentative tax determined under the rate schedule in IRC §2001(c) for the "applicable exclusion amount" determined under the table in IRC §2010(c) for a given year. The applicable exclusion amount is the fair market value of property that an individual can gratuitously transfer free of estate and gift tax.

The applicable exclusion amounts have been different for estate taxes and gift taxes since 2004. The estate tax applicable exclusion amount was $3.5 million in 2009, while the gift tax applicable exclusion amount has remained $1 million throughout the period and remains $1 million in 2010. IRC §§2010(c), 2505.

The estate tax is repealed in 2010. See §10.4. However, it is revived in 2011 under the sunset provisions of EGTRRA-2001, as discussed in §10.5. A table of maximum estate and gift tax rates and applicable exclusion amounts is provided in §10.6.

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§10.4 2. Repeal of Estate Tax in 2010

The estate tax is repealed for the estates of decedents dying after December 31, 2009. IRC §2210(a). The gift tax is not repealed, but the unified rate schedule will be replaced by a separate gift tax schedule that effectively imposes a single 35 percent tax rate. IRC §2502(a)(2). However, the repeal will sunset in 2011, and the 2001 unified estate and gift tax rates will be revived. See §10.5.

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§10.5 3. Sunset of Repeal in 2011

EGTRRA-2001 is scheduled to sunset for all taxable years beginning after December 31, 2010. EGTRRA-2001 §901. Thus, unless there is further legislative action, all provisions of EGTRRA-2001 will cease to apply after that date and the rates as they existed in the year 2001 will be in effect (with a $1 million applicable exclusion amount). Many practitioners believe that further legislative changes to the transfer tax laws are likely to occur before that date.

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Source: Estate Planning/California Estate Planning/10 Estate and Gift Taxes/§10.6 4. Table: Maximum Rates and Applicable Exclusion Amounts

§10.6 4. Table: Maximum Rates and Applicable Exclusion Amounts

YEAR	MAXIMUM ESTATE TAX RATE	MAXIMUM GIFT TAX RATE	ESTATE TAX APPLICABLE EXCLUSION AMOUNT	GIFT TAX APPLICABLE EXCLUSION AMOUNT
2001	55%	55%	$675,000	$675,000
2002	50%	50%	$1,000,000	$1,000,000
2003	49%	49%	$1,000,000	$1,000,000
2004	48%	48%	$1,500,000	$1,000,000
2005	47%	47%	$1,500,000	$1,000,000
2006	46%	46%	$2,000,000	$1,000,000
2007	45%	45%	$2,000,000	$1,000,000
2008	45%	45%	$2,000,000	$1,000,000
2009	45%	45%	$3,500,000	$1,000,000
2010	0%	35%	unlimited	$1,000,000
2011	55%	55%	$1,000,000	$1,000,000

NOTE: In 2011, an additional tax of 5 percent will apply to amounts of more than $10,000,000 and less than $17,184,000. IRC §2001(c)(2).

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§10.7 B. Tax Advantages of Lifetime Gifts

Despite the unification of the estate and gift tax systems, an important difference between the two tax systems remains: The estate tax is tax inclusive and the gift tax is tax exclusive. The term "tax inclusive" means that the estate tax is imposed on the entire amount of property transferred at death, including the property that will be used to pay the estate tax. "Tax exclusive" means that the property used to pay the tax is not included in calculating the gift tax; only the actual gift that is being transferred is taken into account.

EXAMPLE: Assume that a 50 percent estate and gift tax rate is applicable, no unified credit is available, and the client's total assets are worth $1,500,000. If the client makes a gift of $1,000,000, the gift tax will equal $500,000. But if the client does not make the gift and dies with a taxable estate of $1,500,000, the estate tax will be $750,000. Thus, after the estate tax is paid, only $750,000 will remain to distribute from the client's estate.

An exception to the tax-exclusive rule for gift tax applies to gifts made by a decedent or the decedent's spouse within 3 years before the decedent's death. In that event, the amount of the gift tax paid is included in the decedent's gross estate for purposes of calculating the estate tax. IRC §2035(b). In this example, inclusion would result in an additional tax of $250,000 for a total of $750,000. Gifts made within 3 years before death, therefore, do not receive the tax-exclusive advantage of gifts made more than 3 years before death. See §10.15.

PRACTICE TIP: Before deciding to make a taxable lifetime gift of property, the client should consider the effect of the loss of the use of any earnings the client would have received on the gifted property and of the money used to pay any gift taxes. Further, an analysis of the income tax consequences to the donee of a contemplated transfer also should be made because of the different basis rules for property acquired from a decedent (basis step-up) and property acquired by gift (no basis step-up). IRC §§1014-1015. See chap 12.

Another advantage of lifetime gifts over transfers at death is that any appreciation of the gifted property after the date of the gift escapes both estate and gift tax, because the gift tax is based on the property's fair market value on the date of the gift and the property is no longer part of the donor's estate. See chap 25.

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§10.8 C. Calculating Estate and Gift Taxes

Under the unified system of estate and gift taxation, the decedent's death causes the decedent's last transfer to be subject to taxation except in 2010, when the estate tax is repealed. The estate tax is calculated on the basis of the total of previous transfers subject to the gift tax and the transfer at death. See §§10.9-10.10. Sample calculations are provided in §10.11.

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§10.9 1. Estate Tax

The estate tax, before taking into account appropriate credits, is calculated as follows (IRC §2001(b)):

- The decedent's taxable estate is calculated by reducing the gross estate (see §10.13) by appropriate exclusions and deductions (such as the marital and charitable deductions, debts, and expenses, or losses of administration as discussed in §§10.47-10.58).
- The decedent's estate tax base is then calculated by increasing that taxable estate by the aggregate value of those adjusted taxable gifts made after December 31, 1976, which are not required to be included in the decedent's gross estate under the rules discussed in §§10.13-10.42 (IRC §§2035-2038, 2040, 2042).
- A "tentative tax" is then calculated with respect to the resulting total by applying the rate table in IRC §2001(c). A separate table with lower rates applies to soldiers and astronauts killed in the line of duty and victims of certain terrorist attacks. IRC §2201.
- The tentative tax is then reduced by the amount of gift tax payable on lifetime taxable gifts made after December 31, 1976, using the rates in effect at death, not those in effect when the gifts were made.
- Finally, the tentative tax is then reduced by the remaining IRC §2010 applicable credit amount not used by taxable gifts.

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§10.10 2. Gift Tax

The gift tax due in any calendar year is calculated as follows (IRC §2502(a)):

- The tentative tax is calculated on the sum of the taxable gifts made by the donor during the current taxable year, plus the value of all previous taxable gifts made by the donor since June 6, 1932, using the current estate and gift tax rate schedule in IRC §2001(c). For gifts in 2010, when the estate tax is repealed, a separate gift tax schedule is provided in IRC §2502(a)(2).
- The tentative tax on previous gifts alone is calculated using the same schedule, even though the current rates may differ from the rates originally used to tax those gifts.
- The tentative tax on previous gifts is subtracted from the tentative tax on the sum of current gifts and previous gifts to arrive at the tentative gift tax.
- Any remaining portion of the IRC §2505 applicable credit amount that has not been used for gifts in prior years (but not exceeding the amount needed to reduce the tax to zero) is subtracted. Then any credit for foreign gift taxes is subtracted to arrive at the gift tax payable by the donor.

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Source: Estate Planning/California Estate Planning/10 Estate and Gift Taxes/§10.11 3. Sample Estate and Gift Tax Calculations

§10.11 3. Sample Estate and Gift Tax Calculations

Assume that Dawn, a California resident, made outright gifts to her son Steve of $512,000 in 2006 and $1,012,000 in 2007. Dawn died in 2008 with a $1,000,000 taxable estate (total gross estate less exclusions and deductions). Dawn made no other previous taxable gifts. The estate tax applicable credit amount was $780,800 in 2006-2008, although the gift tax applicable credit amount is $345,800 in all years. IRC §§2010(c), 2505. Dawn's gift taxes and estate tax are calculated as follows (note that total taxes of $225,000 are equal to 45 percent of taxable transfers in excess of $2 million):

SAMPLE GIFT TAX CALCULATION

Gifts Made During Calendar Year 2006		
Step 1 Calculate Total Taxable Gifts:	Total gifts in 2006 *Less* annual exclusion amount under IRC §2503(b) *Equals* total taxable gifts for 2006 *Plus* taxable gifts from prior years ***Equals* total taxable gifts**	$512,000 (12,000) $500,000 0 **$500,000**
Step 2 Calculate Tentative Tax:	Tentative tax on total taxable gifts *Less* tentative tax for gifts from prior years ***Equals* tentative tax for gifts in 2006**	$155,800 (0) **$155,800**
Step 3 Calculate Tax Due and Payable:	Tentative tax for gifts in 2006 *Less* gift tax applicable credit amount available in 2006 (not to exceed tentative tax) ***Equals* gift tax due and payable in 2006**	$155,800 (155,800) **$ 0**

Gifts Made During Calendar Year 2007		
Step 1 Calculate Total Taxable Gifts:	Total gifts in 2007 *Less* annual exclusion amount under IRC §2503(b) *Equals* total taxable gifts for 2007 *Plus* taxable gifts from prior years ***Equals* total taxable gifts**	$1,012,000 (12,000) $1,000,000 500,000 **$1,500,000**
Step 2 Calculate Tentative Tax:	Tentative tax on total taxable gifts *Less* tentative tax for gifts from prior years ***Equals* tentative tax for gifts in 2007**	$555,800 (155,800) **$400,000**
Step 3 Calculate Tax Due and Payable:	Tentative tax for gifts in 2007 *Less* gift tax applicable credit amount available in 2007 ($345,800 minus $155,800 used in 2006) ***Equals* gift tax due and payable in 2007**	$400,000 (190,000) **$210,000**

SAMPLE ESTATE TAX CALCULATION

Step 1 Calculate Estate Subject to Tentative Tax:	Taxable estate in 2008 (includes $210,000 in gift tax paid in 2007 because within 3 years of death) *Plus* adjusted taxable gifts made after 12/31/76 ***Equals* estate subject to tentative tax calculation**	$1,000,000 1,500,000 **$2,500,000**
Step 2 Calculate Gross Estate Tax:	Apply rates for tentative tax (maximum tax rate 45 percent) *Less* total gift tax payable after 12/31/76 ***Equals* gross estate tax**	$1,005,800 (210,000) **$795,800**
Step 3 Calculate Federal Estate Tax Due and Payable:	Gross estate tax *Less* estate tax applicable credit amount in 2006 ***Equals* federal estate tax due and payable**	$795,800 (780,800) **$15,000**

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II. ESTATE TAX

§10.12 A. Scope of Tax

The federal estate tax is imposed on the "taxable estate" of every decedent who is a citizen or resident of the United States. IRC §2001(a). The taxable estate is calculated by subtracting certain deductions in IRC §§2053-2058 from the decedent's "gross estate" as determined under IRC §§2031-2046. IRC §2051. See §§10.47-10.58. The gross estate includes the worldwide assets of U.S. citizens and residents. Treas Reg §20.2031-1(a). Valuation is discussed in §§10.34-10.46. Credits against the tax are found in IRC §§2011-2016. See §§10.59-10.65. Filing the estate tax return and payment of tax are discussed in §§10.66-10.78.

Nonresident aliens are taxed on U.S. situs property. IRC §§2101, 2103. Situs rules for estate tax purposes are in IRC §§2104-2105, and are not necessarily the same as the situs rules for income tax purposes or for ancillary probate. See *Estate of Noordin M. Charania* (2009) 133 TC No. 7 (stock of U.S. corporation owned by nonresident aliens is U.S. situs property for estate tax purposes). These rules may be modified by tax treaties. Estate tax credits under IRC §§2011-2013 are generally allowed. IRC §2102(a)-(b). A special unified credit applies to estates of nonresident aliens under IRC §2102(c).

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§10.13 B. Property Included in Gross Estate

The gross estate of a U.S. citizen or resident includes all of the decedent's property, real or personal, tangible or intangible, wherever situated. IRC §2031(a). This includes property in which the decedent had an interest at the time of death. IRC §2033. See §10.14. One exception to the general rule is that a portion of real property subject to a qualified conservation easement may be excluded from the gross estate. IRC §2031(c). See §§10.33, 23.42-23.47.

In addition to property interests owned at death, the gross estate includes the value of certain lifetime transfers under IRC §§2035-2038. Joint interests in property are included as provided in IRC §2040. Property subject to a general power of appointment is included under IRC §2041. Under IRC §2042, proceeds of a life insurance policy on the decedent's life may be included. Generally, the gross estate does not include certain interests that terminate at the decedent's death, such as an annuity payable only during the decedent's life. IRC §2039. However, the gross estate includes other interests that terminate at death, such as QTIP property for which the estate of a predeceased spouse took a marital deduction. IRC §2044. See §§10.15-10.32.

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§10.14 1. Property in Which Decedent Had an Interest (IRC §2033)

The gross estate includes all property in which the decedent had a beneficial interest at the time of death. IRC §2033; Treas Reg §20.2033-1(a). A partial ownership interest in property that the decedent can transfer at death, such as a community property or tenancy-in-common interest, may be included under §2033. For discussion of community property with right of survivorship, see §12.9. Even misappropriated property that has been commingled with a decedent's assets has been held to be includable in the decedent's gross estate where the decedent had exercised dominion and control over such property. See *Estate of Hester v U.S.* (WD Va 2007) 2007-1 USTC ¶60,537, 99 AFTR2d 1288. Property in which the decedent had an interest includes a decedent's income rights from property or services outstanding at the decedent's death. See Treas Reg §20.2033-1(b). This income in respect of a decedent (IRD) consists of amounts earned before death but not received until after death. IRC §691. Some examples of IRD are salary or bonuses payable to the decedent at the time of death, fees for professional services, accrued rent from real or personal property, accrued interest, the right to stock dividends payable at the time of death, deferred compensation, pensions, individual retirement accounts, proceeds from a sale negotiated by a decedent but not closed before death, and annuities. For discussion of income tax treatment of IRD, see chap 13.

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§10.15 2. Gifts Made Within 3 Years Before Death (IRC §2035)

The gross estate includes the value of any property transferred, or with respect to which certain powers were relinquished, by the decedent within 3 years before death if such property would have been included in the decedent's gross estate under IRC §2036 (transfers with retained life estate), IRC §2037 (transfers taking effect at death), IRC §2038 (revocable transfers), or IRC §2042 (proceeds of life insurance) if the decedent had retained the property or the relinquished power. IRC §2035(a). See §§10.16-10.26, 10.30. The gross estate is increased by the amount of any gift tax paid by the decedent or by the decedent's estate on any gift made by the decedent or the decedent's spouse within 3 years before the decedent's death. IRC §2035(b). Note that a gift made 3 years to the day before the date of death is not included. IRS Letter Ruling 200432016. In *Brown v U.S.* (9th Cir 2003) 329 F3d 664, cert denied (2003) 540 US 878, the decedent was treated as paying gift tax under the step-transaction doctrine when the decedent gave the decedent's spouse money equal to the gift tax owed because of the decedent's gift to a trust and the spouse paid the tax. Section 2035(a) does not apply to a bona fide sale for adequate and full consideration in money or money's worth (*i.e.,* when there is no gift). IRC §2035(d).

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§10.16 3. Transfers With Retained Life Estate (IRC §2036)

When a decedent makes a lifetime transfer of property and retains certain interests or rights in the property for life or for a period not ascertainable without reference to, or that does not in fact end before, the decedent's death, the property is included in the gross estate under IRC §2036. The retained interest can be for the benefit of the decedent, such as a retained income interest in the property, or for the benefit of others, such as a power to decide who shall enjoy the property. The IRS has issued regulations to provide guidance as to what portion of a trust is includable in a decedent's gross estate when a decedent has retained the use of trust property during his or her lifetime and fails to survive the term of the retained interest. TD 9414, 2008-35 Int Rev Bull 454. These rules apply to valuing remainder interests in split-interest trusts such as grantor retained annuity trusts (GRATs), grantor retained income trusts (GRITs), and qualified personal residence trusts (QPRTs). The regulations take the approach that the includable portion of the trust estate should be valued as of the decedent's death using the then-existing IRC §7520 rates to determine the portion of the trust necessary to produce income to provide for annual payments to which the decedent was entitled without reducing or invading principal. Treas Reg §20.2036-1(c)(2). In most cases, this amount will be different from the present value of the remaining payments under the trust, and in many cases the amount will be equal to the value of the entire trust estate. The regulations also clarify that such interests should be reported under IRC §2036 rather than under IRC §2039. Treas Reg §20.2039-1(e). See §10.27.

NOTE: The amount included in the decedent's gross estate is the same regardless of the length of the decedent's retained interest. The value of an annuity included in the decedent's estate is the same for a retained life annuity as for an annuity retained for a term certain that did not expire before the decedent's death. Treas Reg §20.2036-1(c)(2)(iii), Example 2.

An interest is treated as retained if, at the time of the transfer, an express or implied understanding was made that the interest or right would be reserved. IRC §2036(a); Treas Reg §20.2036-1(a). There are three ways that property will be brought back into a decedent's gross estate under IRC §2036 (see §§10.17-10.21).

Section 2036 does not apply to a bona fide sale for an adequate and full consideration in money or money's worth. IRC §2036(a). See However, some courts have held that a transfer to a family limited partnership (FLP) that only changes the form in which a decedent holds property is not a bona fide sale for full and adequate consideration. See *Estate of Thompson v Commissioner* (3d Cir 2004) 382 F3d 367; *Estate of Hilde E. Erickson,* TC Memo 2007-107; *Estate of Lillie Rosen,* TC Memo 2006-115; *Estate of Morton B. Harper,* TC Memo 2002-121. But see *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257; *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703; *Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015; *Estate of Samuel P. Black* (2009) 133 TC No. 15; *Estate of Anna Mirowski,* TC Memo 2008-74; *Estate of Charles Porter Schutt,* TC Memo 2005-126; *Estate of Eugene E. Stone, III,* TC Memo 2003-309. In *Estate of Wayne C. Bongard* (2005) 124 TC 95, the Tax Court held that a transfer to an entity is not a bona fide sale unless there is a "legitimate and significant nontax reason" for creating the entity. In *Estate of Strangi v Commissioner* (5th Cir 2005) 417 F3d 468, the Fifth Circuit held that the Tax Court did not clearly err in finding that the formation of the partnership was not a bona fide sale because the estate failed to prove that there was a "substantial business [or] other non-tax" purpose for the formation of the partnership. In *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955, the court held that proof of a bona fide sale for full and adequate consideration required proof of a legitimate and significant nontax reason for the creation of an FLP. See §§18.37-18.37E.

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§10.17 a. Right to Income, Possession, or Enjoyment

If a decedent retains a right to possession or enjoyment of, or a right to the income from, property the decedent has transferred during his or her lifetime, it will be included in the decedent's estate under IRC §2036(a)(1). Possession or enjoyment of gifted property is retained when there is an express or implied understanding to that effect among the parties at the time of transfer. Treas Reg §20.2036-1(a). See, *e.g., Estate of Charles E. Reichardt* (2000) 114 TC 144 (property included); *Estate of Floyd G. Paxton* (1986) 86 TC 785 (same); *Estate of Roger D. Malkin,* TC Memo 2009-912 (same); *Estate of Concetta H. Rector,* TC Memo 2007-367 (same); *Estate of Hilde E. Erickson,* TC Memo 2007-107 (same); *Estate of Lillie Rosen,* TC Memo 2006-115 (same); *Estate of Morton B. Harper,* TC Memo 2002-121 (same); *Estate of Gizella Wells,* TC Memo 1981-574 (property not included). Retained interests commonly arise from reciprocal trusts and gifts of residences with a continued right of occupancy. See §§10.18-10.19.

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§10.18 (1) Reciprocal Trusts

Internal Revenue Code §2036(a)(1) applies to reciprocal trusts. For example, assume that Greg creates a trust for the benefit of his spouse, Geraldine, for life with the remainder to their children. At the same time, Geraldine sets up a trust with the same terms and of equal value benefiting Greg for life with the remainder to their children. Under the reciprocal trust doctrine, the grantors of the reciprocal trusts are switched and both Greg and Geraldine are treated as if they each created a trust for themselves with a retained life interest. Consequently, the corpus of their respective trusts would be included in each of their gross estates at death under IRC §2036(a)(1). See *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. In IRS Letter Ruling 200426008, the IRS ruled that the reciprocal trust doctrine will not cause life insurance trusts established by a husband and wife for each other's benefit to be included in the estate of the benefited spouse because of differences in the terms of the two trusts, based on the decision in *Estate of Herbert Levy*, TC Memo 1983-453. Despite the implications of the ruling, practitioners cannot be certain that modest (or even significant) differences in trusts executed at the same time by closely connected parties (particularly spouses and siblings) will not be uncrossed under the reciprocal trust doctrine. It remains clear that a person who furnished consideration for the creation of a trust may be treated as the settlor of the trust. *Lehman v Commissioner* (2d Cir 1940) 109 F2d 99. Practitioners should also note the expanding boundaries of the reciprocal trust doctrine (see, *e.g.*, *Estate of Bruno Bischoff* (1977) 69 TC 32) and the reciprocal transaction doctrine (see §10.99).

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§10.19 (2) Right to Occupy Residence

If a donor gifts a residence to donees but continues to live in the residence without paying fair market value rent, the court may find that there was an implied agreement that the donor retained "possession or enjoyment" of the property within the meaning of IRC §2036(a)(1), which means that the residence will be included in the donor's estate. See, *e.g., Estate of Maxwell v Commissioner* (2d Cir 1993) 3 F3d 591; *Estate of Adrian K. Rapelje* (1979) 73 TC 82; *Estate of Eleanor T. R. Trotter*, TC Memo 2001-250.

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§10.20 b. Right to Designate Possession or Enjoyment

If a decedent has the power, either alone or in conjunction with another person, to designate who shall possess or enjoy, or have the right to income from, property transferred by the decedent during his or her lifetime, the entire property will be included in the decedent's estate, not merely the affected interest. IRC §2036(a)(2). In *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468, the court held that assets of a partnership created by the decedent were included in the decedent's estate. The decedent held a 49-percent interest in the corporate general partner, and the manager of the corporate general partner had the sole and absolute discretion to distribute the assets of the partnership. The court found that, because the decedent in conjunction with the other shareholders had the power to accumulate partnership income rather than disperse it, the decedent retained the right to designate who shall possess and enjoy the property. In essence, the court held that a power to affect the timing of distributions is tantamount to the power to designate who shall possess and enjoy property, extending the reach of IRC §2036(a)(2). Although the Fifth Circuit decision in *Strangi* does not discuss §2036(a)(2), practitioners drafting family limited partnerships or similar entities should try to avoid retention of such powers by transferors. Powers over property that do not affect enjoyment of income during the decedent's lifetime are governed by IRC §2038. Treas Reg §20.2036-1(b)(3). See §10.23. For further discussion of *Strangi*, see §18.37.

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§10.21 c. Retained Voting Rights in Controlled Corporation

The retention of the right to vote, directly or indirectly, shares of a "controlled corporation" transferred by the decedent is considered a retention of enjoyment of the transferred shares, which are included in the decedent's gross estate. IRC §2036(b)(1). For purposes of §2036(b)(1), a corporation is treated as a controlled corporation if, after the transfer of the shares and within 3 years before the decedent's death, the decedent owned (with the application of the constructive ownership rules of IRC §318) or had the right to vote (alone or with others) at least 20 percent of the voting power of the corporation. IRC §2036(b)(2). For purposes of IRC §2035, the relinquishment or cessation of such voting rights will be treated as a transfer of property made by the decedent. IRC §2036(b)(3).

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§10.22 4. Transfers Taking Effect at Death (IRC §2037)

Property transferred in trust or otherwise is included in the transferor's gross estate under IRC §2037(a) to the extent that:

- Possession or enjoyment of the property by a transferee can only be obtained by surviving the transferor (IRC §2037(a)(1)); and
- The transferor retained a reversionary interest in the property whose value is greater than 5 percent of the property immediately before the transferor's death (IRC §2037(a)(2)).

"Reversionary interest" is defined in IRC §2037(b) as including the possibility that the property transferred by the decedent may return to the decedent or the decedent's estate or may be subject to a power of disposition by the decedent. A reversionary interest may arise either under the express terms of a trust or by operation of law. Thus, the applicability of IRC §2037(a) is determined at the decedent's death.

EXAMPLE: Before his death, a husband transfers property to a trust with income payable to his wife for life and with the remainder to himself if he is then living or, if not, to his daughter or her estate. The daughter cannot receive the property without surviving her father. Therefore, assuming that the husband's reversionary interest exceeds 5 percent of the value of the property at his death, the value of the property, less the wife's remaining life estate, would be included in his gross estate. Treas Reg §20.2037-1(e), Example 3.

Estate planners should consider all potential reversionary interests when drafting an estate plan for a client. In valuing the decedent's reversionary interest, the IRS disregards the grantor's actual health and uses mortality and actuarial tables to determine value. Treas Reg §20.7520-3(b)(3)(ii). See *Estate of Allen v U.S.* (Ct Cl 1977) 558 F2d 14; *Robinson v U.S.* (9th Cir 1980) 632 F2d 822; *Estate of Dwight B. Roy, Jr.* (1970) 54 TC 1317.

Internal Revenue Code §2037 does not apply to transfers that are bona fide sales for adequate and full consideration in money or money's worth. IRC §2037(a). See *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8.

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§10.23 5. Revocable Transfers (IRC §2038)

The gross estate includes the value of an interest in property transferred by the decedent, in trust or otherwise, when the decedent could change the enjoyment of the interest by exercising a power to alter, amend, revoke, or terminate the interest, or when the decedent relinquished any such power during the 3-year period ending on the date of the decedent's death. IRC §2038(a)(1). The power may be held as a trustee. See §10.24.

NOTE: Because California law presumes that a trust is revocable unless expressly made irrevocable (Prob C §15400), a transfer to a trust created under California law automatically falls under IRC §2038 if the trust is silent on its revocability.

The power may be held alone or in conjunction with third parties, even if the other party is adverse. Section 2038 does not apply, however, when a decedent holds a power requiring the consent of all interested persons and the power adds nothing to the parties' rights under local law. Treas Reg §20.2038-1(a)(2).

Section 2038 does not apply to transfers that are bona fide sales for adequate and full consideration in money or money's worth. Treas Reg §20.2038-1(a)(1). See *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8; *Estate of Harry R. Michelson,* TC Memo 1978-371.

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§10.24 a. Trustee Powers Included

Internal Revenue Code §2038 applies when at the date of death the decedent has the power to alter the time or manner of enjoyment of property or its income, such as the power to accumulate or distribute income or to distribute corpus to a trust beneficiary regardless of whether the power is exercised. Treas Reg §20.2038-1(a). This includes the power to name new beneficiaries of a trust, to shift beneficial interests among existing beneficiaries, and to accumulate income. See Rev Rul 80-255, 1980-2 Cum Bull 272 (provision for after-born and after-adopted children as trust beneficiaries is not treated as a power to change beneficial interests).

A decedent is regarded as having possessed the powers of a trustee if he or she had an unrestricted power to remove the trustee and appoint anyone (including the decedent) as trustee. Treas Reg §20.2038-1(a)(3). However, the reservation of a power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent (within the meaning of IRC §672(c)) is not considered a reservation of the trustee's discretionary powers of distribution over the property. Rev Rul 95-58, 1995-2 Cum Bull 191.

Section 2038 does not apply to certain limited powers. See §10.25. Powers over enjoyment of income during the decedent's lifetime are governed by IRC §2036. See §§10.16-10.21. For a comparison of IRC §2036 with IRC §2038, see §10.26.

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§10.25 b. Exception for Certain Limited Powers

General administration, management, and investment powers held in a fiduciary capacity are not covered by IRC §2038, because the fiduciary is accountable to a court of equity and may not discriminate between the various interests in the trust. See Prob C §16003. For example, when a decedent merely retains the right to allocate dividends or receipts between principal and income, property subject to the power is not included under §2038, because the exercise of the power is not considered to affect the beneficial enjoyment of a trust. *Old Colony Trust Co. v U.S.* (1st Cir 1970) 423 F2d 601. Also, the power does not fall within §2038 if it is limited by an objective ascertainable standard. *Jennings v Smith* (2d Cir 1947) 161 F2d 74. Despite the exception for appropriately limited powers, the more conservative approach is to avoid transferors retaining distribution powers.

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§10.26 c. Comparison of IRC §2036 With IRC §2038

Although IRC §§2036 and 2038 may appear similar, §2036 is stronger than §2038 because it may include more in the gross estate. Section 2038 includes only the interest subject to change and IRC §2036 includes the amount of corpus proportionate to the decedent's retained power over income. For example, if the decedent retained the right to half of the income interest, §2036(a)(1) would include half of the corpus in the gross estate. If half of the income interest were subject to a §2038 power, only half of the income interest (rather than corpus) would be included in the decedent's gross estate.

Another distinction between IRC §2036 and IRC §2038 relates to the requirements for applying these sections. For example, under §2036, the grantor must retain either the right to income, possession, or enjoyment of the property or the power to designate the beneficial enjoyment of the transferred property. Section 2038 is broader in that it applies to any power that affects the time of enjoyment, as well as applying to both income and remainder interests. See Treas Reg §20.2038-1(a). But see *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468, which in effect applies §2036(a)(2) to a power affecting the time of enjoyment, as discussed in §10.20.

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§10.27 6. Annuities (IRC §2039)

The gross estate includes the value of an annuity or other payment, receivable by any beneficiary under a contract or agreement by reason of surviving the decedent, if the annuity was payable to the decedent or if the decedent had the right to receive the annuity either alone or with someone else, for the decedent's life or for any period not ascertainable without reference to the decedent's death or for any period that does not in fact end before the decedent's death. IRC §2039(a).

The gross estate includes only the value of the annuity or other payment receivable that is proportionate to the decedent's contribution toward the purchase price. Contributions made by the decedent's employer or former employer are considered to be contributed by the decedent. IRC §2039(b). However, specified benefits paid to family members by statute are not included under §2039. See Rev Rul 2002-39, 2002-2 Cum Bull 33. Nor does §2039 apply to include in a decedent's gross estate any portion of a trust over which the decedent retained a right to use property of the trust or retained an annuity, unitrust, or other interest during his or her lifetime when the decedent fails to survive the term of the retained interest. Such interests should be reported under IRC §2036 rather than under IRC §2039. Treas Reg §20.2039-1(e). See §§10.16-10.21.

Internal Revenue Code §2039 does not apply to life insurance policies, even though they are payable in the form of an annuity. Treas Reg §20.2039-1(d). These proceeds would be includable under IRC §2042. See §10.30. For discussion of annuities, see chap 20.

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§10.28 7. Joint Interests (IRC §2040)

The gross estate includes the value of a decedent's interest held jointly with another person that expires at the decedent's death. IRC §2040. Section 2040 covers joint tenancies and tenancies by the entirety, but it does not cover tenancies in common or community property interests. Treas Reg §20.2040-1(b). Tenancies in common and community property interests are included under IRC §2033. See §10.14. For discussion of community property with right of survivorship, see §12.9.

Generally, the portion of the property included in the gross estate is the same as the proportion of the consideration the decedent paid to acquire his or her interest in the property. IRC §2040(a). There is a rebuttable presumption, however, that the decedent furnished all the consideration for the jointly held property, unless the executor can present evidence of the surviving joint owner's contributions. Treas Reg §20.2040-1(a)(2). Thus, joint property owners should keep records of their contributions. If the property was received by the joint owners as a gift from a third party, the portion each owner received as a gift is included in that person's gross estate. If the decedent made a gift to the other joint tenants of the consideration used to purchase the jointly owned asset, that consideration is attributable to the decedent for purposes of §2040(a). Treas Reg §20.2040-1(c).

In *Estate of Marie L. Concordia,* TC Memo 2002-216, the court held that the decedent's use of her niece's property provided adequate consideration for the niece's acquisition of a joint tenancy interest in the decedent's house. Accordingly, only a one-half interest in the decedent's house was included in the decedent's estate.

The income earned by the gifted property may qualify as a contribution by the surviving donee tenant in certain circumstances. For example, if the surviving donee tenant sold the property and used the proceeds to purchase the joint property, any gain from the date of the gift to the date of sale would be treated as a contribution by the surviving tenant. *Harvey v U.S.* (7th Cir 1950) 185 F2d 463. This is not the result when the gifted property is held jointly with the decedent and then reinvested in another joint property. *Endicott Trust Co. v U.S.* (ND NY 1969) 305 F Supp 943.

A different rule applies to joint interests of a husband and wife as long as the surviving spouse is a U.S. citizen. In that case, half of the property is included in the gross estate of the first spouse to die (and receives a step-up in basis at death under IRC §1014(a)) regardless of contribution. IRC §2040(b). See chap 16.

PRACTICE TIP: The result for joint interests is in contrast to property held as community property where both halves of appreciated property receive a step-up in basis on the first death under IRC §1014(b)(6). For this reason, many estate planners will either have married clients transmute their jointly-held property to community property or have their clients sign a form of marital property agreement stating that property titled in joint tenancy is titled that way for convenience only and is really the couple's community property. The agreement allows the surviving spouse to claim a full step-up in basis on the first death. However, there are benefits to joint tenancy property in that the property is not available to satisfy claims against the estate while community property is available to satisfy claims. Thus, the attorney should consider all the consequences of a transmutation in the clients' situation before recommending it. See chap 4.

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§10.29 8. Powers of Appointment (IRC §2041)

In general, the gross estate includes property over which the decedent had a general power of appointment. IRC §2041(a)(2). A general power of appointment is a power to appoint property to one or more of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate. IRC §2041(b); Treas Reg §20.2041-1(c)(1). To be included in the gross estate, the power must either be possessed by the decedent at death or have been exercised or released by the decedent in a manner that would cause inclusion of the property subject to the power in his or her gross estate under IRC §§2035-2038. IRC §2041(a)(2).

A power that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the holder is not a general power of appointment. IRC §2041(b)(1)(A); Treas Reg §20.2041-1(c)(2). Nor is a power that is exercisable only in conjunction with the creator of the power, or with someone having a substantial interest in the property that is adverse to the decedent, a general power of appointment. IRC §2041(b)(1)(C)(i)-(ii). For further discussion of powers of appointment, see chap 9.

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§10.30 9. Proceeds of Life Insurance (IRC §2042)

The proceeds of an insurance policy on the decedent's life are included in the decedent's gross estate if the proceeds are (1) receivable by or for the benefit of the decedent's estate or (2) receivable by other beneficiaries and the decedent had any incidents of ownership in the policy at death. IRC §2042. See chap 19.

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§10.31 10. Transfers for Insufficient Consideration (IRC §2043)

If a decedent transfers property with retained rights under IRC §§2035-2038 (see §§10.15-10.26), or makes a taxable transfer by the exercise or release of a general power of appointment under IRC §2041 (see §10.29), and receives consideration in money or money's worth, but the transfer is not a bona fide sale for adequate and full consideration, the gross estate includes the excess of the date of death value of such property over the value of the monetary consideration received. IRC §2043(a).

EXAMPLE: The grantor of the trust reserves a life income interest in a trust, naming his children as the remainder beneficiaries. The grantor then sells his income interest to his children based on his actuarial life expectancy. Had the grantor not sold his life interest, the entire trust would have been included in his or her estate under IRC §2036(a). If the sale were a bona fide sale for full and adequate consideration, none of the trust would be included in the grantor's estate; only the proceeds of the sale would be included. When there is not a bona fide sale for full and adequate consideration, the value of the trust as of the date of death is included in the grantor's gross estate, reduced only by the monetary consideration received from the sale of the income interest, under IRC §2043(a).

Relinquishment of marital rights such as dower or curtesy is generally not treated as consideration. IRC §2043(b). Relinquishment of a half interest in community property, however, is consideration that is deductible for purposes of IRC §2043(a). *Estate of Christ v Commissioner* (9th Cir 1973) 480 F2d 171.

In cases involving transfers of remainder interests for consideration, there is a conflict among the circuits over whether the consideration received must be measured against the value of the actual interest transferred or the total value of the property that would have been included in the decedent's estate. Courts in the Third, Fifth, and Ninth Circuits have held that adequate and full consideration is measured by the value of transferred interest, not by the full value of the property. *Estate of Magnin v Commissioner* (9th Cir 1999) 184 F3d 1074; *Wheeler v U.S.* (5th Cir 1997) 116 F3d 749; *Estate of D'Ambrosio v Commissioner* (3d Cir 1996) 101 F3d 309, cert denied (1997) 520 US 1230. Courts in the Federal Circuit and the Tenth Circuit have held that consideration received must equal the full value of the property. *Gradow v U.S.* (Fed Cir 1990) 897 F2d 516; *U.S. v Allen* (10th Cir 1961) 293 F2d 916. These cases are primarily of interest when the transfer of the remainder interest occurred before the enactment of IRC §2702, which now may treat a transfer of a remainder interest as a transfer of the entire property for purposes of valuing the gift resulting from the transfer.

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Source: Estate Planning/California Estate Planning/10 Estate and Gift Taxes/§10.32 11. Certain Property for Which Marital Deduction Was Previously Allowed (IRC §2044)

§10.32 11. Certain Property for Which Marital Deduction Was Previously Allowed (IRC §2044)

The gross estate includes the value of property transferred to a decedent from a predeceased spouse, which qualified for the marital deduction as qualified terminable interest (QTIP) property under IRC §2056(b)(7) or §2523(f). IRC §2044. See §17.29.

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§10.33 C. Qualified Conservation Easement Exclusion

A portion of real property subject to a qualified conservation easement may be excluded from the gross estate. IRC §2031(c). The exclusion is in addition to the reduction in value of the property as a result of the easement. The property must be located in the United States or in a U.S. possession. The definition of "qualified conservation easement" is similar to the definition of "qualified conservation contribution," which is eligible for an income tax deduction under IRC §170(h), with certain additional restrictions. The easement may be created during life or at death. The easement may also be created after death by family members or by an executor or trustee, although no income tax deduction is available for an easement created at death or after death. See IRC §2031(c)(9). For further discussion, see §§23.93-23.102.

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§10.34 D. Valuation of Property in Gross Estate

Property included in a decedent's gross estate is generally valued as of the decedent's date of death. IRC §2031(a). If certain requirements are met, the executor may instead elect to value all property in the gross estate as of 6 months after the decedent's date of death. IRC §2032(a). This date is called the "alternate valuation date." See §10.35. Property is generally valued at its fair market value under the "willing buyer, willing seller" test, which may result in discounts or premiums relative to the decedent's percentage ownership interest in real property or closely held businesses. Treas Reg §20.2031-1(b). See §10.36, chap 18. Other rules apply to specific kinds of property. See §§10.37-10.45. Real property used in a farm, trade, or business may be eligible for a reduced "special use" valuation under IRC §2032A. See §10.46.

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§10.35 1. Alternate Valuation Date Election

The alternate valuation date is generally the date 6 months after the date of the decedent's death. Property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date of its distribution, sale, exchange, or other disposition. IRC §2032(a)(1); Treas Reg §20.2032-1(c).

To use the alternate valuation date, the executor must make an election on a timely filed estate tax return. The election will not be allowed if it is made on a return that is more than a year late, including extensions. IRC §2032(d); IRS Letter Ruling 200419005.

The election must decrease the value of the gross estate and the sum of federal estate tax and generation-skipping transfer tax payable. IRC §2032(c). Therefore, the election may not be used to increase the basis of estate assets in a zero-tax estate. See chap 12.

If the change in value is the result of a mere lapse of time, the property will be valued as of the decedent's date of death with adjustment for any difference in its value as of the subsequent valuation date not due to a mere lapse of time. IRC §2032(a)(3). Patent, life estates, remainders, or similar interests are examples of such assets. Treas Reg §20.2032-1(f). Proposed regulations provide that postdeath changes in the property, other than changes in "market conditions," such as corporate reorganizations and the impact of transferring some interests in property while retaining others, are disregarded in determining alternate valuation date values. Prop Treas Reg §20.2032-1(f)(3); REG-112196-07, 2008-21 Int Rev Bull 1021.

The election is irrevocable. IRC §2032(d). It must be made for the entire property in the gross estate, not merely a portion of the assets. IRC §2032(a); Treas Reg §20.2032-1(d). Regulations make clear that protective elections are permitted and irrevocable. If a protective election is made and it is later determined that the estate is eligible, the election will apply. Treas Reg §20.2032-1(b)(2). In *Estate of Kenneth R. Mapes* (1992) 99 TC 511, the court approved a protective election that would be valid only in the event the estate failed to qualify for special use valuation under IRC §2032A. The regulations would not necessarily permit such an election.

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§10.36 2. Fair Market Value

Property included in a decedent's gross estate is generally valued at its fair market value at the decedent's date of death (or alternate valuation date). "Fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas Reg §20.2031-1(b).

The estate tax is imposed only on the asset that passes at the time of death regardless of the relationship between the decedent and the ultimate recipient of the property. Thus, the decedent's interest in the property is not aggregated with other interests already owned by the recipient in determining whether discounts or premiums apply in valuing the decedent's interest. *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999. See §10.38, chap 18.

The transfer must be analyzed from the viewpoint of a hypothetical buyer and a hypothetical seller rather than a particular person or family member who would most likely undertake the transaction. *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191; *Morrissey v Commissioner* (9th Cir 2001) 243 F3d 1145; *Estate of McClatchy v Commissioner* (9th Cir 1998) 147 F3d 1089. Although the hypothetical buyer and seller are not identified with particular persons, actual sales in the normal course of business within a reasonable time before or after the valuation date are evidence of what a hypothetical buyer and seller would agree on. *Estate of Joyce C. Hall* (1989) 92 TC 312.

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§10.37 a. Household and Personal Effects

Household and personal effects generally include such things as art, jewelry, clothing, automobiles, furniture, and other household furnishings. These items are generally valued based on the fair market value of the item in its present condition. Treas Reg §20.2031-6(a). For articles with marked artistic and intrinsic value of a total in excess of $3000, an expert appraisal, under oath, must be filed with the estate tax return. Treas Reg §20.2031-6(b).

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§10.38 b. Real Property

For estate tax purposes, real property is valued to reflect the highest and best use of the property on the valuation date, unless special use valuation is elected under IRC §2032A. See §10.46. "Highest and best use" is defined as the most economic use that is reasonably probable. *Estate of Evelyn Wendt Pattison*, TC Memo 1990-428.

Different factors may be considered, depending on the type of real property involved (*e.g.*, apartment building, residential house, shopping center, or vacant land). For example, a residential tract lot might be valued based on comparables while an income-producing commercial building might be valued on the stream of rental payments. The value may also be affected by conservation easements and fractional-interest discounts. See §§10.39-10.40.

The value of real property as appraised for local tax purposes should not be used as the value for estate tax purposes unless it is determined that the value represents the fair market value at the applicable valuation date. Treas Reg §20.2031-1(b). See *Estate of Manuel Stanton*, TC Memo 1989-341 (assessments by local tax assessors or probate court representatives are not controlling).

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§10.39 (1) Effect of Conservation Easements

The value of property subject to a conservation easement is diminished by the value of the easement, and some of the remaining value of the property may be excluded from the gross estate if the easement qualifies under IRC §2031(c). See §10.33.

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§10.40 (2) Discounts for Fractional Interests

As with business interests (see §10.42), valuation discounts apply to partial interests in real property, although some courts have limited the discount to the cost of partition. See, *e.g., Estate of William Busch,* TC Memo 2000-3 (10 percent discount for 50 percent interest based on partition costs); *Estate of Eileen Kerr Stevens,* TC Memo 2000-53 (25 percent discount for 50 percent interest not limited by partition costs). In *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248, the court allowed a 15 percent discount in valuing the decedent's one-half community property interest in real property. No fractional-interest discount is available, however, for joint tenancy property held by spouses valued under IRC §2040(b). *Estate of Wayne-Chi Young* (1998) 110 TC 297. See §10.28.

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§10.41 c. Stocks and Bonds

The value of stocks and bonds for estate tax purposes is the fair market value per share or per bond on the valuation date. Treas Reg §20.2031-2(a). For publicly traded stocks and bonds, the fair market value is the mean between the highest and lowest quoted selling prices on the valuation date. If no sales occurred on the valuation date, the value is based on sales within a reasonable period (both before and after the valuation date) taking a weighted average of mean prices on the nearest dates before and after the valuation date. Treas Reg §20.2031-2(b). For example, if a decedent died on a Saturday, the value of the decedent's stocks will be determined by taking a mean of the prices on the previous Friday and the following Monday. The value of restricted shares of a publicly held company should be adjusted to take into consideration SEC regulations limiting the number of restricted shares that can be sold in any 3-month period as well as the likelihood of a corporate redemption or the possibility of a private placement of shares. See *Estate of Georgina T. Gimbel*, TC Memo 2006-270, in which the court allowed a 13.9-percent valuation discount for a hypothetical block of stock likely to be redeemed by the corporation and a 14.4-percent discount for shares that would need to be liquidated over a 31-month period because of the SEC Rule 144 restrictions. For unlisted stocks and securities, the value is determined by taking into account, in addition to all other factors, the value of publicly traded stocks or securities of corporations engaged in the same or a similar line of business. IRC §2031(b). See §10.42.

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§10.42 d. Business Interests

Interests in businesses such as closely held corporations, sole proprietorships, and partnerships may be included in the decedent's gross estate by calculating the value of the decedent's stock in the corporation, the value of all the assets in a sole proprietorship, or the value of the decedent's partnership interest as established by the partnership agreement or, if none, by a proportionate share of each asset, including goodwill. See Treas Reg §20.2031-3. Special valuation rules apply to certain retained interests and qualified payment rights. IRC §§2701-2704. See chap 25.

Under Rev Rul 59-60, 1959-1 Cum Bull 237 (modified by Rev Rul 65-193, 1965-2 Cum Bull 370, amplified by Rev Rul 77-287, 1977-2 Cum Bull 319, amplified by Rev Rul 80-213, 1980-2 Cum Bull 101, amplified by Rev Rul 83-120, 1983-2 Cum Bull 170), the following factors may be considered in valuing business interests:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook in general and the condition and outlook of the specific industry in particular;
- The book value of the company's stock and its financial condition;
- The company's earning capacity;
- The company's dividend-paying capacity;
- Whether the enterprise has goodwill or other intangible value;
- Sales of the stock and the size of the block to be valued; and
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter.

These factors are not exclusive, nor is any one factor controlling. Other factors also may be taken into account depending on the nature of the business. Discounts for lack of marketability, lack of control, or minority interest are commonly applied to closely held business interests. A "blockage discount" may apply to a large block of stock whose sale all at once on the market would depress the value. A control premium may be added to a controlling interest in a business. A premium may also apply to a minority interest when that interest may potentially control the corporation in the form of a swing vote. For discussion of discounts and premiums, see chap 18.

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§10.43 e. Promissory Notes

The fair market value of all promissory notes (secured and unsecured) includes the amount of unpaid principal plus interest accrued to the date of death, unless the executor proves otherwise. Treas Reg §20.2031-4. If a promissory note is not secured, the face value of the note may not be the fair market value.

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§10.44 f. Commercial Annuities and Insurance

In general, replacement value (also known as interpolated terminal reserve value) is used for the fair market value of commercial annuities or insurance policies on the lives of persons other than the decedent. Treas Reg §§20.2031-7(b), 20.2031-8. See chaps 19-20.

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§10.45 g. Noncommercial Annuities, Life Estates, Terms of Years, Remainders, and Reversionary Interests

In general, the fair market value of a noncommercial annuity, interest for life or a term of years, remainder, or reversionary interest is the present value of the interest as determined using the valuation tables prescribed under IRC §7520. Treas Reg §20.2031-7(a). Alternative valuation methods may be used, however, if the tables produce an unrealistic and unreasonable value, *e.g.*, lottery payments subject to a statutory transfer restriction in the Ninth Circuit. See *Estate of Gribauskas v Commissioner* (2d Cir 2003) 342 F3d 85; *Shackleford v U.S.* (9th Cir 2001) 262 F3d 1028. But see *Negron v U.S.* (6th Cir 2009) 553 F3d 1013; *Anthony v U.S.* (5th Cir 2008) 520 F3d 374, cert denied (2008) 555 US ___, 172 L Ed 2d 36, 129 S Ct 115 (nonassignable commercial annuities must be valued using IRC §7520 tables); *Estate of Cook v Commissioner* (5th Cir 2003) 349 F3d 850; *Davis v U.S.* (D NH 2007) 2007-1 USTC ¶60,542, 99 AFTR2d 3341 (nonassignable rights to future lottery payments are to be valued under IRC §7520).

The taxpayer in *Anthony* raised an additional argument not made in *Cook,* taking the position that the transfer restriction was an "other restriction" within the meaning of Treas Reg §20.7520-3(b)(1)(ii). However, the court concluded that the regulation is concerned with restrictions that might result in the beneficiary not receiving the benefits assumed by the table, whereas the restriction on transferability did not change the fact that the decedent had an unrestricted right, independent of market forces, to receive specified amounts of money at specified times. The *Anthony* decision is noteworthy for its use of an original regulation preamble to resolve a dispute concerning the meaning of the regulation.

The *Davis* decision is similar to the Tax Court decision reversed by the court appeal in *Estate of Paul G. Gribauskas* (2001) 116 TC 142, rev'd (2d Cir 2003) 342 F3d 85. These decisions have relatively little significance in the Ninth Circuit because of the taxpayer-friendly decision in *Shackleford*. Regardless of how nonassignable rights to future lottery payments are valued, proceeds from the sale of the right to receive future lottery payments are taxed as ordinary income. *Watkins v Commissioner* (10th Cir 2006) 447 F3d 1269; *Lattera v Commissioner* (3d Cir 2006) 437 F3d 399, cert denied (2007) 549 US 1212; *U.S. v Maginnis* (9th Cir 2004) 356 F3d 1179. For discussion of noncommercial or private annuities, see chap 20. Special rules apply to the valuation of remainder interests, life estates, and terms of years in charitable remainder trusts and pooled income funds. See chaps 23-24.

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§10.46 3. Special Use Valuation (IRC §2032A)

The executor may elect to value qualified real property in a farm, trade, or business based on its qualifying use rather than on its highest and best use. IRC §2032A(a). The election must be made on the estate tax return, and a recapture agreement signed by each person with an interest in the property must be filed with the return. IRC §2032A(a)(1)(B), (d); Treas Reg §20.2032A-8(a), (c). A protective election may be made on the return pending the final determination of value. Treas Reg §20.2032A-8(b).

To qualify for IRC §2032A treatment, the following requirements must be met:

- The decedent must have been a U.S. resident or citizen and the qualified real property must be in the United States. IRC §2032A(a)(1)(A), (b)(1).
- The property must pass to a qualified heir of the decedent. A "qualified heir" is a member of the decedent's family, defined as a spouse or an ancestor of the decedent, a lineal descendant of the decedent or of the decedent's spouse or parent, or a spouse of any such lineal descendant. IRC §2032A(b)(1), (e)(1)-(2).
- The property was used for a qualified use by the decedent or a member of the decedent's family on the date of the decedent's death. IRC §2032A(b)(1).
- At least 50 percent or more of the adjusted value of the gross estate consists of the adjusted value of real or personal property that was (a) being used for a qualified use by the decedent or a member of the decedent's family on the date of the decedent's death and (b) acquired from or passed to a qualified heir of the decedent. IRC §2032A(b)(1)(A).
- At least 25 percent of the adjusted value of the gross estate consists of the adjusted value of such real property. IRC §2032A(b)(1)(B).
- During at least 5 of the 8 years preceding the decedent's death (a) the property was owned by and used for a qualified use by the decedent or a member of the decedent's family and (b) there was material participation by the decedent or a member of the decedent's family. IRC §2032A(b)(1)(C). For the definition of "material participation," see IRC §2032A(e)(6) and Treas Reg §20.2032A-3.

The aggregate decrease in the value of qualified real property may not exceed $750,000, plus cost-of-living adjustments. IRC §2032A(a)(2)-(3). For estates of decedents dying in 2010, if the estate tax is extended, the aggregate decrease may not exceed $1,000,000. Rev Proc 2009-50, 2008-45 Int Rev Bull 617.

PRACTICE TIP: An estate that meets the requirements for IRC §2032A special use valuation may also be eligible for a qualified conservation easement exclusion under IRC §2031(c) and installment payment of estate tax under IRC §6166. See §§10.33, 10.72.

There is a potential recapture tax if, within 10 years after the decedent's death and before the death of the qualified heir, the heir disposes of the property or ceases to use it for a qualified purpose. IRC §2032A(c). The qualified heir is generally liable for the recapture tax. IRC §2032A(c)(4)-(5). However, a "qualified conservation contribution" of a conservation easement in special use property is not a disposition of the property. IRC §2032A(c)(8). See IRS Letter Ruling 200840018 (sale of conservation easement to charity is not a "contribution" within the meaning of IRC §170(h)). See also *Estate of Gibbs v U.S.* (3d Cir 1998) 161 F3d 242, 250 n7 (same in dictum).

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§10.47 E. Deductions From Gross Estate

In determining the value of the taxable estate, the estate may deduct certain amounts from the value of the gross estate. IRC §§2053-2058. See §§10.48-10.58.

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§10.48 1. Expenses, Indebtedness, and Taxes (IRC §2053)

The estate may deduct from the value of the gross estate amounts allowable by local law for funeral expenses, administration expenses, claims against the estate, unpaid mortgages or property indebtedness, and other administrative expenses. IRC §2053. See §§10.49-10.53. Amounts allowed as deductions under §2053 for estate tax purposes are not allowed to the estate as deductions for income tax purposes. IRC §642(g). Section 2053 does not contain a specific directive to value deductions at their date-of-death values. Courts addressing the issue have reached different conclusions regarding the extent to which post-death events should be considered in valuing claims against the estate. Compare *Ithaca Trust Co. v Commissioner* (1929) 279 US 151, 73 L Ed 647, 49 S Ct 291 (holding that the estate tax charitable deduction must be determined as of the date of death) and its progeny (see §10.51) with *Jacobs v Commissioner* (8th Cir 1929) 34 F2d 233, cert denied (1929) 280 US 603 (holding that only claims presented and determined as valid against the estate and actually paid could be deducted against the estate) and its progeny. The IRS has issued regulations intended to settle this split of authority. TD 9468, 2009-44 Int Rev Bull 570.

In general, the regulations adopt the *Jacobs* approach and allow deductions under IRC §2053(a)(3) only for amounts actually paid in settlement of claims against the estate. The regulations contain an important de minimis rule that an executor may deduct the current value of unpaid claims that are otherwise deductible totaling not more than $500,000. Treas Reg §20.2053-4(c). If contested or contingent claims cannot be resolved before the expiration of the period of limitations for refund claims, the estate would be able to file a protective claim for refund to preserve its right to claim the deduction. Treas Reg §20.2053-1(d)(5).

PRACTICE TIP: Because the new regulations are expected to increase the number of situations in which it is necessary to file refund claims, many practitioners have been concerned that the IRS might examine the entire return when action was taken on a refund claim. Such a reexamination is permitted under case law because the IRS must determine whether there has actually been an overpayment of tax when acting on such claims. The IRS has stated that it will limit examination of the estate tax return to evidence relating to the deduction that was the subject of the protective claim when action is taken on a refund claim if the period of limitations on assessments has expired. Notice 2009-84, 2009-44 Int Rev Bull 592.

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§10.49 a. Funeral Expenses

Funeral expenses for a "reasonable" amount may be deducted. These expenses include the cost of the funeral and burial ceremonies as well as related expenses such as the casket, flowers, food for the mourners, clothing for the decedent, and the cost of transporting the body to the burial site. A reasonable amount may also be deducted for expenses related to the burial site such as a tombstone or landscaping. Treas Reg §20.2053-2. Fortunately, funeral expense issues are rarely litigated or even raised as tax audit issues. Nevertheless, the estate should be prepared to provide some evidence establishing that a claimed funeral expense is a normal and customary part of a funeral under the circumstances. In *Estate of Sarah M. Davenport*, TC Memo 2006-215, the court denied a deduction for a claimed $3639 expense for a "funeral luncheon." The court held that the record was insufficient to establish the requisite necessity of the funeral reception because the estate failed to itemize the charges.

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§10.50 b. Administration Expenses

Administration expenses are generally the expenses actually and necessarily incurred in administering the decedent's estate. These expenses include executors' commissions and attorney fees actually paid or reasonably expected to be paid and miscellaneous administration expenses such as court costs, appraiser fees, accountant fees, notary fees, and costs of sale if a sale is necessary to pay debts, expenses of administration, or taxes; to preserve the estate; or to effect distribution. Treas Reg §20.2053-3. However, deductions are not allowable without actual payment, except that deductions may be allowed for expenses not yet paid provided that the amount to be paid is ascertainable with reasonable certainty and will be paid. Treas Reg §20.2053-1(d)(1), (d)(4). These expenses may be deducted on either the estate tax return or the income tax return, but not both. IRC §642(g). For deduction of administrative expenses not subject to claims, see §10.53.

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§10.51 c. Claims Against Estate

Claims against the decedent's estate are the decedent's personal obligations existing at the date of death and any interest accrued at the time of the decedent's death. Treas Reg §20.2053-4(a)(1). The claim must be enforceable against the decedent's estate at the time of payment, and must actually be paid by the estate in satisfaction of the claim. Treas Reg §20.2053-4(a)(1). The regulations state: "Events occurring after the date of a decedent's death *shall* be considered in determining whether and to what extent a deduction is allowable." Treas Reg §20.2053-4(a)(2) (emphasis added).

However, the regulations bar deductions for potential and unmatured or contested claims. Treas Reg §20.2053-4(d)(1)-(2). Unenforceable claims are not deductible even if paid. Treas Reg §20.2053-4(d)(4). Thus, amounts actually paid that are time-barred, or otherwise unenforceable at the time paid, are not deductible.

Deductions may be allowed in certain instances if an amount "has been paid or *will* be paid" pursuant to a court decree. Treas Reg §20.2053-1(b)(3)(i) (emphasis added). This requirement is met when a court actually passes on the facts on which deductibility depends, and also will be met when a consent decree resolves a bona fide issue in a genuine contest. Treas Reg §20.2053-1(b)(3)(ii). Another rule concerning settlements favorably allows "paid or will be paid" treatment for settlement of nuisance claims that arguably lack merit, provided the suit is not clearly barred by the statute of limitations or a probate claims period. Treas Reg §20.2053-1(b)(3)(iv). An estate also may deduct the decedent's unpaid subscriptions and charitable pledges made before death. Treas Reg §20.2053-5.

The present value of recurring payments (or amounts paid for the purchase of a commercial annuity from an unrelated dealer in an arm's-length transaction to satisfy the obligation to pay) is deductible only if the obligation is enforceable, certain, and not subject to any contingencies. Treas Reg §20.2053-4(d)(6). However, the amount of the claim based on a decedent's obligation to make recurring payments contingent on death (measured according to actuarial principles, using factors set forth in the transfer tax regulations or provided by the IRS) will be deemed ascertainable with reasonable certainty. Treas Reg §20.2053-4(d)(6)(i). The regulations appear to validate the decision in *Estate of Van Horne v Commissioner* (9th Cir 1983) 720 F2d 1114, in which the court allowed a deduction for the present value of the decedent's obligation to pay a monthly sum to a former spouse for the life of the former spouse without regard to the fact that the former spouse died only 6 months after the decedent.

Intra-family loans may be deductible if they have real economic substance. In *Estate of Kimberly A. Hicks*, TC Memo 2007-182, in a case involving the allocation of a personal injury settlement between a trust for the injured child and the child's father (for loss of consortium), the Tax Court held that a court-ordered $1 million loan from the father to the trust created a bona fide debt that was deductible by the child's estate under IRC §2053(c)(1)(A). However, the regulations establish a presumption that claims by family members, related entities, and beneficiaries are not bona fide. Treas Reg §20.2053-1(b)(2).

Taxes accrued and enforceable at a decedent's death are deductible only as claims against the estate, except to the extent that excise taxes may be allowable as administration expenses. Treas Reg §20.2053-6(a), (e). Taxes accruing after the decedent's death are not deductible. Treas Reg §20.2053-6(b); *Estate of Margot Stewart*, TC Memo 2006-225. See Treas Reg §20.2053-6(f) for the determination of taxes deductible if spouses file a joint income tax return. For discussion of the consequences of deducting expenses on the income tax return, see §§17.17, 17.42.

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§10.52 d. Unpaid Mortgages or Property Indebtedness

The full amount of an unpaid mortgage or any other indebtedness regarding any property of the gross estate may be deducted. The deduction is allowed only for the amount of the liability that was contracted bona fide and for adequate and full consideration in money or money's worth. Treas Reg §20.2053-7.

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§10.53 e. Other Administrative Expenses

A deduction is allowed for amounts representing expenses incurred in administering property not subject to claims (generally property of an inter vivos trust) if they would have been allowed as deductions if the property being administered were subject to claims against the estate (see §10.51) and were paid before the period of limitation for assessment expires under IRC §6501. Treas Reg §20.2053-8.

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§10.54 2. Losses (IRC §2054)

The estate may deduct from the value of the gross estate losses incurred during the settlement of the estate arising from fires, storms, shipwrecks, or other casualties, or from theft, when such losses are not compensated by insurance or otherwise. IRC §2054. If the loss is partly compensated, the executor may deduct the uncompensated amounts. Treas Reg §20.2054-1. Amounts allowed as deductions under IRC §2054 for estate tax purposes are not allowed to the estate as deductions for income tax purposes. IRC §642(g).

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§10.55 3. Charitable Deduction (IRC §2055)

A charitable deduction may be claimed for estate tax purposes for interests passing to or for the use of qualified recipients for public, charitable, and religious uses as described in IRC §2055(a). Property received under a power of appointment and included under IRC §2041 (see §10.29) is considered as having passed from the decedent. IRC §2055(b). If estate tax or other death taxes are payable from the amount passing to charity under a decedent's will or state law, then the charitable deduction is reduced by the amount of such taxes. IRC §2055(c). The deduction is limited to the value of the transferred property required to be included in the gross estate. IRC §2055(d). A charitable deduction may be permitted for a split interest in property passing to both charitable and noncharitable recipients, such as to a charitable remainder trust, charitable lead trust, or pooled income fund, if certain requirements are met. See IRC §2055(e)(2). For further discussion, see chaps 23-24.

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§10.56 4. Marital Deduction (IRC §2056)

An unlimited marital deduction is generally allowed for transfer from a decedent to the decedent's surviving spouse. IRC §2056(a). For transfers to noncitizen spouses, the deduction is allowed only for property transferred to a qualified domestic trust. IRC §§2056(d), 2056A. For terminable interests, the deduction is allowed only if the transfer is in the form of a qualified terminable interest property trust or other qualifying trust. IRC §2056(b). See chap 17.

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§10.57 5. Qualified Family-Owned Business Interest (QFOBI) Deduction (IRC §2057)

For estates of decedents dying before January 1, 2004, an executor may elect a deduction for qualified family-owned business interests (QFOBIs) if certain requirements are met. IRC §2057(a)(1). The maximum deduction is $675,000, but the IRC §2010 applicable exclusion amount combined with the deduction cannot exceed $1.3 million. IRC §2057(a)(2)-(3). As a result, the maximum amount by which the estate can be reduced in 2011 and thereafter if the estate tax is restored under EGTRRA-2001 is $300,000. In 2004-2009, the applicable exclusion amount by itself exceeds $1.3 million and the deduction is repealed. IRC §2057(j). If IRC §2057 applies, the estate also may qualify for IRC §2032A special use valuation as described in §10.46.

The following requirements must be met to qualify for the deduction:

- The decedent was a U.S. citizen or resident at death. IRC §2057(b)(1)(A).
- An election is made on the estate tax return and a recapture agreement signed by each person with an interest in the business is filed with the return. IRC §2057(b)(1)(B), (h).
- The adjusted value of the interests plus certain lifetime gifts of such interests exceed 50 percent of the adjusted gross estate. IRC §2057(b)(1)(C), (c).
- During at least 5 of the 8 years preceding the decedent's death the interests were owned by the decedent or a member of the decedent's family, with material participation by the decedent or a member of the decedent's family in the operation of the business. IRC §2057(b)(1)(D). For definitions of "family member" and "material participation," see IRC §§2057(i), 2032A(e)(2), (6).
- The interests are included in the gross estate and acquired by or passed to a qualified heir from the decedent. IRC §2057(b)(2). For definition of "qualified heir," see IRC §§2057(i)(1), 2032A(e)(1).
- The interests are either (1) interests as a proprietor in a trade or business carried out as a sole proprietorship or (2) interests in a trade or business in which at least 50 percent of the value of the business was owned by the decedent or the decedent's family (30 percent if two families own 70 percent of the business or three families own 90 percent of the business). IRC §2057(e)(1).
- The principal place of business is in the United States. IRC §2057(e)(2)(A). Other restrictions apply to interests in personal holding companies and other businesses holding cash and marketable securities. IRC §2057(e)(2)(B)-(D).

For these purposes, notes evidencing debt owed by a family business corporation to the deceased shareholder do not constitute QFOBIs in determining whether 50 percent of the decedent's gross estate consists of QFOBIs under IRC §2057(c). See *Estate of Farnam v Commissioner* (8th Cir 2009) 583 F3d 581.

If the qualified heir fails to materially participate in the business or disposes of any portion of a QFOBI within 10 years after the decedent's death and before the date of the qualified heir's death, an additional tax is imposed on the qualified heir equal to a gradually decreasing percentage of the adjusted tax difference attributable to the QFOBI, plus interest. IRC §2057(f)(1)(A)-(B). This additional tax also applies if the qualified heir loses his or her citizenship or the principal place of business is no longer in the United States. IRC §2057(f)(1)(C)-(D). In IRS Letter Ruling 200252084, the Service ruled that a corporation's redemption of a qualified heir's stock would trigger additional tax, even though all other stockholders were members of the heir's family. In IRS Letter Ruling 200327016, however, the Service ruled that an IRC §303 redemption of stock to pay estate taxes (see §10.77) was not a disposition that would trigger additional tax. The additional tax continues to apply to estates making the election for decedents dying before termination of the QFOBI deduction in 2004. See IRC §2057(j).

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§10.58 6. Deduction for State Death Taxes Paid (IRC §2058)

In 2005, the IRC §2011 state death tax credit was repealed and replaced by a deduction for state death taxes paid. IRC §2058. See §10.60. In states with a pick-up tax, such as California, repeal of the credit results in zero state death taxes. See chap 15.

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§10.59 F. Estate Tax Credits

In addition to the IRC §2010 unified credit, which shields a portion of a decedent's estate and lifetime gifts from tax (as discussed in §§10.2-10.11), the Code provides for credits against estate tax otherwise payable for various taxes paid on the decedent's property. IRC §§2011-2016. See §§10.60-10.65.

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§10.60 1. State Death Tax Credit (IRC §2011)

For estates of decedents dying before January 1, 2005, a credit is allowed under IRC §2011 for any state death taxes actually paid with respect to property included in the decedent's gross estate and with respect to the decedent's estate. The credit is limited to a percentage of an amount based on the amount of the adjusted taxable estate. In a state with a pick-up tax, such as California, the credit has the effect that a portion of the estate tax that otherwise would have been paid to the IRS under IRC §2001 is paid to the state. The credit was repealed in 2005. See IRC §2011(f). Repeal of the credit results in zero state death taxes in states with a pick-up tax. See chap 14.

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§10.61 2. Credit for Gift Tax Paid (IRC §2012)

A credit is allowed for gift tax paid on the decedent's lifetime transfers if the transferred property is included in the decedent's estate. IRC §2012. Inclusion of gifted property may occur if the decedent retained certain interests in the property under IRC §§2035-2038. See §§10.15-10.26.

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§10.62 3. Credit for Tax on Prior Transfers (IRC §2013)

To provide relief from the imposition of estate taxes on deaths that occur in quick succession, IRC §2013 provides a credit for estate tax paid with respect to a transfer of property to the decedent by another person, the transferor, who died within 10 years before, or 2 years after, the decedent. The credit is 100 percent of the amount determined under IRC §2013(b) if the deaths occur within 2 years of each other, and the credit is reduced as the deaths occur further apart. IRC §2013(a). The credit is the amount that bears the same ratio to the estate tax paid with respect to the transferor's estate as the value of the transferred property bears to the taxable estate of the transferor, with certain modifications. IRC §2013(b). The credit cannot exceed the tax attributable to the transferred property included in the decedent's gross estate. IRC §2013(c). The credit will not be allowed for the surviving spouse's estate if the estate of the first spouse to die paid no estate tax on the transferred property because a marital deduction was allowed under IRC §2056. IRC §2013(d).

In some cases, better tax savings may be achieved by using the IRC §2013 credit than by using the IRC §2056 marital deduction. If the surviving spouse is in poor health, it may be advisable to disclaim a portion of the marital deduction property under IRC §2518 to produce an estate tax so that the spouse's estate can receive the §2013 credit for property passing to the spouse, or the executor of the decedent's estate may choose not to make a qualified terminable interest property (QTIP) election under IRC §2056(b)(7) with respect to property in which the surviving spouse has a qualifying life income interest. Making a disclaimer or not making a QTIP election may become desirable if the surviving spouse dies unexpectedly. Therefore, the estate of a deceased spouse should generally request an automatic 6-month extension to file the federal estate tax return. See §10.67. For discussion of marital deduction planning, see chap 17.

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§10.63 4. Credit for Foreign Death Taxes (IRC §2014)

To remedy some of the effects of double taxation that may occur because the United States taxes a decedent's worldwide assets, a credit is allowed for foreign death taxes on property in the foreign country and included in the decedent's gross estate. IRC §2014(a). The credit is limited to the lesser of the amount of foreign death tax attributable to foreign property or the amount of estate tax attributable to foreign property. IRC §2014(b). The foreign death taxes must actually have been paid and the credit claimed within 4 years after the decedent's federal estate tax return was filed, unless a petition for redetermination is pending under IRC §6213(a) or an extension has been granted under IRC §6161. IRC §2014(e). For discussion of extensions, see §10.70. If the U.S. has entered into an estate tax treaty with the country to which an IRC §2014 credit applies, the estate may apply the credit allowed under either the treaty or §2014. Treas Reg §20.2014-4(a).

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§10.64 5. Credit for Death Taxes on Remainders (IRC §2015)

A credit is available for state or foreign death taxes on a reversionary or remainder interest in property in the decedent's gross estate for which a credit would be allowable under IRC §2011 or IRC §2014, respectively. IRC §2015. For estates of decedents dying after 2004, when the state death tax credit will not apply, the credit will be available only for foreign death taxes under §2014. See §§10.60, 10.63. The IRC §2015 credit applies only if an election is made to postpone the time for payment of the part of the federal estate tax attributable to a reversionary or remainder interest under IRC §6163. See §10.70.

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§10.65 6. Recovery of Taxes Claimed as Credits (IRC §2016)

If any tax claimed as a credit for state or foreign death taxes under IRC §2011 or IRC §2014, respectively, is recovered from the state or foreign country, the executor or other person receiving the recovery must notify the IRS, which will redetermine the estate tax liability. IRC §2016. For estates of decedents dying after 2004, when the state death tax credit does not apply, the notification is required only for foreign death taxes recovered. See §§10.60, 10.63.

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§10.66 G. Filing Estate Tax Return

The estate tax return, IRS Form 706, must be filed within 9 months after the date of the decedent's death (*e.g.*, the day in the 9th calendar month after the decedent's death numerically corresponding to the day the decedent died), unless an extension is obtained. IRC §6075(a). If there is no numerically corresponding day in the 9th month, the return is due on the last day of the 9th month. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is the next succeeding day that is not a Saturday, Sunday, or legal holiday. Treas Reg §20.6075-1.

All estate tax returns (except returns for American Samoa, Guam, the U.S. Virgin Islands, and Puerto Rico) are filed at the IRS Service Center in Cincinnati, Ohio. See IRS Announcement 2001-74, 2001-2 Cum Bull 40. For discussion of extensions and late-filing penalties, see §§10.67-10.68.

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§10.67 1. Extension of Time to File

An automatic 6-month extension to file the return may be requested by the regular due date on IRS Form 4768. Treas Reg §20.6081-1(b). If there is a surviving spouse, it is usually desirable to request the automatic extension in the event the surviving spouse dies within the 6-month extension period. See §10.62.

If a request for an automatic extension is not timely filed, an extension of up to 6 months can be requested on IRS Form 4768. An extension will be granted on a showing of good cause. Treas Reg §20.6081-1(c). The request must include an estimate of the amount of estate and generation-skipping transfer (GST) tax liabilities of the estate. Treas Reg §20.6081-1(a). Executors who are out of the country may apply for an extension beyond 6 months. IRC §6081(a); Treas Reg §20.6081-1(c).

An extension for the time to file a return does not extend the time to pay the tax. Treas Reg §20.6081-1(e). See §10.69.

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§10.68 2. Late-Filing Penalty

There is a late-filing penalty of 5 percent per month, not to exceed 25 percent, of the amount of the tax. IRC §6651(a)(1). If the failure to file was fraudulent, the penalty is increased to 15 percent per month with a maximum of 75 percent. IRC §6651(f). A return filed even 1 day late is subject to the penalty. For example, if an estate tax return with $100,000 due is filed a day late, a penalty of $5000 will be imposed on the estate. Filing a late return also precludes the executor's ability to elect to defer the payment of estate taxes under IRC §6166. See §10.72.

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§10.69 H. Payment of Estate Tax

The estate tax must be paid at the time fixed for filing the estate tax return, without regard to extensions. IRC §6151(a). If no extension of time for payment is available under IRC §6161 or §6163, and installment payments are not available under IRC §6159 or §6166, a late-payment penalty of 0.5 percent per month not to exceed 25 percent of the amount of the tax due will apply. IRC §6651(a)(2). In *Estate of Antoinette Hartsell,* TC Memo 2004-211, penalties were imposed when the executor failed to take reasonable steps to liquidate estate assets to pay the tax after the executor's request for a further 1-year extension was denied. In *Baccei v U.S.* (ND Cal 2008) 2008-2 USTC ¶60,562, 102 AFTR2d 5801, the late-payment penalty was imposed because the executor's request for an extension of time to file the return did not explicitly request an extension of time to pay the tax and a cover letter that requested an extension of time to pay did not specify the period of the extension sought. For discussion of extensions and installment payments, see §§10.70-10.74A. For discussion of planning for liquidity to pay the tax, see §§10.75-10.78.

The executor or administrator of the estate is liable for payment of the estate tax. IRC §§2002, 2203. This duty applies to the entire tax even though the gross estate may consist of property not within the possession of the executor or administrator. If there is no executor or administrator appointed, qualified, and acting in the U.S., anyone in actual or constructive possession of any property of the decedent, *e.g.,* the trustee of a revocable trust, must pay the entire tax to the extent the value of the property is in that person's possession. Treas Reg §20.2002-1.

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§10.70 1. Extension of Time for Payment

In general, the IRS may extend the time to pay the tax for a reasonable period not to exceed 12 months. IRC §6161(a)(1). The IRS may also extend for up to 10 years the time to pay the estate tax, or any part of an installment payment under IRC §6166 (see §10.72), for "reasonable cause." IRC §6161(a)(2). This extension must be requested on IRS Form 4768 and usually requires a showing of undue hardship. Treas Reg §20.6161-1(a)(2). If an extension is granted, the estate must pay interest on the tax liability during the period of the extension. IRC §6601(a); Treas Reg §20.6161-1(c)(2).

The executor may elect to postpone the payment of tax on a remainder or reversionary interest included in the decedent's gross estate until 6 months after the termination of the precedent interest or interests in the property. IRC §6163.

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§10.71 2. Installment Payments for All Taxpayers

The IRS may enter into a written agreement with a taxpayer to pay taxes through installment payments, if the IRS believes that the agreement will facilitate tax collection. The IRS may terminate the agreement if inaccurate information is provided. The IRS may also alter, modify, or terminate the agreement if payment is not made, or if a significant change occurs in the taxpayer's financial situation. IRC §6159. Installment payment of estate tax is available as a matter of right for estates that include closely held business interests under IRC §6166. See §10.72.

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§10.72 3. Installment Payments for Closely Held Business Interests

If an estate includes an interest in a closely held business whose value exceeds 35 percent of the adjusted gross estate, the executor may elect to pay a proportionate part of the estate tax due in ten equal installment payments. The first payment can be deferred for 5 years after the estate tax is due. IRC §6166(a). During the deferral period, interest must be paid. See §10.73. In some cases, 5-year deferral does not apply, and in some cases the tax must be paid in five installments. IRC §6166(b)(8), (10). To qualify for the extension, the decedent must have been a U.S. citizen or resident at death. IRC §6166(a). The election must be made on a timely filed estate tax return. IRC §6166(d). There is no "reasonable cause" exception to this requirement, and the IRS generally cannot grant relief from the statutory deadline. See IRS Legal Memorandum 200628042.

An interest in a closely held business is defined as (IRC §6166(b)(1)):

- An interest as a proprietor in a proprietorship;
- An interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest in the partnership is included in determining the decedent's gross estate, or the partnership had 45 or fewer partners; or
- Stock in a corporation carrying on a trade or business if 20 percent or more in value of its voting stock is included in determining the gross estate of the decedent, or the corporation had 45 or fewer shareholders.

In Rev Rul 2006-34, 2006-1 Cum Bull 1172, the IRS provides certain safe harbors and a nonexclusive list of factors that are likely to be relevant in determining whether a deceased owner's activities with regard to real property are sufficiently active to support a finding that the real property constitutes a closely-held business interest under IRC §6166. The ruling updates guidance provided by Rev Rul 75-365, 1975-2 Cum Bull 471; Rev Rul 75-366, 1975-2 Cum Bull 472; Rev Rul 75-367, 1975-2 Cum Bull 472.

Stock or partnership interests owned by a husband and wife are treated as owned by one shareholder or partner. IRC §6166(b)(2). The estate also may elect to treat non-readily-tradable stock or partnership interests owned by members of decedent's family as owned by the decedent for purposes of the 20-percent capital interest test, with loss of 5-year deferral. IRC §6166(b)(7); IRS Letter Ruling 200529006. Deferral is not available for passive assets held by the closely held business (*i.e.*, assets not used in carrying on a trade or business). IRC §6166(b)(9). Special rules apply to interest on deferred payments, acceleration of payment on deferred tax, and security for payment of deferred tax. See §§10.73-10.74A.

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§10.73 a. Interest on Deferred Payments

If an extension is granted to make installment payments, the estate must pay interest on the deferred tax. IRC §6166(f). Interest only is payable during the first 5 years of deferral, and thereafter is paid with the annual installment of tax due. The first payment of interest is due 1 year and 9 months after the decedent's date of death. In addition to the advantage of deferred payment, a special 2 percent interest rate applies to the estate tax attributable to the first $1 million (plus cost-of-living adjustments) in value of closely held business interests in excess of the applicable exclusion amount. IRC §6601(j). The amount for estates of decedents dying in 2010 is $1,340,000. Certain interests not eligible for 5-year deferral are also ineligible for the 2 percent rate. IRC §6166(b)(8). Non-readily-tradable partnership interests and stock owned by estates making an election under IRC §6166(b)(7) (see §10.72) also are ineligible for the 2-percent rate. Interest applies to the balance of the estate tax at 45 percent of the regular rate for underpayment of tax under IRC §6601(a). IRC §6601(j). Interest paid is not deductible for income tax purposes. IRC §163(k). Nor is interest deductible for estate tax purposes (IRC §2053(c)(1)(D)), with the result that the net cost of deferred payments for closely held business interests in excess of the 2 percent portion is about the same (slightly less at the current maximum rate of 45 percent, relative to the historical maximum rate of 55 percent) as it would have been with regular interest minus the deduction, without the need to file a return and recalculate the value of the estate every year.

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§10.74 b. Acceleration of Deferred Tax

Payment of deferred tax may be accelerated if the closely held business interest is distributed, sold, exchanged, or otherwise disposed of, or if money is withdrawn from the business, which in aggregate is at least 50 percent of the value of the interest. IRC §6166(g)(1). In IRS Letter Ruling 200321006, the Service ruled that cash leases of farmland by a testamentary trust to single-member limited liability companies owned by the beneficiaries did not constitute dispositions that would accelerate payment of deferred tax. Failure to make an interest or principal payment within 6 months of the due date will also accelerate the date of payment, as well as disqualify the payment for the special interest rate. IRC §6166(g)(3). In practice, a failure to make an installment payment when due causes the IRS to send a letter informing the estate to pay the installment or lose the privilege. Rev Proc 2005-33, 2005-1 Cum Bull 131. If a delinquent payment is made within the 6-month grace period, the estate will nevertheless be subject to late payment penalties for that installment and lose the benefit of the special interest rate. Acceleration precludes an action for refund based on recalculation of the tax under IRC §7422(j). *Hansen v U.S.* (8th Cir 2001) 248 F3d 761.

In IRS Letter Ruling 200648028, the Service took the position that an overpayment of estate and generation-skipping transfer (GST) taxes subject to installment payments pursuant to an IRC §6166 election could not be reallocated to delinquent gift taxes. The ruling went on to state, however, that the estate could rescind its designation of the payment for estate and GST taxes, and allow the Service to apply the overpayment to other taxes in its discretion.

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§10.74A c. Security for Payment of Deferred Tax

In some cases, the IRS may require a bond or a special lien under IRC §6324A to secure payment of the deferred tax, but there is no mandatory bond requirement that may be applied by the IRS without exercising discretion. See *Estate of Edward P. Roski, Sr.* (2007) 128 TC 113. The IRS has issued interim guidance in advance of regulations that would set standards to be applied on a case-by-case basis in determining whether a bond or lien will be required to qualify for the election to pay tax in installments. Notice 2007-90, 2007-46 Int Rev Bull 1003. In IRS Legal Memorandum 200747019, the Service provided guidance on the issue of when it will accept closely held corporation stock as collateral in lieu of a bond under IRC §6166(k)(2). The IRS guidance indicates that expectation of survival of the business for the deferral period is a primary consideration both in accepting a special lien in lieu of a bond and in asking for a bond or special lien in the first place.

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§10.75 4. Planning for Liquidity to Pay Tax

Because taxes must be paid in cash, liquidity is an important consideration in the estate planning process. Some methods used to plan for liquidity to pay estate tax are discussed in §§10.76-10.78.

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§10.76 a. Insurance

Life insurance is a useful means of providing an estate with the liquidity to pay the estate tax. For discussion of the use of insurance for providing liquidity, see chap 19.

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§10.77 b. Redemption Agreements

To obtain liquidity, an estate may need to redeem stock of a closely held business included in the estate if deferring payments under IRC §6166 is not available or is undesirable. See §10.72. If it is anticipated that stock of a closely held business may need to be sold to pay a shareholder's estate taxes and expenses, a redemption agreement between the shareholder and the corporation can ensure that the corporation will redeem the stock at the shareholder's death.

If certain requirements are met, the distribution made to redeem the stock will receive favorable tax treatment. Under IRC §303, a distribution made in redemption of stock, to the extent necessary to pay estate, inheritance, legacy, and succession taxes, and funeral and administrative expenses, will be treated as a payment in exchange for the stock, rather than as a dividend. This treatment results in the distribution being treated more favorably as a capital gain only to the extent that the purchase price exceeds the value of the stock for estate tax purposes (which is used to determine the basis of the stock under IRC §1014 and which will be the same as the purchase price if the redemption agreement is used to determine the value of the stock), rather than as a dividend to the extent of the shareholder's prorata share of earnings and profits. IRC §§301, 303(a). For discussion of basis, see chap 12.

To be eligible for this treatment, the value of all corporate stock that is included in the estate must exceed 35 percent of the value of the decedent's gross estate. IRC §303(b)(2)(A). To meet the 35 percent test, stock of two or more corporations is treated as the stock of one corporation if at least 20 percent of the outstanding stock of each corporation is included in the gross estate. IRC §303(b)(2)(B).

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§10.78 c. Buy-Sell Agreements

A buy-sell agreement between the decedent and a third party may permit or require the third party to purchase the decedent's interest in a business for a specified price or for a price calculated under a specified formula. The purchase price will not necessarily be binding on the government for estate tax purposes—particularly if the parties are related, in which case IRC §2703 may apply. Under §2703, provisions of an agreement that affect value will be disregarded unless they satisfy each of the following requirements:

- The agreement is a bona fide business arrangement.
- It is not a device to transfer property to members of the decedent's family for less than full and adequate consideration.
- Its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

The statute applies to rights or restrictions created or "substantially modified" after October 8, 1990. Pub L 101-508, §11602(e)(1)(A)(ii), 104 Stat 1388. In IRS Letter Ruling 200625011, the IRS ruled that an amendment to a pre-1990 buy-sell agreement involving S corporation stock clarifying that the agreement applies only to nonvoting stock owned by shareholders was not a substantial modification of the agreement. When the statute does not apply, similar rules in Treas Reg §20.2031-2(h) will apply. The result can be devastating. In *Estate of George C. Blount,* TC Memo 2004-116, aff'd in part and rev'd in part on other grounds (11th Cir 2005) 428 F3d 1338, the Tax Court disregarded a stockholder agreement establishing the price for a mandatory redemption of the decedent's stock because the decedent had the power to amend the agreement as the majority stockholder and only surviving party to the original agreement. The estate tax on the value of the stock as determined by the Tax Court was approximately equal to the amount received in redemption, although the value of the stock was reduced on other grounds by the court of appeals. A more favorable result was achieved in *Estate of Pearl I. Amelie*, TC Memo 2006-76, in which the Tax Court held that the estate tax value of closely held bank stock was determined by the price term of a restrictive agreement entered into by the decedent's conservator and the decedent's prospective heirs—even though the heir who purchased the stock at the agreed price and the conservator later entered into agreements with a third party providing for resale of the stock at a higher price after the decedent's death. For further discussion, see Business Buy-Sell Agreements, chap 2 (Cal CEB 1991).

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§10.78A I. Apportionment of Estate Tax

Proration of the estate tax among beneficiaries is determined as provided in Prob C §§20100-20125. This statutory scheme provides default rules that apply if the decedent does not otherwise specifically direct the source of payment of the tax and there is no applicable federal apportionment rule. Prob C §20110(b). Federal statutes include IRC §§2206 (life insurance beneficiaries bear tax on proceeds), 2207 (appointee pays tax on appointed property), 2207A (in effect, beneficiaries pay estate tax on QTIP property included in surviving spouse's estate under IRC §2044 and donees pay gift tax on gifts of QTIP property under IRC §2519), and 2207B (tax on an inter vivos gift included in an estate is paid by the donee). The decedent can override the federal rules by directing a different source of payment. Problems often arise from:

- Inartfully drafted tax clauses;
- Lack of coordination between different clauses in different instruments; and
- Miscalculations by the client or the planner concerning the size of the source of payment.

A recurring problem concerns the overuse of proration clauses that purport to charge all death taxes to the residue of an estate or living trust. Such a clause can wipe out the residue if the residue is smaller than expected—a potentially disastrous result if the person receiving the residue is the favored beneficiary. In *Lurie v Commissioner* (7th Cir 2005) 425 F3d 1021, the marital deduction trust was wiped out and additional estate tax was incurred because a proration clause required payment of tax on after-discovered assets from the trust.

Another problem concerns the waiver of the right of recovery when QTIP property is included in the survivor's estate under IRC §2044. The legislative history of IRC §2207A indicates that "the right of recovery with respect to QTIP is waived only to the extent that language in the decedent's will or revocable trust specifically so indicates (*e.g.*, by a specific reference to QTIP, the QTIP trust, section 2044, or section 2207A)." H Rep No. 105-148 at 614 (1997). It also states that a general provision specifying that all taxes shall be paid by the estate is not sufficient to waive the right of recovery. The risk of the kind of litigation evidenced by the case of *Eisenbach v Schneider* (Wash App 2007) 166 P3d 858 (provision in joint revocable trust directing that taxes were to be allocated pro rata between QTIP trust and survivor's trust was sufficient to override the statutory apportionment scheme) can be greatly reduced by making sure that such provisions expressly mention IRC §2207A.

For discussion of the surviving spouse's right of recovery for gift tax paid on QTIP property, see §17.29. For further discussion of estate tax proration problems, see Drafting California Revocable Trusts, chap 15 (4th ed Cal CEB 2003).

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III. GIFT TAX

§10.79 A. Introduction

The federal gift tax closes the transfer tax loophole created by the federal estate tax. It also serves to discourage transfers of property for income-shifting purposes. The gift tax is imposed on lifetime transfers of property for less than adequate and full consideration in money or money's worth. IRC §§2501(a), 2512(b). The gift tax applies to a broad range of transfers. See §§10.80-10.91. A transfer is subject to gift tax once it becomes a completed gift. See §§10.92-10.94. Most transfers incident to divorce are not included in gifts. See §10.95.

The total amount of gifts includes all transfers subject to gift tax less annual exclusions gifts, payments for educational and medical expenses, and certain loans of artwork. IRC §2503(b)-(c), (e), (g); Treas Reg §25.2503-1. See §§10.96-10.118. Taxable gifts include the total amount of gifts made in a calendar year less charitable gifts under IRC §2522 and marital deduction gifts under IRC §2523. IRC §2503(a). See §§10.119-10.120. Spouses may elect to split gifts under IRC §2013. See §10.121. Disclaimers are discussed in §10.122. Valuation of gifts is discussed in §10.123. Filing the gift tax return and paying the tax are discussed in §§10.124-10.128.

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§10.80 B. Transfers Subject to Gift Tax

The gift tax applies to transfers of property by gift whether in trust or otherwise, whether directly or indirectly, whether real or personal property, tangible or intangible property. IRC §2511(a). Examples of taxable transfers are the creation of a trust, the forgiving of a debt, and the assignment of insurance benefits. Treas Reg §25.2511-1(a).

For a nonresident alien, the gift tax applies only to transfers of real and tangible property in the United States. Although transfers of intangible property by a nonresident alien are not subject to gift tax, this exception does not apply to expatriates who lost their U.S. citizenship within 10 years before the transfer if tax avoidance was a principal purpose for the loss. IRC §§2501(a)(2)-(3), 2511(b); Treas Reg §§25.2511-1(b), 25.2511-3.

The transferor's donative intent is not essential for gift tax purposes; application of the gift tax is based on the objective facts of the transfer and the circumstances under which the gift is made, rather than the donor's subjective motives. Treas Reg §25.2511-1(g)(1). Particular transactions that may result in a taxable gift are discussed in §§10.81-10.91.

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§10.81 1. Below-Market Interest Rate Loans

Internal Revenue Code §7872 provides for imputed transfers between the lender and the borrower of the forgone interest on loans with below-market interest rates. The term "loan" covers any extension of credit. Prop Treas Reg §1.7872-2(a). Any loan with a below-market interest rate when the forgoing of interest "is in the nature of a gift" is treated as a gift loan. IRC §7872(f)(3). There are two types of gift loans: demand loans and term loans. The imputed transfers are characterized differently for each type of loan for income and gift tax purposes. See §§10.82-10.83. Exceptions to gift loan treatment are discussed in §10.84.

Section 7872 does not apply to loans that are debt instruments given for the sale or exchange of property to which IRC §1274 applies, deferred interest payments to which IRC §483 applies, or loans from foreign trusts to which IRC §643(i) applies. IRC §7872(f)(8).

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§10.82 a. Demand Loans

A below market demand loan is a loan fully payable on demand in which interest on the loan is payable at a rate less than the applicable federal rate (AFR). IRC §7872(e)(1)(A), (f)(5). The AFR for a demand loan is the short-term rate in effect under IRC §1274(d) for the period for which the interest is being determined, compounded semiannually. IRC §7872(f)(2)(B). The forgone interest on demand loans between the borrower and the lender during any calendar year is treated as though it was transferred from the lender to the borrower as a gift and retransferred from the borrower to the lender as income on the last day of such calendar year. IRC §7872(a).

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§10.83 b. Term Loans

A below market term loan is any loan other than a demand loan in which the amount lent exceeds the present value of all payments due under the loan. IRC §7872(e)(1)(B), (f)(6). "Present value" is the amount of the payments discounted at the applicable federal rate (AFR) in effect under IRC §1274(d) as of the date of the loan, compounded semiannually. IRC §7872(f)(1), (2)(A). The AFR is the short-term, mid-term, or long-term rate, depending on the term of the loan. IRC §1274(d).

For gift tax purposes, on the day the loan is made, the lender is treated as transferring, and the borrower is treated as receiving, cash in the amount of the excess of the amount lent over the present value of all payments required under the loan. IRC §7872(b)(1), (d)(2).

The loan also is treated as having original issue discount in the amount of the imputed transfer, which is treated as income under IRC §1272. IRC §7872(b)(2).

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§10.84 c. Exceptions to Gift Loan Treatment

There is a de minimis exception to the imputed transfer rule for gift loans between individuals for any day on which the aggregate outstanding amount of loans between such individuals does not exceed $10,000. IRC §7872(c)(2)(A). This exception does not apply to any gift loans attributable to the purchase or acquisition of income-producing assets. IRC §7872(c)(2)(B). A de minimis exception also applies for compensation-related and corporate-shareholder loans in which the aggregate outstanding amount of loans between the borrower and lender does not exceed $10,000. IRC §7872(c)(3).

For gift loans made on any day on which the aggregate outstanding amount of loans between the borrower and the lender does not exceed $100,000, the amount treated as retransferred for income tax purposes in a loan directly between individuals will not exceed the borrower's net investment income for the year, unless tax avoidance is a principal purpose of the loan. IRC §7872(d).

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§10.85 2. Exercise or Release of General Power of Appointment (IRC §2514)

The exercise or release of a general power of appointment created after October 21, 1942, is treated as a property transfer by the powerholder for gift tax purposes. IRC §2514(b). The lapse of a power during the powerholder's lifetime is treated as a release to the extent that the property subject to the power exceeds the greater of $5000 or 5 percent of the value of the assets from which the lapsed power could have been exercised. IRC §2514(e). A general power of appointment is defined as a power to appoint property exercisable in favor of the individual holding the power, his or her estate, his or her creditors, or the creditors of the estate. IRC §2514(c). A power is not a general power of appointment, however, if the exercise of the power is subject to an ascertainable standard relating to the health, education, support, or maintenance of the powerholder, or the power can be exercised only in conjunction with the creator of the power or a person with a substantial, adverse interest. IRC §2514(c). For further discussion of powers of appointment, see chap 9.

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§10.86 3. Payment of Generation-Skipping Transfer (GST) Tax (IRC §2515)

Payment of generation-skipping transfer (GST) tax on a direct skip is a gift of the amount of the tax. IRC §2515. The combined gift tax on the amount of the direct skip and the GST tax simulates the double gift tax that would be paid in the event of a gift to a child followed by a gift from the child to a grandchild. For discussion of the GST tax, see chap 11.

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§10.87 4. Discharge of Indebtedness

In a family context a discharge of indebtedness or a legal obligation for no consideration generally constitutes a gift by the creditor to the debtor at the time of discharge. Treas Reg §25.2511-1(a). This rule does not apply to discharge of the tax liability on jointly filed income tax returns when one spouse pays the entire tax. Treas Reg §25.2511-1(d). In a business context in which there is no donative intent, a discharge of indebtedness may result in the debtor's being deemed to receive taxable income.

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§10.88 5. Transfers to and From Corporations and Partnerships

The gift tax is imposed on individuals. IRC §2501(a); Treas Reg §25.0-1(b). A gift from a corporation is treated as a gift from the shareholders to the donee. If the donee also is a shareholder, there is a gift from the other shareholders, but only to the extent it exceeds the donee's interest in such amount as a shareholder. A gift to a corporation is treated as a proportionate gift from the donor to the shareholders. If the donor is a shareholder, the proportion of the transfer that corresponds to the portion of the corporation owned by others will be subject to gift tax. Treas Reg §25.2511-1(h)(1). See *Heringer v Commissioner* (9th Cir 1956) 235 F2d 149, cert denied (1956) 352 US 927. The same rule may apply to the transfer of property to a partnership. See *Shepherd v Commissioner* (11th Cir 2002) 283 F3d 1258. In *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044, the court determined that contributions of stock to a newly formed partnership were gifts to the limited partners because the donor failed to prove that the contributions were made before the donor made gifts of the limited partnership interests. In *Thomas H. Holman* (2008) 130 TC 170, however, the court determined that gifts of limited partnership interests made 5 days after formation of the partnership did not result in gifts of the partnership property by the donor to the limited partners. See §18.37D.

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§10.89 6. Payment for Services to Third Party

Gift taxes apply to the transfer of property, not to services. However, if a person makes a payment of money or transfers property to another as consideration for the performance of services for a third party, the amount of consideration is a gift to the third party. Treas Reg §25.2511-1(h)(3).

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§10.90 7. Joint Bank Accounts

There may be a gift for tax purposes when money is withdrawn from a joint bank account. For example, if Aaron creates a joint bank account for himself and his daughter Betsy, there is a taxable gift by Aaron when Betsy withdraws from the account for her own benefit. The same result occurs when Aaron purchases a savings bond registered as payable to Aaron or Betsy and Betsy surrenders the bond for cash without any obligation to give Aaron part of the proceeds. Treas Reg §25.2511-1(h)(4).

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§10.91 8. Community Property Life Insurance Proceeds

A gift may occur when community property is used to purchase life insurance on the husband's life, but a third party rather than the wife is designated as beneficiary of that policy. The wife is entitled to half of the proceeds on the husband's death, because the policy was purchased with community funds. If all proceeds pass to a third party beneficiary, the wife is treated as making a gift of half of the insurance proceeds, as long as state law considers the husband's death as making the transfer by the wife absolute. Treas Reg §25.2511-1(h)(9). This result does not occur when the surviving spouse receives at least half of the community property. *Kaufman v U.S.* (5th Cir 1972) 462 F2d 439.

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§10.92 C. Completed Gifts

A transfer is not subject to gift tax unless it is a completed gift. A gift is complete when the donor has so parted with dominion and control of the property transferred as to leave the donor no power to change its disposition, whether for the donor's benefit or the benefit of another. Treas Reg §25.2511-2(b). For example, if the donor delivers a properly endorsed stock certificate to the donee or the donee's agent, the gift is a completed gift on the date of delivery; but if the donor delivers a stock certificate to the donor's own agent, the gift is completed on the date the stock is transferred on the corporation's books. Treas Reg §25.2511-2(h).

NOTE: In 2010, when the estate tax is repealed, any transfer in trust will be treated as a taxable gift unless the trust is a grantor trust treated as owned by the donor or the donor's spouse under IRC §§671-679. IRC §2511(c).

If the donor reserves a power of appointment over property transferred to a trust for the benefit of others, the gift is incomplete. Treas Reg §25.2511-2(c). See §10.93. A donor may also reserve the power to revoke a gift made while he or she was a minor or incompetent, making the gift incomplete. See §10.94.

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§10.93 1. Gifts With Retained Powers

If the donor retains the power to change beneficiaries, the gift is incomplete. Treas Reg §25.2511-1(c). If the donor can exercise the power only with a nonadverse party, the donor is treated as holding the power alone and the gift is incomplete. Treas Reg §25.2511-2(e). However, in the case that owners of Section 529 plans retain the power to change beneficial interests, the gift is still considered complete. See chap 21A.

Certain powers can be retained that do not render a gift incomplete. For example, a gift is not rendered incomplete if the donor merely reserves the power to change the manner or time of enjoyment of a gift, such as the power to decide whether the income of a trust shall be distributed or accumulated for the benefit of the beneficiary. Treas Reg §25.2511-2(d). However, the gift is only complete when the amounts are actually paid out to the beneficiaries or when the donor either relinquishes or terminates the power to change beneficiaries. Treas Reg §25.2511-2(f).

PRACTICE TIP: Occasionally, a donor may wish to make a transfer to a trust for the benefit of others that is a completed gift, but the donor also wishes to remain the owner of the trust for income tax purposes. This result may be achieved by retaining certain powers under IRC §§671-679. See chap 13. For example, a completed gift occurs if the donor retains the power to substitute assets of equivalent value or if the trust allows a nonadverse party to add a beneficiary. The grantor may then decrease the size of his or her estate by paying the income tax for the trust beneficiaries without incurring additional gift tax. See chap 27.

Generally, if the donor transfers property to an irrevocable trust and retains an income interest, there is a completed gift of the remainder but not the income interest. If the exercise of the trustee's power in favor of the donor is limited by an ascertainable standard (see §10.29), the gift is incomplete to the extent of the ascertainable value of the rights retained by the donor. Treas Reg §25.2511-2(b).

If an independent third party trustee has discretionary power to distribute income to the donor, and the trust assets cannot be reached by the donor's creditors under state law, there is a completed gift of the entire transfer. See Treas Reg §25.2511-2(g). See also *Estate of Vak v Commissioner* (8th Cir 1992) 973 F2d 1409; *Estate of Leon Holtz* (1962) 38 TC 37, acq 1962-2 Cum Bull 4; Rev Rul 77-378, 1977-2 Cum Bull 347.

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§10.94 2. Transfer by Minor or Incompetent

The effect of a transfer by a minor depends on whether local law gives the minor a power to revoke the gift. If a minor can disaffirm a gift until he or she reaches the age of majority, the gift is incomplete until the minor reaches majority. *Commissioner v Allen* (3d Cir 1939) 108 F2d 961, cert denied (1940) 309 US 680. Family Code §6710 states that a minor can disaffirm a contract.

A transfer by someone adjudicated incompetent is not a gift if state law requires a donor's competency to contract in order to make a valid gift. See *Estate of Mona E. Bettin,* TC Memo 1974-102, aff'd (9th Cir 1976) 543 F2d 1269. A guardian, however, may make a valid gift on behalf of an incompetent by judicial decree. *Commissioner v Greene* (9th Cir 1941) 119 F2d 383, cert denied (1941) 314 US 641; Rev Rul 73-612, 1973-2 Cum Bull 322; Rev Rul 67-280, 1967-2 Cum Bull 349. An agent under a durable power of attorney can also have the power to make a valid gift if specifically authorized to do so. Prob C §4264(c); *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345.

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§10.95 D. Transfer Incident to Divorce (IRC §2516)

Transfers of property or interests in property under a written agreement entered into by a husband and wife relative to the settlement of their marital or property rights, or to provide a reasonable allowance for the support of children of their marriage during minority, are considered to be made for full and adequate consideration in money or money's worth, and are therefore exempt from gift tax. The spouses must obtain a final divorce decree within the period starting 1 year before and ending 2 years after the agreement is made, although it is not necessary that the property be received within that 3-year period. IRC §2516; Treas Reg §25.2516-1. Transfers incident to a dissolution of a registered domestic partnership, however, may result in taxable gifts because the partners are not treated as spouses under federal law. See chap 4.

With property transferred for the benefit of children, only amounts necessary for their support during minority will qualify for the gift tax exemption. Other ways may be available, however, to exclude amounts transferred in excess of that amount from gift tax, such as payments for educational or medical expenses under IRC §2503(e) or by contributions to IRC §529 plans. See §§10.114-10.115.

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§10.96 E. Annual Exclusion Gifts (IRC §2503(b))

Under IRC §2503(b), the first $10,000 (plus cost-of-living adjustments) of present interest gifts to any person (*i.e.,* not gifts of future interests in property), made during a calendar year are not included in the total amount of gifts made during such year. In 2009, the annual exclusion amount is $13,000. Rev Proc 2008-66, 2008-45 Int Rev Bull 1107. Annual exclusion gifts do not reduce the donor's IRC §2010 or §2505 applicable exclusion amounts for estate or gift tax purposes.

The annual exclusion is not cumulative. Unused amounts may not be carried over to another year. For this reason, an estate planner should regularly communicate early each year with clients who are in a position to make gifts. The exclusion applies to the first $13,000 of gifts made each year. If a client is going to make more than $13,000 worth of gifts in a particular year to a particular individual, and the donor has a preference about which gifts should qualify for the annual exclusion, then those gifts should be made first.

Annual exclusion gifts can be used to provide funds to pay premiums on a life insurance policy owned by a trust (see chap 19), to provide funds for a donee to buy assets from the donor or participate in other estate freeze techniques (see chap 25), or to transfer fractional ownership interests in an asset, such as a family limited partnership, or undivided interests in real estate, both obtaining valuation discounts for the assets transferred and setting up the donor's estate for discounts on the portion of the asset remaining in the donor's estate at death (see chap 18). Requirements and features of annual exclusion gifts are discussed in §§10.97-10.100. Trusts qualifying for annual exclusion gifts, especially *Crummey* trusts, are discussed in §§10.104-10.112. Particular uses of annual exclusion gifts are discussed in §§10.113-10.114.

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§10.97 1. Present Interest Requirement

The annual exclusion applies to gifts of present interests and does not apply to gifts of future interests. IRC §2503(b)(1). A present interest is defined as an "unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)." Treas Reg §25.2503-3(b). A future interest is defined as "a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time." Treas Reg §25.2503-3(a). See *Fondren v Commissioner* (1945) 324 US 18, 89 L Ed 668, 65 S Ct 499.

EXAMPLE: Under the terms of a trust, the trustee is directed to distribute trust income to the beneficiary but has discretion to withhold a payment and add such income to trust corpus. The beneficiary's interest is not a present interest, and no annual exclusion is allowable. Treas Reg §25.2503-3(c), Example 1.

Although an outright gift generally constitutes a gift of a present interest, some outright gifts may be gifts of future interests if substantial restrictions are imposed on the donee's ability to enjoy the benefits of the transferred property. See, *e.g.*, Rev Rul 76-360, 1976-2 Cum Bull 298 (gift of non-income-producing stock); *Stinson Estate v Commissioner* (7th Cir 2000) 214 F3d 846 (gift to corporation).

Similarly, gifts of limited partnership interests may not be gifts of present interests if too many restrictions are imposed on the limited partners' rights to obtain economic enjoyment of the partnership interest. See *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664.

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§10.98 2. No Limit on Number of Transferees

There is no limit to the number of annual exclusion gifts a donor may make each year. Thus, a donor with numerous objects of his or her bounty may significantly reduce his or her estate with tax-free transfers. Planning for the systematic use of the annual exclusion can go a long way in reducing transfer taxes for a client, but care must be exercised in designing transactions. See §§10.99-10.100.

EXAMPLE: A client has four children and six grandchildren to whom the client would like to make gifts. The client could give a total of $130,000 (10 × $13,000) per year free of gift tax. If the client is married, and the client's spouse consents to split gifts under IRC §2513 (see §10.121), the client and spouse could give away $260,000 per year and incur no gift tax. The gifted amount would pass out of the client's estate without gift or estate taxes.

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§10.99 a. Reciprocal Transaction Doctrine

Taxpayers may be tempted to increase the number of annual exclusion gifts by entering into reciprocal arrangements with siblings or friends. For example, Abe would make annual exclusion gifts to his two children and his brother Bob's two children. Likewise, Bob would make annual exclusion gifts to his two children and Abe's two children. Abe and Bob would each claim four annual exclusions. The IRS, however, would apply the reciprocal transaction doctrine of *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730 (see §10.18), and allow only two annual exclusions each to Abe and Bob for the gifts to his own children. The other two gifts made by each of them would be treated as taxable gifts to the donor's own children instead of a gift to the nieces or nephews. To the extent that the donor has IRC §2010 applicable credit amount available, no gift tax would be paid at that time, but the applicable credit amount available for future transfers would be reduced. See *Estate of Schuler v Commissioner* (8th Cir 2002) 282 F3d 575; *Sather v Commissioner* (8th Cir 2001) 251 F3d 1168.

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§10.100 b. Intermediaries Disregarded

The IRS will not allow the number of annual exclusions to be increased by transfers to intermediaries. For example, Grandma transfers $13,000 to each of Son, Son's Wife, and Son's two Children. Wife and Children each transfer their $13,000 gift to Son. The IRS will disregard the intermediaries and treat the entire transaction as a gift from Grandma to Son, resulting in a taxable gift of $39,000. See *Heyen v U.S.* (10th Cir 1991) 945 F2d 359; *Estate of Marie A. Bies*, TC Memo 2000-338; *Estate of Joseph Cidulka,* TC Memo 1996-149.

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§10.101 3. Trusts Qualifying for Annual Exclusion Gifts

Gifts to trusts that postpone the beneficiary's enjoyment to a future time usually do not qualify for the annual exclusion. There are three types of trusts, however, that can be used to qualify some or all of the transfers to a trust for the annual exclusion: the "income trust," the "minor's trust" under IRC §2503(c), and the *Crummey* trust under *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. Each one has different features and limitations that must be considered when planning a transfer. These considerations are discussed in §§10.102-10.112.

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§10.102 a. Income Trust

A transfer to a trust that provides that all income shall be distributed to the beneficiary (income trust) may qualify in part for the annual exclusion under IRC §2503(b) if certain conditions are met. The premise of an income trust is that the transfer in trust is actually composed of two separate interests: the income interest, which is a present interest; and the remainder interest, which is a future interest. Treas Reg §25.2503-3(b). The income interest is valued under Treas Reg §25.2512-5(d)(2)(iii) using IRC §7520 actuarial factors. Because a gift to an income trust is a gift of both a present interest and a future interest, a gift tax return must be filed to report the value of the remainder interest, equal to the value of the property minus the value of the income interest, and the value of the income interest to the extent that it exceeds the annual exclusion amount. See §10.124.

PRACTICE TIP: Although seldom used in practice, the income trust may be useful for a client who wishes to have a trust that provides income for the beneficiary beginning while the beneficiary is a minor and continuing for longer than the period allowed by an IRC §2503(c) minor's trust. See §10.103.

To qualify for the annual exclusion, there can be no limitation on the payment of income. See Treas Reg §25.2503-3(c), Example 1. The income must be payable at least annually, beginning immediately, and must be capable of being valued. Thus, a trust that holds non-income-producing property would not qualify, because a gift in trust of the right to income from non-income-producing property is a gift of a future interest, for which no annual exclusion is allowable. *Jesse S. Phillips* (1949) 12 TC 216; Rev Rul 69-344, 1969-1 Cum Bull 225. Further, although principal may be retained in an income trust for as long as the grantor wishes, it may not be distributed to someone other than the income beneficiary before the termination of the income interest, because doing so would deprive the beneficiary of the income from the principal that is removed from the trust. See Treas Reg §25.2503-3(c), Example 4. This type of trust may not be used if discretionary spray and sprinkle provisions are desired. See Treas Reg §25.2503-3(c), Example 3.

For discussion of drafting considerations and forms regarding the income trust, see Drafting California Irrevocable Trusts §§12.64-12.79 (3d ed Cal CEB 1997).

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§10.103 b. Minor's Trust

The entire amount of a gift to a trust for the benefit of a minor meeting the requirements of IRC §2503(c) minor's trust will qualify for the annual exclusion even though the gift would otherwise be considered a gift of a future interest. To qualify for this exclusion, before the beneficiary attains age 21, the trustee must have the power to pay to or for the benefit of the beneficiary any part of the property or its income. To the extent it is not distributed, any property remaining in the trust when the beneficiary attains age 21 must be distributed to the beneficiary at that time. This condition may be satisfied by giving the beneficiary an absolute right to withdraw the trust property after he or she reaches age 21. If the beneficiary dies before age 21, the property must either be payable to the beneficiary's estate or as he or she may appoint under a general power of appointment. IRC §2503(c); Treas Reg §25.2503-4. See chap 8.

For discussion of drafting considerations and forms for a minor's trust, see Drafting California Irrevocable Trusts §§12.38-12.63 (3d ed Cal CEB 1997).

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§10.104 c. *Crummey* Trust

A *Crummey* trust is any trust in which the beneficiary has the power to withdraw all or a portion of contributions made to the trust for a short period of time in order to qualify gifts to the trust for the present interest annual exclusion under IRC §2503(b). The withdrawal power lapses after a specified period of time and the property subject to the power becomes subject to the terms of the trust. The *Crummey* power got its name from *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82, in which the court held that a beneficiary's unrestricted power to demand all or a portion of the property added to a trust for that year constitutes a present interest qualifying the transfer for the annual exclusion from gift tax under IRC §2503(b). The court also held that such a power is effective to convey a present interest even if the beneficiary given the power is a minor who could not exercise the power personally. The fact that a guardian could be appointed in time to exercise the power was considered sufficient. See Rev Rul 73-405, 1973-2 Cum Bull 321.

The *Crummey* power is widely used because it allows clients to create trusts that can fully use their annual exclusion from gift tax as well as keep the property in trust with more flexible terms than either the income trust (see §10.102) or the minor's trust (see §10.103). For example, *Crummey* trusts can have limitations on distributions of income and can continue for a period of time beyond the beneficiary's minority. This approach allows the grantor to control the terms of distribution for as long as he or she wishes. Such trusts also can have more than one beneficiary, although in certain circumstances this can present tax complications when *Crummey* powers lapse.

Features and uses of *Crummey* trusts are discussed in §§10.105-10.112. For discussion of drafting considerations and forms for *Crummey* trusts, see Drafting California Irrevocable Trusts §§12.80-12.110 (3d ed Cal CEB 1997).

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§10.105 (1) Requirements for Exercise of Withdrawal Power

To qualify a gift to a trust for the annual exclusion, the beneficiary must have notice of the withdrawal right and a reasonable time to exercise that right. See §§10.106-10.107. Often a client's concern about a *Crummey* trust is whether the beneficiary will actually exercise the right to withdraw the assets. As a practical matter, this problem rarely arises because most beneficiaries recognize that, even though they have a legal right to withdraw property, the consequences of doing so might mean fewer or no gifts from the grantor in the future or that the purpose of the trust would be defeated. There can be no prearranged understanding, however, that the beneficiary will not exercise the power.

If a client is uncertain about whether he or she wishes to confer the power, or to control the amount of gifts subject to the power, the trust can be written so that the *Crummey* withdrawal power is granted only in any year or in such amounts that the grantor explicitly permits, usually in a writing to the trustee.

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§10.106 (a) Actual Notice

No particular form of notice was required in *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. The decision required only that the beneficiary have actual notice. Thus, to have some basis to prove that actual notice was given, it is advisable that a written notice be sent to the beneficiaries when the trustee receives a gift that is subject to a *Crummey* withdrawal power. See Rev Rul 83-108, 1983-2 Cum Bull 167; Rev Rul 81-7, 1981-1 Cum Bull 474.

PRACTICE TIP: Most trust instruments for trusts intended to receive annual exclusion gifts require the trustee to send notice to the beneficiaries of the trust who have *Crummey* powers. Although not required, some attorneys have the beneficiary return a copy of the notice acknowledging receipt of the notice as well. The authors' preference is not to require an acknowledgment, because lack of one in the file may lead to an inference that notice was not sent. If an acknowledgment is used, it is important that there be only an acknowledgment and not a release of the power. If a right of withdrawal is released before the gift is made, the gift may not be considered a present interest.

If the trustee is also a beneficiary, notice need not be sent to the trustee, because he or she would have actual notice. If the beneficiary is a minor, the notice should be sent to both the minor and the parent or other legal guardian, especially if a parent is the grantor.

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§10.107 (b) Reasonable Time to Exercise

Although it is important that the right to withdraw the contribution begin at the time of the transfer (as opposed to the time of the notice) in order to qualify as a present interest, there is no definitive rule on the duration of the power to withdraw. The IRS has allowed the annual exclusion for periods as short as 15 days. See, *e.g.*, *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1. The authors recommend at least 30 days.

PRACTICE TIP: Some trusts provide that a withdrawal power will expire at the end of the calendar year in which the gift is made. If it is made too close to the end of the year, an annual exclusion gift could be disallowed because there is insufficient time for the powerholder to exercise the power. However, it is not necessary for the power to expire in the year the gift is made; the gift will be considered complete in year one even if the power lapses in year two. See Rev Rul 83-108, 1983-2 Cum Bull 167. Thus, the authors suggest that withdrawal powers not be drafted to expire at the end of the year. If a trust already has such a provision, the gift should be made early enough in the year so there is sufficient time to exercise the power. If it is close to the end of the year, the donor could execute a writing extending the withdrawal period as a condition of the gift.

Although a gift that is made at the end of the year and lapses in the next year is complete for gift tax purposes in the first year, problems could arise from the lapse in the second year. See §10.108.

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§10.108 (2) Avoiding Tax Consequences of Excess Lapses

The amount that should be subject to withdrawal depends on the purposes of the trust and the intended tax consequences to the grantor and beneficiaries. Because a *Crummey* withdrawal power that exceeds the greater of $5000 or 5 percent of the property from which the withdrawal power may be exercised is a general power of appointment over the property subject to withdrawal, both the exercise and the lapse of the power may have gift, estate, generation-skipping transfer (GST), and income tax consequences for the powerholder. See chaps 9, 11.

To avoid the consequences of a lapse in excess of the 5 or 5 amount, the *Crummey* withdrawal power should generally be limited to the *lesser* of the 5 or 5 amount or the donor's available annual exclusion for gifts when the anticipated gifts are likely to fall within these limitations. Because an individual donee is allowed only one 5 or 5 power amount to lapse each year, it important that the trust provide that the withdrawal amounts allowed to a powerholder be reduced for all other annual exclusion gifts made to that powerholder earlier in the same year. See §10.111.

When the income tax consequences of a lapse of a *Crummey* withdrawal power in excess of the 5 or 5 amount are otherwise acceptable, two methods are generally used to avoid a current gift at the time of the lapse. See §§10.109-10.110.

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§10.109 (a) Special Powers of Appointment

The trust may give the powerholder a special power of appointment over the amount in excess of the 5 or 5 amount. The power of the powerholder to alter the ultimate beneficiary of a gift will render the gift incomplete. Treas Reg §25.2511-2(b). The power of appointment can be exercisable during the powerholder's lifetime, at death, or both. The gift will become complete, however, when the powerholder dies or when the property is distributed to another beneficiary. This approach is attractive for a trust that is expected to be distributed to a powerholder during his or her lifetime and that is likely to be included in the powerholder's estate if he or she dies before the termination of the trust even if there was no special power of appointment.

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§10.110 (b) Hanging Powers

The trust may allow a lapse each year only up to the 5 or 5 amount, with the excess continuing to be subject to the *Crummey* power—a so-called hanging power. The power does not lapse with respect to amounts in excess of the 5 or 5 amount. Rather, after the specified withdrawal period, the powerholder continues to have a power to withdraw the accumulated excess amounts. As the trust grows (and the 5 percent amount increases) or when the donor stops making gifts to the trust, the withdrawal powers with respect to the 5 or 5 amount allowed to lapse each year will eventually cover these accumulated excess amounts. This approach works best when there is no reason to worry that the powerholder will exercise the power to withdraw.

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§10.111 (3) Multiple *Crummey* Powers

In Rev Rul 85-88, 1985-2 Cum Bull 202, the IRS ruled that one 5 or 5 amount applies to each individual beneficiary for trusts established by the same grantor, regardless of the number of trusts involved. As a result, the lapses of the various powers could exceed the 5 or 5 amount even if each trust instrument limits the withdrawal right to that amount. For example, this would occur if there were two trusts for the same beneficiary, each of which would allow a $5000 lapse because $5000 is greater than 5 percent of the trust corpus. In that event, the beneficiary would be allowing a $10,000 lapse, which would exceed the 5 or 5 amount because the total amount in both trusts is less than $200,000. Therefore, to avoid excess lapses, a *Crummey* trust should provide that the withdrawal amount allowed a powerholder in any year be reduced by all other annual exclusion gifts made by the donor to that powerholder earlier in the year.

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§10.112 (4) Naked *Crummey* Powers

Taxpayers may be tempted to benefit from multiple annual exclusions by giving *Crummey* withdrawal powers to friends or relatives who never exercise their powers. These "naked" *Crummey* powers are illusory powers with no purpose other than maximizing the number of annual exclusions. The IRS has frequently challenged annual exclusions for gifts to trusts giving withdrawal powers to multiple beneficiaries who are not primary trust beneficiaries. The IRS's position is that annual exclusions should be disallowed in these cases because the failure to exercise the withdrawal powers evidences an advance agreement between the donor and the powerholders not to do so. See IRS Letter Rulings 9141008, 9045002.

In *Estate of Maria Cristofani* (1991) 97 TC 74, acq 1992-1 Cum Bull 1, acq 1996-2 Cum Bull 1, a trust was established for the primary benefit of the donor's two children and allowed discretionary distributions of principal to the donor's five grandchildren. If a child predeceased the donor, the grandchildren were entitled to distributions of income and a share of the trust on termination of the trust. In a unanimous reviewed decision, the Tax Court allowed the annual exclusions for the grandchildren, stating that their rights in the trust were more substantial than those in *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82, and that there was no evidence of an advance agreement not to exercise the withdrawal powers. The Tax Court also allowed annual exclusions for contingent beneficiaries based on lack of evidence of prearrangement in *Estate of Lieselotte Kohlsaat,* TC Memo 1997-212.

The IRS acquiesced to *Cristofani* in result only, and continues to challenge naked *Crummey* powers when the powerholders have no other property interests or hold only contingent remainder interests. AOD 1996-010; IRS Letter Ruling 9628004.

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§10.113 4. Gifts Made Close to Death

The annual exclusion can be used to reduce the value of a person's estate when he or she is near death. Because the gift tax is brought back into an estate under IRC §2035 only if the gift is made within 3 years before death (see §10.15) and no gift tax is payable on an annual exclusion gift, any gifts made before death to the donor's intended heirs and legatees will save the estate tax that would have been imposed on the gifted property. It is thus sometimes advisable for someone to have a power of attorney that authorizes gifts of the donor's assets up to the annual exclusion amount. Without such authorization, no gifts can be made when the donor is incompetent. Prob C §4264(c); *Estate of Swanson v U.S.* (Fed Cir 2001) 2001-1 USTC ¶60,408, 87 AFTR2d 2345.

If gifts are made when the donor is close to death, it is important that the donee receive the gift before the donor dies. If the gift is made by check, the check must clear before death. It is therefore recommended that cashier's checks be used when making death bed transfers intended to qualify for the annual exclusion. A check that is given at the end of one year, but clears in the next, relates back to the year in which it was made in determining whether the gift qualifies for the annual exclusion, provided the donor is alive when the check clears. On the other hand, a gift of a check that is made *before* death, but clears *after* death, does not relate back and is an incomplete gift. Rev Rul 96-56, 1996-2 Cum Bull 16; *Rosano v U.S.* (2d Cir 2001) 245 F3d 212; *Metzger v Commissioner* (4th Cir 1994) 38 F3d 118.

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§10.114 5. Gifts to Qualified Tuition Programs

Under IRC §529, gifts to qualified tuition programs qualify for the annual exclusion even though they would otherwise fail to qualify because they would be gifts of future interests. Five times the regular IRC §2503(b) annual exclusion amount ($13,000 plus future cost-of-living adjustments) can be claimed in the current year, although this "advance" results in no annual exclusions being available in subsequent years until, in effect, the advance is repaid. IRC §529(c)(2). If the donor fails to survive that period of time, the amount of the advance remaining "unpaid" is included in the donor's estate. IRC §529(c)(4). The gifts are not gifts of tuition that are subject to the unlimited gift tax exclusion for tuition payments under IRC §2503(e). See §10.115.

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§10.115 F. Exclusion for Education and Medical Expenses

Under IRC §2503(e), certain qualified payments made on behalf of an individual for tuition or medical care are excluded from gift tax. This exclusion is not limited in amount. It is available in addition to the annual gift exclusion and without regard to the relationship between the donor and the donee. Treas Reg §25.2503-6(a). For the definition of education and medical expenses, see §§10.116-10.117.

To qualify for the education and medical expenses exclusion, payments must be made directly to the educational or medical institution or service provider. IRC §2503(e)(2). For example, a donor's payment of tuition directly to a university as described in IRC §170(b)(1)(A)(ii) is exempt from gift tax. Treas Reg §25.2503-6(c), Example 1. In contrast, a transfer by a donor to a trust with provisions to use the funds for tuition expenses for a donee is a taxable gift not within the exclusion for education expenses, because the payment was made to the trust rather than directly to the educational institution. Treas Reg §25.2503-6(c), Example 2.

Payments of medical expenses must be paid directly to the medical service provider, not as a reimbursement to an individual who previously paid a medical service provider. Treas Reg §25.2503-6, Example 4.

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§10.116 1. "Education Expenses" Defined

Qualified education expenses include only the tuition expenses of full-time or part-time students paid directly to the qualifying educational institution. Not included are amounts paid for books, supplies, dormitory fees, board, and similar expenses that are not direct tuition costs. IRC §2503(e)(2)(A); Treas Reg §25.2503-6(b)(2). In IRS Letter Ruling 200602002, the IRS ruled that prepayment of a grandchild's private school tuition for future years qualified for the IRC §2503(e) gift tax exclusion and the comparable IRC §2611(b)(1) GST tax exclusion. Alternatively, tuition expenses may be covered by making annual exclusion gifts to IRC §529 qualified tuition programs. See §10.114.

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§10.117 2. "Medical Expenses" Defined

Qualified medical expenses include expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, for the purpose of affecting any structure or function of the body, for transportation primarily for and essential to medical care, and for medical insurance on behalf of an individual. Treas Reg §25.2503-6(b)(3). Medical expenses include payments for acupuncture, and possibly homeopathic treatment, and some forms of cosmetic surgery as long as the surgery also improves the function of the body or has some other medical function such as the diagnosis, cure, mitigation, treatment, or prevention of disease. IRC §§213(d), 2503(e)(2)(B).

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Source: Estate Planning/California Estate Planning/10 Estate and Gift Taxes/§10.118 G. Exclusion for Loans of Works of Art

§10.118 G. Exclusion for Loans of Works of Art

A loan of a qualified work of art to an IRC §501(c)(3) exempt organization, other than a private foundation, is excluded from gift tax. A qualified work of art is any archeological, historic, or creative tangible personal property. The work must be used for the organization's exempt purpose. IRC §2503(g).

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§10.119 H. Marital Deduction (IRC §2523)

An unlimited marital deduction is available for gift transfers of property between spouses who are U.S. citizens under IRC §2523(a). The deduction does not apply to a noncitizen donee spouse, but the annual exclusion amount for gifts under IRC §2503(b) is increased from $10,000 to $100,000, plus cost-of-living adjustments. IRC §2523(i)(2). In 2009, the first $133,000 of gifts to a spouse who is not a U.S. citizen are excluded from gift tax. Rev Proc 2008-66, 2008-45 Int Rev Bull 1107. The unlimited marital deduction does not apply to transfers of life estates or other terminable interests. IRC §2523(b). See chap 17. The marital deduction also does not apply to transfers between registered domestic partners because they are not treated as spouses under federal law. See chap 4.

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Source: Estate Planning/California Estate Planning/10 Estate and Gift Taxes/§10.120 I. Charitable Deduction (IRC §2522)

§10.120 I. Charitable Deduction (IRC §2522)

An unlimited gift tax deduction is provided for gifts made to qualified charitable organizations as described in IRC §2522(a). This deduction is similar to the deduction provided for estate taxes under IRC §2055, but organizations to which the transfer can be made and still qualify for the deduction differ. For discussion of charitable giving, see chap 23.

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§10.121 J. Split-Gift Election (IRC §2513)

If an election is made under IRC §2513, a gift made by a husband or wife to a third party may be considered as made one half by each. This method allows one spouse to use both IRC §2503(b) annual exclusions and IRC §2505 applicable exclusion amounts. An election covers all gifts made during the calendar period to third parties while the parties are married. Treas Reg §25.2513-1(b). Thus, it is not possible to select some gifts for the election and exclude others made during the same calendar year.

PRACTICE TIP: The split-gift election is not necessary for gifts of community property, because these transfers are treated as coming from each spouse equally. The election is important to consider when a spouse wishes to make a transfer of his or her separate property or in noncommunity property jurisdictions.

To qualify for the split-gift election, both spouses must be U.S. citizens or residents and be married when the gift is made. IRC §2513(a). Both spouses must consent to splitting the gift, and the nondonor spouse must sign the donor spouse's gift tax return. IRC §2513(b); Treas Reg §25.2513-2.

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§10.122 K. Qualified Disclaimers

Qualified disclaimers are a useful estate planning tool to keep assets that the transferee does not want or need out of the transferee's estate and avoid a second taxable transfer of the disclaimed assets. If a qualified disclaimer is made, the person making the disclaimer is treated as if the disclaimed interest had never been transferred to that person. IRC §2518(a). To make a qualified disclaimer, the disclaimer must be in writing and be received by the transferor within 9 months after the later of the date on which the transfer creating the interest is made or the day on which the person disclaiming attains age 21; the person making the disclaimer must not have accepted the disclaimed interest or any of its benefits; and the interest must pass without any direction on the part of the disclaiming person to someone other than the person making the disclaimer. IRC §2518(b). For discussion of disclaimers, see chap 27.

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§10.123 L. Valuation of Gifts

A gift is valued as of the date of the gift. IRC §2512(a). Like the valuation of property for estate tax purposes, the valuation of gifted property is made under the willing-buyer/willing-seller rule discussed in §10.36. One tax advantage of lifetime gifts is that, if fractional interests in an asset are gifted to more than one donee, they are valued separately for gift tax purposes, rather than the entire interest being valued as it would be for estate tax purposes. Thus a minority discount may apply to each fractional interest gifted. *Samuel J. LeFrak*, TC Memo 1993-526. For a discussion of minority interest discounts, see chap 18.

Special valuation rules apply to certain transfers of interests in property to family members. IRC §§2701-2704. For discussion of these rules, see chap 25.

A gift of encumbered property is generally valued at the excess of the unencumbered fair market value of the property over the outstanding debt. *Fernie C. Laughinghouse* (1983) 80 TC 425. If property is transferred for less than full and adequate consideration, only the amount that exceeds the consideration paid is included in the amount of the gift. IRC §2512(b). See chap 12 on the allocation of basis when there is a part gift, part sale.

To establish the value of the gift for both estate and gift tax purposes, the donor must disclose the gift on a gift tax return. See §10.127.

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§10.124 M. Filing Gift Tax Return

Gift tax returns must be filed for all taxable gifts no later than April 15 of the year after the calendar year in which the gift was made, unless an extension is granted. IRC §§6019, 6075(b)(1). If April 15 falls on a Saturday, Sunday, or legal holiday, the return is due the next succeeding day that is not a Saturday, Sunday, or legal holiday. See Treas Reg §25.6075-1(d). If the donor dies in the year the gift is made, the return must be filed on the earlier of the estate tax return due date or April 15 of the year after the calendar year in which the gift was made. IRC §§6018, 6075(b)(3); Treas Reg §25.6075-1(b)(2).

All gift tax returns (except returns for American Samoa, Guam, the U.S. Virgin Islands, and Puerto Rico) must be filed at the IRS Service Center in Cincinnati, Ohio. See IRS Announcement 2001-74, 2001-2 Cum Bull 40. For discussion of extensions and late-filing penalties, see §§10.125-10.126.

The donor has the primary responsibility for filing the return. IRC §6019; Treas Reg §25.6019-1(a). If the donor dies before filing the return, the executor or administrator is responsible for doing so. Treas Reg §25.6019-1(g).

The return must be filed even when no gift tax is payable because of marital or charitable deductions under IRC §2522 or §2523 or because of the application of the unified credit under IRC §2505. Treas Reg §25.6019-1(f). A return need not be filed for annual exclusion gifts under IRC §2503(b), but filing may be desirable to start the running of the statute of limitations on redetermination of the value of the gifts for estate or gift tax purposes. See §10.127.

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§10.125 1. Extension of Time to File

The taxpayer may request an extension of no more than 6 months (unless the donor is abroad) to file a gift tax return by writing a letter to the IRS before the due date of the return showing good and sufficient cause. IRC §6081(a); Treas Reg §25.6081-1. An extension granted for income tax purposes is also deemed to be an extension for gift tax filing. IRC §6075(b)(2). The taxpayer may receive an automatic 6-month extension by filing IRS Form 4868. An extension of the time to file does not extend the time to pay the tax. Treas Reg §§25.6075-1(b)(1), 25.6081-1. See §10.128.

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§10.126 2. Late-Filing Penalty

The late-filing penalty is 5 percent per month, not to exceed 25 percent, of the amount of the tax, unless it is shown that the failure is due to reasonable cause and not due to willful neglect. IRC §6651(a)(1). Reliance on an attorney or accountant to file the return is not reasonable cause for failure to file by the executor. See *Estate of Gertrude Zlotowski*, TC Memo 2007-203. If failure to file was fraudulent, the penalty is increased to 15 percent per month with a maximum of 75 percent. IRC §6651(f). A return filed even 1 day late is subject to the penalty. For example, if a gift tax return with $100,000 of tax due is filed a day late, a $5000 penalty will be imposed on the donor. There is no late-filing penalty if no tax is due, although a penalty may apply for failure to report transfers to foreign trusts under IRC §6677. Filing a late return also delays the running of the statute of limitations for redetermining the value of the gift. See §10.127.

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§10.127 3. Effect of Filing Gift Tax Return

The statute of limitations for reported gifts is 3 years after the date the return is filed. IRC §6501(a). The statute never begins to run, however, if the gift is not adequately disclosed on the return. IRC §6501(c)(9). If a return is not filed or if the gift is not adequately disclosed on the return, a gift tax may be assessed at any time. IRC §6501(c)(3). Once the limitations period expires, the amount of the gifts as reported on the return may not be adjusted for purposes of determining future estate tax liability, even if the value of the gift as shown on the return results in no tax being owed. IRC §2001(f). Most practitioners therefore advise that gift tax returns always be filed in order to begin the running of the statute of limitations.

The IRS has issued regulations listing information that taxpayers must report on their gift tax returns. Treas Reg §301.6501(c)-1(f). The regulations make it clear that, if there is adequate disclosure, with the result that the assessment period runs and the value of the transferred property can no longer be disputed, the IRS is bound with respect to "adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of gift tax law." Treas Reg §20.2001-1(b). Thus, the IRS loses the ability to challenge both annual exclusion claims (*e.g.,* challenge the validity of a trust's *Crummey* clauses) and deduction claims (*e.g.,* marital and charitable deductions). The IRS also loses the ability to raise claims involving later inclusion of the transferred property in the estate (*e.g.,* a claim that a transfer was revocable because the holder of a durable power of attorney did not have the power to make the gift). For further discussion of valuation, see chap 19.

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§10.128 N. Payment of Gift Tax

Payment of the gift tax must be made when the return is due, regardless of extensions. IRC §6151(a). See §10.124. The IRS may extend the time for payment of the gift tax for a reasonable period not to exceed 12 months. IRC §6161(a)(1). An extension must be requested on IRS Form 4768 and generally requires a showing of undue hardship. Treas Reg §25.6161-1(b). If an extension is granted, the estate must pay interest on the tax liability during the period of the extension. IRC §6601(a); Treas Reg §25.6161-1(d).

The donor has the primary responsibility for paying the gift tax. IRC §2502(c); Treas Reg §25.2511-2(a). If the donor dies before paying the tax, the executor or administrator is responsible for filing the gift tax return and for paying the tax from the donor's estate. If there is no qualified executor or administrator, the donees must file the gift tax return and pay the tax to the extent of the value of the property share received by each donee. If a husband and wife split gifts under IRC §2513, there is joint and several liability with respect to the gift tax. Treas Reg §25.2502-2.

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11

Generation-Skipping Transfer Tax

Kim Marois

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I. CONCEPTUAL OVERVIEW

§11.1 A. Purpose of Tax

In 1986, Congress enacted the generation-skipping transfer (GST) tax (IRC §§2601-2664) to simulate the tax results that would occur if family wealth were subject to an estate or gift tax at each generation. The tax scheme identifies situations in which the estate and gift taxes fail to accomplish this objective, defines the taxable events necessary to plug the identified gaps, and then imposes a tax that simulates, with varying degrees of success, either an extra estate tax or an extra gift tax, using the maximum estate tax rate.

NOTE: The GST tax is repealed in 2010 and restored in 2011 with a rate of 55 percent under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38). This chapter does not address GST issues that may arise as a result of the repeal of the estate and GST taxes.

The basic features of the GST tax are discussed in §§11.2-11.5. The different types of generation-skipping transfers are discussed in §§11.6-11.11. Tax calculation and exemptions are discussed in §§11.12-11.27. Other important concepts are introduced in §§11.28-11.42. Separate trust and valuation problems are discussed in §§11.43-11.49. Fundamental GST tax strategies are discussed in §§11.50-11.58. Other common strategies and precautions are discussed in §§11.59-11.62. For a comprehensive discussion of the GST tax, see Harrington, Plaine & Zaritsky, Generation-Skipping Transfer Tax: Analysis With Forms (2d ed 2001).

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§11.2 B. Second Tax on Same Transfer

The GST tax is a second transfer tax that is imposed in addition to the estate or gift tax on transfers benefiting "skip persons" (persons assigned to generations two or more below that of the transferor). IRC §§2601, 2611-2613. See §11.33. The tax is imposed when the transfer is considered to occur. See §11.3. Except in the special case of a reverse QTIP election (see §11.51), the GST tax "transferor" is the same person who made a transfer of the property for estate or gift tax purposes, whether or not any estate or gift tax was actually payable. IRC §2652(a). See §11.32. There are exceptions to the imposition of the GST tax in certain cases when the intervening generation is deceased at the time of the transfer. See §11.33. The GST tax does not apply to transfers before the effective date of the statute. See §11.35.

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§11.3 C. Timing of Tax

The GST tax is imposed as soon as all persons having an "interest" in transferred property (defined for all GST tax purposes to mean a *present* interest by which the beneficiary is currently entitled or eligible to receive benefits (see §11.42)) are "skip persons." IRC §2613; Treas Reg §26.2612-1(e)(1). Thus, the tax is imposed immediately in the case of a gift or devise to a grandchild, but in the case of a trust that may make distributions to both skip persons and nonskip persons, the GST tax is delayed until the interests of the nonskip persons cease to exist. This occurs with respect to distributed property whenever there is a distribution to a skip person and with respect to undistributed property remaining in trust whenever death or another specified event results in no nonskip persons having a present interest in the trust. See §11.4.

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§11.4 D. Taxable Events

The statute defines three taxable events: direct skips, taxable terminations, and taxable distributions. IRC §2611(a). Direct skips are transfers to skip persons, as defined in IRC §2613, on which GST taxes are imposed at the same time as the estate or gift tax because no nonskip person has a present interest in the transferred property at that time. IRC §2612(c). See §11.3. Examples of direct skips include direct gifts to grandchildren or to trusts benefiting only grandchildren. Taxable distributions occur when there is a distribution from a trust to a skip person. IRC §2612(b). The distribution may be constructive. For example, the lapse of a withdrawal power or other power of appointment may be treated as a taxable distribution. See Treas Reg §§26.2612-1(c)(1), 26.2652-1(a)(5), Example 5. Taxable terminations occur when the interest of the last nonskip person terminates. IRC §2612(a). The effective GST tax rate depends on the taxable event. See §11.5.

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§11.5 E. Tax Rates

Assuming that a transfer is not exempt from the GST tax to any extent, the GST tax rate is the maximum estate tax rate imposed on decedents dying in the year of the transfer (55 percent under current law in 2011 and thereafter). IRC §§2001, 2641. Although there is only one rate of GST tax at any particular time, the amount of the GST tax imposed varies with the type of transfer, because the method of computing the tax and the amount subject to the tax differs, depending on the type of transfer (direct skip, taxable distribution, or taxable termination) and on whether the transfer is inter vivos or made at death. In contemplating generation-skipping transfers, it is important to consider the interrelationship of the GST tax and the estate and gift taxes. In general, inter vivos direct skips incur the lowest overall taxes and transfers made at death to trusts from which there will be taxable distributions or a taxable termination incur the greatest overall taxes. The computation of the GST tax, depending on the type of transfer, is similar to the imposition of the gift and estate taxes, which are computed on a tax-exclusive and tax-inclusive basis, respectively. For example, if the GST is a direct skip, the method of computation simulates the imposition of the gift tax, with the GST tax rate being applied to the after-tax net amount received by the beneficiary. While the "tax-exclusive" method of computation reduces the effective GST tax rate to 33.33 percent of the total gift plus the GST tax when the GST tax rate is 50 percent, there is also the additional cost of the gift tax that is imposed on both the transfer and any GST taxes imposed on the transfer. For specific computations of the GST tax, see §§11.6-11.8.

In all other cases, necessarily involving the existence of a multigenerational trust or trust equivalent (*e.g.,* a legal life estate and a remainder) in which one or more nonskip persons have interests, the taxable events will consist of "taxable distributions" or "taxable terminations." The GST tax on these events simulates imposition of an estate tax, with the GST tax rate being imposed on the entire fund available for both the net gift and the payment of the tax. This "tax-inclusive" computation results in the effective rate being the full GST tax rate. See §§11.9-11.11.

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§11.6 F. Tax on Direct Skips

The tax-exclusive nature of the GST tax imposed on a direct skip, as discussed in §11.5, may be illustrated by the examples of a transferor who makes an inter vivos gift to a grandchild and a decedent who makes a bequest to a grandchild. The inter vivos transfer to the grandchild is subject to a gift tax. However, in the case of a direct transfer to the grandchild, no estate or gift tax would be imposed at the generation of the transferor's child, because no actual transfer was made by the child or a member of the child's generation. The GST tax addresses this situation by defining a transfer to a person who is two or more generations below the transferor as a taxable event known as a *direct skip* and imposing a tax that simulates the *gift tax* that would been imposed *on a transfer by the child* if the transferor had first transferred the property to the child and then the child had immediately retransferred the property to the grandchild. For a computation of the taxes imposed on an inter vivos direct skip, see §11.7. In the case of a direct skip to a grandchild on the death of a grandparent, the GST tax regime attempts to simulate the *estate tax* that would been imposed *on a transfer by the child* if the transferor had first transferred the property to the child at death and then the child had immediately retransferred the property to the grandchild by gift. For a computation of the taxes imposed on a direct skip at death, see §11.8.

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§11.7 1. Inter Vivos Gift

In the case of an inter vivos direct skip, the GST tax is applied in a tax-exclusive manner to the amount of the gift and the gift tax is applied to the amount of the gift *and* to the GST tax under IRC §2515. For example, in the case of an inter vivos direct skip of $100,000 in 2002 (when the maximum gift tax rate and GST tax rate were 50 percent), assuming that all exemptions and credits have been used, the total cost of the gift would be $225,000, consisting of the amount of the gift ($100,000) plus the GST tax on the gift ($50,000) plus the gift tax on the gift ($50,000) plus the gift tax on the GST tax ($25,000). This result simulates a $150,000 gift by the transferor with a gift tax of $75,000, followed by a $100,000 gift to the recipient of the direct skip with a gift tax of $50,000. This is the best-case scenario, with both the transfer tax and the GST tax applied in a tax-exclusive manner. For discussion of the tax-exclusive manner of calculating the gift tax, see chap 10.

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§11.8 2. Transfer at Death

In the case of a direct skip transfer at death, the GST tax is applied in a tax-exclusive manner to the amount of the transfer and the estate tax is applied to the fund used to make the transfer and pay the estate tax and GST tax. For example, in the case of a direct skip of $100,000 in 2002 (when the maximum estate tax rate and GST tax rate were 50 percent), assuming that all exemptions and credits have been used, the total cost of the transfer would be $300,000, consisting of the amount of the transfer ($100,000) plus the amount of GST tax on the transfer ($50,000) plus the estate tax on the $300,000 fund used to make the transfer and pay the estate tax and GST tax ($150,000). This result simulates a $150,000 bequest by the transferor with an estate tax of $150,000, followed by a $100,000 gift to the recipient of the direct skip with a gift tax of $50,000. The total cost of the transfer is the same as the cost of an inter vivos gift to a trust followed by a taxable distribution or taxable termination, with the transfer tax applied in a tax-inclusive manner and the GST tax applied in a tax-exclusive manner. See §11.10.

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§11.9 G. Tax on Taxable Distribution or Termination

The tax-inclusive nature of the GST tax imposed on a taxable distribution or taxable termination, as discussed in §11.5, may be illustrated by the example of a transferor who transfers property to a trust that is designed to pay income to the transferor's child for life with the remainder of the trust passing to the transferor's grandchild at the death of the child. Assuming no inclusion in the child's estate under IRC §§2035-2042 for powers granted the child, no estate or gift tax would be imposed at the death of the child, because the trust property is not includable in the child's estate. The GST tax addresses this situation by defining the child's death as a taxable event known as a taxable termination and imposing a tax that looks very much like the *estate tax* that would have been imposed at the child's death if the transferor had devised the original trust corpus to the child and if the child had then devised the remaining trust estate to the grandchild. Any pretermination distributions to the grandchild would have been similarly taxed as "taxable distributions." In such events, the GST tax will be imposed on the entire fund available to make the transfer and pay the GST tax. See §§11.10-11.11.

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§11.10 1. Inter Vivos Gift to Trust

In the case of an inter vivos gift to a trust followed by a taxable distribution or taxable termination, the GST tax is applied in a tax-inclusive manner to the amount of the taxable distribution or taxable termination and the gift tax is applied to the gift to the trust in a tax-inclusive manner. For example, assuming that the estate, gift, and GST tax rates are 50 percent and all exemptions and credits have been used, the total cost of a net gift of $100,000 would be $300,000, consisting of the net after-tax amount received by the beneficiary ($100,000), GST tax on the taxable termination or taxable distribution ($100,000), and gift tax on the $200,000 gift to the trust ($100,000). This result simulates a $200,000 gift by the transferor with a gift tax of $100,000 followed by a $100,000 bequest to the beneficiary with an estate tax of $100,000. The total cost of the gift is the same as the cost of a direct skip transfer at death. See §11.8.

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§11.11 2. Transfer at Death to Trust

In the case of a transfer at death to a trust followed by a taxable distribution or taxable termination, the GST tax is applied in a tax-inclusive manner to the amount of the taxable distribution or taxable termination and the estate tax is applied to the total fund needed to make the transfer to the trust. For example, assuming that the estate and GST tax rates are 50 percent and all exemptions and credits have been used, the total cost of a net transfer of $100,000 would be $400,000, consisting of the net after-tax amount received by the beneficiary ($100,000), GST tax on the taxable distribution or taxable termination ($100,000), and estate tax on the $400,000 transfer to the trust needed to pay the net after-tax amount to the beneficiary and pay the estate tax and GST tax ($200,000). This result simulates a $400,000 bequest by the transferor with a $200,000 estate tax followed by a second estate tax inclusion of $200,000, resulting in a $100,000 bequest to the beneficiary after a $100,000 estate tax. This is the worst-case scenario, with both the transfer tax and the GST tax applied in a tax-inclusive manner. For discussion of the tax-inclusive manner of calculating the estate tax, see chap 10.

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II. TAX CALCULATION AND EXEMPTIONS

§11.12 A. Tax Calculation Formula

The GST tax is calculated by multiplying the "taxable amount" by the "applicable rate." IRC §2602. Taxable amounts are defined separately for the different types of GST transfers. IRC §§2621-2623. The "applicable rate" is defined as the inclusion ratio multiplied by the maximum federal estate tax rate in effect at the time of the GST transfer. IRC §2641. The "inclusion ratio" is defined in IRC §2642 as the excess of "1" over the "applicable fraction" determined from the trust from which the distribution is made, or, in the case of a direct skip, the applicable fraction for such skip. The "applicable fraction" is further defined to be the fraction determined with a numerator equal to the amount of the GST exemption allocated to the trust or, in the case of a direct skip, the property transferred in the skip, and a denominator equal to the value of property transferred to the trust (or the value of the property involved in the direct skip), reduced by the any federal estate or state death tax credit actually recovered from the trust attributable to such property and any charitable deduction allowed under IRC §2055 or §2522 with respect to such property.

Thus, the statute provides a system that uses a varying tax rate in the form of an "applicable rate" equal to the maximum federal estate tax rate multiplied by the "inclusion ratio" with respect to the transfer, which is in turn defined by reference to the "applicable fraction." Because of the complexity of these calculations, estate planners generally find that it is conceptually much easier to work with (and establish) GST trusts that are wholly exempt or wholly nonexempt (or derive exempt and nonexempt fractions of the trust for purposes of the calculation), and that for the nonexempt trusts or fractions, the tax is calculated by multiplying the value of the trust or fraction by the applicable tax rate.

Under this conceptual scheme, the "inclusion ratio" is the nonexempt fraction of the trust subject to the GST tax rather than the fraction that correspondingly reduces the tax rate, after the GST exemption is applied. See §11.13.

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§11.13 B. The GST Exemption

Every individual is given a GST exemption. In 2004-2009, the GST exemption was equal to the applicable exclusion amount ($3.5 million in 2009). IRC §2631. Unless Congress changes the law, the GST tax does not apply to transfers in 2010. IRC §2664. After 2010, the amount of the exemption is $1 million plus cost-of-living adjustments. In these years, the disparity between the GST exemption and the IRC §2010 applicable exclusion amount of $1 million will be significant for GST tax planning. See §11.51. The GST exemption functions differently from the applicable exclusion amount and corresponding applicable credit amount that assure that no estate or gift tax is payable until an individual's transfers exceed the applicable exclusion amount, because any available applicable credit amount (for estate and gift tax purposes) is automatically applied to the earliest transfers. IRC §§2010, 2505. See chap 10. In contrast, use of GST exemption is discretionary. IRC §2632. An overview of the exemption allocation rules is provided in §11.14.

Another notable feature of the GST exemption is that allocation of the exemption to property transferred to a trust may cause the trust to be exempt on a fractional share basis. For example, allocation of the entire $2 million GST exemption (in 2006-2008) to a $3 million trust will cause the trust to be two-thirds exempt, with the result that only one-third of the property subject to GST tax events will be subject to the GST tax. The term "inclusion ratio," in substantive effect, designates the fraction of the trust that is subject to tax. This is calculated after first computing the "applicable fraction" (or exempt fraction) and subtracting the exempt fraction from one to determine the nonexempt fraction or inclusion ratio. IRC §2642(a)(1). The numerator of the fraction is the amount of the GST exemption applied to the transferred property and the denominator is the value of the property on the effective date of the allocation. IRC §2642(a)(2). The inclusion ratio of a trust may change if property is added to the trust or more exemption is applied to the trust. See §11.28.

For reasons discussed in §11.43, estate planners often are careful to avoid creating trusts that are only partially exempt. If the amount transferred to the trust exceeds the GST exemption allocated to the trust, it is usually desirable to establish separate trusts so that one trust is fully exempt and the other is fully nonexempt. Existing trusts with an inclusion ratio of more than zero and less than one may be severed into two trusts, one with an inclusion ratio of zero and one with an inclusion ration of one, under IRC §2642(a)(3). See §11.49.

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§11.14 C. Overview of GST Exemption Allocation Rules

The GST exemption allocation rules, which allow an individual to allocate his or her IRC §2631 GST exemption at any time on or before the due date for filing the individual's estate tax return, are included in IRC §2632. Unless an election is made not to allocate the GST exemption, a transferor's GST exemption is automatically allocated to direct skips made during life (IRC §2632(b)) and then to certain inter vivos indirect skips to GST trusts, as defined (IRC §2632(c)) and, at death, first to direct skips occurring at the individual's death and then to trusts with respect to which the individual was the transferor and from which a taxable termination or taxable distribution could occur at or after the individual's death (IRC §2632(e)). The individual may elect automatic allocation to transfers made during life to trusts that are not GST trusts (IRC §2632(c)), and the transferor or personal representative of the transferor's estate may allocate GST exemption to any transfer made during life or at death to which automatic allocation does not apply (IRC §2632(a), (d)). Allocation of the GST exemption to lifetime transfers is discussed in §§11.15-11.25. Allocation of exemption to transfers at death is discussed in §11.26. Relief provisions allow late timely allocations and elections before and after death. See §11.27.

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§11.15 D. Allocating Exemption to Lifetime Direct Skips

The simplest form of GST exemption allocation involves lifetime direct skips, such as outright gifts to grandchildren. Transfers to trusts also may be direct skips if the trust has no nonskip person beneficiaries. IRC §2612(c). See §11.4. To the extent the transferor has remaining GST exemption available, the law provides for automatic allocation of enough exemption to give the direct skip an inclusion ratio of zero, thereby making the transfer wholly exempt. IRC §2632(b)(1). The transferor may, however, elect out of the automatic allocation for direct skips on a timely filed gift tax return, although such elections are unusual. IRC §2632(b)(3). The automatic allocation to direct skips is effective on the date of the gift, and the property is valued as of that date for inclusion ratio determination purposes. Automatic allocations to direct skips and elections out of the automatic allocation are irrevocable after the due date of the gift tax return on which the transferor might have elected out of the automatic allocation or made the election. Treas Reg §26.2632-1(b)(1). The IRS may grant extensions of time to make automatic allocation elections in appropriate circumstances. IRC §2642(g)(1). See §11.27.

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§11.16 E. Allocating Exemption to Other Lifetime Transfers

Lifetime transfers that are not direct skips include: (1) transfers to trusts benefiting both skip and nonskip persons (*e.g.,* children and their issue); and (2) transfers to nonskip persons for life (or term of years, etc.) with remainder to skip persons (*e.g.,* transfer of Blackacre to child for life, with remainder to grandchild).

Automatic allocation may apply to transfers to trusts, which may include a life estate with remainder under IRC §2652(b), and the transferor may elect automatic allocation or elect to have automatic allocation not apply. IRC §2632(c). See §11.17.

WARNING: If automatic allocation does not apply, GST tax will be imposed if there is a taxable distribution or taxable termination before there has been an effective allocation of exemption, unless a retroactive allocation is available (see §11.19). Accordingly, it is possible for a relatively small transfer to be charged with the GST tax even if the transferor has ample remaining exemption.

If automatic allocation does not apply, the transferor may allocate exemption to the transfer, and if exemption is not allocated during the transferor's lifetime, the personal representative of the transferor's estate may allocate exemption to the transfer (or exemption may be allocated by default) after the transferor's death. See §11.18. Lifetime transfers to trusts may be subject to the ETIP rule. See §11.23.

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§11.17 1. Automatic Allocation to Indirect Skips

To the extent that the transferor has GST exemption remaining, exemption is automatically allocated to indirect skips. IRC §2632(c). Indirect skips are defined as any transfer of property (other than a direct skip) subject to the gift tax made to a GST trust. IRC §2632(c)(3)(A). A GST trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor unless at least one of the following criteria is met (IRC §2632(c)(3)(B)):

- **More than 25 percent to nonskip person by age 46.** The trust instrument provides that more than 25 percent of the trust corpus must be distributed or may be withdrawn by one or more nonskip individuals, either before the date such individual attains age 46, or on or before dates specified in the trust instrument that will occur before the individual attains age 46, or on the occurrence of an event that, in accordance with the Treasury Regulations, may reasonably be expected to occur before the date the individual attains age 46.
- **More than 25 percent to nonskip person, on death of person more than 10 years older.** The trust instrument provides that more than 25 percent of the trust corpus must be distributed or may be withdrawn by one or more individuals who are nonskip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individual.
- **General power of appointment over more than 25 percent.** The trust instrument provides that if one or more of the individuals who are nonskip persons die on or before the date or event described in the first two criteria, more than 25 percent of the trust corpus must be distributed to the estate or estates of one or more of such individuals or the trust is subject to a general power of appointment exercisable by one or more of such individuals.
- **Subject to tax in nonskip beneficiary's estate.** The trust is a trust any portion of which would be included in the gross estate of a nonskip person (other than the transferor) if such person died immediately after the transfer.
- **Specified charitable trusts.** The trust is a charitable lead annuity trust (within the meaning of IRC §2642(e)(3)(A)) or a charitable remainder annuity trust or a charitable remainder unitrust (within the meaning of IRC §664(d)).
- **Certain charitable lead unitrusts.** The trust is a charitable lead unitrust that is required to pay principal to a nonskip person if that person is alive when the yearly payments for which the deduction was allowed terminate.

In the absence of regulations, it is difficult to determine the precise meaning of several of these criteria.

Fortunately, it is generally unnecessary to determine whether a trust is a GST trust, because an individual may elect to have automatic allocation apply or not apply to any or all transfers made to a particular trust by attaching a prescribed statement to a timely filed gift tax return for the calendar year in which a transfer was made. IRC §2632(c)(5); Treas Reg §26.2632-1(b)(2). The instructions to IRS Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) allow the transferor to elect in or out of automatic allocation for a specific transfer or for all present and future transfers to a particular trust by attaching a statement to the return describing the election and clearly identifying the transfers or trusts to which the election applies. To avoid undesired results, the transferor generally should elect in or out of automatic allocation for all transfers to trusts that are not direct skips. The IRS may grant extensions of time to make automatic allocation elections in appropriate circumstances. IRC §2642(g)(1). See §11.27.

Some practitioners believe that the transferor should not elect out of automatic allocation if the transferor intends to use a late allocation strategy (unless the trust clearly is a GST trust) out of concern that the IRS may not allow late allocations after an election out of automatic allocation, which would prevent the use of a late allocation strategy in any event if the trust is a GST trust. See §11.20.

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§11.18 2. Timely Allocations—General Rule

Allocations of the GST exemption to lifetime transfers, other than direct skips and indirect skips to which the automatic allocation rules apply, may be "timely" or "late." Treas Reg §26.2632-1(b)(4)(ii). Timely allocations are made by appropriately completing IRS Form 709 (United States Gift (and Generation-Skipping Transfer) Tax Return) and timely filing the return. Form 709 is used even if the transferor dies shortly after the gift and the allocation are made by the personal representative of the transferor's estate. Retroactive allocations permitted by IRC §2632(d) are treated as timely allocations. See §11.19. Late allocations may be treated as timely allocations under the "relief provisions" of IRC §2642(g)(1)(A), which allow taxpayers to belatedly request an extension of time to make an allocation of GST exemption. See §11.27. All other allocations not made on a timely filed return for the year of the transfer are treated as late allocations. See §§11.20-11.21. Default allocation may occur if timely or late elections are not made during life or at death. See §11.22.

If the allocation is timely, life is relatively simple because of the following factors:

- **Value of property for inclusion ratio purposes.** The value of the transferred property for the purpose of determining the inclusion ratio will be its fair market value on the date of the transfer. IRC §2642(b).
- **Effective date.** The effective date of the exemption allocation will be the date of the transfer even though Form 709 may be timely filed much later. Accordingly, the allocation will be deemed to occur before any GST taxable events occur even if those events actually take place before the Form 709 is filed.
- **Allocating correct amount of exemption.** For a variety of strategy reasons, a trust usually should be either fully exempt from GST tax (have an inclusion ratio of zero) or fully nonexempt. If a trust is to be fully exempt, the amount of GST exemption allocated to the trust must equal the value as of the valuation date specified by the statute for determining the inclusion ratio. To deal with the risk that the IRS will later adjust the date-of-transfer value of the property, the taxpayer can use a formula that allocates the amount of exemption necessary to produce an inclusion ratio of zero for the transfer. This is expressly permitted by Treas Reg §26.2632-1(b)(4)(i). (A formula also may be used for a late allocation. See §11.20.) Unless there is no possible doubt about the value of the property on the relevant date, the use of a formula is highly recommended. The only drawback to using a formula is that it results in uncertainty concerning the transferor's remaining balance of unused GST exemption.

NOTE: Form 709 makes little provision for allocating exemption to transfers that are not direct skips or indirect skips. The total amount of exemption allocated is stated on Schedule C, Part 2, Line 6, and then an explanation (referred to as a notice of allocation) is to be attached to the return. The notice of allocation should contain not only the information described on the final page of the Instructions for Form 709, but, if applicable, the additional value and inclusion ratio information described in Treas Reg §26.2632-1(b)(2)(i). If a formula allocation is being made, it is probably appropriate to enter the assumed value of the transfer on Line 6, annotate the entry with an asterisk, write "*Amount Estimated. See Notice of Allocation" at the bottom of the page, and then use the notice of allocation to explain that the amount shown is an estimate and the true amount allocated is the amount necessary to reduce the inclusion ratio to zero.

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§11.19 3. Retroactive Allocations

The GST exemption may be allocated retroactively to certain transfers to trusts when the transferor did not allocate GST exemption, because the trust was expected to benefit only nonskip persons, but a nonskip person beneficiary dies prematurely, thereby causing a taxable termination in favor of a skip person to which the GST tax would apply. IRC §2632(d), applicable in the case of deaths of nonskip persons after December 31, 2000. The transferor may elect to allocate any remaining GST exemption to any previous transfers (on a chronological basis) to a trust when a nonskip person beneficiary who is a child, niece, nephew, or child of a first cousin of the transferor, or the transferor's spouse or former spouse, dies before the transferor. IRC §2632(d)(1). The retroactive allocation must be made on a timely filed gift tax return for the calendar year of the nonskip person beneficiary's death. The remaining amount of the transferor's GST exemption is determined, and the allocation is effective immediately before the nonskip person's death and the gift tax value is used as the value of the gift, as though a timely allocation had been made. IRC §2632(d)(2).

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§11.20 4. Late Allocations on Form 709

Late allocations of the GST exemption may be made before or after the death of the transferor, and are sometimes made by default if the transferor fails to otherwise allocate the remaining GST exemption. Late allocations are made on the basis of values at the time of the allocation, not at the time of the gift. Late allocations are sometimes intentionally made for strategy reasons (as discussed below), to obtain a lower value to which to allocate the GST exemption, thereby using a lesser amount of the exemption. An allocation on a late Form 709 may be made by the transferor or the personal representative of the transferor's estate. The personal representative has the alternative of making the late allocation on Form 706 if the personal representative is confident that it is not necessary for the allocation to be effective before the estate tax return can be filed. See §11.21. Assuming Form 709 is used:

- **Value of transferred property for inclusion ratio purposes.** The basic rule for late allocations is that the value of the property for purposes of determining the inclusion ratio is its value on the date the return is filed. IRC §2642(b). The general rule is subject to an election that permits the taxpayer to use the value on the first day of the month in which the return is filed except in the case of life insurance. Treas Reg §26.2642-2(a)(2). The IRS may grant relief from inadvertent late allocations in appropriate circumstances. IRC §2642(g)(1). See §11.27.
- **Effective date.** The exemption allocation is effective the day the return is filed. For the benefit of those who like to live dangerously, there is a special rule that provides that the exemption allocation is deemed to take effect before any taxable termination or taxable distribution occurring on the same day. Treas Reg §26.2632-1(b)(4)(iii), Example 4.
- **Allocating the correct amount of exemption.** As is the case with a timely allocation (see §11.18), a late allocation may be made according to a formula that allocates the amount of exemption necessary to reduce the inclusion ratio to zero. Treas Reg §26.2632-1(b)(4)(i). This is highly recommended, particularly in the case of life insurance, which may be very difficult to value accurately.

NOTE: The "date the return is filed" valuation rule makes a late allocation desirable if asset values have dropped, no automatic allocation applies to the transfer, and no GST-taxable events have occurred in the interim. The value of a term life insurance premium may drop to almost zero between the time the premium is paid and the extended due date for filing a gift tax return. This may justify taking a "wait and see" approach with respect to allocation decisions, in which the decision of whether to file timely or late is put off until the last possible day, with the return being intentionally filed 1 day late if the insured is still healthy. (Sometimes two returns are necessary if a timely return is needed for gift tax purposes.) If the transfer is made to a GST trust, however, or to a trust that may be a GST trust, the late allocation strategy may depend on whether yet-to-be issued regulations permit late allocations after an election out of the automatic allocation rules for indirect skips. See §11.17.

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§11.21 5. Late Allocations to Lifetime Transfers Using Form 706

A *timely* allocation of exemption to a lifetime transfer is always made on Form 709, but a late allocation can be made on Form 706. The allocation is effective on the date of filing unless the transferred property is included in the gross estate, in which case the allocation is effective as of the date of death. IRC §2642(b). In either case, the value on the effective date is used to determine the inclusion ratio. Treas Reg §26.2632-1(d)(1). The IRS may grant relief from inadvertent late allocations in appropriate circumstances. IRC §2642(g)(1). See §11.27.

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§11.22 6. Default Allocation to Lifetime Transfers

If not all of a transferor's GST exemption is used by the time the Form 706 is due, the default allocation rules of IRC §2632(e) may result in allocation of exemption to property subject to an inter vivos transfer to which the automatic allocation rules did not apply. See §11.26. This may rescue a situation in which a taxpayer has unwittingly initiated an inter vivos transfer that will produce a generation-skipping transfer in the future. The default allocation rules typically do not work well whenever an amount in excess of the remaining GST exemption will pass to trusts having the potential for later GST-taxable events. The default rules tend to dissipate the exemption by allocating it to all trusts on a prorata basis, contrary to the basic GST tax strategy rule of making sure that a trust is either completely exempt or completely nonexempt. However, partially exempt trusts generally may be severed into exempt and nonexempt trusts under IRC §2642(a)(3). See §11.49.

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§11.23 7. ETIP Exception to General Rules

The rules stated in §§11.18-11.22 for allocating exemption to inter vivos transfers that are not direct skips are subject to two exceptions. The first of these, providing special rules in the case of a charitable lead annuity trust, is beyond the scope of this chapter. See chap 25. The second, the estate tax inclusion period (ETIP) rule, requires brief mention. Under the ETIP rule, an allocation of the GST exemption generally is not effective until the estate tax inclusion period ends, and the valuation date for inclusion ratio purposes is similarly delayed. See §§11.24-11.25.

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§11.24 a. ETIP Defined

The ETIP is the period after the actual transfer during which, should death occur, the value of the transferred property would be includable (other than by reason of IRC §2035) in the gross estate of the transferor or the transferor's spouse. IRC §2642(f). The ETIP rules apply to all retained interest trusts, including qualified personal residence trusts (QPRTs) and grantor retained annuity trusts (GRATs). As a result, such trusts are not effective devices for taking maximum advantage of a donor's GST exemption. The ETIP rules also will apply whenever a spouse is given a withdrawal power over a transfer to a trust, including a *Crummey* withdrawal power, unless the amount subject to the power is no more than the greater of $5000 or 5 percent of the trust corpus, and the withdrawal right terminates no later than 60 days after the transfer to the trust. Treas Reg §26.2632-1(c)(2)(ii)(B).

ETIP situations should not be confused with situations in which property will be included in the transferor's taxable estate because the transfer was not complete for gift tax purposes. For example, a transfer to a revocable trust does not create an ETIP, and a transfer out of the revocable trust during the settlor's lifetime would be treated as a transfer by the settlor, with no need to allocate exemption to the trust.

Similarly, the ETIP rules do not apply when transferred property will be included in the transferor's estate solely by reason of the limited "transfer within three years of death" provisions of IRC §2035. This most typically occurs when an insured transfers a life insurance policy within 3 years of death. A timely allocation of exemption can be made in the usual manner in this situation, and the transferred property will generally retain the resulting inclusion ratio following its inclusion in the estate, unless there is a postdeath allocation of more exemption. Treas Reg §26.2642-4(a)(3).

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§11.25 b. Effect of ETIP

If a trust is subject to an ETIP, it is generally the case that the exemption allocation rules are applied as if the transfer to the trust was made on the date that the ETIP ends. IRC §2642(f). Thus, it may be possible to make a timely exemption allocation many years after the transfer. However, a problem arises in the rare case that a trust will make a taxable distribution before the end of the ETIP. If that occurs, exemption can be allocated to the trust at that time, and an inclusion ratio will be determined solely for purposes of taxing the particular taxable distribution. Subsequently, the exemption remains allocated to the trust, but the inclusion ratio will fluctuate with changes in the value of the trust estate until the end of the ETIP. Treas Reg §26.2632-1(c)(1)(ii), (c)(3)(iii), (c)(5), Example 2. The ETIP rule also delays the effective date of automatic allocations to indirect skips. IRC §2632(c)(4). See §11.17.

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§11.26 F. Allocating Exemption to Property Included in Gross Estate

Allocation of the GST exemption to property included in the gross estate is accomplished by the personal representative on Schedule R of Form 706. If the executor fails to allocate any or all of the remaining GST exemption on a timely return, the statute makes a default allocation, first allocating exemption to direct skips occurring at death and then allocating the remaining exemption on a prorata basis to all those inter vivos and testamentary trusts that might later have taxable distributions or taxable terminations. IRC §2632(e). The return preparer should not rely on the default rules. The value of the property for purposes of determining the inclusion ratio is its estate tax value, if postdeath changes in value are allocated under the rules of Treas Reg §26.2642-2 (see §11.47), or otherwise its date of distribution value. IRC §2642(b)(2).

The allocation of the GST exemption at death raises some of the most complex issues of the GST tax engendered by (1) separate share and separate trust rules that can have the effect of treating intended multiple trusts or trust shares as a single entity for exemption allocation and inclusion ratio purposes; and (2) valuation rules that sometimes cause property to be valued as of the date of distribution rather than as of the date of death for purposes of determining the inclusion ratio. These rules are discussed in §§11.43-11.49.

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§11.27 G. Relief Provisions

Provisions in IRC §2642(g) allow relief for inadvertent late allocations or elections and statutorily introduce the concept of substantial compliance into the arena of GST exemption allocations. Section 2642(g)(1)(A) directs the Treasury Secretary to issue regulations to prescribe circumstances and procedures for extensions of time to make allocations of GST exemption described in IRC §2642(b) (see §§11.18-11.22) and allocation elections provided in IRC §2632(b)(3) or §2632(c)(5) (see §§11.15-11.17). The time for making the allocations and elections will be treated as not prescribed by statute, with the result that the allocations and elections will be eligible for discretionary relief under Treas Reg §301.9100-3. IRC §2642(g)(1)(B).

Internal Revenue Code §2642(g)(2) provides:

> An allocation of GST exemption under section 2632 that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of so much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances shall be taken into account, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant.

Notice 2001-50, 2001-2 Cum Bull 189, provides that the methods for seeking relief under the statute are those provided under the regulation. As a practical matter, this usually means that relief must be sought under Treas Reg §301.9100-3 through a procedure that combines the specific requirements of the regulation with the more general, exhaustive (and exhausting) requirements for applying for a private letter ruling. In limited cases in which no gift tax return was required for the year for which relief is sought because the transfers were fully excluded from taxable gifts by the IRC §2503(b) annual exclusion, the donor can make the application by attaching a notice of allocation to a gift tax return for the year of the gift. See Rev Proc 2004-46, 2004-2 Cum Bull 142.

The IRS has been generous in granting relief in a wide variety of circumstances under Treas Reg §301.9100-3. The Service routinely grants relief for late allocations of GST exemption and late elections out of the automatic allocation rules. See, *e.g.,* IRS Letter Rulings 200925028, 200905002, 200831021, 200831018, 200743025, 200716008, 200637011, 200636091, 200633014, 200632009, 200629016, 200626008.

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III. OTHER IMPORTANT CONCEPTS

§11.28 A. Changing Inclusion Ratios

Generally, the inclusion ratio for a trust can change in two ways: (1) The transferor may add property to the trust, or (2) the transferor may apply additional GST exemption to the trust. IRC §2642. See §11.13. Distributions, whether of income or principal, do *not* cause a change in the ratio. Similarly, income accumulations and changes in asset values do not affect the inclusion ratio. Treas Reg §26.2642-4. (Remember, under the literal language of the statute, the inclusion ratio actually affects the tax rate, and there is no reference to a "nonexempt" trust share. IRC §2641. See §11.12.) The rules and regulations are complex, but they follow a logical pattern consistent with the following scenario.

EXAMPLE: Settlor creates a trust, funds it with $50,000, and makes an allocation of $40,000 of GST exemption to the trust on a timely gift tax return. As a result, the initial inclusion ratio is 1:5. (Literally, the inclusion ratio is one minus the applicable fraction. The numerator of the applicable fraction is $40,000 and the denominator is $50,000.) Over the next year, the trust assets appreciate 20 percent to $60,000, but the inclusion ratio does not change. As a result, the values of the exempt and nonexempt shares also increase 20 percent to $48,000 and $12,000 respectively. At that point, Settlor adds $20,000 to the trust, but does not make a timely allocation of exemption. This increases the value of the nonexempt share to $32,000 and increases the value of the total trust to $80,000. The new inclusion ratio is 2:5 ($32,000 divided by $80,000). If Settlor now wishes to make the trust fully exempt, this can be accomplished by allocating an additional $32,000 of GST exemption.

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§11.29 B. Limited Annual Gift Tax Exclusion

The gift tax provides an annual exclusion of $10,000 (plus cost-of-living adjustments) per donor per donee per calendar year. IRC §2503(b). Beginning in 2009, the annual exclusion is $13,000. See chap 10. The GST tax incorporates the annual exclusion on a limited basis by providing that the inclusion ratio for the transferred property is zero except in specified situations. Under IRC §2642(c), the annual exclusion from GST tax is available if:

- The transfer qualifies for the gift tax annual exclusion; and
- The transfer has only one beneficiary.

Satisfying the second requirement necessarily means that the transfer will be a direct skip. IRC §2612(c). See §11.4.

A transfer to a trust meets the requirement if the trust has only one beneficiary during the beneficiary's life and any trust assets remaining at the beneficiary's death must be included in the beneficiary's estate for estate tax purposes. Such a trust is often called a "vested interest trust" and most obviously includes custodianships and IRC §2503(c) trusts for minors. See chap 8.

The planning significance of these rules is that there is no annual exclusion for GST purposes for the typical *Crummey* trust having more than one beneficiary, including the typical life insurance trust. If the trust is not a GST trust to which an automatic allocation of the GST exemption will be made, these trusts will not be exempt from GST tax unless automatic allocation is elected (see §11.17) or the GST exemption is allocated by filing a gift tax return (see §11.18). Thus, it may be necessary to file a gift tax return for GST tax purposes even if the transfers are completely excluded for gift tax purposes. For discussion of the serious problems the GST tax poses for life insurance trusts and other irrevocable inter vivos trusts that rely on the use of *Crummey* clauses to multiply annual gift tax exclusions, see §§19.67-19.68. See also Ross, *Crummey Powers and the GST Tax*, 15 CEB Est Plan Rep 37 (Oct. 1993).

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§11.30 C. Educational and Medical Expenses Exclusion

The GST tax is not imposed on payments of educational and medical expenses that would not be treated as taxable gifts under IRC §2503(e) if made by inter vivos gift. IRC §2611(b). Thus, the GST tax exclusion for such expenses is actually broader than the gift tax exclusion, because it applies not only to inter vivos gifts but also to trust distributions. See §10.116.

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§11.31 D. Broad Definition of "Trust"

Under IRC §2652(b)(1) and Treas Reg §26.2652-1(b), the term "trust" includes "any arrangement (other than an estate) that has substantially the same effect as a trust." Thus, for example, arrangements involving legal life estates and remainders, estates for years, and insurance and annuity contracts are trusts. See chaps 19-20. So are custodianships for minors. See chap 8. The regulation also provides, somewhat dubiously and by negative implication, that a testamentary transfer may create a trust if the identity of the transferee is contingent on an event that is not certain to occur within 6 months of death. Treas Reg §26.2652-1(b)(1)-(2), Examples 2-3.

EXAMPLE: Under the regulation, a transfer to a child, *C,* if she survives 6 months and otherwise to her issue, will result in a *direct skip* to *C*'s issue if *C* dies before 6 months; but if the contingency period exceeds 6 months, the result would be that a trust was created for the survival period and that a *taxable termination* will occur if *C* dies during that period. See §11.4.

As discussed in §11.44, it is generally best to use a 90-day survival period to meet the requirements of Treas Reg §26.2651-1(a)(2)(iii), which treats a living descendant who dies no later than 90 days after the transfer as having predeceased the transferor, with the result that the predeceased ancestor rule may apply to step up a generation and avoid a direct skip.

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§11.32 E. Identifying the GST Transferor

The general rule is that the GST tax "transferor" of property is the person who is treated as having most recently made a transfer of the property for purposes of the estate or gift tax. IRC §2652(a). This includes a deceased beneficiary of a prior transfer who held a general power of appointment under IRC §2041; the spouse of a donor who consents to a split gift under IRC §2513 (Treas Reg §26.2652-1(a)(5)); and the beneficiary spouse in the case of a transfer for which a QTIP election is made under IRC §2056(b)(7). See chaps 9-10.

Under this general rule, a single trust may have multiple transferors for GST tax purposes, and the identities of the transferors may change from time to time. If the identity of the transferor changes, no further GST taxable events can occur with respect to the original transferor under IRC §2612, and the GST exemption allocation by the original transferor under IRC §2632 expires. The new transferor may allocate the GST exemption to the new transfer, and generation assignments will be measured by reference to the new transferor. See §§11.3-11.4, 11.33. In some cases, the original transferor may be reassigned to a lower generation. See §11.34.

There is an important exception to the general transferor rule, called the "reverse QTIP election," that is relevant only in QTIP trust situations. See §11.51.

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§11.33 F. Generation Assignments

The IRC §2651 generation assignment rules used to determine whether a transfer is made to a skip person under IRC §2613 (see §11.2) are fairly straightforward:

- **Close relatives.** The generation assignments of close relatives (descendants of grandparents of the transferor and the transferor's spouse or former spouse) are measured in the usual way. IRC §2651(b). Any person who marries someone on this broad family tree also joins the family tree. IRC §2651(c).
- **Other persons.** Except in the case of close relatives, persons more than 12½ years younger than the transferor are assigned to the generation one level below the transferor; persons more than 37½ years younger are two generations below the transferor; and similar rules apply for a new generation every 25 years, such that persons more than 62½ years younger are three generations below. IRC §2651(d). An individual who would be assigned to more than one generation is assigned to the youngest of the generations to which that individual would be assigned. Treas Reg §26.2651-2(a). However, adopted children who are lineal descendants of a grandparent of the adoptive parent (or the spouse or former spouse of the adoptive parent) who were under age 18 at the time of the adoption are generally treated as a member of a generation that is one generation below the adoptive parent. Treas Reg §26.2651-2(b). The adopted child's generation assignment also applies in determining the generation assignment of his or her descendants, his or her former spouse, and the spouse or former spouse of each of his or her descendants. Treas Reg §26.2651-2(c). The claim of authority to promulgate these adoption rules is based on an assertion that such adoptions cause persons to have two generation assignments. Under IRC §2651(f)(1), a person who has two generation assignments is assigned to the youngest of the generations "except as provided by regulations." The IRS position is illustrated by an example in Treas Reg §26.2651-2(d).
- **Charities.** Charities are assigned to the generation of the transferor. The unpleasant consequence is that a transfer to a trust with a charitable beneficiary cannot be a direct skip. IRC §2651(f)(3).
- **The deceased ancestor rule.** Under IRC §2651(e), if a person is a descendant of a parent of the transferor (or the transferor's spouse or former spouse), and the parent of that person who is also such a descendant is dead at the time of a transfer, that person is reassigned to the generation of the deceased parent, with each descendant of that person also moving up one generation. The rule does not apply to nieces, nephews, or their descendants unless the transferor has no lineal descendants at the time of the transfer.
- **The deceased ancestor 90-day grace period.** The scope of the deceased ancestor rule is expanded by Treas Reg §26.2651-1(a)(2)(iii), which provides that a living descendant who dies no later than 90 days after the transfer is treated as having predeceased the transferor. The living descendant must in fact die within the period, not merely be treated as dead under a state disclaimer statute. Treas Reg §26.2651-1(a)(2)(iv). The 90-day grace period will not apply if the dying descendant unconditionally acquires ownership of the transferred property within the 90-day period, but a disclaimer may be used retroactively to satisfy this requirement. The regulations further provide that the descendant's generation assignment also applies in determining the generation assignment of his or her descendants, his or her former spouse, and the spouse or former spouse of each of his or her descendants. Treas Reg §26.2651-1(a)(2)(i). In the event that a transfer is subject to estate or gift tax more than once, the relevant date is the date of the first transfer. (If, for example, a settlor of a qualified personal residence trust (QPRT) fails to survive the term, with the consequence that the residence is included in the settlor's estate, the relevant date is the date of the gift rather than the date of death.) Treas Reg §26.2651-1(a)(3). In the case of a QTIP trust, the relevant date for determining the generation assignments under the deceased ancestor rule is the date of the surviving spouse's death. Treas Reg §26.2651-1(a)(3). Many practitioners believe that when drafting dispositive provisions for large estates, the drafter should make transfers to issue subject to a 90-day survival requirement. They point out that the theoretical possibility of a disclaimer by the deceased descendant's personal representative often will be illusory under IRC §2518 if the disclaimer would change the recipient of the property (*e.g.*, cause the property to pass to issue rather than the deceased descendant's spouse). In such a situation a disclaimer might violate the fiduciary duties the personal

representative owes to the beneficiaries of the estate. For discussion of disclaimers, see chap 27.

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§11.34 G. Multiple Skips

Although only one GST tax is imposed on direct skips for any single taxable event, regardless of the number of generations skipped, the GST tax statute generally attempts to impose a tax at each generation for which no estate or gift tax is imposed. Thus, a nonexempt trust that results in no estate or gift tax at two generations will frequently (but not always) trigger two GST taxes. The statute accomplishes this by providing that if property is still held in trust after a transfer, the GST tax still applies to subsequent transfers, but the transferor is reassigned to the first generation above the highest generation, as determined under IRC §2651 (see §11.33), of any person having an interest in the trust. IRC §2653(a).

EXAMPLE 1: Transferor, *T,* makes a transfer in trust for child, *C,* for life, remainder in trust for grandchild, *GC,* for life, with remainder to *GC*'s issue. When *C* dies there is a taxable termination, tax is paid, and *T* is reassigned to *C*'s generation. As a result, *GC* is no longer a skip person, and distributions to her after the reassignment are not taxable, but a taxable termination will occur at *GC*'s death. Better results are achieved in Example 2.

EXAMPLE 2: Transferor, *T,* makes a transfer to a trust for grandchild, *GC,* for life, with remainder to *GC*'s issue. There is an immediate GST tax on the direct skip and *T* is immediately reassigned to child, *C*'s, generation. In this scenario, distributions to *GC* are not taxable distributions because *GC* is only one generation below *T,* but a taxable termination will occur at *GC*'s death. This result is better than the result in Example 1, because the initial transfer is a direct skip. See §11.5. Even better results are achieved in Example 3.

EXAMPLE 3: Transferor, *T,* makes a transfer to a trust for great-grandchild, *GGC,* for life, with remainder to *GGC*'s issue. In this scenario, there is immediate GST tax on the direct skip, but distributions to *GGC* are not taxable distributions and a taxable termination will not occur until *GGC*'s death because *T* is immediately reassigned to grandchild, *GC*'s, generation. Child, *C,* and *GC* will pay no estate or gift tax on the trust because *C* and *GC* have no interest in the trust. Thus, no further transfer tax will occur during *C's* lifetime or at *C*'s death, or during *GC*'s lifetime or at *GC*'s death. Under the "present interest" rule, these results also would occur if the trust allows distributions only to *GGC* for the first few years and then allows discretionary distributions to *C* and *GC*. See §11.42.

As a practical matter, planners generally should avoid creating nonexempt trusts that will result in multiple skips. The cycle can be broken by giving grandchildren (or great-grandchildren) general powers of appointment that cause trust property to be included in their estates, thereby offering the possibility of tax rates less than the maximum federal estate tax rate applicable for GST tax purposes. See chap 10.

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§11.35 H. Grandfathered Transfers

The GST tax was enacted as part of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085). The legislation included transition rules that generally avoided retroactive taxation of transfers made before October 22, 1986 (September 25, 1985, in the case of inter vivos transfers) and provided protection for later transfers under dispositive terms that could not be amended owing to incompetence of the transferor on that date. TRA 1986 §1433(b)(2)(A). The IRS has issued regulations applying the transition rules. See Treas Reg §26.2601-1. Details of these provisions are beyond the scope of this chapter, but counsel is warned to exercise extreme care when engaging in transactions involving grandfathered trusts. Problems can be caused by actual or constructive additions to these trusts, by amendments to trusts, by the exercise, release, or lapse of a general power of appointment, and by other exercises of authority in some exceptional circumstances. See §§11.36-11.37.

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§11.36 1. Exercise, Release, or Lapse of General Power of Appointment

Effective November 18, 1999, the transition regulations provide that an exercise, release, or lapse of a general power of appointment, with respect to an otherwise grandfathered trust, is treated for GST tax purposes as a transfer by the person holding the power. Treas Reg §26.2601-1(b)(1)(i). In *Bachler v U.S.* (9th Cir 2002) 281 F3d 1078, the Ninth Circuit held to the contrary when a general power of appointment created before the enactment of the GST tax was exercised in favor of grandchildren before the effective date of the regulations. In *Simpson v U.S.* (8th Cir 1999) 183 F3d 812, a case decided before the final transition regulations were promulgated, the Eighth Circuit also found that an exercise of a general power of appointment, in favor of grandchildren, under a trust established before September 25, 1985, was eligible for the transitional relief from the GST tax under TRA 1986 §1433(b)(2)(A). The courts in *Bachler* and *Simpson* interpreted the transition provisions of §1433(b)(2)(A) more broadly than the final transition regulations, to exempt generation-skipping transfers that are made possible by the terms of a grandfathered trust agreement, including transfers resulting from the exercise of a general power of appointment granted in the trust agreement. In contrast, the Second Circuit in *E. Norman Peterson Marital Trust* (1994) 102 TC 790, aff'd (2d Cir 1996) 78 F3d 795, and the Sixth Circuit in *Estate of Eleanor R. Gerson* (2006) 127 TC 139, aff'd (6th Cir 2007) 507 F3d 435, cert denied sub nom *Kleinman v Commissioner* (2008) ___ US ___, 171 L Ed 2d 806, 128 S Ct 2502, construed the transition rules to not exempt generation-skipping transfers that occur pursuant to the exercise of a general power of appointment granted in a grandfathered trust. In *Estate of Gerson,* the Sixth Circuit, in its de novo review of the reviewed decision of the full Tax Court, upheld the validity of the transition regulations. In *Estate of Timken* v U.S. (ND Ohio 2009) 630 F Supp 2d 823, citing *Estate of Gerson* with approval, the court held that a decedent's unexercised general power of appointment over a grandfathered GST trust, coupled with disclaimers by her nieces and nephews of interests that would otherwise have passed to them from the trust, resulted in a taxable termination of the trust when the trust interests passed to the decedent's grandnieces and grandnephews on the decedent's death as a result of the disclaimers. For discussion of powers of appointment, see chap 9.

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§11.37 2. Transactions Not Involving General Power

With respect to the possible loss of grandfathered status in situations other than that of a general power, the regulations address changes resulting from the following (Treas Reg §26.2601-1(b)(4)):

- Exercises of discretionary trustee powers to distribute to a new trust or retain trust principal in a continuing trust (*e.g.,* a trustee's spray power that includes the power to distribute to a new trust for a minor);
- Settlements of bona fide controversies;
- Judicial construction of instruments; and
- Other changes.

The basic statement of the applicable rules is followed by examples that make clear that there is no loss of exemption in a variety of routine situations involving such things as divisions or mergers of trusts. See §§11.38-11.41.

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§11.38 a. Exercise of Discretionary Trustee Powers

Generally, an exercise of a trustee's discretionary power to distribute to a new trust will not cause loss of exempt status if the trustee has the power under the instrument or state law at the time the trust becomes irrevocable to make distributions to a new trust or retain trust principal in a continuing trust without the consent or approval of any court or beneficiary *and* the new trust will not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period that extends beyond a life in being plus 21 years, measured from the creation of the original trust. This requirement is deemed met if the period in question does not exceed 90 years. Treas Reg §26.2601-1(b)(4)(i)(A).

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§11.39 b. Settlements of Bona Fide Controversies

Changes in trust terms resulting from settlements of bona fide controversies will not result in loss of the exemption if the settlement is the product of arm's-length negotiations and the result is within the range of "reasonable outcomes under the governing instrument." Treas Reg §26.2601-1(b)(4)(i)(B).

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Source: Estate Planning/California Estate Planning/11 Generation-Skipping Transfer Tax/§11.40 c. Changes Resulting From Judicial Construction

§11.40 c. Changes Resulting From Judicial Construction

Changes resulting from a judicial construction will not result in loss of the exemption if there is a bona fide issue regarding the meaning of the provisions in question and the construction is consistent with applicable state law. Treas Reg §26.2601-1(b)(4)(i)(C).

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§11.41 d. Other Changes

Other changes will not result in loss of the exemption if the modification (1) does not shift a beneficial interest to a person with a lower-generation assignment and (2) does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust. Treas Reg §26.2601-1(b)(4)(i)(D). See, *e.g.*, IRS Letter Ruling 200923012 (consolidation of exempt trusts).

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§11.42 I. "Present Interest" Rule

For purposes of determining when GST tax events occur, it is important to know who has an interest in a trust. Under IRC §2652(c)(1), a person generally has an interest in a trust if that person has a right "other than a future right" to receive income or corpus, or the person is a "permissible current recipient of income or corpus" and is not a person described in IRC §2055(a) (*i.e.*, charities). An interest is disregarded if it is used primarily to postpone or avoid any tax. IRC §2652(c)(2).

Accordingly, it is not literally correct that a taxable termination occurs when a trust ceases to have a nonskip person as a beneficiary. See §11.3. It may occur when a nonskip person ceases to be a person with present mandatory or discretionary distribution rights.

This rule offers a planning opportunity in cases in which planned generation-skipping transfers will exceed the exemption amount. In such cases, it is better to make direct skip transfers because of the lower effective tax rate. See §11.5. It is also best to make the direct skip to as low a generation as possible to avoid multiple impositions of the tax under IRC §2653(a). See §11.34. However, the client may be unwilling to create a trust that benefits, for example, only great-grandchildren. A potential solution is to create a trust that limits distributions to great-grandchildren for the first few years and then allows discretionary distributions to children and grandchildren. The initial transfer will be a direct skip and the transferor will be assigned to the generation of the grandchildren for purposes of determining future GST taxes (because no one above the generation of great-grandchild has a *present* interest), but the children and grandchildren will pay no estate or gift taxes on the trust because they have no ownership interest in the trust. See chap 10.

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IV. SEPARATE TRUST AND VALUATION PROBLEMS

§11.43 A. Need for Separate Trusts

As noted in §11.13, one of the fundamental strategy rules of GST tax planning is that transferred property should always be completely exempt from GST tax (with an inclusion ratio of zero) or completely nonexempt (with an inclusion ratio of one). A trust with an inclusion ratio other than one or zero wastes the GST exemption on distributions to nonskip persons and results in some GST tax on distributions to skip persons. Under ideal circumstances, the dispositive terms would provide for the exempt property to be transferred to or for the benefit of skip persons while the nonexempt property would be transferred to or for the benefit of nonskip persons.

The obvious prerequisite of this strategy is that the transfers receiving the GST exemption must be clearly separate from the other transfers. In general, trusts that are treated as separate trusts from inception under local law are recognized as separate trusts for purposes of Chapter 13, to which GST exemption may be allocated and for which various elections permitted for GST tax purposes may be made. Under limited circumstances, a single trust may have "substantially separate and independent shares" that are recognized for GST tax purposes. The concept of separate shares is illustrated by the following examples from Treas Reg §26.2654-1(a)(5):

EXAMPLE 1: *Separate shares as separate trusts.* Transferor, *T,* transfers $100,000 to a trust under which income is to be paid in equal shares for 10 years to *T*'s child, *C*, and *T*'s grandchild, *GC* (or their respective estates). The trust does not permit distributions of principal during the term of the trust. At the end of the 10-year term, the trust principal is to be distributed to *C* and *GC* in equal shares. The shares of *C* and *GC* in the trust are separate and independent and, therefore, are treated as separate trusts. The result would not be the same if the trust permitted distributions of principal unless the distributions could be made only from a one-half separate share of the initial trust principal, and the distributee's future rights with respect to the trust are correspondingly reduced. *T* may allocate part of *T*'s GST exemption under IRC §2632(a) to the share held for the benefit of *GC*.

EXAMPLE 2: *Separate share rule inapplicable.* The facts are the same as in Example 1, except the trustee holds the discretionary power to distribute the income in any proportion between *C* and *GC* during the last year of the trust. The shares of *C* and *GC* in the trust are not separate and independent shares throughout the entire term of the trust and, therefore, are not treated as separate trusts.

Note that in Example 1, the IRS correctly concludes that there are really two separate $50,000 trusts. The happy result for GST tax purposes is that only $50,000 of GST exemption must be allocated to the grandchild's "trust" to produce a zero inclusion ratio. In contrast, in Example 2, there is only one trust and it will be necessary to use $100,000 of exemption to fully exempt the trust and thereby avoid GST tax on each and every trust distribution to *GC.*

The important point here is that GST tax-sensitive estate plans should be drafted so that the issues raised by these examples will not arise. Even in Example 1, which produces a favorable result, the drafter would have been much better off designing one trust for the skip person and a different trust for the nonskip person, each of which would constitute a separate trust from the inception under local law. Trusts treated as separate trusts under local law are recognized as separate trusts for GST tax purposes as well as for purposes of filing returns and the payment of tax and for purposes of other taxes imposed by the Internal Revenue Code. However, separate shares of a single trust treated as separate trusts for GST tax purposes are not recognized as separate trusts for filing returns or payment of tax, or for purposes of computing any other tax.

In addition to recognition of separate shares of a single trust as separate trusts for GST tax purposes, trusts may be severed to accommodate GST exemption allocations and elections or for the purposes of the trust or the interests of the beneficiaries. The technicalities of the trust severance provisions and separate trust or separate share provisions are addressed in IRC §§2642(a)(3) and 2654(b) and the regulations thereunder. See §11.47.

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§11.44 B. Separating Transfers at Death

A complication in the GST tax area involves the question of when trusts are created for GST exemption allocation purposes when the transferred property is included in the transferor's estate. See §11.26. This is particularly a problem with a revocable trust, because such a trust is susceptible to the contention that it is a single trust for GST tax purposes. See Treas Reg §26.2654-1(a)(5), Examples 3-4. Such a contention, if successful, would result in the settlor's GST exemption being diluted by the value of the entire revocable trust estate, an obviously undesirable result. Fortunately, the IRS appears to be concerned about this problem only in the case of pecuniary gifts that do not include safeguards to prevent manipulations that might allow excessive funding of GST-exempt gifts, as discussed in §11.46. Nevertheless, discretion being the better part of valor, practitioners are cautioned by the following:

- Do not waive statutory interest on pecuniary gifts (see §11.48); and if the pecuniary gift is payable in kind, make sure that it is to be funded at date-of-distribution values or funded with assets that fairly reflect net appreciation or depreciation in the assets available to fund the gift.
- Do not structure dispositive provisions in a will or revocable trust in a way that expressly provides that the required distributions do not occur at death. This advisory prohibition includes not using the unnecessary provision authorizing the trustee or personal representative to delay distributions for the period of administration.
- Use a 90-day survival period for gifts to issue because, under Treas Reg §26.2651-1(a)(2)(iii), a living descendant who dies no later than 90 days after the transfer is treated as having predeceased the transferor. If, for example, a child dies in the 90-day period and the child's children become entitled to the gifts, there will not be a generation-skipping transfer because they will be reassigned to the generation of the deceased child. See §11.33. For transfers that would not qualify for the predeceased ancestor rule, do not make a transfer to a skip person or to a trust for skip persons (or any other disposition indirectly affecting the size of such transfers) using a survival period of more than 6 months. Treas Reg §26.2652-1(b)(1), (2), Examples 2-3. See §11.31.

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§11.45 C. Separate Share for Pecuniary Amount

A pecuniary gift will be treated as a separate and independent share, to which GST exemption may be allocated, if (1) the pecuniary amount is entitled to "appropriate interest" as defined in Treas Reg §26.2642-2(b)(4) (see §11.48) or is paid within 15 months, and (2) the funding of the pecuniary amount is satisfied in cash or in kind using date-of-distribution values or, if funded in kind using other than date-of-distribution values, is fairly representative with respect to net appreciation or depreciation in the assets available to pay the pecuniary amount measured from the date of death to the date of distribution. Treas Reg §26.2654-1(a)(1)(ii). These rules are designed to prevent manipulations in the value of property to which the GST exemption will be allocated, as discussed in §11.46.

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§11.46 D. Separating and Valuing Pecuniary Gifts

Planners and the IRS have long understood that pecuniary gifts can be structured in ways that can result in the pecuniary gift having a true value that is more or less than the stated dollar amount. This in turn can result in different values for a residuary gift that follows a pecuniary gift. For example, the value of a pecuniary gift changes depending on when it is paid and the rights of the recipient to receive interest in the event of delay.

A scheme that caused the IRS to issue Rev Proc 64-19, 1964-1 Cum Bull 682, applicable to marital deduction gifts, also has importance in the GST area. This manipulative strategy involved giving the executor the power to fund the pecuniary gift in kind using federal estate tax values and without requiring that the executor be fair in allocating subsequent asset appreciation and depreciation. This allegedly allowed the executor to allocate asset appreciation and depreciation in a disproportionate manner to favor either the pecuniary gift or the residuary gift. For example, each beneficiary might receive property with a date-of-death value of $100, but the favored gift would be funded with assets that had appreciated to $200, while the disfavored gift would be funded with assets that had no appreciation.

In the case of the GST tax, manipulations of the values of pecuniary gifts and the residuary assets remaining after distribution of the pecuniary gifts are restricted by nonrecognition of the pecuniary gift as a separate share (see §11.45), thereby diluting the value of the GST exemption, and also by penalty rules that increase the value of the *applicable fraction* denominator for the gift, thereby increasing the amount of GST exemption that must be applied to the gift in order to achieve the desired inclusion ratio of zero. See Treas Reg §26.2642-2. For example, the denominator for a pecuniary gift might be increased to the date-of-distribution value of the assets used to satisfy the gift rather than the stated pecuniary amount.

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§11.47 E. Separate Trusts Established (or Severed) at Death

The trust severance provisions and the separate trust or separate share provisions are addressed in IRC §§2642(a)(3) and 2654(b) and the regulations thereunder. While the code sections are closely related, IRC §2654 and the regulations thereunder generally concern trusts that are included in the decedent/transferor's gross estate and that relate back to the date of the decedent's death, while IRC §2642(a)(3) applies to the severance of any trust for prospective purposes only as discussed in §11.49.

A trust that is severed pursuant to a mandatory direction in the governing instrument will be recognized as a separate trust for GST tax purposes. See Treas Reg §26.2654-1(b)(1)(i). An example of a mandatory direction to divide a trust is a revocable trust that requires the establishment of a marital deduction formula trust and a residuary trust on the death of the first to die of the settlors. See Treas Reg §26.2654-1(b)(4), Example 2.

When a trust established at the death of the decedent would benefit from a division into two or more trusts to allow the transferor's GST exemption to be allocated separately, but a division is not mandated by the trust instrument, the trust may be divided under Treas Reg §26.2654-1(b)(1)(ii), either pursuant to discretionary authority in the governing instrument or under local law. In California, Prob C §15412 permits the discretionary division of a trust on petition by a trustee or beneficiary, for good cause shown, if the court determines that dividing the trust will not defeat or substantially impair the accomplishment of the trust purposes or the interests of the beneficiaries. Examples of discretionary divisions include dividing a marital trust to facilitate ultimate distributions at the surviving spouse's death to children and grandchildren or to facilitate a reverse QTIP election. See Treas Reg §26.2654-1(b)(4), Examples 1, 3.

A discretionary severance under Treas Reg §26.2654-1(b)(1)(ii) will be respected if the following conditions are satisfied:

(A) The terms of the trust provide, in the aggregate, for the same succession of interests of beneficiaries as in the original trust instrument;

(B) The severance occurs (or a reformation proceeding, if required, is commenced) before the due date (including extensions) of the transferor's federal estate tax return; and

(C) Either—

(1) The new trusts are severed on a fractional basis (although they may be funded on a nonprorata basis using date-of-funding fair market values or in a manner that fairly reflects net appreciation and depreciation as measured from the valuation date to the date of funding), or

(2) If the severance is required by the governing instrument to be made on the basis of a pecuniary amount, the funding satisfies the separate share rule for the determination of a pecuniary amount in Treas Reg §26.2654-1(a)(1)(ii). See §11.45.

If a court order severing the trust has not been issued at the time the estate tax return is filed, a copy of the petition must be attached to the return. If the governing instrument or local law authorizes the severance of the trust, the executor must indicate on the estate tax return that separate trusts will be created (or funded) and clearly set forth the manner in which the trusts will be severed and the separate trusts funded, as discussed above.

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§11.48 F. Appropriate Interest

The "appropriate interest" requirement (see §11.45) can be satisfied in a variety of ways, but the simplest is to pay interest on the pecuniary amount in accordance with state law. Treas Reg §26.2642-2(b)(4)(i)(A)(1). California requires payment of interest on distributions of pecuniary amounts made more than 1 year after death for both estates and trusts unless the will or trust provides otherwise. Prob C §§12001, 12003, 16340(b). Thus, the appropriate interest requirement will be met in any case where California law applies to the postdeath administration of a will or trust unless the drafter inserts a provision overriding the applicable statute. See chaps 5-6.

If state law does not provide an interest rate (as might happen if a client moved to another state), the instrument must provide for payment of interest of at least 80 percent but not in excess of 120 percent of the IRC §7520 rate in effect on the date of death. Treas Reg §26.2642-2(b)(4)(i)(A)(2). The risk that a client will die domiciled elsewhere can be addressed either by relying on the provision that permits compliance with the "appropriate interest" rule by making the distribution within 15 months, or by adding a clause that states:

This gift shall bear interest from the date specified under applicable law (and, if none, from the date of the settlor's death) to the date of payment. The interest rate shall be at the statutory rate applicable to pecuniary bequests under the state law governing the administration of this trust or, in the absence of such statutory rate, at 80 percent of the rate applicable under Internal Revenue Code §7520, or successor provision, at the date of the settlor's death.

The appropriate interest requirement can also be satisfied if the pecuniary gift is entitled to receive a prorata share of the income earned between the date of death and the date of payment from the fund from which the pecuniary gift is to be made, either under state law (not in California) or under the terms of the instrument. Treas Reg §26.2642-2(b)(4)(ii)(B).

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§11.49 G. Trust Severance Provisions

Under IRC §2642(a)(3), a trust with a fractional inclusion ratio can be divided pursuant to a "qualified severance" into a trust having an inclusion ratio of one and a trust having an inclusion ratio of zero. The regulations under IRC §2642(a)(3) also recognize a "non-qualified severance" that will result in two (or more) trusts that will have the same fractional inclusion ratio as the original trust, but will allow for subsequent allocations of the GST exemption to one of the trusts instead of to all of the resulting trusts.

If it were not for the application of IRC §2642, most GST trusts with fractional inclusion ratios would be stuck with those ratios. The regulations in Treas Reg §26.2642-6 facilitate planning for a variety of purposes, including the common purpose of segregating a fractional inclusion ratio trust into separate trusts with inclusion ratios of one or zero as well as for purposes of accommodating different investment philosophies or different branches of the family.

Divisions under IRC §2642(c) have many practical applications. See, *e.g.*, IRS Letter Ruling 200651028, which permitted the partition of trusts to accommodate the birth or adoption of children after the creation of the trust. See IRS Letter Ruling 200832020 for a comprehensive discussion of a trust severance to accommodate divergent family interests following the sale of a family-owned business. See IRS Letter Ruling 200820003 for a trust severance coupled with disclaimers to facilitate GST tax planning. See IRS Letter Ruling 200913002, which permitted a trust division to accommodate an interest in an S corporation.

Under IRC §2642(a)(3), a trust may be severed pursuant to the governing instrument or local law if the trust is divided on a fractional share basis and the terms of the new trusts, in the aggregate, provide for the same succession of interests of the beneficiaries as are provided in the original trust and the severance does not shift a beneficial interest in the trust to any beneficiary in a lower generation. If the single trust has an inclusion ratio of more than zero and less than one, it must be divided into two trusts, one having a fractional share of the total value of the trust assets equal to the applicable fraction of the single trust, which will have an inclusion ratio of zero, and one having the remaining trust assets, which will have an inclusion ratio of one—usually the desired outcome of trust severance. The resulting trusts may be funded on a nonprorata basis, but the assets must be valued not taking into account any discount or premium arising from the severance.

A severance that meets the requirements of IRC §2642(a)(3) and the additional requirements of Treas Reg §26.2642-6(d)(4) will be recognized as a "qualified severance," and each of the newly severed trusts will be treated as separate trusts for GST tax purposes, which may have differing inclusion ratios. Any attempt to achieve a qualified severance will require a careful review of the applicable severance regulations, because they contain specific directives that are not included in the statute. For example, the severed trusts must be funded immediately and within 90 days of the valuation date. Treas Reg §26.2642-6(d)(3). The severance regulations also prescribe the method for reporting a qualified severance on Form 706-GS(T) or such other form as the IRS may require. See Treas Reg §26.2642-6(e). The regulations are somewhat liberal in determining whether the terms of the new trusts provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. For example, the regulations permit a division of a trust with discretionary distributees in such a manner that not all of the distributees would have to be beneficiaries of each of the newly-divided trusts. Treas Reg §§26.2642-6(d)(5), 26.2642-6(j), Example 2.

The regulations permit an initial division into more than two trusts if either one trust or multiple trusts in the aggregate receive the fractional share of the original trust that is equal to the value of the applicable fraction used to determine the inclusion ratio. Treas Reg §§26.2642-6(d)(7), 26.2642-6(j), Example 9 (trust with inclusion ratio of 75 percent divided into three trusts, with 25 percent of trust assets passing to a completely exempt trust and 75 percent passing in specified shares to two nonexempt trust).

In view of the qualified severance rules, it is generally desirable for revocable trusts to mandate the division of a trust to facilitate separate trust recognition under IRC §2654 or, at a minimum, to include a general authorization to sever trusts. The same is true for wills that create trusts. For sample forms, see Drafting California Revocable Trusts §17.19 (4th ed Cal CEB 2003); California Will Drafting §15.43 (3d ed Cal CEB 1992).

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V. GST TAX STRATEGIES

§11.50 A. Fundamental Strategies

Just as estate and gift tax planning involves making maximum use of gift tax exclusions and the unified credit (IRC §§2010, 2505), GST tax planning involves making maximum use of the GST tax exclusions and the GST exemption (IRC §2631).

The fundamental strategies for *maximum* use of GST exemptions are the following:

- **Make excluded gifts.** The client should immediately begin giving each of his or her skip person descendants maximum annual exclusion gifts ($13,000 in 2009). These gifts can be made in trust as long as each trust has only one beneficiary, each gift qualifies for the annual gift tax exclusion, and the trust is taxable in the beneficiary's estate if he or she predeceases its final distribution. IRC §2642(c). See §11.29.
- **Pay tuition and medical expenses.** The client should immediately begin paying the gift-tax-excluded tuition and medical expenses of these skip persons. IRC §§2503(e), 2611(b). See §11.30.
- **Transfer of GST exemption amount.** The client should consider the immediate creation of a GST-exempt trust in the amount of the client's remaining GST exemption, even if this will require immediate payment of gift tax to the extent of the difference between the client's unused IRC §2505 gift tax applicable exclusion amount and the remaining GST exemption. In this respect it is important to remember that, under time value of money principles, apart from the hazards of investment choices, a gift today is always more valuable than a gift in the future. Of course, the advisability of making maximum use of GST exemption must be assessed in the context of the possibility of repeal of estate and GST taxes and the continuing applicability of gift taxes.
- **Do not give exempt property to nonskip persons.** To the greatest extent possible, GST tax-exempt funds should be used exclusively for the benefit of skip persons, transfers to whom would otherwise be subject to GST tax.
- **Skip more than one generation.** The GST-exempt trust should be designed in a manner that permits avoidance of transfer tax at more than one generation—not just the children's generation. This can be accomplished with flexible distribution provisions and limited powers of appointment. For example, each child or grandchild can be given a limited testamentary power of appointment that has the effect of giving the holder the choice of making outright distributions to the next generation or continuing the trust. This makes it possible to preserve the trust for the perpetuities period without forcing that result. IRC §2653(a). See §11.34.
- **Delay the interest of higher generation beneficiaries.** Because the GST tax sometimes ignores the interests of persons not having current distribution rights, it can sometimes be advantageous to create a trust that does not allow distributions to older beneficiaries during the first few years of operation. IRC §2652(c). See §11.42.

For clients who do not use all of their GST exemption before death, a reverse QTIP election often may be a useful strategy. See §11.51. Additional GST tax strategies and precautions commonly used and observed by estate planners are discussed in §§11.59-11.62.

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§11.51 B. Reverse QTIP Election Strategy

Few clients will follow all, if any, of the recommendations in §11.50. The immediate gift of the client's remaining IRC §2631 GST exemption is particularly unlikely, despite the fact that a substantial tax burden results if the client waits until death to make this transfer. Further, it is possible with married couples that the first spouse to die will not fund a GST tax-exempt trust to the maximum extent possible. Rather, the deceased spouse usually will establish a trust having a value equal to the decedent's remaining IRC §2010 applicable exclusion amount. Such a trust may be too small to utilize the entire GST exemption if significant non-generation skipping inter vivos gifts or gifts at death are made (see §11.13), but also wastes potentially valuable GST tax-exempt funds if it provides for distributions to nonskip persons, such as the spouse and children.

It is in the context of the disparity between the available GST exemption and the unused estate tax applicable exclusion amount that relief is provided by the strategy of creating a reverse QTIP election trust to accommodate the otherwise conflicting client objectives of both (1) paying no tax on the first spouse's death and (2) making "full" use of the remaining GST exemption. See §11.52.

The QTIP election is made by listing the property subject to the election on Schedule M of IRS Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return). The reverse QTIP election permitted by IRC §2652(a)(3) is made by listing the property subject to the election on Schedule R (line 9 of Part 1) of Form 706. The procedures under Treas Reg §§301.9100-1—301.9100-3, which generally require a letter ruling request, are available to remedy a defective election. The IRS has been liberal in granting authority to make late severances under IRC §2642 and Treas Reg §301.9100-3, particularly in the case of reverse QTIP elections. Fortunately, these late severances generally result in the proper allocation of GST exemption to the reverse QTIP trust and the exemption trust, often as a result of the automatic allocation rules, leaving both trusts with zero inclusion ratios. See, *e.g.*, IRS Letter Rulings 200908002, 200916002. Revenue Procedure 2004-47, 2004-2 Cum Bull 169, provides a simplified alternative method for certain executors and trustees to request relief to make a late reverse QTIP election, in lieu of the letter ruling process and without a user fee, under certain limited circumstances in which the estate is not eligible for an automatic 6-month extension to file the return.

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§11.52 C. Effect of Reverse QTIP Election

The reverse QTIP election strategy discussed in §11.51 makes use of IRC §2652(a)(3), which provides that if a QTIP election is made for an eligible trust under IRC §2056(b)(7) (or the gift tax equivalent in IRC §2523), the executor or donee-spouse can make a separate election to treat the QTIP property for purposes of the GST tax as if the QTIP election had not been made.

The result of such an election is that the surviving spouse does not later become the GST tax transferor of the trust before any generation-skipping transfers are possible (as is otherwise the case when a QTIP trust is included in the surviving spouse's estate under IRC §2044). Thus, it may become useful to apply the deceased spouse's GST exemption to the reverse QTIP trust, even though the reverse QTIP trust wastes valuable GST tax-exempt property because of the QTIP requirement that the trust pay all income to the surviving spouse. In the relatively common situation in which few if any taxable gifts have been made, however, estate planners will need to weigh the costs of establishing a separate exempt QTIP to protect this amount from the GST tax, particularly if that amount is intended primarily to pass to children rather than grandchildren at the death of the surviving spouse. See §11.53.

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§11.53 D. Separating Reverse QTIP Trust

Two significant problems arise in designing reverse QTIP trusts. The first is that the reverse QTIP election must be made on an "all or nothing" basis for any particular trust. This will produce results inconsistent with the strategy rule of making sure that all trusts have inclusion ratios of zero or one, whenever the election is made for a trust having a value greater than the transferor's remaining GST exemption. It is generally undesirable to apply the remaining GST exemption (the amount available after allocating GST exemption to a bypass trust funded with the IRC §2010 applicable exclusion amount) to a much larger QTIP trust, resulting in an inclusion ratio of more than zero. To avoid this result, it is necessary to create a separate reverse QTIP trust that will have a value equal to the amount of GST exemption allocated to it. See §11.54. The second problem in designing reverse QTIP trusts is the need to avoid having that trust burdened with the estate tax that will be imposed when the trust is included in the estate of the surviving spouse under IRC §2044. See §11.57.

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§11.54 E. Discretionary Reverse QTIP Trust

Creating a separate reverse QTIP trust as discussed in §11.53 is particularly difficult because it is frequently impossible to know in advance how much of the GST exemption will be available. The amount of available exemption will be unknown whenever there is uncertainty regarding the actual value of inter vivos gifts that received automatic allocations of the GST exemption or intentional formula allocations of "whatever it takes to produce an inclusion ratio of zero." The amount also may depend on whether (and to what extent) administration expenses are deducted on the income tax return or the estate tax return. If they are deducted on the income tax return, the value of the bypass trust may be reduced. If so, this lowers the amount of the GST exemption needed to produce a zero inclusion ratio for the bypass trust and increases the amount available for the reverse QTIP trust. One common approach to carving out the reverse QTIP trust is simply to authorize, but not compel, an actual severance of a larger QTIP trust as allowed by IRC §2642(a)(3). See §11.49. This severance strategy can be used even when the original drafter of the estate plan failed to make any provision for a reverse QTIP trust. If a reverse QTIP trust may be useful, the dispositive instrument should expressly authorize the severance. For a form of authorization, see §11.55. In some cases, however, a mandatory reverse QTIP trust should be considered. See §11.56. Some practitioners, depending on the circumstances, also use the approach of either compelling or authorizing the division of any trust with an inclusion ratio greater than zero into two trusts, with one trust having an inclusion ratio of zero and the other trust having an inclusion ratio of one.

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Source: Estate Planning/California Estate Planning/11 Generation-Skipping Transfer Tax/§11.55 F. Form: Establishment of Separate Trusts

§11.55 F. Form: Establishment of Separate Trusts

11.55-1 Establishment of separate trusts

If an election is to be made to qualify all or part of the Marital Trust for the federal estate tax marital deduction, and if a reverse QTIP election is to be made, the Marital Trust so qualified shall, if and as necessary, be divided and established as two separate trusts rather than one to permit the reverse QTIP election to be made with respect to one trust (the Reverse QTIP Trust), but not the other (the Nonexempt QTIP Trust). The division shall be accomplished in a manner satisfying the requirements of Internal Revenue Code §2654 and the regulations thereunder.

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§11.56 G. Mandatory Reverse QTIP Trust

The advantage of the severance strategy in §11.54 is its simplicity. It also provides considerable flexibility, giving great discretion to the trustee or personal representative in terms of choosing which transfers will receive the GST exemption.

Such broad discretion may be undesirable, or at least worrisome, if the planner determines that the reverse QTIP trust should have different remainder provisions than the regular QTIP. For example, the planner may want to distribute the reverse QTIP trust remainder to a multigenerational trust, with the nonexempt QTIP trust remainder passing to the children. In such cases, giving the personal representative or trustee great discretion with respect to the relative sizes of the two QTIPs may raise unwanted questions about fiduciary duties, conflicts of interest, and powers of appointment. This is particularly problematic if the optimum tax decision will result in the creation of a nonexempt QTIP trust that will be completely exhausted by the obligation to pay the estate taxes attributable to the reverse QTIP trust. If these issues are judged significant in a particular case, the drafter may wish to mandate the creation of the reverse QTIP trust in the amount of the GST exemption that would otherwise be wasted. Unfortunately, this requires trying to devise a formula in order to specify the value of the trust. This also requires custom drafting that usually provides, among other things, that the GST exemption is to be allocated first to the bypass trust.

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§11.57 H. Shifting Estate Tax Burden

Failure to avoid the estate tax burden on the reverse QTIP trust resulting from inclusion in the surviving spouse's estate as discussed in §11.53 will result in substantial loss of valuable GST tax-exempt funds. This problem is commonly dealt with by establishing a second QTIP trust that is not GST tax exempt and directing that this "nonexempt QTIP trust" pay the estate taxes imposed on the reverse QTIP trust. This tax directive must be included in the trust instrument. See IRS Letter Ruling 199927007, in which the IRS took the position that each QTIP must pay its own share of estate tax in the absence of such a provision.

The nonexempt QTIP trust must have sufficient assets at the survivor's death to pay the estate tax on both QTIP trusts. If this is unlikely because the deceased spouse's estate is too small, avoidance of an estate tax burden on the reverse QTIP trust requires that the surviving spouse be willing to pay the tax from other assets in the survivor's estate. To avoid diminution of the reverse QTIP trust, the nonexempt QTIP trust should contain a provision similar to the one in §11.58.

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§11.58 I. Form: Estate Tax Apportionment

11.58-1 Estate tax apportionment

The amount of estate taxes subject to a right of recovery under Internal Revenue Code §2207A as a result of inclusion of the Reverse QTIP Trust and the Nonexempt QTIP Trust in the estate of the surviving spouse under Internal Revenue Code §2044 shall be paid from the Nonexempt QTIP Trust to the extent possible. Likewise any state death taxes resulting from inclusion of the two trusts in the surviving spouse's estate shall be paid from the Nonexempt QTIP Trust.

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VI. ADDITIONAL STRATEGIES

§11.59 A. Cutting Off Nonexempt Transfers

As a result of the GST tax, it is frequently, but certainly not always, important to draft transfers in a manner that assures that no generation-skipping transfer is possible. This can be done only by assuring that property is not transferred below the next generation, a counterintuitive strategy for many planners. See §11.2.

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§11.60 B. Tax Apportionment

If none of the IRC §2631 GST exemption is used during life, the taxpayer can use the entire exemption at death. The amount that may be exempted is a net amount after the payment of all estate taxes. If the will or trust fails to clarify that a generation-skipping transfer is a transfer of a net amount after payment of estate tax, the result can be a generation-skipping transfer that is much smaller than the remaining GST exemption under IRC §2632. See §11.14.

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§11.61 C. Completing Schedule R

Many GST tax mistakes are a direct result of failing to complete Schedule R, the GST tax portion of Form 706. This schedule must be completed to avoid application of the default rules for allocating any of the decedent's remaining GST exemption. See §11.26. It also is completed to make a reverse QTIP election. See §11.51.

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§11.62 D. Sensitive Beneficiary Checklists

As a result of the GST tax, it is important for the planner to double-check generation assignments of a client's transferees. A client's "nephews" are not always really nephews and a client's "loyal friend" or "neighbor" is not necessarily a nonskip person. Checklists should raise those questions necessary to determine generation assignments. See §11.33. In this context, give equal attention to contingent dispositions. A gift to a nephew if he is living and to the nephew's children will otherwise produce a GST tax or raise questions about GST tax allocation if the nephew fails to survive. The dispositive instrument should at least reflect knowledge of these potential consequences and indicate the client's wishes with respect to the tax apportionment and any GST tax allocation issues that may result.

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12

Income Tax Basis

Monica Dell'Osso

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§12.1 I. RELEVANCE OF INCOME TAX BASIS

An important factor in planning for transfers of property, whether at death or during lifetime, is the income tax basis that the property will have in the hands of the transferee. Basis will determine the gain or loss that the transferee will realize on a subsequent sale or other disposition of the property. In some circumstances, basis considerations will be critical to the discussion of whether to transfer an asset during lifetime (see §§12.13-12.17) or at death (see §§12.2-12.12, §§12.18-12.29).

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II. BASIS RULES FOR TRANSFERS AT DEATH

§12.2 A. Federal Basis Provisions

The basis of property acquired from a decedent is generally the fair market value of that property on the date of the decedent's death. IRC §1014(a)(1). If the alternate valuation date is selected on the federal estate tax return for the decedent's estate, the basis will be the fair market value on that date. IRC §1014(a)(2). If an election is made to apply special use valuation under IRC §2032A, the basis of the property will be its value as determined under the provisions of that section. IRC §1014(a)(3).

When the fair market value of the property at the date of death is greater than its basis in the hands of the decedent, the result will be a "stepped up" basis. However, a fair market value less than the decedent's basis at the date of death causes a "step down" in basis. Special basis rules apply in 2010. See §12.18.

The categories of property that are treated as acquired or passing from a decedent are enumerated in IRC §1014(b). Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, qualifies as passing from the decedent. IRC §1014(b)(1). Also listed among the categories are community property and property includible in the surviving spouse's gross estate under IRC §2044, *i.e.,* property for which a marital deduction was previously allowed. IRC §1014(b)(6), (10). Property is deemed to pass from a decedent if it is acquired by reason of death, form of ownership, or other condition and is required for that reason to be included in the decedent's gross estate. IRC §1014(b)(9). Property can be transferred either by will or intestate succession. Treas Reg §1.1014-2(a)(1). Under Treas Reg §1.1014-3(a), the estate tax value of the property is prima facie evidence of the fair market value of the property. Although the regulation does not preclude rebutting the presumption that results from the prima facie evidence, the duty of consistency can have the effect of making the presumption conclusive. In *Janis v Commissioner* (9th Cir 2006) 461 F3d 1080, the court held that estate executors who inherited an art gallery must use the "blockage" discounted estate tax value of the individual artworks as the "costs of goods sold" in determining profit and loss on later sales of the works. Under the duty of consistency, the beneficiaries were estopped from claiming that the fair market value of the artworks at death was different from the estate tax value. In *Janis v Commissioner* (2d Cir 2006) 469 F3d 256, the Second Circuit reached the same conclusion on appeal by the other executor in the same case but did not rely on the duty of consistency.

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§12.3 B. Exceptions to Basis Adjustment Rule

Several types of property are not subject to the basis adjustment rule of IRC §1014. Transferees of this property inherit the same basis that the property had in the hands of the decedent. See §§12.4-12.5.

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§12.4 1. Income in Respect of Decedent

Income in respect of a decedent (IRD) is income that a decedent was entitled to receive that was not properly includable in his or her taxable income before death. IRC §691; Treas Reg §1.691(a)-1. Income on installment obligations, deferred or unpaid compensation, and distributions from IRAs and qualified retirement plans are examples of IRD. The basis of IRD property in the hands of its eventual recipient is the same as the decedent's basis. IRC §1014(c).

For property on which no income tax has been previously paid, such as distributions from IRAs or qualified retirement plans, this rule will ordinarily result in a zero basis for income tax purposes. For installment obligations, it will mean that, for purposes of calculating gain or loss on the payments, the transferees will use the same inclusion ratio as the one used by the decedent. Treas Reg §1.691(a)-5(a).

Property subject to a binding sale contract on the date of death may not receive a basis adjustment, but rather the gain realized on the sale relative to the decedent's basis also may be treated as IRD. In Rev Rul 78-32, 1978-1 Cum Bull 198, the IRS ruled that the decedent had substantially completed all of the substantive prerequisites for consummating the sale, and therefore was unconditionally entitled to the proceeds of sale at the time of death. Accordingly, the gain realized from the sale that was completed by the decedent's executor was IRD and the decedent's estate was not entitled to a new estate tax valuation basis under IRC §1014. In IRS Letter Ruling 200744001, however, the IRS ruled that real property subject to a sale contract on the date of death would receive a new basis and the proceeds of sale would not be IRD because the discovery of an underground gas pipeline on the property had created "economically material contingencies that might have disrupted the sale."

Interest on Series E (and Series EE) savings bonds is another example of IRD. The accrued interest is not required to be reported until redemption of the bonds under IRC §454(a). If the interest is not reported on redemption, the taxpayer has the burden of proving that the interest was taxed in earlier years. *Janet E. Landers,* TC Memo 2003-300. However, the personal representative of an estate may report all accrued interest on the decedent's final income tax return. Rev Rul 68-145, 1968-1 Cum Bull 203. If this is done, the decedent's increased income tax is treated as a liability of the decedent that can be deducted on the federal estate tax return. See §10.51.

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§12.5 2. Appreciated Property Acquired From Decedent

If appreciated property is acquired by a decedent by gift within 1 year before death and that property passes on the decedent's death, directly or indirectly, to the donor or the donor's spouse, no basis adjustment is permitted. The basis of the property is its basis in the hands of the decedent immediately before death. IRC §1014(e).

"Appreciated property" is defined as property with a fair market value greater than its basis on the date it was transferred to the decedent. IRC §1014(e)(2)(A). This rule prevents a donor from obtaining a stepped-up basis by transferring property that has appreciated in value to a terminally ill donee and then inheriting the property from the donee at his or her death.

It is uncertain whether IRC §1014(e) would preclude a basis adjustment for assets that a surviving spouse had transmuted from separate to community property within a year before the donee spouse's death. Equally unclear is the question of whether the problem would be resolved by transfer of the property on the death of the donee spouse to a QTIP or other trust for the benefit of the surviving spouse. See Price on Contemporary Estate Planning §3.35.5 (2000).

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§12.6 C. California Basis Provisions

In general, the California rules regarding adjustment to the tax basis of property acquired from a decedent parallel the federal provisions. With only minor exceptions, IRC §1014 has been incorporated by reference in California. Rev & T C §18031. The exceptions pertain to basis in certain foreign personal holding company stock and stock in a domestic international sales corporation (DISC) acquired from a decedent. Rev & T C §17024.5(b). There is also an implied exception for community property of registered domestic partners treated as spouses under California law. See Fam C §297.5. Same-sex domestic partners are not treated as spouses for federal income tax purposes, because the federal Defense of Marriage Act provides that the term "spouse" only refers to "a person of the opposite sex who is a husband or wife." See 1 USC §7. However, registered domestic partners are generally treated as if federal law recognized domestic partnerships in the same manner as California law when federal provisions are referred to or relied on by provisions of California law. Fam C §297.5(e). As a result, the community property of a surviving domestic partner should be entitled to a step-up in basis for California income tax purposes under IRC §1014(b)(6). See §12.8.

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D. Application of Basis Rule to Particular Forms of Ownership

§12.7 1. Joint Tenancy

Joint tenancy property included in the decedent's estate receives a new basis at the time of the decedent's death. IRC §1014(b)(9). The basis adjustment applies to that portion of the property which is included in the gross estate for tax purposes. Therefore, if the surviving joint tenant has made a contribution to acquisition of the joint tenancy with the result that only a portion of the property is includable in the decedent's gross estate, only that portion is deemed to be acquired from the decedent and eligible for the basis adjustment.

If the joint tenancy is a qualified joint interest between spouses, only one-half the interest is included in the decedent's estate. IRC §2040(b). The basis adjustment is then limited to the decedent's one-half interest. This rule does not apply if one of the spouses is a noncitizen (IRC §2056(d)(1)(B)) or if the joint tenancy was created before 1977. *Therese Hahn* (1998) 110 TC 140. If joint tenancy property of registered domestic partners is transmuted into community property, it would appear that the property would then be treated as owned equally for federal income tax purposes, with the result that one-half of the property would be treated as eligible for the basis adjustment, although the property would be treated as community property for California income tax purposes. See §12.8.

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§12.8 2. Community Property

Both halves of property held by spouses as community property receive a step-up in basis at the death of the first spouse. The surviving spouse's one-half interest in the community property is regarded as property acquired from the decedent and is therefore eligible for the adjustment. IRC §1014(b)(6). For California income tax purposes, this rule also applies to community property of same-sex registered domestic partners. See §12.6.

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§12.9 3. Community Property With Right of Survivorship

Civil Code §682.1 authorizes creation of community property with right of survivorship. See §7.30. The intent of this statute is to provide a form of title for real property that combines the benefits of both joint tenancy and community property. The interest of the deceased spouse can be terminated by affidavit after the death of the first spouse, and the basis step-up available for community property under IRC §1014(b)(6) is preserved.

Although CC §682.1 does not apply to accounts in banks or other financial institutions, functionally the same form of title is created under the Uniform TOD Security Registration Act (Prob C §§5500-5512). The Act allows securities and securities accounts to be registered as community property with ownership to pass on death to designated beneficiaries. Prob C §5502.

There has been no definitive statement by the IRS that community property with right of survivorship will qualify for the basis adjustment under IRC §1014(b)(6). Other community property states (Nevada, Alaska, and Arizona) have had similar statutes for several years, and the IRS appears not to have raised any challenges to the basis issue in those jurisdictions.

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§12.10 4. Tenancy in Common

A tenancy in common is a co-ownership interest in which there is no right of survivorship. CC §685. The cotenancy interests may be unequal and each cotenant may devise his or her interest in the property by will or otherwise. To the extent that the cotenant's interest is includable in his or her gross estate at death, that interest is eligible for a basis adjustment under IRC §1014.

For the purpose of dividing property on dissolution, property acquired by spouses during marriage as tenants in common is presumed to be community property. Fam C §2581. This presumption, which is rebuttable, does not apply at death. However, to the extent that the surviving spouse can prove a transmutation of the property to community property, IRC §1014(b)(6) would allow an adjustment in the basis of the entire property on the death of the first spouse.

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§12.11 5. Separate Property

Any property that an individual owns before marriage or acquires subsequent to marriage by gift, devise, or bequest is separate property. Fam C §770. Separate property that passes to a beneficiary or heir on the owner's death, and that is includable in the owner's gross estate for estate tax purposes, is eligible for a basis adjustment under IRC §1014. No basis adjustment is allowed on the death of the first spouse for separate property owned by the surviving spouse.

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§12.12 6. Planning Considerations

The fact that property receives a stepped-up basis at death is ordinarily a reason to consider reserving appreciated property for transfer at death rather than by inter vivos gift. This strategy will permit the transferee of the property to avoid income tax on the appreciation at the time of a subsequent sale. However, as discussed below, there are circumstances when a lifetime transfer of appreciated property to a donee in a lower income tax bracket may be appropriate.

If the property has depreciated so significantly in value that the owner's basis is greater than the fair market value, it may be sensible for the property to be sold before death so that the loss can be realized. If the property is transferred at death, the basis will be stepped down to the fair market value with the result that any opportunity for recognition of the loss will be eliminated.

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III. BASIS RULES FOR TRANSFERS DURING LIFETIME

A. Federal Provisions

§12.13 1. General Rule

When property is transferred by inter vivos gift, either outright or in trust, the donee's basis is the same as the donor's adjusted basis at the time of the gift. However, if the basis is greater than the fair market value of the property at the time of the gift, the basis for purposes of determining loss on a subsequent disposition of the property is limited to fair market value. IRC §1015(a). Therefore, separate rules apply for computing gain and loss.

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§12.14 2. Increase in Basis for Gift Tax Paid

The donee's basis is increased, but not above fair market value, by the amount of the gift tax paid. For gifts made before 1976, the increase in basis is equal to the total amount of the gift tax paid. IRC §1015(d)(1). For gifts made after 1976, the increase in basis is limited to the amount of the gift tax attributable to the net appreciation in the value of the gift. IRC §1015(d)(6)(A). Net appreciation is the amount by which the fair market value of the gift exceeds the donor's adjusted basis. IRC §1015(d)(6)(B). The tax attributable to the net appreciation is computed by multiplying the gift tax paid on the transfer by a fraction, the numerator of which is the net appreciation in the value of the gift and the denominator of which is the amount of the gift. IRC §1015(d)(6)(A). The amount of the gift is determined after deduction of the gift tax exclusion under IRC §2503(b).

The computation of the basis increase can be illustrated by the following example. A parent (donor) gave his or her son (donee) real property with a fair market value of $112,000 in 2006. The donor's adjusted basis in the property was $50,000. The donor, whose unified credit was used up by prior gifts, paid a gift tax of $41,000 on a taxable gift of $100,000. The basis of the property in the hands of the donee is $75,420, computed as follows:

Fair market value	$112,000
Adjusted basis	$50,000
Net appreciation	$62,000
Gift tax paid	$41,000
Portion of gift tax attributable to net appreciation*	$25,420
Donee's basis ($50,000 + $25,420)	$75,420

*Calculation:

Value of gift less $12,000 exclusion amount for 2006	$100,000
$41,000 × $\frac{\$62,000}{\$100,000}$ =	
$41,000 × 0.62 =	$25,420

If the donor makes more than one gift during the calendar year (or preceding calendar period), or the gift to which the basis increase applies consists of more than one item of property, the gift tax must be apportioned. In the case of multiple gifts, the total tax paid must be allocated to each gift based on the ratio of the value of that gift to the total gifts made during the year or calendar period. With respect to multiple items comprising a single gift, a similar apportionment is made based on the relative value of the item to the total value of the gift. IRC §1015(d)(2); Treas Reg §1.1015-5(b)(1). If the donor and his or her spouse elect gift-splitting, the gift tax paid is the sum of the amounts of tax paid with respect to each half. IRC §1015(d)(3); Treas Reg §1.1015-5(b)(3).

Under the rules discussed above, the increase in basis is limited to the portion of the gift tax attributable to the net appreciation in the value of the gift. The Internal Revenue Service has taken the position that there is no increase for gift tax purposes if the donor's basis is equal to or more than the fair market value of the property at the time of the gift. Rev Rul 79-371, 1979-2 Cum Bull 294. Under those circumstances, there would be no net appreciation subject to gift tax. For example, if the donor above had an adjusted basis in the property of $112,000, there would be no basis increase because no part of the gift tax is attributable to the net appreciation in the value of the property.

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§12.15 3. Part Gift/Part Sale

If a transfer of property is part gift and part sale, the transferee's basis is the greater of (1) the amount paid by the transferee for the property or (2) the transferor's adjusted basis at the time of transfer. Under either alternative, the basis may be increased for gift tax paid. Treas Reg §1.1015-4(a). This means that the transferee may have a basis in excess of cost if he or she can demonstrate that a portion of the transfer was a gift. *Kaufman's Inc.* (1957) 28 TC 1179. However, for purposes of determining loss, the basis cannot be greater than the fair market value of the property. Treas Reg §1.1015-4(a).

The regulations set forth several examples of this rule. A parent has property with an adjusted basis of $30,000 and a fair market value of $60,000. The parent transfers the property to a child for consideration of $30,000. The basis of the property in the hands of the child, before adjustment for gift tax paid, is $30,000. Treas Reg §1.1015-4(b), Example 1. Assume that the same parent has property with an adjusted basis of $30,000 and a fair market value of $90,000. The parent transfers that property to a child for consideration of $60,000. The unadjusted basis of the property in the hands of the child is $60,000. Treas Reg §1.1015-4(b), Example 2.

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§12.16 B. California Provisions

The California rules for the basis of property transferred during lifetime are the same as the federal provisions. California has incorporated by reference IRC §1015. Rev & T C §18031.

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§12.17 C. Planning Considerations

In general, the basis rules support lifetime gifts of appreciated rather than depreciated property. Particularly if the donee is in a lower income tax bracket than the donor, it may be advantageous to transfer to him or her property that has a significant amount of built-in gain. In addition to the benefit of the lower brackets, the donee will receive an increase in basis for the gift tax paid on the transfer. That increase will further lessen the gain recognized on a sale of the property.

If the donor is elderly or in poor health, a gift of appreciated property may not be an appropriate plan. It may be more sensible for the donor to retain the property so that it is transferred at death with a stepped-up basis.

It is ordinarily not good strategy to transfer property that has depreciated significantly in value so that the donor's basis exceeds the fair market value. If such property is transferred, the donee's basis for determination of loss on sale will be limited to fair market value. Because there is no net appreciation, no adjustment can be made for gift tax paid. IRC §1015(d)(6). Therefore, the full benefit of the depreciation is lost. The better plan is for the donor to sell the property, realize the loss, and gift the proceeds or some other property.

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IV. BASIS RULES AFTER REPEAL OF ESTATE TAX

§12.18 A. General Rule

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), the step-up in basis is eliminated for decedents dying after December 31, 2009. IRC §1022(a). This change coincides with repeal of the estate tax, which is effective for decedents dying in 2010. Because the gift tax remains in effect, EGTRRA-2001 makes no modifications to the basis rules of IRC §1015 for lifetime transfers.

EGTRRA-2001 provides that, absent certain allowable adjustments, property transferred at death will have a carryover basis determined in the same manner as the basis for property transferred during lifetime under IRC §1015. Therefore, in most instances, property acquired from a decedent will have a basis equal to the lesser of the decedent's adjusted basis or the fair market value of the property at date of death.

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§12.19 B. Increases to Basis

Internal Revenue Code §1022 provides for certain increases to the basis of assets acquired from a decedent. These increases cannot cause the basis of an asset to exceed its fair market value at the time of the decedent's death. IRC §1022(d)(2).

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§12.20 1. Basis Increase of $1.3 Million

The basis of property in a decedent's estate is entitled to an aggregate increase of $1.3 million, adjustable for inflation. IRC §1022(b)(2), (d)(4). This amount is increased by any capital loss carryover under IRC §1212(b), any net loss carryover under IRC §172 that would, but for the death of the decedent, be carried from the decedent's last tax year to a later tax year, and any losses that would have been allowable under IRC §165 if the property acquired from the decedent had been sold at fair market value immediately before the decedent's death. IRC §1022(b)(2)(C). This latter adjustment is referred to as a "built-in" loss.

In the case of a nonresident alien, the basis increase is limited to $60,000. IRC §1022(b)(3) This amount is adjusted for inflation, but is not increased by loss carryovers or built-in losses. IRC §1022(b)(3), (d)(4).

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§12.21 2. Spousal Basis Increase of $3 Million

An additional basis increase of $3 million, adjustable for inflation, is available for "qualified spousal property." IRC §1022(c), (d)(4). "Qualified spousal property" is property that passes outright to the surviving spouse from the decedent or is qualified terminable interest property. IRC §1022(c)(3). Qualified terminable interest property means property that passes from the decedent and in which the surviving spouse has a qualifying interest for life. IRC §1022(c)(5). The surviving spouse has a qualifying income interest if the surviving spouse is entitled to all income for life payable annually or at more frequent intervals and no person other than the surviving spouse has a power to appoint any part of the property to any person other than the surviving spouse. IRC §1022(c)(5). Under these rules, a QTIP trust would be eligible for the basis increase, but a marital deduction estate trust would not.

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§12.22 3. Executor Discretion

The executor has the authority to allocate the basis increases among the assets of the decedent's estate. IRC §1022(d)(3)(A). The executor determines whether or not a basis adjustment will be made and the amount of the adjustment. In estates that do not involve a formal probate, this authority would presumably devolve on the trustee or other person responsible for administration of the decedent's estate.

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Source: Estate Planning/California Estate Planning/12 Income Tax Basis/§12.23 4. Property Eligible for Increases to Basis

§12.23 4. Property Eligible for Increases to Basis

Property acquired from a decedent is eligible for an increase in basis, provided that the property was owned by the decedent at the time of death. IRC §1022(d)(1)(A).

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Source: Estate Planning/California Estate Planning/12 Income Tax Basis/§12.24 a. Property Acquired From Decedent

§12.24 a. Property Acquired From Decedent

Property acquired from a decedent is specifically defined and includes the following (IRC §1022(e)):

- Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent.
- Property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC §645(b)(1), *i.e.* any trust treated under IRC §676 as owned by the decedent.
- Property transferred by the decedent during his or her lifetime to a trust in which the decedent reserved the right to make any change in the enjoyment of the trust through exercise of a power to alter, amend, or terminate the trust.
- Any other property passing from the decedent by reason of death to the extent that the property passed without consideration, *e.g.,* property held as joint tenants with right of survivorship.

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§12.25 b. Property Owned by Decedent

To qualify for the basis increase, property must be owned or treated as owned by the decedent at the time of death. IRC §1022(d). Ownership is specifically defined. Not all property acquired from a decedent as identified in §12.23 satisfies the ownership requirements. For example, it appears that assets in a QTIP trust would not be considered as owned by the surviving spouse for purposes of the $1.3 million basis increase in the surviving spouse's estate.

The following rules determine ownership (IRC §1022(d)(1)(B)):

- For property held as joint tenants or tenants by the entirety with the surviving spouse, the decedent is treated as owner of a 50-percent interest.
- For property held in a nonspousal joint tenancy or tenancy by the entirety for which the decedent furnished consideration, he or she is treated as owner of a share of the property proportional to the consideration provided.
- For property held in a nonspousal joint tenancy acquired by the parties by gift, bequest, or inheritance (and the interests in which are not otherwise specified or fixed by law), the decedent is treated as owner to the extent of a fractional part determined by dividing the value of the property by the number of joint tenants.
- The decedent is treated as owner of property transferred by the decedent to a qualified revocable trust as defined in IRC §645(b)(1), *i.e.,* any trust that is treated as owned by the decedent under IRC §676.
- The surviving spouse's one-half share of any community property held by the decedent and the surviving spouse is treated as owned by and acquired from the decedent, provided that at least one-half of the community interest in the property is treated as owned by and acquired from the decedent. Therefore, similar to the rule under existing IRC §1014(b)(6), both the decedent's and the surviving spouse's one-half interests would be eligible for a basis increase.

The decedent will not be treated as the owner of property over which he or she holds a power of appointment. IRC §1022(d)(1)(B)(iii). Because the statute makes no distinction between them, this rule apparently applies to both general and special powers of appointment.

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§12.26 5. Property Ineligible for Increases to Basis

An increase to basis is available only for property that was acquired from and owned by the decedent. The following categories of property are not considered owned by the decedent and are therefore not eligible for a basis increase:

- Property acquired by the decedent within 3 years of death by gift or inter vivos transfer for less than adequate and full consideration. IRC §1022(d)(1)(C). This rule does not apply to property the decedent received from his or her spouse unless, during the 3-year period, the spouse acquired the property in whole or in part by gift or inter vivos transfer for less than adequate and full consideration. IRC §1022(d)(1)(C). This exception clearly permits deathbed transfers between spouses and the resulting opportunity to maximize the available basis increases in the decedent's estate.
- Stock or securities of a foreign personal holding company; stock of a domestic international sales corporation (DISC) or former DISC; stock of a foreign investment company; and stock of a passive foreign investment company, unless the company is a qualified electing fund with respect to the decedent. IRC §1022(d)(1)(D).
- Income in respect of a decedent under IRC §691. IRC §1022(f). This rule parallels IRC §1014(c), which disallows any basis increase for IRD items.

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§12.27 6. Treatment of Liabilities in Computing Gain and Basis

Under current law, when property subject to liabilities is sold or otherwise disposed of, the transferor realizes gain on the amount of the liabilities. Therefore, when property with liabilities in excess of basis is transferred by gift, the donor recognizes gain equal to the amount of the excess. *Malone v U.S.* (ND Miss 1971) 326 F Supp 106. The rationale is that assumption of the indebtedness constitutes an economic benefit to the donor.

The step-up basis rule of IRC §1014 generally provides that the basis of encumbered property that is acquired from a decedent is the fair market value of the property. Any liability is disregarded in computing the basis.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) modifies these provisions for decedents dying after December 31, 2009. Under IRC §1022(g)(1), liabilities in excess of basis are disregarded in determining whether gain is recognized on acquisition of property from a decedent. Therefore, gain is not recognized at the time of death when the estate or heir acquires property that is subject to a liability greater than the decedent's basis in that property. Similarly, no gain is recognized on the distribution of that property to a beneficiary of the estate (other than a tax-exempt beneficiary). IRC §1022(g)(1). With the exception of a tax-exempt beneficiary, liabilities in excess of basis are disregarded in determining the adjusted basis of property acquired from a decedent.

For purposes of this section, a tax-exempt beneficiary is defined to include:

- The U.S., any state or possession of the U.S., and any organization that is exempt from income tax (IRC §1022(g)(2)(A));
- Any foreign person or entity within the meaning of IRC §168(h)(2), *i.e.*, a foreign government or organization and any person who is not a U.S. citizen (IRC §1022(g)(2)(C)); and
- To the extent provided in regulations, any person to whom property is transferred for the principal purpose of tax avoidance (IRC §1022(g)(2)(D)).

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§12.28 7. Reporting Requirements

The carry-over basis system will include new reporting requirements for transfers at death. For estates of decedents dying after December 31, 2009, a return must be filed if the fair market value of noncash assets acquired from the decedent exceeds $1.3 million, as adjusted for inflation but not as increased by loss carryovers or unused built-in losses under IRC §1022(b)(2)(C). IRC §6018(b). The reporting requirement also applies to appreciated property that was received by a decedent within 3 years of death if this property was ineligible for a basis adjustment due to the 3-year rule under IRC §1022(d)(1)(C) and the property was required to be included on a gift tax return. IRC §6018(b).

The return must be filed with the decedent's final income tax return or at a later date to be specified in the regulations. IRC §6075(a). The return must include the following information (IRC §6018(c)):

- The name and taxpayer identification number of the recipient of the property;
- An accurate description of the property;
- The adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;
- The decedent's holding period for the property;
- Sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- The amount of basis increase allocated to the property under IRC §1022(b) or (c); and
- Any other information that the IRS may require by regulation.

Significant monetary penalties are imposed for failure to comply with the reporting requirements. IRC §6716. The penalties do not apply to any reporting failure due to reasonable cause. IRC §6716(c).

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§12.29 8. Planning Considerations

Implementation of the carry-over basis system will require additional record-keeping by clients and will inevitably generate some uncertainty about the basis of assets. Although the change will not take effect until 2010, it would be prudent for clients with estates that will exceed the amount covered by the allowable basis increases to begin assembling basis information about the assets that they currently own. They should maintain good records of assets that they acquire in the future.

In planning for the change, it is important to recognize that the $1.3 million and $3 million basis adjustments apply not to the value of the assets but to an increase in value. These amounts are increases to the carryover basis, although they cannot cause the basis to exceed the fair market value of the asset. Therefore, to take full advantage of the basis adjustments, the assets to which they are allocated should have appreciation in the amount of $1.3 million, or $3 million in the case of spousal property.

A significant part of the planning process will be to ensure that the first spouse to die leaves sufficient assets to the surviving spouse to take maximum advantage of the basis adjustments, whether the $3 million or the entire $4.3 million. The spousal basis adjustment is available for property that passes outright to the surviving spouse or to a QTIP trust. As discussed in §12.21, some trusts that qualify for the marital deduction are not eligible for the basis increase.

Despite the fact that the QTIP trust satisfies the requirements for use of the basis adjustment at the first spouse's death, it is not an optimal strategy for maximizing use of the basis adjustment at the death of the surviving spouse. Apparently a QTIP trust does not qualify as property owned by the surviving spouse for the purpose of using the $1.3 million basis adjustment in his or her estate. See §12.24. The only solution to this dilemma, which has limited applicability, is to distribute the QTIP trust assets to the surviving spouse before death.

If the spouses' estates are unequal in value, transfers can be made before the first death to correct the situation. Gifts made to a spouse within 3 years of death are eligible for the basis adjustments provided that the donor spouse did not receive them as a gift during that period. IRC §1022(d)(1)(C). See §12.25. In contrast to current law, the transferred property qualifies for the basis adjustment even if the deceased donee-spouse leaves the same property to the donor spouse on death. Although effective, this strategy raises the usual risks and difficulties connected with deathbed planning.

The effective use of basis adjustments may be complex and difficult. The problems will be mitigated if the marital and nonmarital shares of the estate are distributed to the same beneficiaries. If these shares have different beneficiaries, *i.e.,* a current spouse and children by a prior marriage, conflicts are possible. For example, the spouse may prefer to have the $3 million increase allocated to the less highly appreciated assets so that a larger number of assets are affected. This design may be at odds with the plan of the children, who would prefer that more highly appreciated assets are allocated to the spouse so that fewer assets are affected.

One issue of continuing concern is the amount of discretion that should be given to the executor or trustee to make decisions regarding basis allocation. The options range from leaving the entire decision in the hands of the fiduciary to providing in the planning documents specific directions regarding the method and priority of the allocations. A middle ground provides broad guidance to the fiduciary, *e.g.*, allocating assets in a manner that results in the surviving spouse receiving the largest aggregate value so as to maximize use of the spousal property adjustment. If the document is silent, the fiduciary has an obligation under law to make the allocations fairly. However the question of what is fair in this context remains open. Does "fairness" demand a prorata allocation based on the fair market value of the assets? Or a prorata allocation based on the proportional shares of the beneficiaries? Or something else entirely?

Regardless of the approach adopted, it is prudent to include in the planning document a provision that exculpates the fiduciary from liability for allocation decisions. That provision can be very broad, basically protecting the fiduciary with respect to any basis allocation decision. In some circumstances, the provision should be more narrowly drafted to except from protection only conduct that is intentional or grossly negligent.

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13

Taxing Income of Estates and Trusts

Theodore E. Calleton
Jeffrey C. De Francisco

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§13.1 I. CONDUIT PRINCIPLE AND EXCEPTIONS

While C corporations and their shareholders are separate taxable entities that each pay tax, and partnerships are conduits that pay no tax, Part I of Subchapter J of the Internal Revenue Code (IRC §§641-685) places trusts and estates in a middle ground: the conduit principle applies to distributions to beneficiaries, but the trust or estate is treated as an entity as to undistributed taxable income. Income tax is allocated between the estate or trust and its beneficiaries according to the amount of income received or retained by each, as measured by a special formula called distributable net income or DNI. DNI determines the amount and character of income that must be taken into account by the trust or estate and its beneficiaries. It is a concept unique to subchapter J.

As always, there are exceptions. Certain trusts (or portions of trusts), called grantor trusts, are not treated as trusts at all for income tax purposes; instead, the grantor or another person is treated as the owner of the trust's income, deductions, and credits for income tax purposes. Charitable remainder trusts are non-taxable entities with special taxation rules for distributions to beneficiaries. Electing small business trusts (ESBTs) turn the rules around, taxing all the trust's S corporation income at the highest marginal rate, with no tax on the amounts distributed to beneficiaries.

The income tax rules for estates and trusts are slightly different, because estates are perceived as temporary custodians of decedents' property while trusts are perceived as continuing entities that invest and distribute over a longer period of time. The differences between estates and trusts can, however, be eliminated on the death of the revocable trust settlor when a qualified revocable trust elects to be treated as an estate. IRC §645. See §§13.160A-13.160E.

The first part of this chapter discusses federal income taxation of estates and trusts. The second part discusses grantor trusts. The third part discusses charitable trusts, QSSTs and ESBTs, and foreign trusts in addition to qualified revocable trusts. The last part discusses California fiduciary income taxation.

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II. ESTATES AND NONGRANTOR TRUSTS

§13.2 A. Taxable Income

The Internal Revenue Code applies the same formula to the taxation of estates and nongrantor trusts as it applies to individuals: gross income minus allowable deductions equals taxable income. See IRC §§63(a), 641(b); Treas Reg §§1.641(a)-2, 1.641(b)-1. Gross income is all income derived from whatever source. IRC §61(a). Subchapter J contains the modifications to a trust's or estate's gross income necessary to arrive at its taxable income. Subchapter J makes a further distinction between *taxable income* and *fiduciary accounting income*, the latter being the "income" that is to be distributed to the beneficiaries entitled to income under applicable local law. In subparts A through D of subchapter J (concerning estates and nongrantor trusts), the unmodified word "income" means fiduciary accounting income. IRC §643(b); Treas Reg §1.643(b)-1. Conversely, the regulations under subpart E (concerning grantor trusts) define "income" as taxable income and "ordinary income" as fiduciary accounting income. Treas Reg §1.671-2(b).

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§13.3 B. Federal Tax Rates

Internal Revenue Code §1(e) imposes steeply graduated rates on the ordinary income of trusts and estates (*i.e.*, income other than that received by reason of capital gains and qualified dividends), the practical effect of which is to encourage distribution of income and discourage accumulation of income. Trusts with substantial itemized deductions may be subject to the alternative minimum tax (AMT). See §13.20. The statutory rates are adjusted for inflation. The ordinary income tax rates for 2010 are:

- 15 percent of the first $2300 of taxable income;
- 25 percent of the next $3050 of taxable income;
- 28 percent of the next $2850 of taxable income;
- 33 percent of the next $3000 of taxable income; and
- 35 percent of the amount exceeding $11,200.

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§13.3A C. Estimated Tax

Estates and trusts are required to make estimated tax payments in the same manner as individual taxpayers. IRC §6654(*l*)(1). However, estates and qualified revocable trusts electing under IRC §645 need not make estimated tax payments during the first 2 years after the decedent's or deceased settlor's death. IRC §6654(*l*)(2). Charitable trusts and private foundations subject to the tax on unrelated business taxable income also are exempt from making estimated tax payments. IRC §6654(*l*)(3). Estates and trusts that did not have a tax liability for the preceding taxable year or will have a tax less than $1000 in the current year are also exempt. IRC §6654(e).

In all other cases, estates and trusts must make four estimated tax payments each year, each equal to 25 percent of the required annual payment.

For estates and trusts with adjusted gross income of $150,000 or less under IRC §67(e) in the preceding tax year, the required annual payment is the lesser of (i) 90 percent of the tax for the current taxable year or (ii) 100 percent of the tax for the preceding taxable year, if it was a taxable year of 12 months and a return was filed. IRC §6654(d)(1)(B).

For estates and trusts with adjusted gross income in excess of $150,000 under IRC §67(e) in the preceding tax year, the required annual payment is the lesser of (i) 90 percent of the tax for the current taxable year or (ii) 110 percent of the tax for the preceding taxable year, if it was a taxable year of 12 months and a return was filed. IRC §6654(d)(1)(C).

For taxable years beginning in 2009 only, the required annual payment for an estate or trust with gross income less than $500,000 under IRC §67(e) that certifies that it received more than 50 percent of its gross income in the previous year from a small business (*i.e.*, a business with an average number of fewer than 500 employees for the calendar year ending with or within the previous taxable year) is the lesser of (i) 90 percent of the tax for the current taxable year or (ii) 90 percent of the tax for the preceding taxable year, if it was a taxable year of 12 months and a return was filed. IRC §6654(d)(1)(D).

The fiduciary reports estimated taxes on IRS Form 1041-ES, which contains detailed instructions regarding payment dates and filing an early return rather than paying a fourth installment of estimated tax.

Penalties for underpayment of estimated taxes also apply to estates and trusts. IRC §6654(a)-(b).

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§13.4 D. Deductions

Estates and trusts are allowed most of the deductions allowed to individuals, with some important differences. Most significantly, estates and trusts are allowed a deduction for distributions of income to beneficiaries. IRC §§651, 661. The scope of this deduction is discussed in §13.31. In addition, trusts are not allowed a standard deduction. IRC §63(c)(6)(D). See §§13.5-13.20 for other deductions.

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.5 1. Deduction in Lieu of Personal Exemption

§13.5 1. Deduction in Lieu of Personal Exemption

Estates and trusts (except qualified disability trusts, as defined in IRC §642(b)(2)(C)) receive no personal exemption deduction under IRC §151. IRC §642(b)(3). Instead, estates (including trusts electing to be treated as estates) receive a $600 deduction; trusts that must distribute all of their income annually (except qualified disability trusts) receive a $300 deduction; and all other trusts receive a $100 deduction in lieu of the personal exemption. IRC §642(b)(2); Treas Reg §1.642(b)-1.

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§13.6 2. Losses

Like any individual, a trust or estate may deduct losses incurred in connection with a trade or business or in a transaction entered into for profit, and also may deduct losses resulting from theft, fire, storm, shipwreck, or other casualty to the extent not compensated by insurance. IRC §165(a); Treas Reg §1.165-1(a). Casualty and theft losses are subject to statutory limitations discussed in §13.16.

Trusts and estates are also allowed to claim net operating loss carrybacks and carryovers. IRC §§642(d), 172(a)-(b). Net operating losses are the excess of allowable deductions over gross income incurred in a trade or business. IRC §172(c). Deductions for charitable contributions and distributions to beneficiaries are expressly excluded when calculating operating losses. Treas Reg §1.642(d)-1(b). Managing an estate or trust is not per se a trade or business, and expenses of administration are not trade or business expenses. *Refling v Burnet* (8th Cir 1931) 47 F2d 859. Operating loss deductions are not limited to actual business losses incurred by the estate or trust; however, any operating loss not attributable to a trade or business is deductible only to the extent of gross income not derived from a trade or business. IRC §172(d)(4); Rev Rul 73-323, 1973-2 Cum Bull 71. Note, however, that an estate or trust that operates a business runs the risk of being taxed as an association. See, *e.g.,* Treas Reg §§301.7701-2, 301.7701-4(b); *Laurel Hill Cemetery Ass'n v U.S.* (ED Mo 1977) 427 F Supp 679, aff'd (8th Cir 1977) 566 F2d 630 (trust was association, not charitable trust); IRS Letter Ruling 9547004 (charitable remainder trust with multiple grantors was association, not trust).

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.7 3. Depreciation, Depletion, and Amortization

§13.7 3. Depreciation, Depletion, and Amortization

Estates and trusts are allowed deductions for depreciation and depletion, but only to the extent not allowed to their beneficiaries. IRC §642(e); Treas Reg §1.642(e)-1. The same rule applies to amortization deductions allowed with respect to pollution control facilities under IRC §169 and with respect to goodwill and other intangibles under IRC §197. IRC §642(f); Treas Reg §1.642(f)-1. Because trusts and estates, as a general rule, are not expected to operate businesses, the option to expense rather than depreciate business assets under IRC §179 is not available to trusts and estates. IRC §179(d)(4).

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§13.8 a. Estates

Depreciation and depletion are apportioned between an estate and its "heirs, legatees and devisees" on the basis of income allocable to each. IRC §§167(d), 611(b)(3)-(4); Treas Reg §§1.167(h)-1(c), 1.611-1(c)(5). Because most estates do not make regular distributions of current income, the depreciation and depletion deductions will generally be allocable to the estate rather than to the heirs, legatees, and devisees.

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§13.9 b. Trusts

Depreciation and depletion are apportioned between a trust and its beneficiaries in accordance with the terms of the governing instrument or, if the governing instrument is silent, on the basis of the fiduciary accounting income (before applying any depletion or depreciation deductions) allocable to each. IRC §§167(d), 611(b)(3); Treas Reg §§1.167(h)-1(b), 1.611-1(c)(4). For these purposes, income allocable is income distributable. See *Fleming v Commissioner* (5th Cir 1941) 121 F2d 7; *McBride Bldg. Trust* (1951) 10 TCM 13. Thus, the trust and its beneficiaries share depreciation and other deductions in the same ratio as they share distributable income. Note, however, that if the trust owns encumbered real property and pays the principal portion of the loan payment from trust income, the trustee will be deemed to have established a reserve, and a fractional portion of the depreciation will be allocable to the trust. See Rev Rul 90-82, 1990-2 Cum Bull 44.

Despite rather generous statutory language, the regulations severely limit the trustee's options in allocating depreciation and depletion to the trust. Unless the trustee, acting under the trust instrument, establishes a reserve for depreciation or depletion, or local law requires a reserve (which is not generally the case), a trust required to distribute all income must allocate its entire depreciation or depletion deduction to the income beneficiary. See Treas Reg §§1.167(h)-1(b), 1.611-1(c)(4)(ii). See also *Dusek v Commissioner* (10th Cir 1967) 376 F2d 410 (reserve required by trust instrument, beneficiary could not claim depreciation). This rule applies even if the trust has no income (see *Sue Carol* (1934) 30 BTA 443, acq 1934-2 Cum Bull 4 (all depreciation allocated to mandatory income beneficiary even though trust had no net income)), or the amount of the deduction exceeds the income allocable to the income beneficiaries (Rev Rul 74-530, 1974-2 Cum Bull 188), unless the deduction is limited by the passive loss rules of IRC §469 (see §13.19).

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§13.10 c. Allocation Among Beneficiaries

Once the depletion or depreciation deduction has been allocated between the trust or estate and its beneficiaries, the beneficiaries' portion can be allocated among themselves. Logic suggests that the deductions should be allocated ratably among income beneficiaries according to the tier distribution rules. See §13.43. Similarly, logic would suggest that if one beneficiary were entitled to all of the income from the depreciable property and another beneficiary were entitled to all other income, the deductions would be allocated to the beneficiary of the income from the property generating the deduction. But this is not what the statute provides. To the contrary, in the absence of specific provisions in the governing instrument in the case of a trust (but not an estate), IRC §§167(d) and 611(b)(3)-(4) direct that the deductions simply be allocated between the entity and the heirs, or beneficiaries on the basis of "[i]ncome allocable to each." At best, that implies that all beneficiaries share in the deductions, even if the income of a depreciable/depletable asset specifically goes to one of them. The depletion regulations are somewhat more helpful because they state that the depletion deduction is to be allocated on the basis of the income from *such property* allocable to each. Treas Reg §1.611-1(c)(4). A reasonable approach is to treat both depreciation and depletion deductions in this way, so long as the allocation of the deduction has "economic effect." See Treas Reg §1.167(h)-1(b) (flush language).

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§13.11 4. Charitable Deduction

Despite the fact that an estate or trust is, ostensibly, to be taxed in the same manner as an individual, there are substantial differences between IRC §642(c), governing charitable deductions for estates and trusts, and IRC §170, governing charitable deductions for individuals. For example, there are no limitations on the deductible amount for an estate or trust. Compare IRC §642(c)(1) with §170(b). However, the IRC §642(c) deduction is allowed only for contributions made from trust income. See §13.11A. An estate or trust may not take a deduction for amounts distributed to charity unless it is done "pursuant to the terms of the governing instrument." IRC §642(c)(1); Treas Reg §1.642(c)-1(a)(1); Prop Treas Reg §1.642(c)-2(e) (requiring that the estate or trust satisfy the recordkeeping and return requirements of Treas Reg §1.170A-13); IRS Legal Memorandum 200848020 (contending that no deduction was allowable for accelerated payments to charity made pursuant to court reformation of a trust because the modification was not made in settlement of a trust contest). In *United States Trust Co. v IRS* (5th Cir 1986) 803 F2d 1363, the court held that the instrument must provide that the gift is to be funded from gross income, and the instrument must either authorize or direct the payment of income to charity. See *Old Colony Trust Co. v Commissioner* (1937) 301 US 379, 81 L Ed 1169, 57 S Ct 813; *Brownstone v U.S.* (2d Cir 2006) 465 F3d 525; *Rebecca K. Crown Income Charitable Fund v Commissioner* (7th Cir 1993) 8 F3d 571; *Ernest & Mary Hayward Weir Found. v U.S.* (SD NY 1973) 362 F Supp 928, aff'd (2d Cir 1974) 508 F2d 894. However, a trust may deduct a charitable gift of income made by a partnership in which the trust is a partner, even if the trust instrument does not itself authorize charitable distributions. Rev Rul 2004-5, 2004-1 Cum Bull 295. This conclusion also should apply to a trust other than an ESBT that holds an interest in an S corporation that makes a charitable contribution. The regulations specifically allow an ESBT to deduct a charitable contribution by an S corporation in which the ESBT has an interest. See §13.155.

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§13.11A a. Contributions of Gross Income

An estate or trust may elect to deduct amounts of gross income received during its taxable year (or any preceding taxable year if not previously deducted) that are paid to charity pursuant to the terms of its governing instrument during its taxable year and those paid in the year following that taxable year, but it may not carry forward unused deductions. IRC §642(c)(1); Treas Reg §1.642(c)-1(b). (In contrast, carryovers of excess contributions are generally allowed for individuals for 5 years. See IRC §170(d); Treas Reg §1.170A-10.) Although the election must be made not later than the time, including extensions, prescribed for filing the income tax return for the subsequent tax year, the IRS has granted a trustee an extension of time to make the election when the trustee acted reasonably and in good faith. Treas Reg §§1.642(c)-1(b)(2), 301.9100-3; IRS Letter Ruling 200702016. Distributions for charitable purposes include distributions to foreign as well as domestic charities. Treas Reg §1.642(c)-1(a)(2). However, the charitable deduction does not reduce a trust's unrelated business income (*i.e.,* income that would be treated as unrelated business taxable income (UBTI) if the trust were exempt from income taxation under IRC §501(c)(3)). IRC §681(a). See discussion of UBTI in §13.150.

While the nature of the property contributed or the recipient organization affects an individual's deduction, an estate or trust is limited only in that its deduction cannot exceed the amount of its "gross income." IRC §642(c)(1); Treas Reg §1.642(c)-1(a)(1). In *Estate of Dehgani-Fard* (2006) 141 CA4th 797, 46 CR3d 289, the IRS allowed a probate estate to deduct 37.5 percent of the estate income from after-discovered assets when a settlement agreement provided that a charity was entitled to 37.5 percent of the residue of the estate. (The court then ruled that the burden of income taxes paid on the remaining income was borne only by the noncharitable distributees.) A trust is not allowed an income tax deduction for a qualified conservation contribution under IRC §170(h) because the IRC §642(c) deduction is allowed only for contributions made from trust income. Rev Rul 2003-123, 2003-2 Cum Bull 1200. See also *Thomas B. Goldsby, Jr.*, TC Memo 2006-274.

Although the current regulations appear to allow a trust instrument to direct the order in which distributions of income are made to charity, *e.g.,* first from ordinary income, then short-term capital gains, then long-term capital gains, and then tax-exempt income, the IRS has consistently taken the position that, regardless of the literal wording of the regulations, such ordering provisions will be disregarded if they have no economic effect independent of income tax consequences. Treas Reg §1.642(c)-3(b)(2); Rev Proc 2008-46, 2008-30 Int Rev Bull 238 (charitable lead unitrust); IRS Letter Ruling 200648025 (charitable lead annuity trust). The IRS has now issued proposed regulations that expressly state that income-ordering provisions will not be honored unless they have some economic effect independent of income tax consequences. Prop Treas Reg §§1.642(c)-3(b)(2), 1.643(a)-5(b); REG-101258-08, 2008-28 Int Rev Bull 111.

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§13.11B b. Set Asides

Estates, or trusts established on or before October 9, 1969, also may deduct amounts of gross income permanently set aside for future distribution to, or to "be used exclusively" for, charity in addition to amounts actually paid to charity. IRC §642(c)(2); Treas Reg §1.642(c)-2(a)-(b); Prop Treas Reg §1.642(c)-2(e). No amount is considered permanently set aside, however, unless under the terms of the governing instrument and the circumstances of the case demonstrate the possibility that the amount set aside will not be used for charitable purposes is so remote as to be negligible. Treas Reg §1.642(c)-2(d). Thus, any possibility that principal will be invaded for noncharitable purposes will foreclose a set-aside deduction. The IRS has interpreted the regulation as foreclosing a deduction to a trust the trustee of which has the discretion to allocate capital gains to income or to principal because future gains allocated to income could deplete the amount set aside for charity. Rev Rul 73-95, 1973-1 Cum Bull 322; *Samuel P. Hunt Trust v U.S.* (D NH 2003) 93 AFTR2d 351.

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§13.12 c. Adjustments to Charitable Deduction

A trust or estate cannot satisfy a general pecuniary charitable bequest with a distribution of income and obtain a distribution deduction in addition to the set-aside deduction for the same amount. Treas Reg §1.663(a)-2. See *Mott v U.S.* (Ct Cl 1972) 462 F2d 512, cert denied (1973) 409 US 1108. See also *Crestar Bank v U.S.* (ED Va 1999) 47 F Supp 2d 670. Likewise, no charitable deduction is allowed for distributions of amounts other than "gross income," such as tax-exempt income or corpus. See Treas Reg §1.642(c)-3(b)(1); Rev Rul 68-667, 1968-2 Cum Bull 289. See also *Mott v U.S., supra*. This is not to say that no charitable deduction will be allowed for distributions that are required by the governing instrument that consist of tax-exempt income when the trust or estate has gross income. Because all income is fungible, the deduction will simply be reduced proportionally by the amount of the tax-exempt income. Treas Reg §1.642(c)-3(b)(2). Thus, if a trust's income consists of 80 percent dividends and taxable interest and 20 percent tax-exempt interest, and it must distribute $20,000 from income to charity each year, the amount allowable under IRC §642(c) will be $16,000. See Treas Reg §1.662(c)-4. On the other hand, a trust's charitable deduction is directly reduced by amounts allocable to the trust's unrelated business income. Treas Reg §1.642(c)-3(d).

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.13 d. Charitable Deduction for Income in Respect of Decedent

§13.13 d. Charitable Deduction for Income in Respect of Decedent

Because items of income in respect of a decedent (IRD) enter into gross income, items of IRD distributed to charity qualify for the deduction. Treas Reg §1.642(c)-3(a). See *Estate of Freund v Commissioner* (2d Cir 1962) 303 F2d 30 (deduction only for amount of IRD actually received by estate); IRS Letter Rulings 200537019, 200452004 (estate's assignment of IRD item to charity did not cause realization of income).

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§13.14 e. Charitable Deduction for Capital Gains

A trust or estate that realizes capital gains and that must make distributions to charity poses a different problem. Clearly the capital gains are part of gross income, but were *they* distributed? This depends on whether those gains enter into the computation of distributable net income. See §§13.23-13.25. A related problem arises when a trust or estate makes a distribution in kind of appreciated assets in satisfaction of the charity's right to income. See Treas Reg §1.661(a)-2(f).

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§13.15 5. Limits to Deductions

As with deductions available to individuals, some deductions available to estates or trusts are limited by reference to adjusted gross income. The overall limitation on the amount of deductions, however, does not apply to trusts and estates. IRC §68(e).

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§13.16 a. Casualty Losses

Casualty losses (losses suffered by reason of theft, fire, storm, shipwreck, or other casualty) may be deducted only to the extent that they exceed $500 ($100 for taxable years beginning after December 31, 2009) and then only to the extent that net casualty losses for the year exceed 10 percent of the trust or estate's adjusted gross income and are not deducted on an estate tax return. IRC §165(h)(1), (h)(5)(D). When determining the limitation on personal casualty losses, adjusted gross income is computed in the same manner as for an individual, except that the deductions for "costs paid or incurred in connection with the administration of the estate or trust" are also allowed. IRC §165(h)(5)(C).

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§13.17 b. Miscellaneous Itemized Deductions

Miscellaneous itemized deductions may be deducted only if the aggregate of such deductions exceeds 2 percent of the trust or estate's "adjusted gross income." IRC §67(a). Miscellaneous itemized deductions include those listed in IRC §§162-224 (most of which are inapplicable to trusts and estates), excluding those listed in IRC §67(b), such as, *e.g.*, interest, taxes, casualty or theft losses. The miscellaneous itemized deductions of a trust or estate usually relate to the management of estate assets such as trustees' fees.

Since estates and trusts do not regularly compute an adjusted gross income, IRC §67(e) directs that an estate or trust compute its adjusted gross income in the same manner as an individual, except that the trust or estate is granted (1) a deduction in lieu of the personal exemption, (2) a deduction for distributions to beneficiaries, and (3) a deduction for "costs which are paid in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate." IRC §67(e)(1).

Costs incurred in connection with administration are relatively easy to determine. What costs would not have been incurred if the property were not held in the trust or estate has been the subject of continuing disputes between the IRS and taxpayers. Certainly, statutory executor's commissions and attorney fees meet the "would not have been incurred" criteria. Management expenses, chargeable at least in part to the income account, such as those for investing, preserving, and maintaining estate or trust assets, have been the crux of the dispute. In 2007, the IRS issued proposed regulations in an attempt to resolve the conflict, but in them the IRS adopted the most restrictive and literal interpretation of the statute, stating that only expenses that are "unique" to estates or nongrantor trusts are not subject to the 2-percent floor. Prop Treas Reg §1.67-4(a). The U.S. Supreme Court, in *Knight v Commissioner* (2008) 552 US 181, 169 L Ed 2d 652, 128 S Ct 782, rejected the proposed regulations and held that a trust expense is subject to the 2-percent floor unless it would be "uncommon (or unusual or unlikely)" for a hypothetical individual to incur the expense. Pending final regulations consistent with the *Knight* decision, the IRS has stated that, for tax years prior to 2009, taxpayers are not required to determine what portion of a bundled fiduciary fee is subject to the 2-percent floor, and may deduct the full amount of the fee. Notice 2008-116, 2008-52 Int Rev Bull 1372; Notice 2008-32, 2008-11 Int Rev Bull 593.

The *Knight* decision also has alternative minimum tax (AMT) implications, because the IRS takes the position that IRC §67(e)(1) deductions remain deductible for AMT purposes whereas miscellaneous itemized deductions subject to the 2-percent floor do not. IRC §56(b)(1)(A)(i). See §13.20. Thus, the entire amount of investment income may be taxed with no deduction for investment advisory expenses, which often far exceed 2 percent of trust income and most of which otherwise would be deductible despite the 2-percent floor.

The phaseout of itemized deductions for high-income taxpayers under IRC §68 does not apply to estates and trusts. IRC §68(e).

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§13.18 c. Certain Deductions Disallowed

Some expenses allowable when determining taxable income are also deductible for estate tax purposes under IRC §2053. Most of these are "deductions in respect of a decedent"; that is, items paid by the estate that would have been deductible by the decedent had he or she lived. See IRC §691(b). Prime examples are fees, commissions, and tax liens on real property deductible under IRC §212.

Interest on amounts borrowed to pay estate tax is deductible on the estate tax return, but IRC §163(h)(2)(E) specifically limits the income tax deduction to interest incurred under IRC §6163 (deferral of estate tax on remainder interests). See Chief Counsel Advice 200836027 (no deduction allowed for interest accrued under IRC §6161). However, interest on amounts borrowed to pay estate tax arguably may be deductible as administration expenses under IRC §212 on the basis of a plain reading of Treas Reg §1.212-1(i) (reasonable amounts paid or incurred by the fiduciary of an estate or trust). See *Charles H. Ungerman, Jr., Revocable Trust* (1987) 89 TC 1131 (interest expense under IRC §6166 allowable as deduction under IRC §212 even though it was then also allowable under IRC §163). For further discussion, see Blattmachr & Boyle, *Deducting Interest Paid on Estate Taxes*, 20 Prob Prac Rep 1 (Oct. 2008).

Similarly, interest on delayed bequests, while taxable to the beneficiary receiving it (Treas Reg §1.61-7; Rev Rul 73-322, 1977-2 Cum Bull 44), is not deductible by the estate because it is "personal interest." IRC §163(h)(2); IRS Letter Ruling 9604002 (interest on delayed bequests not deductible on estate tax return even though interest incurred under IRC §6161 or §6166 is deductible under IRC §2053). See §13.56. Most allowable deductions, however, may be taken either on the federal estate tax return or on the estate's income tax return, but not on both. IRC §642(g).

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§13.19 d. Passive Activity Rules

Deductions for passive activity losses are disallowed to the extent that they exceed passive activity income, and passive activity credits are disallowed to the extent that they exceed the regular tax liability of the estate or trust allocable to all passive activities. IRC §469. Disallowed losses and credits are suspended until the next year. IRC §469(b). A passive activity is one that involves the conduct of any trade or business in which the taxpayer does not materially participate. IRC §469(c)(1)(B).

Trusts and estates have multiple parties—decedents or grantors, fiduciaries, and beneficiaries—which complicates the determination of whether or not there is a "material participant." The temporary regulations are of little help. One approach, taken by several commentators, focuses on the activity of the fiduciary. In *Mattie K. Carter Trust v U.S.* (ND Tex 2003) 256 F Supp 2d 536, the court held that a trust materially participated in operating a 15,000-acre cattle ranch when the trust employed a full-time manager and other full- and part-time employees in the conduct of ranching operations. The court rejected the Service's contention that material participation was to be judged solely by the activities of the individual trustee, and the court found that the activities of the trustee alone were sufficient to provide material participation. But many fiduciaries are passive, while beneficiaries are actually active in the business. In that case, IRC §469 should probably be applied at the beneficiary level. However, in response to the *Carter Trust* case, the IRS issued IRS Letter Ruling 200733023 stating that material participation was required of the trustee and that, in measuring the trustee's involvement, activities of employees, agents, and special trustees would not be attributed to the trustee. The application of IRC §469 at the beneficiary level would, of course, require actual distributions unless the rules governing depreciation and depletion are applied. For extended discussion of the material participation rules as applied to fiduciaries, see Abbin, Income Taxation of Fiduciaries and Beneficiaries (2007); Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts and Beneficiaries (3d ed 1999); Schmolka, *Passive Activity Losses, Trusts and Estates*, 58 Tax L Rev 191 (2005).

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§13.20 e. Alternative Minimum Tax

The Code imposes an additional tax on estates and trusts called the alternative minimum tax or AMT, but only to the extent that the AMT exceeds the estate's or trust's regular income tax. IRC §55(a). The Code defines the AMT as the amount of "tentative minimum tax" that is the sum of (1) 26 percent of the "taxable excess" for the year below $175,000, plus (2) 28 percent of the taxable excess exceeding $175,000, reduced by the alternative minimum tax foreign tax credit, subject, however, to a limitation on the tax on net capital gains. IRC §55(b)(1)(A)(i), (b)(3). The "taxable excess" is the amount of taxable income that exceeds the "exemption amount." IRC §55(b)(1)(A)(ii). The "exemption amount" for estates and trusts is $22,500 (IRC §55(d)(1)(D)), reduced by 25 percent of the amount by which the alternative minimum taxable income exceeds $75,000 (IRC §55(d)(3)(C)). Thus, for estates or trusts that have alternative minimum taxable income in excess of $175,000, the tentative minimum tax is simply 26 percent of the first $175,000 of alternative minimum taxable income, plus 28 percent of the balance.

A beneficiary's share of an estate's or trust's alternative minimum taxable income is determined by the beneficiary's share of the alternate minimum taxable distributable net income received by the beneficiary. An estate or trust calculates its alternative minimum taxable income and net distributable alternative minimum taxable income in the same manner as it calculates its regular taxable income and DNI, but with the adjustments required by IRC §§56 and 58 and the addition of the tax preference items required by IRC §57. See IRC §55(b)(2).

The AMT will rarely apply to trusts. Simple trusts distribute all their income and complex trusts that do not distribute all their income will usually be in the maximum regular income tax bracket so that their regular tax will exceed their tentative minimum tax. However, the AMT may apply if the trust has substantial itemized deductions. See §13.17. If a trust does have AMT, the AMT becomes a credit that reduces the amount by which the trust's regular tax may exceed its AMT in future years, until exhausted. IRC §53.

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.21 E. Distributable Net Income

§13.21 E. Distributable Net Income

Distributable net income is the measure of the *amount* of income that the trust or estate may deduct for distributions to beneficiaries, as well as of the amount of income that beneficiaries must include in their gross income. The DNI calculation also determines the *character* of amounts retained by the entity or distributed to the beneficiary. Because DNI measures both the amount and the character of income distributed or retained, it includes taxable *and* non-taxable items. IRC §643(a). Thus, the fact that an item is included in DNI does not mean that it is taxable as ordinary income, or even taxable at all—its original character determines its tax consequences.

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§13.22 1. Computation

The computation of DNI starts with the taxable income of the trust or estate. IRC §643(a). Taxable income for these purposes may include income in respect of a decedent (IRD) under IRC §691(a), such as amounts received from individual retirement accounts (IRAs) and qualified or nonqualified deferred compensation plans. See Chief Counsel Advice 200644016. See also Chief Counsel Advice 200644020 (funding charitable gifts with shares of decedent's IRA resulted in the trust recognizing income that was not deductible under Treas Reg §1.663(a)-2, as discussed in §13.12). Tax-exempt income (adjusted for a prorata share of deductible expenses) is added to the taxable income, as are extraordinary dividends, taxable stock dividends, and capital gains distributed as or allocated to income or utilized in determining income. IRC §643(a)(3)-(5). No adjustment is made for the personal exemption or for distributions to beneficiaries (which come later when determining the entity's taxable income). IRC §643(a)(1)-(2). Note, however, that deductions chargeable to principal under state law are taken into account when calculating DNI. See Treas Reg §1.652(b)-3(b).

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§13.23 2. Capital Gains and Losses

Capital gains pose some of the more difficult conceptual problems in determining DNI. The Code states that gains from the sale or exchange of capital assets are not included when determining DNI if allocated to principal and (1) not paid, credited, or required to be distributed to any beneficiary; or (2) paid to, set aside for, or used for charity. IRC §643(a)(3). See §13.51 for further discussion of treatment of distributions of appreciated or depreciated assets.

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§13.24 a. Limited Inclusion of Capital Gains

The regulations, however, are more restrictive than the Internal Revenue Code, stating that although gains from the sale or exchange of capital assets are not ordinarily included in DNI (Treas Reg §1.643(a)-3(a)), they will be included if (1) allocated to income (unless state law defines "income" as a unitrust amount), (2) allocated to principal but consistently treated as part of a distribution to a beneficiary, or (3) allocated to principal but actually distributed or used to determine the amount distributed to a beneficiary, pursuant to the terms of the governing instrument or local law. Treas Reg §1.643(a)-3(b).

NOTE: Under Prob C §16328, "net income" is defined as a unitrust amount during any period in which the trust is being administered as a unitrust either pursuant to the powers conferred by Prob C §§16336.4-16336.6 or pursuant to the terms of the governing instrument, if the unitrust amount is no less than 3 percent and no more than 5 percent. During these periods, the amount distributed in satisfaction of a right to trust income is generally determined as a percentage of the net fair market value of trust assets without regard to the amount of gains otherwise allocated to income or principal.

The regulations give 14 examples of when capital gains will or will not be included in DNI. Treas Reg §1.643(a)-3(e). The examples appear to give trustees reasonable discretion when determining to allocate capital gains to income, but uncomfortably appear to lock the trustee into a course of action, or election, once the determination has been made. Thus, Example 1 approves the exclusion of capital gains from DNI when the trustee allocates them to principal but invades principal for the benefit of the income beneficiary, but states that, "In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains." Similarly, Example 2 approves the "regular practice" of including discretionary distributions of principal as being first paid from realized capital gains, but states that, "In future years, Trustee must treat all discretionary distributions as being made first from any realized capital gains."

From a tax perspective, it may be desirable to include gains in DNI, thereby creating the possibility that distributions of gain to the beneficiary can reduce the total taxes paid by the trust and the beneficiary. Because capital gains and losses are generally first netted at the trust level, including gains in DNI will not result in the loss of an opportunity to use the trust's losses to offset gains. Treas Reg §1.643(a)-3(d). Distributions of net gains to a beneficiary who has offsetting net losses may benefit both the trust and the beneficiary. See Danforth, *Allocation of Capital Gains to DNI Under §643*, 130 Tax Management Estates, Gifts & Trusts J 242 (Mar-Apr. 2005).

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§13.25 b. Capital Losses

Capital losses, like most capital gains, are excluded from DNI unless they affect the amount of capital gain paid, credited, or required to be distributed. IRC §643(a)(3). The regulations require that capital losses be netted against capital gains at the trust level, except in the case of a gain that is utilized in determining the amount that is distributed or required to be distributed to a particular beneficiary (as might be the case if a particular beneficiary was entitled to the sale proceeds of a particular asset). Treas Reg §1.643(a)-3(d). The result of the foregoing rule is that beneficiaries get no benefit from capital losses except in the year of termination. IRC §642(h); Treas Reg §1.642(h)-1. The capital losses may still be carried forward. IRC §1212(b). Moreover, the estate or trust may offset up to $3000 of excess capital losses against its taxable income each year. IRC §1211(b). Note that bills pending in Congress in 2009-2010 would increase the offset amount to $10,000 (HR 1070) or $20,000 (HR 884).

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§13.26 3. Tax-Exempt Income

Tax-exempt interest is taken into account when calculating the DNI of an estate or trust. However, IRC §643(a)(5) requires that the tax-exempt interest be reduced by a proportionate share of expenses, as described in IRC §265. The regulations under IRC §265 direct that expenses be allocated between exempt and nonexempt income in "reasonable proportion." Treas Reg §1.265-1(c). The Subchapter J regulations are more restrictive, apparently requiring reduction of general expenses in the same proportion that the amount of tax-exempt interest bears to total fiduciary accounting income (after reducing other income by direct expenses). See Treas Reg §§1.643(d)-2(a)(2), 1.652(b)-3(b). The examples in Treas Reg §§1.652(c)-4, 1.661(c)-2, and 1.662(c)-4 seem to apply the formula before reducing for direct expenses. This approach apparently values simplicity over accuracy, because if a direct expense is greater than the income against which it is applied, that item ought to be eliminated from the computation. For a thorough discussion of this problem, see Ferguson, Freeland, & Ascher, Federal Income Taxation of Estates, Trusts and Beneficiaries ¶7.06[E] (3d ed 1998); Zaritsky & Lane, Federal Income Taxation of Estates and Trusts ¶2.13 (3d ed 2003).

Either way, the end result is that the expenses attributable to tax-exempt income do not reduce taxable income; instead, they reduce the amount of tax-exempt income included in DNI. IRC §643(a)(5); Treas Reg §1.643(a)-5(a). Note that the general expenses of a trust or estate that are not allocable to specific classes of income are allocable only to items entering into DNI, such as nontaxable and taxable interest, not to capital gains allocable to principal. IRC §652(b); *Tucker v Commissioner* (2d Cir 1963) 322 F2d 86.

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§13.27 4. Allocation of Expenses to DNI

Simply subtracting the trust's or estate's expenses from its gross income is not sufficient to determine the net amounts of the various items of income comprising DNI. For example, expenses allocable to the production of tax-exempt interest are not deductible. IRC §265(a)(1). However, state income taxes are not "allocable to the production of income," so state income taxes attributable to tax-exempt income *are* deductible and thus reduce DNI. See Rev Rul 61-86, 1961-1 Cum Bull 41. Generally, deductible items attributable to one class of income are allocable to that class. Treas Reg §1.652(b)-3(a). Deductible items not attributable to one class of income (*e.g.*, trustee's commissions, rental of a safe deposit box, and state income and personal property taxes) are allocable in any reasonable fashion. Treas Reg §1.652(b)-3(b)-(c). If the allocable deductions of one class exceed the income of that class, they may be reasonably allocated to other classes of income (including capital gains) as if such excess deduction is not attributable to one class of income, except for excess tax-exempt deductions, which are not usable to reduce DNI. Treas Reg §1.652(b)-3(d).

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§13.28 5. Separate Shares

Solely for the purpose of allocating DNI among beneficiaries of a trust or estate, IRC §663(c) treats separate shares as if they were separate trusts or estates when a trust or estate has more than one beneficiary and those beneficiaries have substantially separate and independent shares. IRC §663(c); Treas Reg §1.663(c)-1(a). The separate share rule attempts to achieve essential fairness when allocating DNI among multiple beneficiaries. It is not elective. Treas Reg §1.663(c)-1(d). For example, if all trust income must be distributed equally to A and B, and the trustee distributes property with a value of more than one-half the trust's income to A, fairness decrees that the excess over A's one-half of the trust income be treated as a distribution of principal. The separate share rule does just that.

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§13.29 a. Rule

In general, the separate share rule requires calculating each share's DNI based on its ratable portion of gross income and deductions taken into account. Treas Reg §1.663(c)-2(b)(1). Gross income is gross *taxable* income. IRC §643(b); Treas Reg §1.663(c)-2(b)(2). See also Treas Reg §1.671-2(b). Income in respect of a decedent (IRD) is included in the separate share calculation, and allocated among the separate shares that "potentially" could be funded, even if the IRD is allocable to principal under state law or the terms of the instrument. Treas Reg §1.663(c)-2(b)(3). See Treas Reg §1.663(c)-5, Examples 6, 9, 10. Noncash DNI items (such as original issue discount or undistributed partnership or S corporation income) are allocated in proportion to the amount of income each share is entitled to under state law or the terms of the instrument. Treas Reg §1.663(c)-2(b)(4). Deductions or losses attributable solely to one share remain with that share and are not allocated to other shares. Treas Reg §1.663(c)-2(b)(5).

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§13.30 b. Application

The separate share rule applies only for the purposes of allocating DNI between the trust or estate and its current beneficiaries; it does not allocate income between successive beneficiaries, require filing additional returns, or generate additional personal exemption deductions. Treas Reg §1.663(c)-1(b). Because the separate share rule does not produce an additional run up the narrow tax brackets or additional deductions, most trust documents require that substantially separate and independent shares be treated as separate trusts, and the separate share rule infrequently affects trusts. However, wills and qualified revocable trusts (*i.e.,* trusts electing to be treated as estates) generally do not establish separate trusts during the period of estate administration, resulting in more frequent application of the rule because they often do create separate economic interests. Thus, a decedent's estate and his or her qualified revocable trust are treated as separate shares for the purpose of computing DNI. Treas Reg §§1.645-1(e)(2)(iii)(A), 1.663(c)-4(a).

Separate economic interests exist when the interest of one beneficiary (or class of beneficiaries) does not affect (or is not affected by) the interest of another beneficiary (or class of beneficiaries). Separate economic interests exist, for example, when the devisee of a specific gift is entitled to the income generated by that gift. Treas Reg §1.663(c)-4(a). Family (or other) allowances that are not entitled to a share of income, pecuniary formula bequests, qualified revocable trusts for which an IRC §645 election is made, and specific gifts of money that are entitled to interest after 1 year under Prob C §12003 and not a share of income, are also treated as separate shares. Treas Reg §1.663(c)-4(a)-(b).

In the unusual event that a trust, other than a qualified revocable trust, were to divide the residue into separate shares (but not separate trusts) for the settlor's children and authorize accumulation or distribution of the income and distribution of principal, the separate share rule would obviously apply. Treas Reg §1.663(c)-3(a). Not so obviously, the rule also applies even if on termination of the trust the beneficiary's share passes to others, including other trust beneficiaries. Treas Reg §1.663(c)-3(a). As might be expected, the rule does not apply if the trustee may sprinkle the income or principal among a group of beneficiaries. Treas Reg §1.663(c)-3(b). Curiously, but logically, a beneficiary may have an interest in more than one separate share. Treas Reg §1.663(c)-3(c).

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F. Taxation of Distributions

§13.31 1. Taxable Distributions

Distributions by the estate or trust are deductible by the entity and represent income to the beneficiary to the extent of DNI distributed. If distributions exceed DNI, the excess has no effect on the taxable income of the trust, estate, or beneficiary. IRC §§651(a), 652(a), 661(a), 662(a). Thus, DNI imposes a quantitative limitation on taxable distributions. DNI also acts as a qualitative conduit: items such as tax-exempt interest or distributed capital gains retain their character in the hands of the beneficiaries. IRC §§652(b), 662(b). The calculation of the exact amount and character of the distribution deduction and inclusion amount for beneficiaries depends on whether a trust is classified as simple (IRC §§651-652) or complex (IRC §§661-663). See §§13.34-13.38.

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§13.32 a. Who Is a Beneficiary

The term "beneficiary" includes heirs, devisees, and legatees. IRC §643(c). An individual, estate, trust, or corporation may be a beneficiary. Treas Reg §1.643(c)-1. See *Diebold v Commissioner* (3d Cir 1952) 194 F2d 266 (corporation). A creditor, however, is not a beneficiary. See *Alfred I. duPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332. The recipient of a pecuniary gift in lieu of compensation is a beneficiary as long as receipt of the specific sum by the legatee under the terms of the governing instrument is not contingent upon the performance of duties. See *U.S. v Merriam* (1923) 263 US 179, 68 L Ed 240, 44 S Ct 69 (services not required, bequest free of income tax); Rev Rul 57-398, 1957-2 Cum Bull 93 (same); Rev Rul 67-375, 1967-2 Cum Bull 60 (services required, distribution taxable as compensation).

Beneficiaries who have a mandatory right to current income are the first taxed, whether they actually receive the income or not, but only to the extent of available DNI. See IRC §§652(a), 662(a)(1). Discretionary distributions *may* carry out income, once again only to the extent of available DNI. See IRC §661(a)(2).

Because a beneficiary's receipt of taxable income depends on the existence of DNI at the estate or trust level, the outcome of an audit of the trust or estate may affect a beneficiary. If the statute of limitations for adjusting the trust's or estate's return has expired, adjustment is foreclosed for the beneficiary. *Fendell v Commissioner* (8th Cir 1990) 906 F2d 362.

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§13.33 b. Death of Beneficiary or Termination of Trust

The final return of a deceased cash-basis beneficiary of a simple or complex trust includes the amount of DNI actually received during the year; the beneficiary's estate includes any undistributed balance due as income in respect of a decedent. Treas Reg §§1.652(c)-2, 1.662(c)-2; *Schimberg v U.S.* (ND Ill 1965) 245 F Supp 616, aff'd (7th Cir 1966) 365 F2d 70.

Termination of an estate, trust, corporation, or other entity that is a beneficiary of a trust or estate is treated in the same fashion as if the beneficiary were a natural person, except that income required to be distributed that was actually distributed to the entity's successors in interest is included in the terminated beneficiary's final return, and not the successors' returns. Treas Reg §§1.652(c)-3, 1.662(c)-3.

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2. Simple Trusts

§13.34 a. Definition of Simple Trust

A simple trust is one that is required to distribute all its trust accounting income currently, that does not provide that any amounts are to be paid or set aside for charity, and that does not distribute anything but current income. Treas Reg §1.651(a)-1.

"Required," of course, means that the trustee must have a duty to distribute the fiduciary accounting income under the terms of the governing instrument or applicable local law. Treas Reg §1.651(a)-2(a). A discretionary power to select among beneficiaries to receive the mandatory trust income distributions does not prevent the trust from being a simple trust. Treas Reg §1.651(a)-2(b). A trust is still simple even if the beneficiary rejects a distribution, and that beneficiary must still include the distribution in his or her gross income. *Stuart A. Seligson,* TC Memo 1992-320, aff'd (9th Cir 1993) 73 AFTR2d 784. A requirement that the trustee establish a depreciation reserve prior to distribution does not disqualify the trust from being a simple trust. Treas Reg §1.651(a)-2(a).

"Currently" means a present right to income. It allows for a modest deferral, such as waiting until after the close of the taxable year. Treas Reg §§1.651(a)-2; 1.652(a)-1. Indeed, even suspension of distribution by the trustee pending termination of a legal dispute as to the amounts properly distributable does not shift the liability for the tax from the beneficiary to the trust (Rev Rul 62-147, 1962-2 Cum Bull 151) or deny the trust a current deduction for that income.

A trust may be simple in one year and complex (*i.e.,* not simple) in the next. Treas Reg §§1.651(a)-1, 1.651(a)-2(c). For example, a trust will not be simple as to any year in which it distributes principal, such as the year of termination or a year in which the trustee makes a discretionary distribution of principal. Treas Reg §1.651(a)-3. Nor will it be a simple trust if it "provides" that any amounts may be paid to charity. IRC §651(a)(2). The regulations indicate, however, that "provides" means to actually distribute an amount to charity or to set aside an amount for charity for which a charitable deduction is allowed under IRC §642(c). Treas Reg §1.651(a)-4.

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§13.35 b. Trust's Deduction

A simple trust receives a deduction for the amount of fiduciary accounting income (FAI) required to be distributed. IRC §651(a); Treas Reg §1.651(b)-1. If the FAI required to be distributed exceeds the trust's DNI, the deduction is limited to the amount of DNI. Treas Reg §1.651(b)-1. In this situation, however, DNI does not include items of trust income not included in gross income, such as tax-exempt interest, foreign income, and excluded dividends. Treas Reg §1.651(b)-1. Thus, the beneficiary rather than the trust bears the burden of taxation.

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§13.36 c. Beneficiary's Inclusion

A beneficiary of a simple trust must include in his or her gross income the amount required to be distributed during the taxable year, again limited to DNI. IRC §652(a); Treas Reg §1.652(a)-1. Note that income required to be distributed includes amounts used to discharge any person's legal obligation. Treas Reg §1.652(a)-1. If FAI exceeds DNI and there is more than one distributee, each includes in his or her gross income a proportionate share of the DNI. IRC §652(a); Treas Reg §1.652(a)-2.

If a simple trust distributes appreciated (or depreciated) assets in satisfaction of a mandatory right to income, the distribution is treated as a sale or exchange and the trust recognizes gain (or loss) on the distribution. Treas Reg §1.651(a)-2(d). See §§13.51-13.53 for discussion of taxation of appreciated or depreciated assets distributed in kind.

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§13.37 d. Character

Income items distributed (or required to be distributed) by a simple trust have the same character in the hands of the beneficiaries as they had in the hands of the trust (*e.g.,* interest is still interest), and the tax treatment of those items depends on the status of the beneficiary, not of the trust. IRC §652(b); Treas Reg §1.652(b)-1. The amount required to be included in the simple trust beneficiary's gross income is treated as having the same proportion of each class of items comprising DNI as the total of each class of items bears to the total amount of DNI, unless the trust, or local law, specifically allocates otherwise. Treas Reg §1.652(b)-2(a). Specific allocation of items of income is possible, but must have independent economic effect other than income tax consequences. Treas Reg §1.652(b)-2(b). The examples given by the regulations are not particularly helpful, but it certainly is possible to direct that all the income from Blackacre be distributed to A, and the balance of the trust income be distributed to B. See Treas Reg §1.652(b)-2(a). Whether a trustee may direct that all tax-exempt income be distributed to A, and the balance of the income be distributed to B is, however, questionable in the eyes of the Service.

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§13.38 e. Allocation of Deductions

When calculating DNI, deductions attributable to one class of income are allocated to that income. Treas Reg §1.652(b)-3(a). If the deductions allocable to one class of income exceed that income; for example, if rental expenses exceed rental income, the excess may be allocated to other classes of taxable income included in DNI (including capital gains), subject to the passive loss rules of IRC §469 (see §13.19). Treas Reg §1.652(b)-3(d). Excess deductions attributable to the generation of tax-exempt income, understandably, may not be used to offset other classes of income. Treas Reg §1.652(b)-3(d). Thus, excess deductions attributable to tax-exempt income do not enter into the calculation of DNI. Deductions not attributable to one class of income, such as trustee commissions, safe deposit box rent, and state income and personal property taxes, may be allocated as the fiduciary deems best, but a portion must be allocated to tax-exempt income. Treas Reg §1.652(b)-3(b)-(c).

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3. Estates and Complex Trusts

§13.39 a. Complex Trust Defined

A complex trust is one that need not distribute all its trust accounting income currently, one that pays or sets aside amounts for charity, or one that distributes principal. See Treas Reg §1.661(a)-1. All estates are treated as complex trusts. Treas Reg §1.661(a)-1. Because distributions from complex trusts can take many forms, subpart C of part I of Subchapter J (IRC §§661-664) governs what amounts of income and/or principal are to be treated as distributed to the different classes of beneficiaries.

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§13.40 b. Estate's or Trust's Deduction

A complex trust or an estate receives a deduction for amounts of fiduciary accounting income *required* to be distributed. IRC §661(a)(1); Treas Reg §1.661(a)-2(a)(1). If the amount required to be distributed is an annuity, the trust or estate will be entitled to a deduction to the extent that the annuity is paid out of income. Reg §1.661(a)-2(b). The distribution deduction of an estate or complex trust excludes any item of DNI that is not included in the trust's or estate's gross income, such as tax-exempt interest. IRC §661(c); Reg §1.661(c)-1.

EXAMPLE: A trust has $25,000 of tax-exempt income and $25,000 of dividend income and no expenses and must distribute $30,000 per year to beneficiary A. The trust has DNI of $50,000, but only receives an IRC §661(a) deduction of $15,000 because the beneficiary's $15,000 share of tax-exempt income is not an item of gross income.

If DNI exceeds the amounts required to be distributed, a complex trust also receives a deduction for "other amounts" distributed. IRC §661(a)(2); Treas Reg §1.661(a)-2(a)(2). "Other amounts" includes all amounts properly paid other than those required to be distributed from income, such as distributions of principal, discretionary distributions (Treas Reg §1.661(a)-2(c)), and amounts used to discharge any person's legal obligation. Treas Reg §1.661(a)-2(d).

If the estate or trust makes a distribution or set aside that qualifies for the charitable deduction under IRC §642(c), the charitable deduction is first ratably apportioned among the classes of income entering into the computation of DNI. IRC §661(b); Treas Reg §§1.643(a)-5, 1.661(b)-2; Prop Treas Reg §1.643(a)-5.

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§13.41 c. Beneficiary's Inclusion

A beneficiary of an estate or complex trust must include in his or her gross income the sum of (1) the amount of income required to be distributed and (2) all other amounts properly distributed to him or her during the taxable year, but not more than his or her share of the distributable net income. IRC §662(a); Treas Reg §1.662(a)-1. If the amount distributed exceeds the estate's or trust's DNI, each beneficiary includes in gross income a proportionate share of DNI; the balance is a non-taxable gift under IRC §102(a). Treas Reg §1.102-1(d); IRC §663(a)(1). How much of the DNI each beneficiary picks up depends on what "tier" he or she is in for distribution purposes, whether the beneficiary's distributive right constitutes a "separate share," or whether the distribution is a bequest that does not carry out income. Sections 13.43-13.47 discuss tiers, §§13.28-13.30 discuss separate shares, and §§13.48-13.50 discuss specific bequests.

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§13.42 d. Character

Unless the estate or complex trust makes a deductible charitable distribution or set aside, distributions have the same character in the hands of the beneficiaries as in the hands of the estate or trust, and the tax treatment of those distributions depends on the status of the beneficiary, not the status of the estate or trust. IRC §662(b); Treas Reg §1.662(b)-1. Amounts required to be included in a beneficiary's gross income are treated as having the same proportion of each class of items comprising DNI as the total of each class of items bears to the total amount of DNI, unless the trust instrument or local law specifically allocates otherwise. IRC §662(b); Treas Reg §1.662(b)-1.

A specific devise of stock, or, for that matter, tax-exempt bonds, will carry its income with it, and thus requires specific allocation. See discussion in §13.57. Likewise, a gift of specific items of income requires allocation of that income to the recipient beneficiary. However, the regulations take the position that the latter allocation will not be recognized unless it has independent economic effect other than income tax consequences. Treas Reg §§1.652(b)-1, 1.662(b)-1. Economic effect is, of course, in the "eye" of the regulations a reason other than tax avoidance. Compare Treas Reg §1.652(b)-2(b)(2) with Treas Reg §1.652(b)-2(b)(3) (dollar amount to be paid first from one class of income is without economic effect whereas a portion of a specified class of income has economic effect).

If the trust or estate makes a charitable contribution that is deductible under IRC §642(c), the same character rule applies, except that the charitable deduction is ignored to the extent that it exceeds the amount of income required to be distributed currently, so that beneficiaries entitled to mandatory distribution of the trust's or estate's income get no benefit from the "excess" charitable deduction. IRC §662(b); Treas Reg §1.662(b)-2.

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§13.43 e. Tier System

Allocation of DNI ratably is permitted as long as all beneficiaries occupy the same position, for example, all as mandatory recipients of income. Ratable allocation between mandatory and discretionary recipients, however, runs afoul of IRC §102, which excludes property acquired by gift, bequest, or inheritance from treatment as income, *but not* the income from such property or a *gift or bequest of income* from such property. To avoid this conflict, subchapter J establishes a tier system to allocate DNI among classes of beneficiaries whenever total distributions exceed total DNI. The tier system first allocates DNI to those beneficiaries to whom distribution of fiduciary accounting income is mandatory, then to other recipients. If distributions to other recipients exceed remaining DNI, these distributions are identified as tax-free distributions of property under IRC §102(a).

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§13.44 (1) First-Tier Distributions

Fiduciary accounting income that is required to be distributed currently constitutes the first tier of distributions. IRC §661(a)(1); Treas Reg §§1.661(a)-2(a)(1), 1.662(a)-1(a)(1). It is included in a beneficiary's gross income, to the extent of DNI, whether or not it is actually distributed. IRC §662(a)(1); Treas Reg §1.662(a)-2(a). If the amount required to be distributed exceeds DNI (without taking into account any charitable deduction), each beneficiary includes a ratable amount of DNI in his or her gross income. IRC §662(a)(1); Treas Reg §1.662(a)-2(b). Income required to be distributed currently includes income *or principal* (such as an annuity) to the extent that it is actually paid out of current trust accounting income. IRC §662(a)(1); Treas Reg §1.662(a)-2(c). First-tier distributions also include amounts required to be paid pursuant to court order, such as a family allowance, to the extent such amounts are paid from trust accounting income. IRC §662(a)(1); Treas Reg §1.662(a)-2(c).

A first-tier distribution that qualifies for the charitable deduction does not qualify for the distribution deduction. IRC §663(a)(2); Treas Reg §1.663(a)-2. A charitable distribution may, however, have an effect on noncharitable first-tier distributions. If the amount required to be distributed, including any charitable distribution, is less than the DNI (computed without taking the charitable deduction into account), the noncharitable first-tier distributees simply take into account the amounts distributed to them. See Treas Reg §1.662(a)-2(e), Example 1. If, however, the amounts required to be distributed *exceed* the amount of DNI (once again, computed without taking the charitable deduction into account), tier one beneficiaries must include in gross income a ratable portion of DNI, the end result being that the charitable deduction is of no benefit to first-tier beneficiaries. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example 2.

If an estate or trust distributes appreciated (or depreciated) assets in satisfaction of a mandatory right to income, the distribution is treated as a sale or exchange and the estate or trust recognizes gain on the distribution. For further discussion of distributions in kind, see §13.51.

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§13.45 (2) Second-Tier Distributions

All distributions properly paid, credited, or otherwise required to be distributed, other than amounts "required to be distributed currently," fall into the second tier. Second-tier beneficiaries are taxable only to the extent that DNI is not used up by first-tier beneficiaries, and then only as to their proportionate share (based on amounts received) of the remaining DNI. IRC §662(a)(2); Treas Reg §§1.662(a)-3(a), 1.662(a)-3(c). "Other amounts distributed" do not, however, include specific gifts payable in fewer than three installments, or distributions that qualify for the charitable deduction. IRC §663(a); Treas Reg §§1.663(a)-1(a), 1.663(a)-2.

A complex trust or estate receives a deduction for, and a second-tier beneficiary takes into account, only those amounts "properly paid or credited." Thus, beneficiaries do not take into account the amount overpaid by mistake of fact or law, but the amount properly payable. See *Freuler v Helvering* (1934) 291 US 35, 78 L Ed 634, 54 S Ct 308. Similarly, payments by an executor to the beneficiary of a testamentary trust not yet established by court order are not properly paid or credited. *Hopper v Government of Virgin Islands* (3d Cir 1977) 550 F2d 844. But see *Buckmaster v U.S.* (10th Cir 1993) 984 F2d 379 (distributions made without court order at executor's peril were properly paid because of subsequent court approval). See also discussion in §13.51 for distributions in kind.

The statute requires actual payment or crediting. IRC §§661(a), 662(a). Nothing in the statute implies that distributions may be accrued. The payment of a debt to a creditor who is also a beneficiary of an estate or trust is not a distribution that is properly paid or credited. See *Alfred I. duPont Testamentary Trust* (1976) 66 TC 761, aff'd (5th Cir 1978) 574 F2d 1332. A distribution to a beneficiary who immediately loans the distributed funds back to the trust or estate, however, qualifies as properly paid, if not part of a prearranged plan. See, *e.g., Tobin Trust* (1951) 10 TCM 1251. Payment is, of course, a factual question. If the executor is a beneficiary and commingles personal and estate funds, the result depends on the facts of administration. See *McCauley v U.S.* (ED Ark 1961) 193 F Supp 938. On the other hand, payments to a third party for a beneficiary's benefit, such as taxes, qualify as payment. See Treas Reg §1.662(a)-4; *Grant v Nicholas* (D Colo 1955) 127 F Supp 236 (beneficiary's income taxes); Rev Rul 58-69, 1958-1 Cum Bull 254 (property taxes).

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§13.46 (3) The Intermediate Tier

As discussed in §13.44, first-tier beneficiaries get no benefit from a trust's or estate's charitable deduction, but because DNI takes the charitable deduction into account, it limits the amounts taxable to tier two beneficiaries. Thus, the charitable deduction is sometimes referred to as the "intermediate tier." If tier two distributions are equal to or less than DNI (computed without taking the charitable deduction into account) minus tier one distributions, the trust or estate gets the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example 1. If tier two distributions exceed DNI (once again, computed without taking the charitable deduction into account) minus tier one distributions, tier two beneficiaries get some or all of the benefit of the charitable deduction. IRC §662(a)(1). See Treas Reg §1.662(a)-2(e), Example 2. The end result is that the charitable deduction is of no benefit to first-tier beneficiaries.

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§13.47 (4) The Variable Tier

Annuities may be first-tier or second-tier distributions. If the annuity amount may only be paid from trust accounting income, it is first-tier. Treas Reg §1.662(a)-2(c). If the annuity amount may only be paid from principal, it is second-tier. Treas Reg §1.662(a)-3(b). If the annuity amount may be paid from either income or principal, it is variable-tier and its treatment will depend on the actions of the fiduciary and the existence of trust income. An annuity that may be paid from income or principal is deemed to come from income to the extent that there is fiduciary accounting income that has not been paid, credited, or required to be distributed to other beneficiaries during the taxable year. Treas Reg §1.662(a)-2(c). See Treas Reg §1.662(a)-2(e), Example 1. As with first-tier or second-tier distributions, annuity recipients are taxable to the extent of the allocable DNI, but the tier rules determine, as between the various beneficiaries, the taxable priorities. Moreover, charitable distributions may affect an annuity recipient's tier status, because the annuity recipient's status is dependent on the amount of FAI available for distribution. See Treas Reg §1.662(a)-2(e), Examples 1-2.

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G. Special Applications

1. Specific Gifts

§13.48 a. Taxation of Income from Gifts

Under IRC §102(a), gifts are excluded from the recipient's gross (*i.e.,* taxable) income. Income generated by gifts, however, is not excluded. IRC §102(b); *Irwin v Gavit* (1925) 268 US 161, 69 L Ed 897, 45 S Ct 475. Subchapter J determines whether a gift is one of property or of income. Thus, distributions in excess of DNI are, except in the case of throwback of trust income of foreign trusts and pre-March 1, 1984, multiple trusts, nontaxable gifts of property under IRC §102(a). IRC §663(a)(1); Treas Reg §1.663(a)-1(a).

To qualify as a nontaxable distribution, the amount distributed must be properly paid or credited as a gift or bequest of specific property or as a specific sum of money in not more than three installments and may not be paid from income. IRC §663(a)(1); Treas Reg §1.663(a)-1(a). This literally requires a will or trust; IRC §663(a) does not apply to intestate inheritances or property passing other than by direction of a will or trust. See Treas Reg §1.663(a)-1(c)(1)(ii). Gifts payable only from income literally do not qualify. IRC §663(a)(1) (last sentence). If the will or trust is silent or if payment may be made from either income or principal, the gift still qualifies (as long as not paid in more than three installments). See Treas Reg §§1.663(a)-1(b)(3), Example 1, 1.663(a)-1(c)(2), Example 3. Payment from accumulated income, however, does not qualify. Treas Reg §1.663(a)-1(b)(2)(i).

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§13.49 b. Specific Gifts Defined

To qualify as a gift or bequest of specific property or of a specific sum, the amount or property must be ascertainable at death or at the inception of the trust. IRC §663(a)(1); Treas Reg §1.663(a)-1(b)(1). Thus, a gift of 100 shares of Widget Co. stock or a gift of a sum equal to the value of decedent's Widget Co. stock at decedent's death will qualify (if not paid in more than three installments). IRC §663(a)(1); Treas Reg §1.663(a)-1(b)(1). See Rev Rul 86-105, 1986-2 Cum Bull 82 (gift of cash or other property with fair market value at date of distribution of $2000x). It is immaterial that the actual *value* distributed may be determined later, as would be the case if the bequest were of stock or a partnership interest. Treas Reg §1.663(a)-1(b)(1). Conversely, a gift of the residue does not qualify, nor does a gift of any other amount that is not ascertainable at the date of death. Treas Reg §§1.663(a)-1(b)(1), 1.663(a)-1(b)(2)(iii). Gifts that specify *kind* but not *amount* also fail to qualify as gifts of specific property. Treas Reg §1.663(a)-1(b)(1). See Rev Rul 72-295, 1972-1 Cum Bull 197 (gift of $8x worth of Y stock, but no more than all of the Y stock owned by the decedent). Had the gift in Rev Rul 72-295 been of $8x, it would have qualified, as would a gift of all of decedent's Y stock; but as stated ($8x of Y, but not more than all of Y), the amount was not ascertainable until distribution—it could have been $8x or a lesser amount of "all Y."

Pecuniary marital deduction gifts, such as a gift of $500,000 to a spouse, qualify as gifts of specific sums. Formula marital deduction gifts do not qualify. Treas Reg §1.663(a)-1(b)(1). For more about marital deductions, see chap 17.

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§13.50 c. Three-Installment Rule

The terms of the will or trust determine whether a gift or bequest is to be paid in more than three installments. Treas Reg §1.663(a)-1(a). Certain gifts, such as specific gifts of personal and household effects and specific gifts of other assets for which no time of payment is specified, are exempt from the three-installment rule. Treas Reg §1.663(a)-1(c)(1)(i). If the will or trust requires payment in more than three installments, the gift does not qualify, even if the fiduciary pays the bequest in three or fewer installments. Treas Reg §1.663(a)-1(b)(2)(iv). The three-installment rule applies on a beneficiary-by-beneficiary basis. See Treas Reg §1.663(a)-1(c)(2), Example 3. Separate gifts of stock, cash, real property, or other items for which no time of payment has been specified are treated as paid or credited in a single installment. See Treas Reg §§1.663(a)-1(c)(1)(iii), 1.663(a)-1(c)(2), Example 1. If, however, the will or trust specifies distributions of multiple items at the same time (*e.g.,* stock and cash at age 25), distribution of those items at the time specified is considered a single installment. See Treas Reg §§1.663(a)-1(c)(1)(iv), 1.663(a)-1(c)(2), Example 1(iii).

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§13.51 2. Distributions in Kind

Cash distributions do not have collateral effects, but distributions of property may cause the estate or trust to recognize gain or loss and may have a concomitant effect on the basis of the items distributed in the hands of the beneficiary.

Property acquired by specific bequest is property acquired by gift or inheritance. IRC §102(a). It is not a taxable distribution to the beneficiary, and the basis of the property in the beneficiary's hands is the property's value for estate tax purposes under IRC §1014(b)(1). Some gifts, such as options to purchase estate property, may consist of both a bequest and a purchase, with the basis determined by IRC §§1014 and 1012. See Rev Rul 67-96, 1967-1 Cum Bull 195.

Distributions of property other than specific gifts or pecuniary gifts that are satisfied in kind are subject to the general distribution rules, picking up a share of DNI equal to the basis of the property in the hands of the beneficiary, but not more than its fair market value. IRC §643(e)(2). The basis of the property in the hands of the beneficiary is the basis in the hands of the estate or trust adjusted for any gain or loss recognized on distribution. IRC §643(e)(1). This usually means that the basis (and amount distributed) will be the estate's or trust's adjusted basis, unless the fiduciary elects to recognize gain on the distribution, in which case the deduction and basis are increased to fair market value. See IRC §643(e)(3).

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§13.52 a. Distribution of Appreciated Property

Distribution of appreciated property in satisfaction of a beneficiary's right to a specific dollar amount, to specific property other than that distributed, or to trust accounting income that is required to be distributed currently, causes the estate or trust to realize gain and gives the recipient of the appreciated property a cost basis under IRC §1012(a). See Treas Reg §§1.661(a)-2(f), 1.1014-4(a)(3). See also *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217 (right to receive $5 million on attaining age 40); *Suisman v Eaton* (D Conn 1935) 15 F Supp 113, aff'd (2d Cir 1936) 83 F2d 1019 (right to receive $50,000 on attaining age 25); Rev Rul 68-392, 1968-2 Cum Bull 284 (property used to satisfy annuity amount). If, however, the appreciated property is in partial satisfaction of a specific gift because the estate cannot fully satisfy the gift, the recipient has no income and only the estate or trust recognizes gain or loss. See Rev Rul 66-207, 1966-2 Cum Bull 243 (distribution of estate's only asset in partial satisfaction of specific gift did not convert gift into residuary gift). Gain or loss is recognized on an item-by-item basis, not on an aggregate basis. See *Williams v McGowan* (2d Cir 1945) 152 F2d 570 (sale of business). Even a simple direction to equalize lifetime gifts made by the decedent can result in recognition of gain by the trust or estate, because it creates a right in the "shorted" beneficiary to a fixed amount. See Rev Rul 82-4, 1982-1 Cum Bull 99. For further discussion, see Danforth, *The Interplay of* Kenan v Comr. *and §663(a)(1)*, 30 Tax Mgmt Est, Gift & Tr J 139 (Mar.-Apr. 2005).

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§13.53 b. Distribution of Depreciated Property

The distribution of depreciated property in satisfaction of a beneficiary's right to a fixed amount causes an estate or qualifying trust to realize a nondeductible loss under the *Kenan* rule and gives the recipient of the depreciated property a cost basis under IRC §1012(a). See *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217; Rev Rul 68-392, 1968-2 Cum Bull 284. If, however, the distribution satisfies a specific bequest under IRC §663(a)(1), the recipient has no income and only the estate or trust realizes the loss. See IRC §643(e)(4); Rev Rul 66-207, 1966-2 Cum Bull 243. Note that a trust (other than an electing IRC §645 qualifying trust) will not recognize any loss. IRC §267(a)(1), (b)(6).

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§13.54 3. Property Representing IRD

Distribution of property that includes the right to income in respect of a decedent (IRD) does not cause immediate recognition of the IRD but puts the beneficiary in the decedent's shoes and requires recognition of the income as collected. IRC §691(a)(1); Treas Reg §1.691(a)-2(a)(3). The basis of the IRD asset is not stepped up (or down) under IRC §1014(a). IRC §1014(c); Treas Reg §1.1014-1(c)(1). The estate, trust, or other person acquiring the IRD item from the decedent takes over the decedent's basis. See Treas Reg §§1.691(a)-5(a), 1.691(a)-5(c), dealing with the treatment of an installment obligation. Transfer of an item of (*i.e.*, the right to receive) IRD by an estate, trust, or person otherwise acquiring it from the decedent to one not entitled to inherit it, is a taxable event that causes the transferor to recognize gain (even if the transfer is by gift) in the amount of the greater of the consideration received or the fair market value of the IRD. IRC §691(a)(2); Treas Reg §1.691(a)-4(a). Thus, for example, an estate's transfer of an installment note received from the decedent in satisfaction of a pecuniary formula marital deduction clause will cause immediate recognition of the previously unrecognized gain since the transfer constitutes a *Kenan* sale or exchange. See §13.52.

Nonrecognition only applies to IRD items received by inheritance from a decedent. See IRS Letter Ruling 200652028, where nonrecognition was allowed for a reformed trust. If the estate or trust sells property using the installment method and takes back a note, distribution of that note triggers immediate recognition of all deferred gain. IRC §453B(a).

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§13.55 4. Interest or Income on Gifts

There are two types of "specific" gifts: specific gifts of property other than cash and gifts of fixed sums of money (called general pecuniary devises). The former carry with them the income that they earn during administration (Prob C §12002(b)), while the latter are not entitled to a share of income, but only to statutory interest commencing 1 year after the decedent's death, unless the will or trust provides otherwise. Prob C §12003. The application of the latter statute to trusts, however, is uncertain because of an apparently inadvertent repeal of former Prob C §16314. This repeal appears to have been based on the questionable assumption that §16314 was replaced by Prob C §16340.

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§13.56 a. Interest on Pecuniary Devises

Interest on a pecuniary devise may or may not be covered by IRC §663(a)(1). If the interest payable is truly interest, IRC §163 governs the estate's or trust's deduction (none, because it is personal interest under IRC §163(h) (see Treas Reg §1.663(c)-5, Example 7; *Schwan v U.S.* (D SD 2003) 264 F Supp 2d 887), and the devisee takes it into account under IRC §61(a)(4). See *U.S. v Folckemer* (5th Cir 1962) 307 F2d 171. While IRC §§661-662 imply otherwise, because the interest certainly is an amount "properly paid," the Service's position is that interest is interest, not a distribution. See Treas Reg §1.663(c)-5, Example 7; Rev Rul 73-322, 1973-2 Cum Bull 44.

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§13.57 b. Income Generated by Specific Devises

While a specific devise of property other than cash, if payable from principal in three installments or less, does not carry out income because of IRC §663(a)(1), the income generated by the specific devise is part of the gross income of the estate or trust and is not covered by IRC §663(a)(1) because the generated income is not received by gift or inheritance. California law provides that a specific devise carries with it the income earned on the devised property, less expenses attributable to that property. Prob C §12002(b). Unless the will or trust specifies otherwise, the income earned by the specific gift property is not required to be distributed currently, and the specific devisee is a tier two beneficiary.

For purposes of allocating DNI, the specific devise constitutes a "separate share" of the estate or trust (see discussion in §13.28), and a portion of the estate's or trust's DNI will be attributed to that separate share based on its gross income and any applicable deductions or losses. Treas Reg §1.663(c)-2(b)(1). This usually means that dividends earned by a specific gift of stock or net rental income attributable to a specific gift of real property will be used to calculate the gift's share of gross income entering into DNI. See Treas Reg §1.663(c)-5, Example 8. A similar rule applies to non-cash items of gross income, such as undistributed partnership income or S corporation income attributable to a specific gift. Treas Reg §1.663(c)-2(b)(4).

If a distribution, other than of the specifically devised property, is made to the specific devisee, he or she will include a portion of the current year's DNI in income *as a second-tier beneficiary*. Thus, if tier one distributions use up available DNI, the specific devisee takes no taxable income into account. If DNI exceeds tier one distributions, the specific devisee takes into account his or her separate share's ratable portion of the excess DNI.

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5. Family Support Payments

§13.58 a. Widow's Allowance

There are two types of widow's/widower's allowances: one that is apparently due as a matter of right, like dower or curtsey found in common law states, and another that is awarded by the court. The former, of course, is not part of the subchapter J estate, the latter usually is, although some states (not including California) make the amount payable a matter of right not subject to the judge's discretion. As long as the amount, or award, is subject to the court's discretion, as in California, the payment is a distribution (presumably first-tier, because it is required by court order to be paid from income) deductible by the estate and taken into account by the surviving spouse to the extent of available DNI. Treas Reg §§1.661(a)-2, 1.662(a)-2(c).

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§13.59 b. Alimony-Type Payments

Frequently, a trust is created to make spousal support payments to the grantor's divorced spouse. Because the trust distributions satisfy the legal obligation of the grantor, the income would be taxable to the grantor as an owner under IRC §677 were it not for IRC §682, which provides for taxation of the income to the payee as a trust beneficiary. IRC §682(b). Thus, these payments are first-tier distributions to the extent of available DNI, as they are required by the trust instrument. Most spousal support payments cease at death of the grantor. If they continue for the life of the former spouse, the present value of the payments required to be made after the grantor's death is a deductible debt of the grantor's estate for estate tax purposes under IRC §2053(a)(3), even though the payments themselves are deductible first-tier distributions, because the rule prohibiting double deductions only applies to expenses of administration, not to the decedent's debts. Rev Rul 67-304, 1967-2 Cum Bull 224. See discussion of double deductions in §13.18.

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§13.60 c. Payments to Minor Children

Distributions of trust income during the grantor's lifetime that satisfy the grantor's obligation to support the grantor's minor children or to satisfy the grantor's other obligations are not deductible distributions, because they trigger ownership of the applicable portion of the trust's income under the grantor trust rules. IRC §677(a)(1); Treas Reg §1.677(a)-1(d). See *Christopher Stone*, TC Memo 1987-454, aff'd (9th Cir 1989) 867 F2d 613 (unpublished opinion) (private high school tuition). If trust principal is distributed in satisfaction of the grantor's obligation of support, the grantor is treated as a second-tier beneficiary. IRC §677(b); Treas Reg §§1.662(a)-4, 1.677(b)-1. Support obligations paid by a decedent's estate or by a trust after the grantor's death are first-tier or second-tier distributions in the same manner as other estate or trust distributions.

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6. Taxable Year of Inclusion

§13.61 a. Fiscal Year/Tax Year

Trusts other than qualified revocable trusts, tax-exempt trusts, and wholly charitable trusts must use the calendar year. IRC §644. Estates and qualified revocable trusts may elect a fiscal year. IRC §645. An estate or qualified revocable trust adopts a fiscal year by filing a federal income tax return for that taxable year even if income is otherwise insufficient to require a return. Treas Reg §1.441-1(c)(1). If a qualified revocable trust is to be treated as part of an estate (or as the estate if no executor has been appointed), the trust (and the executor, if any) must file an election on Form 8855. Treas Reg §1.645-1(c). Selection of a fiscal year other than the calendar year might be made to reduce the number of fiduciary income tax returns necessary to be filed by an estate, depending on the decedent's date of death and anticipated length of administration.

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§13.62 b. Deduction and Inclusion of Distributions

Internal Revenue Code §§651(a) and 661(a) determine when the trust's or estate's distribution deduction is to be taken, and §§652 and 662 govern inclusion by the beneficiary. For simple trusts, the deduction and inclusion occur during the tax year in which the income is required to be distributed. The same rule applies for first-tier distributions by complex trusts. For second-tier or variable-tier distributions (*i.e.*, other amounts properly paid or credited or required to be distributed) made by complex trusts, the phrase "for such taxable year" must be read as "during such taxable year." Note that amounts distributed in the first 65 days of an estate's or complex trust's taxable year may be treated as having been distributed in the preceding taxable year if the fiduciary properly elects to do so. IRC §663(b); Treas Reg §1.663(b)-1(a). The Service may grant an extension of time to make the election. IRS Letter Ruling 200250003.

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§13.63 c. Different Tax Years

If the tax year of an estate and the beneficiary differ, IRC §§652(c) and 662(c) direct that the amount includable by the beneficiary is based on the DNI of the estate for the year ending with or within the beneficiary's tax year. Treas Reg §1.662(c)-1; *Hay v U.S.* (ND Tex 1967) 263 F Supp 813 (1962 income distributed during fiscal year ending in 1963 was includable in beneficiary's 1963 return). Because trusts other than qualified revocable trusts and charitable remainder trusts must adopt a calendar year (IRC §644(a)) and almost all individuals have calendar years (IRC §441(g)), the different taxable year rule is inapt for trusts except in the year of the beneficiary's death. See §13.33. For those trusts that have corporate or other beneficiaries with fiscal years, the rule is the same as for estates.

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7. Terminating the Estate or Trust

§13.64 a. Generally

In the final year of a trust or estate, all of its assets (and liabilities) are distributed to the beneficiaries. All ordinary income received and capital gains realized during that year enter into DNI and are also distributed to the beneficiaries. IRC §643(a)(3). Consequently, the final return shows a second-tier distribution, in addition to any required first-tier distributions, that carries out all income. Unless an IRC §645 election was made for a qualified revocable trust (see Treas Reg §1.645-1(g)(3), (h)), an estate is deemed terminated when all of its assets have been distributed save for a reasonable amount set aside for contingencies. Treas Reg §1.641(b)-3(a)-(b). A trust is deemed terminated after the expiration of a reasonable period for the trustee to complete the administration of the trust. Treas Reg §1.641(b)-3(b).

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§13.65 b. Excess Losses and Deductions

Internal Revenue Code §642(h) allows a carryover of net operating losses, capital losses, and excess deductions to the "beneficiaries succeeding to the property of the estate or trust" on termination of the estate or trust. IRC §642(h); Treas Reg §1.642(h)-1(a). The beneficiaries succeeding to the property are those who must bear the burden of the carryover loss or excess deductions. Treas Reg §1.642(h)-3(a). For an intestate estate, the beneficiaries succeeding to the property are the heirs; for an insolvent estate, the beneficiaries are those who would have taken if the estate had not been insolvent. Treas Reg §1.642(h)-3(b). In the case of a will or trust, the beneficiaries succeeding to the property will usually be the residuary beneficiaries, but if a gift is determined with reference to the carryover, then that devisee also qualifies. Treas Reg §1.642(h)-3(c)-(d).

Each beneficiary succeeding to a portion of the property treats the loss carryover in the same manner as the trust or estate would have for purposes of computing taxable income, adjusted gross income, and any minimum tax, except that in the unusual case that a corporation is the beneficiary succeeding to the property, the loss is treated as a short-term loss. Treas Reg §1.642(h)-1(b). The carryover is first usable in the taxable year of the beneficiary in which the trust's or estate's year ends, but for purposes of determining any limitation on loss carryovers, the last year of the trust or estate and the beneficiary's year of receipt are each deemed to be 1 year. Treas Reg §1.642(h)-1(b). If the loss carryover expires in the year of termination, it is treated as an excess deduction. See Treas Reg §§1.642(h)-1(b), 1.642(h)-2(b).

It is not unusual for an estate to have excess deductions in the year of termination, because most assets have been distributed previously and the bulk of fees and commissions are usually paid in the final year. The excess deductions are only allowed in computing taxable income, not in computing adjusted gross income (Treas Reg §1.642(h)-2(a)), and thus are subject to the 2-percent floor of IRC §67. See IRC §67(b). The deduction is allowable only in the year in which the beneficiary receives it (*i.e.,* the year of the trust's or estate's termination) and may not be carried forward.

Distribution of a trust's or estate's assets on termination will bring the passive activity loss rules of IRC §469(j)(12) into play, increasing the basis of the distributed property and foreclosing use of the suspended losses. However, IRC §469(g)(1), relating to complete disposition of an interest, will apply if the termination is a taxable transaction of an estate, such as the funding of a pecuniary marital deduction trust.

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§13.66 III. TAXATION OF GRANTOR TRUSTS

Subpart E of Chapter J of the Internal Revenue Code treats the grantor of a trust, or in some cases the trust beneficiary, as the "owner" of some part, or all, of the trust under certain described circumstances, with the result that the grantor or other owner must take into account the income, deductions, and credits attributed to the "owned" portion of the trust.

Grantors will normally wish to avoid treatment as owners and the tax burden that results. But this wish often conflicts with the grantor's desire to retain as much control as possible over the management and distribution of the trust estate. In such cases, the difficult challenge for the estate planner is to give the grantor as much discretionary control as possible while skirting the terms that trigger ownership. However, under some circumstances, and for certain purposes, treatment of the grantor as owner for income tax purposes, but not for gift or estate tax purposes, may be quite advantageous and deliberately sought. In these cases, the difficult challenge for the estate planner is to give the grantor, or another person, sufficient powers to trigger ownership, but not enough to cause estate tax inclusion. See §13.135.

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§13.67 A. Definitions

Subpart E is (almost) a world unto itself. As such, it has its own definitions and concepts, often unique to this small corner of the Code. Because the definitions form the footings for the substantive walls, they are worth exploring.

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§13.68 1. Grantor

The grantor is the person who establishes the trust or who gratuitously transfers property to the trust. Treas Reg §1.671-2(e)(1). The term includes a corporation or partnership as well as an individual. IRC §7701(a)(1); Treas Reg §1.671-2(e)(4).

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§13.69 a. Foreign Grantors

Generally, persons who are not U.S. citizens or residents or domestic corporations are precluded from being treated as grantors under subpart E unless they hold a power to revoke all or some portion of the trust or are the only recipients of income or principal distributed by the trust or some portion of the trust. IRC §672(f)(1), (2). Trusts established by foreign grantors that fail one of the foregoing tests are subject to the rules of regular trust taxation. Treas Reg §1.672(f)-1(a)(1). If, however, a foreign grantor received the property used to establish the trust from a United States beneficiary, and holds powers that otherwise would cause the grantor to be treated as an owner of some portion of the trust, the powers held by the grantor are attributed to the beneficiary who is then treated as the owner of a portion or all of the trust. IRC §672(f)(5).

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§13.70 b. Spousal Attribution

A grantor is treated as holding any power or interest held by a person who was his or her spouse when the power or interest was created or who became the grantor's spouse after the power was created. IRC §672(e)(1). Divorced or legally separated spouses are exempted from the initial application of the spousal attribution rule. IRC §672(e)(2). However, a subsequent divorce (or legal separation) does not terminate application of the rule to spouses who were married when the power was created. See S Rep No. 99-313, 99th Cong, 2d Sess, 871 (1986). While the statute does not mention deceased spouses, they are arguably covered by the regulations that state that permanent and complete divestment of any interest that might enable the grantor or grantor's spouse to have income distributed to them, actually or constructively, will terminate the grantor's treatment as an owner (Treas Reg §1.677(a)-1(c)), and the similar rule stating that the timely renunciation of a power to withdraw terminates the application of IRC §678 (IRC §678(d); Treas Reg §1.678(d)-1). For a complete discussion of the spousal attribution rule, see Zaritsky & Lane, Federal Income Taxation of Estates and Trusts ¶7.10 (3d ed 2003).

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§13.71 2. Income

The word "income," when used within subparts A-D, means fiduciary accounting income determined under the terms of the governing instrument and applicable local law. IRC §643(b); Treas Reg §1.643(b)-1. California fiduciary accounting income thus includes a unitrust amount in the range of 3-5 percent. See Prob C §16328. However, the word "income," when used in regulations under subpart E, unless specifically limited, means income determined for tax purposes; the phrase "ordinary income" is used when referring to trust accounting income. Treas Reg §1.671-2(b). By implication, the use of the unmodified word "income" in subpart E, when not used in phrases such as "corpus and income" or "the corpus or the income" or in similar contexts denoting traditional trust principal and income concepts (see, *e.g.*, IRC §674(a), (b)(2)), also means income for tax purposes.

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§13.72 3. Adverse Party

An adverse party is any person having a substantial beneficial interest in a trust that would be adversely affected by the exercise or nonexercise of a power that he or she possesses respecting the trust. IRC §672(a); Treas Reg §1.672(a)-1(a). Thus, an adverse party must not only possess a power, but the exercise of the power must negatively affect the adverse party's beneficial interest in the trust, and that interest must be *substantial*. An interest is substantial if its value, in relation to the total value subject to the power, is "not insignificant." Treas Reg §1.672(a)-1(a). See *Chase Nat'l Bank v Commissioner* (8th Cir 1955) 225 F2d 621, 628 (former wife who had contingent remainder interest if children died and who held, with grantor, joint power to revoke, was not an adverse party). But see *Commissioner v Katz* (7th Cir 1943) 139 F2d 107 (wife who would receive share of income if minor child died without issue was adverse party). See also IRS Letter Rulings 200502014, 200247013 (distribution committee members who were also income beneficiaries were adverse parties). Of course, today, a spouse, by definition, cannot be an adverse party. IRC §672(e)(1). Nor would the interests held by the spouses in *Chase Nat'l Bank* and *Katz* meet the requirements of "beneficial" and "substantial" as discussed in §§13.73-13.74.

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§13.73 a. Possession of Beneficial Interest

An adverse party must possess both a power *and* a beneficial interest of such magnitude that any exercise of the power will diminish his or her economic interest. One who holds a general power of appointment over all or some part of the trust is deemed to have a beneficial interest in the trust that is adverse. IRC §672(a); Treas Reg §1.672(a)-1(a). See *Estate of Floyd G. Paxton,* TC Memo 1982-464 (son of grantor had absolute power to amend trust in his favor); *Corning v Commissioner* (2d Cir 1939) 104 F2d 329 (grantor's father had right to amend trust at any time). Of course, a beneficiary is only adverse with respect to his or her own interest. See Treas Reg §1.672(a)-1(b). Thus, for example, if the grantor retains the power to revoke the trust, but only with the concurrence of income beneficiary *A* who is entitled to one-half of the trust income, beneficiary *B* being entitled to the other one-half, *A* is only adverse with respect to her own interest, not with respect to *B*'s, and the grantor will be treated as owning *B*'s interest. See Treas Reg §1.672(a)-1(b). On the other hand, the mere fact that a person is an income beneficiary will not necessarily make him adverse with respect to a power over trust principal. Treas Reg §1.672(a)-1(c).

A power holder other than the grantor may be affected by the "adverse" interest rule, as for example, when one who is not an income beneficiary or remainderman possesses a power to withdraw a dollar amount of income—but only with the concurrence of the current income beneficiary. Because the withdrawal of any part of the income could diminish the amount payable to the income beneficiary, the latter is an adverse party with respect to the power holder.

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§13.74 b. Substantial Adversity

Substantial adversity is easy to determine if the entire interest of the power holder may be diminished, but not all possibilities are so simple. If the current income beneficiary can veto the exercise of a power held by one not otherwise a beneficiary of the trust to withdraw, annually, the greater of $5000 or 5 percent of the principal value of the trust, is his or her interest adverse? Stated otherwise, is its value in relation to the total value of the property subject to the power "not insignificant"? While the 5 or 5 power holder is only treated as owning 5 percent of the trust (including income), the income beneficiary's veto power is over 100 percent of the amount subject to withdrawal and thus is substantial.

PRACTICE TIP: The regulations give no apparent consideration to family relationships. For example, if a grantor establishes a trust that is to pay income currently to the grantor's son for life, with the remainder to the grantor's daughter's children, and gives the daughter the power during her life to distribute corpus to the grantor, the daughter will not be deemed adverse, notwithstanding the fact that she might be expected to favor her children by not exercising her power to distribute, because *she* has no beneficial interest. See Treas Reg §1.672(a)-1(d); *Commissioner v Prouty* (1st Cir 1940) 115 F2d 331, 335 (power to revoke trust and terminate child's remainder interest not adverse). While this result reflects a difficult choice in the application of tax policy, it is not made easier if we assume that the grantor is not the power holder's father, but is her former husband. In such case, the likelihood that she will now, in less happy times, consider exercising the power in his favor seems remote. On the other hand, she may favor her children even less, and the Code and regulations, if not attuned to personal relationships, are at least objective. See *Barber v U.S.* (5th Cir 1958) 251 F2d 436 (husband's power as trustee not adverse); *Chase Nat'l Bank v Commissioner* (8th Cir 1955) 225 F2d 621 (former wife not adverse).

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§13.75 4. Nonadverse Party

A nonadverse party is any person who is not adverse. IRC §672(b); Treas Reg §1.672(b)-1. Thus, a person who has no substantial beneficial interest or who possesses a substantial beneficial interest and a power but the exercise or nonexercise of the power does not adversely affect her beneficial interest is a nonadverse party. Similarly, an individual trustee who has no substantial beneficial interest in the trust and a corporate trustee are nonadverse parties, even though they could violate their fiduciary duties and not treat every beneficiary equally. Treas Reg §1.672(a)-1(a). The touchstone is economic self-interest, not moral or fiduciary constraints.

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§13.76 5. Related or Subordinate Party

In defining who are related or subordinate parties, the statute and regulations abandon the objective standard used for adverse and nonadverse parties in favor of a bright-line rule naming specific parties who are deemed to fall within the sphere of the grantor's control. Thus, the grantor's spouse (but only if living with the grantor), father, mother, child, grandchild, great-grandchild, brother, or sister (including those related by the half blood (see Rev Rul 58-19, 1958-1 Cum Bull 251)), any employee of the grantor, any corporation in which the grantor has significant stockholdings from the viewpoint of voting control, any employee of such corporation, or any subordinate employee of a corporation of which the grantor is an executive, are deemed to be related or subordinate parties. IRC §672(c); Treas Reg §1.672(c)-1. The foregoing are presumed to be subservient to the wishes of the grantor unless shown not subservient by a preponderance of the evidence. IRC §672(c); Treas Reg §1.672(c)-1. A showing of family or business animosity may be sufficient to prove that the grantor is not in control. See *Haft Trust v Commissioner* (1st Cir 1975) 510 F2d 43 (family attribution rules of IRC §318 not applied because of intrafamily rancor). However, in Rev Rul 80-26, 1980-1 Cum Bull 66, the Service expressed its disagreement with and its disinclination to follow *Haft*. But in any event, what grantor would suggest, much less agree, that such a person should be a trustee?

PRACTICE TIP: Related or subordinate parties are important only as to powers possessed by independent trustees to distribute income or principal to certain classes of beneficiaries (see IRC §674(c)), and with respect to a grantor's borrowing of trust funds from the trust (see IRC §675(3)). Yet when a drafter cannot use a corporate trustee and looks for someone who is qualified, it may be difficult to find someone who does not fall into the related or subordinate category. Conversely, persons falling outside the definition, such as brothers-in-law, sisters-in-law, nieces, nephews, employees of a corporation in which the grantor's stockholdings are not significant, or employees of the grantor's partnership, sole proprietorship, or limited liability company, are not presumed to be subservient to the grantor's wishes despite the fact that these unrelated and "non-subordinate" persons may well slavishly follow the directions of the grantor or acquiesce in the grantor's wishes. The existence of this class of persons to act as trustee offers a handy safe harbor for those drafters who cannot find individuals who qualify. It is also a clever trap for the unwary drafters who name "independent" trustees without thought, such as an in-law of a husband or wife in a community property state, because the in-law is a related or subordinate party as to the other spouse. See discussion of spousal attribution rules in §13.70.

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§13.77 B. Grantor Treatment—The Prism of Section 671

Each substantive section of subpart E states a general rule under which a grantor or another person will be treated as the owner of a portion of the trust, but its actual effect is viewed through the "eye" of IRC §671 which, like a magnifying glass, focuses the rays of the substantive sections and, if done properly (or improperly depending on your point of view), "burns" the grantor. The logical and deceptively simple scheme of taxation espoused by IRC §671 is that when the grantor or another person is treated as the owner of any portion of a trust, those items of income, deduction, and credit that are attributable to the "owned" portion of the trust are included in computing the taxable income and credits of the grantor or other person. Any remaining portion of the trust is subject to normal trust taxation, under subparts A through D. Treas Reg §1.671-2(d).

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§13.78 1. Ownership of Trust Portions

While the term "portion" is not defined, the regulations identify six different "portions" that form the conceptual fabric of ownership: ownership of the entire trust (Treas Reg §1.671-3(a)(1)); ownership of specific trust property and its income (Treas Reg §1.671-3(a)(2)); ownership of a fractional or dollar amount of the trust (Treas Reg §1.671-3(a)(3)); ownership of the ordinary income portion only (Treas Reg §1.671-3(b)(1)); ownership of the corpus portion only (Treas Reg §1.671-3(b)(2)); and ownership of a dollar amount of income (Treas Reg §1.671-3(c)). To determine the items of income, deduction, and credit allocable to the grantor or other owner, one must first identify the grantor or other person's interest or power, then determine the scope of that interest (*i.e.,* fractional, ordinary income, corpus, etc.) and, finally, determine the actual items owned through the mechanism of DNI. See Treas Reg §1.671-3(a)(2), (a)(3), (c).

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§13.79 a. Ownership of Entire Trust

Conceptually, ownership of the entire trust is the easiest "portion" to grasp. An obvious example of this type of ownership is a grantor who retains the power to revoke the entire trust. IRC §676. A less obvious example is a grantor's retained power to reacquire, in a nonfiduciary capacity, any trust asset by substituting property of equivalent value. IRC §675(4)(C). Ownership of the entire trust may also arise nonbeneficially, as when a grantor retains a discretionary power to distribute corpus to the remainderman (and thus to deprive the income beneficiary of income on the corpus distributed), or when a related or subordinate trustee has the discretionary power to distribute income and principal to one or more of the beneficiaries. In each of the foregoing cases, the effect is the same: the grantor is treated as the owner of the entire trust and takes into account all items of income, deduction, and credit (including capital gains and losses) in the same manner "as if the trust were not in existence." Treas Reg §1.671-3(a)(1).

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§13.80 b. Ownership of Specific Trust Property and Its Income

When the grantor or other person holds the right to withdraw one parcel of real property from the trust, or to exchange it for less than adequate and full consideration, and no other rights, the grantor owns the entire item of property subject to his or her power, *but only that portion*. As such, the grantor will take into account all items "directly related" to that item of property (see Treas Reg §1.652(b)-3(a), (d)), whereas items directly related to other trust property will be governed by the normal trust taxation rules. Treas Reg §1.671-3(a)(2). Items such as a trustee's commissions that relate to the entire trust and not to specific items owned by the grantor are apportioned between the trust and the grantor in light of local law, the terms of the trust, and the reasonable practices of the trustee. Treas Reg §1.671-3(a)(2). See Treas Reg §1.652(b)-3(b)-(c).

EXAMPLE: Although the regulations speak in terms of owning "specific trust property and its income" (Treas Reg §1.671-3(a)(2)), it is possible to own a specific item of corpus only or a specific item of income only. For example, if a grantor establishes a trust to pay the income to his mother for life with remainder except for Stock *X* to pass to his children at his mother's death when Stock *X* will revert to him, the grantor will be treated as the owner of Stock *X* if his reversionary interest in Stock *X* is greater than 5 percent of trust value at the inception of the trust. IRC §673(a). See Treas Reg §1.671-3(b)(2). See discussion of 5-percent rule in §13.92. Because the grantor, in this example, owns only a corpus interest in Stock *X,* only the income (and deductions and credits, if any) allocable to that item will be taken into account by him; items directly related to other trust property will be governed by the normal trust taxation rules. Items that relate to the entire trust will presumably be apportioned between the trust and the grantor in light of local law, the terms of the trust, and the reasonable practices of the trustee. Treas Reg §1.671-3(b)(2), (c). This allocation is accomplished by attributing to the grantor those items of income, deduction, and credit that would *not* be included under normal rules when computing the tax liability of the current income beneficiaries with respect to that item of property. Treas Reg §1.671-3(c). Accordingly, only capital gains or losses would be taken into account with respect to Stock *X*.

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§13.81 c. Ownership of Fractional or Dollar Amount of Trust

Ownership of a fractional portion or a dollar amount of the trust occurs, for example, when a grantor retains the power to revoke one-half of the trust or the power to withdraw $10,000 of trust principal each year. In either case, exercise of these powers will deprive the income beneficiary of the income generated by the property withdrawn, with the result that the grantor is treated as the owner of a fractional portion of the trust.

Perhaps the most common instance of ownership of a fractional portion (or dollar amount) of the entire trust is that of a trust beneficiary who holds the power to withdraw the greater of $5000 or 5 percent of the corpus of the trust each calendar year (a "5 or 5" power) so as to give the beneficiary access to corpus without gift or estate tax consequences. The holder of a 5 or 5 power is treated as the owner of a "vertical slice" of the trust and must take into account a share of the trust's income, deductions, and credits. IRC §678(a)(1); Treas Reg §§1.671-3(b)(3), 1.678(a)-1(a). When a grantor or other person owns a fractional or dollar amount of the trust, he or she will take into account a prorata share of all items of income, deduction, and credit of the trust. Rev Rul 67-241, 1967-2 Cum Bull 225.

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§13.82 d. Ownership of Entire Ordinary Income or Corpus Only

Fiduciaries have long distinguished between items of trust accounting income ("ordinary income" in subpart E vernacular) and trust corpus, or principal, and have carefully considered whether to charge items of expense to one or the other. Fiduciaries must balance the equitable, even chronological, rights of the present beneficiaries (income) against those of the future beneficiaries (remaindermen). The regulations recognize this historic distinction, converting trust concepts into tax concepts through the catalyst of DNI. Thus, if one is the owner of the income portion only, as when the grantor establishes a trust reserving only the income to himself or herself for life, he or she is required to take into account only ordinary income items and not items of income allocable to corpus. Treas Reg §1.671-3(b)(1). Actually, the grantor takes into account those items of income, deduction, and credit that a current income beneficiary would include if the income had been distributed to him or her, including those expenses that are allocable to corpus but taken into account when determining DNI (which, of course, would not ordinarily include income allocable to corpus). Treas Reg §§1.671-3(c), 1.677(a)-1(g), Example 1.

Conversely, only income allocable to corpus is included when computing the grantor's tax liability if ownership arises by reason of a power over (or interest in) corpus alone. Treas Reg §1.671-3(b)(2). A grantor's reversionary interest in a short-term ("Clifford") trust under prior law is perhaps the most common example of this possibility. When a grantor owns only the corpus portion of the trust, the grantor takes into account only those items of income, deduction, and credit that would *not* be included under subparts A through D when computing the current income beneficiary's tax liability. Treas Reg §1.671-3(c), 1.677(a)-1(g), Example 2.

A grantor treated as owning all trust accounting income will generally take items of *deduction* into account only if they reduce taxable income in the computation of DNI. Conversely, the grantor treated as owning all trust corpus will be entitled not only to the trust's excess deductions, but also to any losses incurred, capital or operating, because none of these items enter into the computation of DNI (see Treas Reg §1.677(a)-1(g), Example 2; *Glenn E. Edgar* (1971) 56 TC 717) except in the final year of the trust, when these items are passed out to the distributees (IRC §642(h); Treas Reg §1.642(h)-1). If, however, the grantor owns only a portion of the corpus, the excess deductions are allocable to the trust and not the grantor. *Glenn E. Edgar, supra*.

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§13.83 e. Ownership of Dollar Amount or Fractional Share of Income

A grantor or other person will be treated as owning a dollar amount of the trust's income if, for example, the grantor retains the right to the first $10,000 of trust *income* each year. In like fashion, a beneficiary who holds the right to withdraw $5000 or 5 percent *of the trust's income* each year will be an owner of a portion of the income of the trust. See *Fish v U.S.* (9th Cir 1970) 432 F2d 1278; Rev Rul 66-87, 1966-1 Cum Bull 217. Because a trust would need income exceeding $100,000 for the 5-percent rule to apply, in the great majority of cases the $5000 limitation will be applicable. In each case, the ownership interest is that of a dollar amount of trust income, and the regulations direct that the grantor or other owner *first* take into account items of trust accounting income and expense sufficient to cover the owned amount of trust accounting income, and *then* take into account a prorata portion of the amounts otherwise entering into the computation of DNI and a prorata portion of any credits. Treas Reg §1.671-3(c).

A grantor or other owner who has a right to a fractional share of trust income will presumably be treated in the same manner; namely, by only taking into account the items of income and expense sufficient to produce the required amount owned, and a prorata portion of other items entering into the computation of DNI. Treas Reg §1.671-3(a)(3). Because the right to a fractional portion of the income readily converts into a dollar amount, once the amount of income is known, this treatment makes good, and practical, sense.

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§13.84 f. Ownership During Limited Period

When a grantor or other person is treated as the owner of a portion of the trust for a limited period of time, as, *e.g.*, a power to revoke that is later renounced, the portion taken into account by the owner is not so easily determined. While the regulations under IRC §671 are silent, those under IRC §677 provide that if the grantor is divested of *every* interest causing ownership under IRC §677, the grantor will no longer be treated as an owner after the divesting event. Treas Reg §1.677(a)-1(c). See *Victor W. Krause* (1971) 56 TC 1242 (ownership under IRC §677 extinguished when gift tax due by reason of net gift paid); *David B. Keith* (1941) 45 BTA 644, acq 1942-1 Cum Bull 10 (ownership under predecessor of IRC §677 extinguished when grantor's debt paid).

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2. Termination of Grantor Status

§13.85 a. Termination by Renunciation

A renunciation divesting a grantor, or other owner, of every triggering interest is effective to remove a trust from grantor treatment. Complete divestment does not occur when an income beneficiary holding a power of withdrawal allows the power to lapse, because the beneficiary has a continuing interest in the trust. Renunciation of a power that causes grantor trust status may result in recognition of gain by the grantor. See Treas Reg §1.1001-2(c), Example 5; *Bernard Madorin* (1985) 84 TC 667 (trustee's renunciation of tainting power caused realization of gain to extent that trust's share of partnership debt exceeded basis); Rev Rul 77-402, 1977-2 Cum Bull 222.

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§13.86 b. Termination by Death

The death of the grantor terminates grantor trust status. See Rev Rul 75-267, 1975-2 Cum Bull 254. Note, however, that if the trust was funded with community property, it still remains a grantor trust with respect to the portion contributed by the grantor's surviving spouse. The surviving spouse's renunciation of the offending interest or power, as for example renunciation of a right to future distributions, would terminate grantor status, as would the subsequent death of the surviving spouse. See Treas Reg §1.677(a)-1(c). If the grantor is treated as an owner by reason of a power held by his or her spouse, the divorce or separation of the grantor and the spouse will not terminate grantor status. See IRC §672(e).

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§13.87 C. Grantor Trusts as Independent Tax Entities

A grantor treated as the owner of the entire trust takes into account all items of income, deduction, and credit (including capital gains and losses) in the same manner "as if the trust were not in existence." Treas Reg §1.671-3(a)(1). The phrase "as if the trust were not in existence" implies that a trust, entirely owned by a grantor, does not have independent existence. The argument for independent entity treatment is more or less compelling, depending upon the circumstances giving rise to grantor treatment.

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§13.88 1. Revocable Trusts

Nonentity treatment is clearly justified for revocable trusts. See Treas Reg §1.671-4(a). It is illogical to expect that a grantor can purchase assets from a *revocable* trust and obtain a new basis or sell assets to the revocable trust and give the trust a new basis. Were the revocable trust treated as an entity, the trust would recognize gain on the sale of assets to the grantor. This gain would, in turn, be taken into account by the grantor, but the purchase would still confer a new basis on the grantor for purposes of depreciation or future sale (in essence, buying basis). Likewise, if the grantor purchases revocable trust assets or sells assets to the trust with a fair market value less than their basis, the sale will generate a nondeductible loss without giving up ownership of the asset. It is difficult to imagine that any of this furthers the policy behind the grantor trust rules, and entity treatment is undoubtedly inappropriate whenever the grantor engages in transactions with a revocable trust.

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§13.89 2. Irrevocable Trusts

If a trust is not revocable by the grantor, but the grantor is treated as the owner of the entire trust for other reasons, entity treatment is somewhat easier to rationalize. For example, if a related or subordinate trustee can sprinkle income and principal among the trust beneficiaries, thereby causing the grantor to be treated as an owner, should a sale by the grantor to the trust of listed securities at their fair market value be treated as a nullity, or should the grantor be required to recognize gain? The Second Circuit, in *Rothstein v U.S.* (2d Cir 1984) 735 F2d 704, held that a grantor who had purchased the trust's entire corpus for a note was the owner of the entire trust, but that, nevertheless, the trust should be treated as an entity and the sale recognized. The Service disagrees with the *Rothstein* result. Rev Rul 85-13, 1985-1 Cum Bull 184.

Of course, the sale of an asset for cash at its fair market value by a nongrantor trust to the grantor normally will not result in grantor trust treatment, with the result that the grantor obtains a new basis and the trust recognizes gain on the sale. See *LaFargue v Commissioner* (9th Cir 1982) 689 F2d 845 (sale of assets to nongrantor trust in exchange for annuity). What if the sale for a note converts a nongrantor trust to a grantor trust? Stated another way, does the trust become a grantor trust the moment of the sale or the moment after the sale? If the trust becomes a grantor trust the moment of the sale, neither the trust nor the grantor will recognize gain on the transaction because the grantor is dealing with herself, and future income payments will be taken into account by the trust, which for tax purposes is the grantor. This is the position taken by the IRS in *Rothstein* and in Rev Rul 85-13. If grantor status attaches the moment after the sale, however, the trust will recognize gain and the grantor will obtain a new basis; future payments on the note presumably will result in recognition of gain by the trust that is attributed to the grantor, and interest payments on the note will result in the trust's receiving interest income that is attributable to the grantor, with the grantor having an offsetting investment interest deduction. This is the position taken by the court in *Rothstein*. "Section 671 makes it plain that it was not Congress's intention that the taxation of grantor/'owners' be governed by what might otherwise seem the sensible general principle that a taxpayer may not have meaningful dealings with himself." 735 F2d at 709. As a practical matter, the IRS position is more palatable and certainly less complex, and most estate planners treat sales to completely grantor trusts, particularly those that were grantor trusts before the sale, as nullities.

For discussion of planning strategies involving the installment sale of assets by the grantor to the trust, see §§25.42-25.44.

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§13.90 3. Partial Grantor Status

The entity question is more troubling when the grantor owns only a portion of the trust as, for example, when the grantor owns a portion of the *income* of the trust and takes into account a dollar amount of the trust's income. A sale to or purchase from this trust by the grantor (that does not otherwise cause ownership under the grantor trust rules) should be treated no differently than any other sale to a third party. When the income tax transaction does not affect the portion of the trust owned, the trust should be accorded entity treatment. Conversely, if the grantor owns the reversion but not the income interest, a sale to the trust or purchase from the trust should be ignored, because the transaction affects the entire portion of the trust owned.

The most difficult case is when one other than the grantor owns only a portion of the trust under IRC §678, as when a beneficiary has the right to withdraw the greater of $5000 or 5 percent of the trust corpus each year. If, however, the proper rule requires ignoring the trust when the transaction affects the portion of the trust owned and accords entity status to the trust when the transaction does not, it does not seem unreasonable to ignore a portion of the transaction commensurate with the portion owned and accord entity status to the balance. Thus, a sale to the trust (or purchase from the trust) by a beneficiary with the 5 or 5 power would be ignored to the extent of his or her ownership.

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§13.91 4. Conditions Precedent

The statute provides that encumbering the effective exercise of a power with a requirement of notice *or* with the expiration of an intervening period will not prevent the holder from being treated as having the power in question. IRC §672(d); Treas Reg §1.672(d)-1.

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D. Substantive Grantor Trust Rules

§13.92 1. Reversionary Interests

Internal Revenue Code §673 treats the grantor of a trust as the owner of any part of a trust, corpus or income, that will revert to the grantor or the grantor's spouse if the grantor's reversionary interest at the inception of the trust exceeds 5 percent of the value of the trust, *unless* (1) the trust was established for a lineal descendant of the grantor; (2) the descendant holds all of the present interests in the trust; and (3) the reversion will occur only if the descendant fails to attain age 21 (as with a "minor's qualifying trust" under IRC §2503(c)). IRC §673(b). For example, a grantor will not be treated as the owner of the income portion of a trust that distributes its income to his daughter for 35 years and then terminates and reverts to him if the applicable IRC §7520 rate is 9 percent or greater, because his reversionary interest, at the inception of the trust, is less than 5 percent. Nevertheless, the grantor will still be treated as the owner of the trust's corpus, because income attributable to it (*i.e.,* capital gains or accumulated income) will be distributed to him when the reversion falls in. IRC §677(a)(2); Treas Reg §1.673(a)-1(a).

Because ownership of property placed in a reversionary trust must be deferred for a very substantial period in order to avoid ownership of the trust income and because reversionary trusts have Chapter 14 gift tax problems unless all other interests in the trust are "qualified interests" (see IRC §2702(b)), few current irrevocable trusts, other than grantor-retained income trusts for nonfamily members, grantor-retained annuity trusts, grantor-retained unitrusts, personal residence trusts, and some charitable lead trusts, contain reversions. However, contingent reversions are commonly retained by grantors of qualified personal residence trusts in order to make them entirely grantor trusts.

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§13.93 2. Power to Control Beneficial Enjoyment

Certainly the most blatant instance of retained grantor control of beneficial enjoyment is a power in the grantor to direct the distribution of principal or income. Few trusts purporting to avoid grantor treatment would openly grant such a power. The Code recognizes, however, that the power to control the beneficial enjoyment of the principal or income of a trust may be more subtly exercised. See *William B. McGinnis,* TC Memo 1993-45 (grantor's right to demand immediate payment of demand loans would cause trust to terminate and gave grantor unchecked power over beneficial enjoyment of trust corpus). The scope of IRC §674, therefore, extends not only to the obvious, but also to those powers that are sometimes unknowingly retained, or in some instances, not retained at all but given to a person who is not adverse to the grantor. Internal Revenue Code §674(a) states the general rule that the grantor will be treated as the owner of any portion of a trust, the beneficial enjoyment of the principal or income of which is subject to a power of disposition exercisable by the grantor or a nonadverse party (or both) without the approval or consent of an adverse party. See IRS Letter Ruling 200730011 (ruling that unfettered power of grantor's spouse to withhold distributions to a beneficiary caused the trust to be a grantor trust under IRC §674(d)). Thereafter, IRC §674(b), (c), (d) identifies the exceptions to the rule, specifying those powers that may be exercised by anyone (including the grantor), those powers that may only be exercised by independent trustees, and those powers that may be exercised by anyone other than the grantor or the grantor's spouse.

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§13.94 a. Powers Exercisable by Any Person

Internal Revenue Code §674(b), listing powers that may be held by anyone, is the largest safe harbor on the grantor "coast" and offers the most protection to grantors who hold or who have given nonadverse parties the power to distribute principal or income of a trust. In most cases it is immaterial whether the powers are held by a grantor, a nonadverse party, or either as trustee: it is the scope of the power and not its characterization or the fact that it is held in a fiduciary capacity that is important. See Treas Reg §1.674(b)-1(a). Nevertheless, the title "Powers Exercisable by Any Person" is, at best, misleading, because two of the powers discussed below *may not* be exercised by the grantor except in limited instances.

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§13.95 (1) Power to Apply Income to Support of Dependent

The *mere existence* of a power to apply income (including accumulated income and capital gains) for the support of a dependent of the grantor (other than the grantor's spouse) will not cause grantor treatment so long as it is held by the grantor acting as a trustee or by another person, whether or not acting as trustee. IRC §§674(b)(1), 677(b); Treas Reg §§1.674(b)-1(b)(1), 1.677(b)-1(a). This exception functions expressly in conjunction with that of IRC §677(b). See discussion in §13.128. The exception of IRC §674(b)(1) applies to powers over *income*, meaning "taxable income." Treas Reg §1.671-2(b). As such, it applies to powers to distribute either trust accounting income or principal income (capital gains), or both. IRC §677(b); Treas Reg §1.677(b)-1(b).

Whether the grantor-trustee holds a discretionary (*i.e.*, not limited by an ascertainable standard) or nondiscretionary power is not relevant, so long as she is not *required* by the terms of the trust to make distributions. Treas Reg §1.677(b)-1(f). Of course, any distribution actually made for support will, by definition, satisfy the grantor's obligation to support that dependent and thus cause the grantor to be treated as an owner under IRC §§674 and 677 unless the distribution is made from accumulated income or corpus, in which case the grantor will be treated as if she were a trust beneficiary receiving the distribution. IRC §677(b); Treas Reg §1.677(b)-1(b).

A grantor *who is not a trustee* will be treated as an owner if he holds a power to apply income for the support or maintenance of a dependent. IRC §677(b); Treas Reg §1.677(b)-1(e).

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§13.96 (2) Deferred Power to Affect Beneficial Enjoyment

Internal Revenue Code §674(b)(2) is another "coordinating" exception, protecting powers that cannot affect the beneficial enjoyment of the income of a trust during a period that would be protected by IRC §673 were the power a reversionary interest. Since the emasculation of IRC §673 in 1986, this exception has had limited application. Under current law, any deferred power that the grantor holds will attract grantor trust treatment unless the value of the grantor's reversionary interest at the commencement of the trust is less than 5 percent. IRC §§673(a), 674(b)(2). Reversionary interests are discussed in §13.92.

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§13.97 (3) Testamentary Powers

Internal Revenue Code §674(b)(3) allows anyone to hold a power, exercisable by will, to control the beneficial enjoyment of a trust, but this exception does not apply to income that may be accumulated for disposition by the grantor unless the accumulation is subject to the approval or consent of an adverse party. IRC §674(b)(3); Treas Reg §1.674(b)-1(b)(3). Literally, this means that a power to appoint, exercisable presently or at death, by any document other than a will, causes the grantor to be treated as the owner of the portion of the trust subject to that power. Compare Treas Reg §1.674(b)-1(b)(3) with Treas Reg §1.664-3(a)(4) (power to revoke a recipient's interest in a charitable remainder trust exercisable only by will).

EXAMPLE: If the grantor's son (a nonadverse party) has the power to designate how a trust that may accumulate income is to be distributed among his children at his death, and that power is exercisable by an instrument other than a will, the grantor is treated as the owner of the entire trust, unless some other exception applies. While the son's power is "testamentary" in character, as it only takes effect at death, it does not meet the statutory requirement of being exercisable by will and, accordingly, albeit somewhat illogically, fails the test.

A power to appoint by will encompasses six alternatives, including the powers to designate who will receive the trust income only, trust corpus only, the entire trust, accumulated ordinary income, accumulated corpus income, and accumulated income—ordinary and corpus. The grantor can actually hold the power to designate, by will, who will receive the income or corpus (or both) of the trust without incurring grantor status so long as neither ordinary income nor capital gains are accumulated without the consent of an adverse party. Since capital gains are normally added to principal, *i.e.,* accumulated, this exception as regards grantors is more illusory than real. Moreover, retention of the power to determine who will ultimately take the trust assets, even if exercisable only by will, certainly will cause the trust to be included in the grantor's estate under IRC §§2036, 2038.

Any other person can have the power, exercisable by will, to designate who will receive the income, corpus, accumulated income, accumulated capital gains, or the entire trust without causing the grantor to be treated as the owner. Thus, the beneficiary of an irrevocable trust may be given a power to appoint the trust by will at his or her death, whether or not ordinary income or capital gains are accumulated, without causing the grantor to be treated as the owner.

The nature of the power of appointment, whether general or limited in the estate and gift tax sense, is apparently not relevant to the application of the IRC §674(b)(3) exception, although if the power holder has a general power exercisable in his or her favor, the power holder will be treated as an adverse party to the extent of the power.

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§13.98 (4) Power to Allocate Among Charitable Beneficiaries

Any person, including the grantor, may hold a power to determine the beneficial enjoyment of corpus or income irrevocably payable to charities qualified under IRC §170(c). IRC §674(b)(4); Treas Reg §1.674(b)-1(b)(4). For instance, a grantor may establish an irrevocable trust, the income of which must be paid for 5 years to such charities as he annually selects, with the remainder to his children, and the grantor will not be treated as the owner of the income subject to his power of allocation. Similarly, a grantor may establish an irrevocable trust and retain the power to distribute the principal and income to such qualified charities as he might annually select, or may establish an irrevocable trust that accumulates income and adds it to corpus, with the corpus and accumulated income to pass at the grantor's death to a qualified charity to be named by him, in each case without being treated as the owner of the trust's income (including capital gains) for income tax purposes. If, however, the grantor includes a charity or other organization not qualified under IRC §170(c) in the list of permissible beneficiaries, the grantor will be treated as the owner of the portion of the trust subject to the power. Of course, retention of a power to select charitable beneficiaries will cause the assets subject to that power to be included in the grantor's estate under IRC §§2036, 2038.

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§13.99 (5) Power to Distribute Corpus

Certain powers to distribute corpus are also exempt from the application of the grantor trust rules. IRC §674(b)(5). As might be expected, the scope of these exempt powers is limited, but is still broad enough to allow substantial flexibility when drafting a trust.

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§13.100 (a) Governed by Definite Standard

A power to distribute *corpus* to income beneficiaries or remaindermen may be held by the grantor or any other person without triggering grantor treatment so long as the power is limited by a reasonably definite standard set forth in the trust instrument. IRC §674(b)(5)(A); Treas Reg §1.674(b)-1(b)(5)(i). The regulations make it quite clear that the power must be nondiscretionary by requiring that the standard be clearly measurable, that the holder must be legally accountable, and that the determination of the holder *may not* be conclusive. Treas Reg §1.674(b)-1(b)(5)(i). Thus, granting a trustee the power to distribute principal to a beneficiary for health, education, support, or maintenance as the trustee, in the exercise of the trustee's reasonable discretion, deems necessary, qualifies for the exception, whereas the same power, exercisable in the trustee's *absolute* or *sole* discretion, does not. Truly discretionary powers, as for example, the power to distribute so much of the principal or income as the trustee in the trustee's absolute discretion deems best, are clearly outside this exception, as are those that impose pseudo standards such as pleasure, happiness, and the like. The parallel to the definition of a reasonably defined standard in other parts of the Code is obvious. See, *e.g.,* IRC §§2041(b)(1)(A), 2514(c)(1); Treas Reg §§20.2041-1(c)(2), 25.2514-1(c)(2). What constitutes an ascertainable standard is a question of state law. See, *e.g., Estate of Ewing v Rountree* (6th Cir 1965) 346 F2d 471.

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§13.101 (i) Distributee Must Be Beneficiary

While the *statute* speaks in terms of beneficiaries or a class of beneficiaries "whether or not income beneficiaries," the *regulations* limit the class of permissible distributees to income beneficiaries or remaindermen. Compare IRC §674(b)(5)(A) with Treas Reg §1.674(b)-1(b)(5)(i). It is not uncommon to allow invasion of principal for a family member who is neither an income beneficiary nor a remainderman, as for example, the grantor's mother. Thus, a power held by a nonadverse party who is not a trustee or by a related or subordinate trustee to invade for one who is not an income beneficiary or remainderman does not fall within the defined standard exception and, accordingly, causes the grantor to be treated as owner. See Treas Reg §1.674(b)-1(b)(5)(iii), Example 1. Of course, in a broader sense, the grantor's mother is a *beneficiary* of the trust because she can be benefited by it. See Prob C §24(c). Because she is a permissible beneficiary, the grantor's mother arguably falls within the class of recipients included within the statutory exception. However, the Senate Committee Report (S Rep No. 1622, 83d Cong, 2d Sess (1954), reprinted in 1954 US Code Cong & Ad News 4621, 4719) supports the regulations and, given the age of the regulations, they undoubtedly have been "enacted" by the passage of time. See TD 6217, 1956-2 Cum Bull 336. Suffice it to say that if a person who is not an income beneficiary or remainderman is to be a permissible distributee, another exception to the beneficial enjoyment rule should be sought. The absurdity of the "exception to the exception" is demonstrated by actually making the grantor's mother an income beneficiary, for example, to the extent of the lesser of 1 percent of the income or $10 per year. Now, as an "income beneficiary," she will apparently qualify as a recipient of principal for health, support, and other emergency. Of course, this subterfuge is not necessary unless the trustee is a grantor or a related or subordinate party, since the power will otherwise be protected by IRC §674(c).

In those cases when the grantor wants to be the owner of the entire trust for income tax purposes, powers similar to those discussed in the previous paragraph should suffice if the trust requires that income be accumulated by a trustee who is related or subordinate to the grantor. For example, assume a trust that accumulates income until the youngest child of the grantor gains age 30, at which time the trust terminates and distributes principal equally to the grantor's children. If a grantor retains a power of invasion that is subject to a defined standard that includes the grantor's mother as well as the grantor's children in the permissible class of "invadees," the grantor will be treated as the owner of the entire trust (*i.e.,* accumulated ordinary income and capital gains added to principal) under IRC §674(a) by reason of the trust's failure to qualify under IRC §674(b)(5)(A), without adverse estate tax consequences (see *Jennings v Smith* (2d Cir 1947) 161 F2d 74; Rev Rul 73-143, 1973-1 Cum Bull 147), except to the extent that the trust is deemed to satisfy the grantor's obligations of support (see *Richards v Commissioner* (10th Cir 1967) 375 F2d 997).

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§13.102 (ii) No Power to Add Beneficiaries

The exception for a power to distribute corpus if limited by a reasonably defined standard does not apply if anyone can add beneficiaries, of income or corpus, to the trust, unless the added beneficiaries are after-born or after-adopted children. Giving a nonadverse party this power will cause the grantor to be treated as the owner of the corpus portion of the trust, or of the entire trust if income is accumulated. As a practical matter, grantors are hesitant to give anyone the power to add beneficiaries, because the power holder just might do that. The power to add beneficiaries is not limited to the grantor or a nonadverse party. See IRC §674(b)(5) flush language ("any person"), although possession by an adverse party may limit its effect.

The limitation on this exception to the exception (*i.e.,* no power to add beneficiaries unless they are after-born or after-adopted children) is phrased in terms of *children*. However, the scope of this limitation is not entirely clear. The reference most likely includes at least the grantor's children, but probably not just anybody's children (any added beneficiary must be somebody's child). For example, if the grantor establishes a trust for the benefit of her children but reserves the power to add after-born or after-adopted children as beneficiaries, it would appear that the power falls *inside* the permitted class, because those children are her children. If, however, she establishes the trust for her grandchildren and retains the power to add after-born or after-adopted grandchildren, it would appear that the power falls *outside* the permitted class. What if the grantor gives her children the power to add *their* after-born or after-adopted children as beneficiaries of the trust? If "children" refers to the children of the holder of the power, the power would qualify for the exception. Of course, this is accomplishing indirectly what could not be accomplished directly.

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§13.103 (b) Power to Advance Corpus to Income Beneficiary

A grantor or nonadverse party may hold a power that is not limited by an ascertainable standard to distribute corpus to current income beneficiaries and not be treated as an owner if the distribution will be charged to the distributee's separate trust share or to a proportionate part of the trust held for payment of income to that beneficiary. IRC §674(b)(5)(B); Treas Reg §1.674(b)-1(b)(5)(ii). However, if someone other than a current income beneficiary is a permissible recipient of corpus, or the trust corpus generally is charged with the distribution, the power will not fall within the exception, although even here, unless the trustee is a grantor or a related or subordinate party, the power will be protected by IRC §674(c). As a practical matter, this exception will not apply unless there is a separate trust for each current income beneficiary or unless the separate share rule of IRC §663 applies. See §13.28.

EXAMPLE: Grantor establishes a trust that is to pay all of its income in equal shares to the grantor's two nephews for 5 years, at which time the trust will terminate and distribute its corpus in equal shares to the grantor's nieces. The trust gives the grantor the power to distribute corpus to the nephews but requires that such invasions be charged to that nephew's separate share of the trust. The grantor's power falls within the exception. IRC §674(b)(5)(B); Treas Reg §1.674(b)-1(b)(5)(ii), (iii), Example 3. Arguably, the exception applies even if, under the same facts, on termination of the trust the corpus is distributable equally among the class comprised of grantor's nieces *and* nephews. In other words, the fact that the exercise of the power may shift the ultimate ownership of corpus is irrelevant; it is the grantor's inability to vary the income interests and interim distributions of corpus that controls.

The exception for the power to advance corpus to current beneficiaries does not apply if anyone can add beneficiaries, of income or corpus, to the trust, unless the added beneficiaries are after-born or after-adopted children. See discussion in §13.102. Of course, a grantor's retention of this power will cause the portion of the trust subject to the power to be included in her estate. IRC §§2036(a)(2), 2038(a)(1); Treas Reg §§20.2036-1(a), 20.2038-1(a).

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§13.104 (6) Power to Withhold Income Temporarily

Internal Revenue Code §674(b)(6) allows a grantor or nonadverse party to withhold trust accounting income from a current income beneficiary temporarily, so long as the effect is no more than to postpone the time of enjoyment. This exception gives the power holder a very limited power to shift income from one beneficiary to another, but only if the accumulated income must be paid: (1) to that beneficiary, his estate, or his appointees under a broad special power of appointment; (2) to the beneficiary, his appointees, or designated alternative takers (excluding the grantor); or (3) to the current income beneficiaries in specified shares. Treas Reg §1.674(b)-1(b)(6)(i).

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§13.105 (a) Payment to Beneficiary, Estate, or Appointees Under Broad Power of Appointment

The first method of permissible accumulation allows the trust to be structured so that accumulated income ultimately passes to the beneficiary from whom it was withheld, his or her estate, or his or her appointees under a general power of appointment or under a limited power of appointment excluding only the beneficiary, her estate, her creditors, or the creditors of her estate. IRC §674(b)(6)(A); Treas Reg §1.674(b)-1(b)(6)(i)(a). A power to withhold in this form is often found in a "minor's qualifying trust," which must pay accumulated income to the beneficiary, her estate, or the takers under a general power of appointment, or to alternate takers in default of its exercise, in order to constitute a present interest and qualify for the annual gift tax exclusion. IRC §2503(c)(2)(B); Treas Reg §25.2503-4(a)(3). A trust that grants the income beneficiary the power to appoint the corpus, including the accumulated income, by will among a broad class of appointees excluding only the beneficiary, his or her estate, his or her creditors, or the creditors of the estate is another example of a trust containing this exception.

Because this exception focuses on the disposition of accumulated income, there seems to be no reason why any more than the income accumulated need be subject to the power of appointment (or distributed to the income beneficiary's estate) in order for the grantor to avoid being treated as an owner. Moreover, while IRC §674(b)(6) speaks in terms of temporary postponement, withholding income from the current income beneficiary under this exception could actually exclude the income beneficiary entirely.

Granting the income beneficiary a power to appoint the accumulated income to anyone other than herself, her creditors, her estate, or the creditors of her estate necessarily means that the grantor or the grantor's spouse is a permissible distributee and thus must be considered an owner under IRC §677(a)(2). The regulations resolve the conflict by providing that if a trust otherwise qualifies for this exception, the trust income subject to the power will not be treated as owned by the grantor by reason of IRC §677. See Treas Reg §1.674(b)-1(b)(6)(i)(c). As helpful as this is, it falls short of realistic protection because the existence of the power of appointment itself may cause the grantor to be treated as the owner of the income that may be accumulated unless the power is a general power (which makes the holder an adverse party under IRC §672(a)), or unless the power is only exercisable by will under IRC §674(b)(3). This is probably an oversight (or a clever trap). To be safe, powers should be exercisable only by will, rather than by inter vivos instrument, until and unless the law changes, if grantor status is to be avoided.

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§13.106 (b) Payment to Beneficiary, Appointees, or Designated Alternative Takers

The second method of permissible income accumulation allows the trust to be structured so that any income accumulated must ultimately be distributed to (IRC §674(b)(6) (flush language); Treas Reg §1.674(b)-1(b)(6)(i)(b))

- The beneficiary from whom it was withheld; or
- If the beneficiary does not survive a date of distribution that could reasonably be expected to occur during his or her lifetime, to either
- The beneficiary's appointees under any general or special power of appointment or to alternate takers in default of its effective exercise; or
- If the beneficiary has no power of appointment, to designated alternate takers whose shares have been irrevocably specified in the governing instrument so long as they exclude the grantor, his or her spouse and their estates.

The second method of qualifying is, indeed, quite common. Myriad grantors have established trusts with distributive provisions that direct income to be distributed or accumulated until the grantor's child attains a certain age, *e.g.,* 25, when the trust terminates and income and principal passes to the child; if the child does not survive, the trust will be distributed to the grantor's other children equally. See Reg §1.674(b)-1(b)(6)(ii), Example 3. In fact it seems difficult *not* to qualify for this category of the exemption unless the period of postponement is tied to the life of a person younger than the income beneficiary or to a term of years beyond the beneficiary's life expectancy. Problems arise if the income beneficiary has a limited life expectancy, if a less "attainable" date of distribution is specified (is it reasonable to expect the beneficiary to live until distribution at age 95?), or if no alternate takers with specified shares are named (distribution to "heirs" would probably not qualify, but distribution to "cousin Minnie's issue per stirpes" might).

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§13.107 (c) Payment to Current Income Beneficiaries in Specified Shares

The third method of permissible income accumulation allows the trust to accumulate income as long as, on later distribution, the accumulation passes to the current income beneficiaries in shares that are irrevocably specified in the trust instrument. IRC §674(b)(6)(B); Treas Reg §1.674(b)-1(b)(6)(i)(c). Here, accumulated income may be shifted, at least in part, from one beneficiary to another. For example, assume that the grantor's two children are the income beneficiaries, that the grantor may accumulate the income of a child's share if she wishes, and that all corpus and accumulated income is distributable equally to the grantor's two children on termination of the trust in 10 years. If the grantor accumulates all of child *A*'s income while allowing child *B*'s income to be distributed, on termination one-fourth of the income will have been shifted from *A* to *B*. Treas Reg §1.674(b)-1(b)(6)(ii), Example 1.

This exception also applies, by its literal terms, if there are unequal shares with later equal, or unequal, distribution of accumulated income. For example, if *A* is to receive 30 percent of the trust income and *B* is to receive 70 percent, but the trust income may be accumulated, and on termination the trust corpus (and accumulated income) will be distributed equally to *A* and *B*, accumulated income can be shifted either to *A* or to *B*. However, because fixed shares have an inherent lack of flexibility, and flexibility is easily available by using other exceptions under IRC §674, there is a practical limit on the misuse of this particular exception.

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§13.108 (7) Power to Withhold Income During Disability

Internal Revenue Code §674(b)(7) allows a grantor or any other person to withhold trust income from a beneficiary while the beneficiary is legally disabled. Legally disabled includes not only incompetency but also "old-fashioned" minority, that is, while a beneficiary is under the age of 21. IRC §674(b)(7)(B); Treas Reg §1.674(b)-1(b)(7). In practice, most trusts do not give the trustee, or any other person including the grantor, the power to distribute or accumulate trust income on *the occurrence* of disability, but some spendthrift clauses do just that. On the other hand, trusts commonly grant a trustee the power to withhold distributions while a beneficiary is a "minor" or a disabled adult (as in a special needs trust); and "crisis" trusts, which allow trustees to withhold principal or income distributions while a beneficiary struggles with substance abuse or other problems, are not uncommon.

Income accumulated during a period of legal disability need not be distributed to the income beneficiary or the beneficiary's appointees or alternate takers as is required under other exceptions discussed in the preceding sections. Accordingly, the possibility that economic benefits will be shifted is somewhat greater, although probably less likely when practical realities are considered. However, IRC §674(b)(7) contemplates a separate trust or the existence of separate shares, and not a sprinkling trust, because the permitted power is expressed in terms of a singular beneficiary. While the statute speaks in terms of income, which could mean trust income or taxable income, the regulations speak in terms of a power over trust accounting, or ordinary, income. Treas Reg §1.674(b)-1(b)(7). The regulations seem correct, and giving the grantor the power to withhold income during a beneficiary's disability should not cause the grantor to be treated as the owner of trust corpus (including accumulated income) absent other prohibited powers, although retention of that power would cause inclusion of the property subject to it in the grantor's estate. IRC §2036(a)(1); Treas Reg §20.2036-1(b)(3).

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§13.109 (8) Power to Allocate Between Corpus and Income

Internal Revenue Code §674(b)(8) allows a grantor, or any nonadverse party, to hold the power to allocate receipts and disbursements between the corpus and income accounts "even though expressed in broad language." Treas Reg §1.674(b)-1(b)(8). Apparently, this exception applies even if the power to allocate is subject to the absolute control of the grantor. So long as the power must be exercised in a fiduciary capacity, it is not objectionable from the standpoint of shifting economic benefits. However, when receipts may be treated as income or principal in the uncontrolled discretion of the grantor not acting as trustee, the possibility of benefit-shifting seems substantial, and phrases such as "absolute" or "sole" discretion are best avoided.

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§13.110 b. Powers Exercisable by Independent Trustee

Internal Revenue Code §674(c) provides what is likely the most frequented safe harbor from the storms of the grantor trust rules, namely, a power given an independent trustee to sprinkle principal or income. The propriety of this shelter seems almost unquestionable, because the essence of trust law is the duty of the trustee to act fairly towards remaindermen as well as income beneficiaries. Thus, the independent fiduciary's responsibility (and liability) acts as a practical bar to the control of beneficial enjoyment by the grantor.

The elements of this exception are two: the first limits the class of permissible holders of the sprinkling power to trustees, none of whom may be the grantor and no more than half of whom may be related or subordinate to the grantor; the second limits the power itself to accumulation or distribution of income or payment of corpus to a beneficiary, beneficiaries, or within a class of beneficiaries. IRC §674(c); Treas Reg §1.674(c)-1. Both elements must be satisfied.

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§13.111 (1) Permissible Holders

The power may only be held by a trustee who is independent, or by trustees, no more than one-half of whom are related or subordinate parties. Under "related or subordinate" as defined by IRC §672(c), the scope of the disfavored class is limited. Granting the power to a trustee who is the grantor's daughter-in-law, mother-in-law, or other-in-law, by definition, vests the power within the acceptable class (remembering that when community property funds a trust, the in-law of one of the grantors is a disfavored relative of the other). Of course, a bank or trust company (unless a corporation in which the grantor has significant voting interest) will also qualify as an independent, though nonadverse, trustee.

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§13.112 (2) Permissible Distributions

Income may be accumulated, distributed, or apportioned to, for, or within a class of beneficiaries (IRC §674(c)(1)), and principal may be distributed to a beneficiary or beneficiaries or class of beneficiaries, whether or not income beneficiaries (IRC §674(c)(2)). For example, an independent trustee can be granted the power to accumulate the income or to sprinkle it among the grantor's children and can also be granted the power to distribute principal to the children *and* to the grantor's mother and sister, all without causing the grantor to be treated as the owner of the trust.

PRACTICE TIP: The substantial degree of flexibility permitted by this power makes its use very attractive, even to a grantor who hesitates to give up control, particularly when one or more (but not more than half) of the trustees may be related or subordinate parties. So long as trustees are required by state law to act unanimously (see, *e.g.,* Prob C §15620), the nonindependent trustee has a veto power over the independent trustee's actions, subject to the fiduciary restraints of local trust law. Interestingly, as long as there are two trustees, one of the trustees *may* be an income or corpus beneficiary. For example, the trust could name one of the grantor's children, a beneficiary, as a co-trustee with the grantor's spouse. In this case, because the child is an adverse party, the requirements of IRC §674(c) are met, and the child will not be treated as the owner under IRC §678(a)(1) as he or she does not have the *sole* power to vest the income or corpus in himself or herself. If this (or any similar) combination of trustees is to prevent the grantor from being treated as an owner, the trustee-beneficiary's interest must be entirely adverse. While all of the foregoing seems obvious, the problems of using related trustees cannot be overemphasized, particularly because trustees do die or resign. Thus, planners must consider every possible combination of proposed co-trustees *and events* if the grantor is to be assured of the desired tax consequences.

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§13.113 c. Powers Exercisable by Trustee Other Than Grantor or Spouse

Internal Revenue Code §674(d) provides a final exception to the reach of IRC §674(a) by allowing a trustee, who is not the grantor or the grantor's spouse if living with the grantor, to sprinkle *income* to or accumulate *income* for one or more beneficiaries or a class of beneficiaries, if the power is limited by a reasonably definite external standard. Treas Reg §1.674(d)-1. See §13.100 for a discussion of the term "reasonably definite standard." Because the regulations under IRC §674(d) use the word "income" rather than the phrase "ordinary income," they imply that this power relates to "taxable income" (ordinary income plus capital gains). Treas Reg §1.671-2(b). Thus, this power literally includes the power to distribute realized capital gains but not corpus.

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§13.114 d. Further Limitation—Removal of Trustee

The regulations impose a further limitation on the IRC §674(b), (c), and (d) exceptions, namely that neither the grantor nor the grantor's spouse may have an unrestricted power to remove, substitute, or add trustees. Treas Reg §1.674(d)-2(a). (The regulations do not actually mention a power held by the grantor's spouse because they predate the addition of IRC §672(e), but they must be read in light of that provision.) Thus, a grantor may not retain the power to remove an independent trustee and substitute any person including himself or herself, but may have the power to remove an independent trustee and substitute a new independent trustee. The key, of course, is the requirement that the grantor, or the grantor's spouse, not have the power to alter the trust so that it would not qualify under IRC §674(c).

If the power to substitute is exercisable only under limited conditions, as for example, upon the resignation of the current trustee, the grantor will not be treated as an owner *until* the power "vests." Treas Reg §1.674(d)-2(a). How long thereafter the grantor will be treated as an owner will likely depend on the scope of the power, although absent strict limitations, the Service most certainly will argue that once lighted, the flame is eternal.

PRACTICE TIP: The power to substitute oneself as trustee may be held by a nonadverse party because the regulations speak only of possession by "the grantor." However, the effectiveness of granting a nonadverse party the right to substitute himself or herself as a trustee is limited. For example, assume the grantor gives his sister the power to substitute herself for an independent trustee such as a bank or trust company. While possession of such power will not cause the grantor to be treated as an owner under IRC §674(c), its exercise will, if the result is to make less than one-half of the trustees independent. For that reason, a grantor wishing to avoid attributed ownership is unlikely to grant such power to anyone.

Of course, a direct taint may be placed on the trust by naming the grantor's spouse, brother, sister, etc. as sole trustee of a trust that contains a power to sprinkle, because this will cause the grantor to be treated as the owner of the portion of the trust that is subject to the power. By the same token, granting the grantor's spouse a power to add related or subordinate trustees or to remove the independent trustee and replace it with a related or subordinate trustee will also cause the grantor to be treated as the owner of the portion subject to the sprinkling power. Once again, the likelihood that non-tainted successor trustees will be appointed or that the holder of the trustee removal power will die must be considered to assure continuous grantor trust treatment. Moreover, the scope of the power must also be considered: a grantor who wants to take only the trust's ordinary income and deductions into account will not be happy if he or she is treated as the owner of the corpus and the trust's capital gains or accumulated income or as the owner of the entire trust. In most cases, the scope of the power (to accumulate income and to distribute corpus) will cause ownership of the entire trust. However, if only income may be accumulated or only corpus distributed, the ownership will be limited to that particular portion (or fractional or dollar amounts, as the case may be).

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§13.115 3. Administrative Powers

Just as IRC §674 forbids a grantor from exercising direct control over beneficial enjoyment of trust assets on pain of incurring grantor treatment for income tax purposes, so, too, does IRC §675 forbid a grantor from exercising indirect control of beneficial enjoyment through manipulation of its administrative mechanisms. And yet, such an analysis goes too far, because the proscription of administrative powers only relates to those that might be used to benefit the grantor, not those that might vary the economic interests of the beneficiaries. Compare Treas Reg §1.675-1(a) with IRC §674(b)(8). Internal Revenue Code §675 contains four "prohibited controls," the existence of which will cause the grantor to be treated as an owner:

- The power to deal with the assets of the trust for less than adequate and full consideration (IRC §675(1); Treas Reg §1.675-1(b)(1));
- The power to borrow the corpus or income without adequate interest or security (IRC §675(2); Treas Reg §1.675-1(b)(2));
- Any borrowing from a related or subordinate trustee not completely repaid before the beginning of the current taxable year (IRC §675(3); Treas Reg §1.675-1(b)(3)); and
- Certain general powers of administration not exercisable in a fiduciary capacity, including the power to vote (IRC §675(4)(A); Treas Reg §1.675-1(b)(4)(i)), or control the investment of trust funds in (IRC §675(4)(B); Treas Reg §1.675-1(b)(4)(ii)), stock of a corporation in which the grantor holds a significant voting interest; and the power to reacquire the trust corpus by substituting assets of equivalent value (IRC §675(4)(C); Treas Reg §1.675-1(b)(4)(iii)).

In each of these cases, the initial question is whether such a power exists. For example, does the trust expressly state that the grantor may purchase the assets of the trust for less than adequate and full consideration? Answering that question in the affirmative, except as to the limitation on actual borrowing, makes the grantor the owner of the portion of the trust subject to the power. On the other hand, if the answer to that question is negative, the inquiry becomes a factual one and the language of the trust is not necessarily determinative. Treas Reg §1.675-1(c). Thus, the fact that the trust does not contain language *prohibiting* the grantor from borrowing from the trust without adequate interest or security does not mean that the trust is tainted and that the grantor must be treated as an owner. Similarly, the fact that the grantor has borrowed from the trust and has not repaid the loan does not necessarily mean that the grantor will be treated as the owner of a portion of the trust. But see Rev Rul 86-82, 1986-1 Cum Bull 253. If, however, examination discloses that the latter loan is without adequate interest or security or is from a related or subordinate trustee, the grantor *will* be treated as an owner.

If the grantor possesses a power to *amend* the administrative provisions of the trust in a manner that would give the grantor one or more of the forbidden IRC §675 powers, the grantor will be treated as an owner of the portion of the trust subject to amendment from its inception. Treas Reg §1.675-1(a). While the regulations do not discuss the effect of another person holding a "tainting" power to amend, that power, if held by a nonadverse party, will be sufficient to subject the grantor to ownership. For example, if the grantor's brother can, at any time, direct the trustee to sell the assets of the trust to the grantor for less than adequate and full consideration, the grantor will be treated as the owner of the portion of the trust subject to the power. See IRC §675(1); Treas Reg §1.675-1(b)(1). Likewise, if the grantor's brother has the power to amend the trust so that the trustee must sell the assets of the trust to the grantor for less than adequate and full consideration, the grantor should, similarly, be treated as the owner of the entire trust.

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§13.116 a. Power to Deal With Assets for Less Than Adequate and Full Consideration

The power of the grantor or nonadverse party, exercisable without the consent of an adverse party, to deal with the trust or to dispose of the principal or income for less than adequate consideration will cause the grantor to be treated as the owner of the portion of the trust subject to the power. IRC §675(1); Treas Reg §1.675-1(b)(1). See *Chandler v Commissioner* (3d Cir 1941) 119 F2d 623 (power to direct sales of trust property to himself or others at his own price); *Charles T. Fisher* (1933) 28 BTA 1164 (power to reacquire trust property on payment of small amount, grantor owner as to excess over that amount). While it will be the rare grantor who intends to hold such power, and even rarer when a trust expressly gives such power to the grantor, if the grantor controls the investments of the trust or retains a substantial managerial power, the Service may contend that the grantor owns the income earned by the property subject to that power. See, *e.g., U.S. v Morss* (1st Cir 1947) 159 F2d 142 (grantor-trustee's broad power to manage, sell, and otherwise deal with stock of company controlled by his family held subject to fiduciary limitations). The Service has not been historically successful in asserting that the power to direct investments causes a grantor to be treated as an owner, except in those instances when the grantor was the trustee and engaged in self-dealing or other egregious activities. See, *e.g., Ellis H. Warren* (1941) 45 BTA 379, aff'd (6th Cir 1942) 133 F2d 312 (grantor was trustee with broad powers who sold stock of his company to trust retaining stock and vote). It appears that the usual state trust law prohibition against self-dealing by trustees will be sufficient to prevent any assertion that the grantor, acting as trustee, may deal in other than a fiduciary capacity with the trust. See, *e.g., U.S. v Morss, supra* (power to invest in absolute and uncontrolled discretion); *Commissioner v Betts* (7th Cir 1941) 123 F2d 534 (power to direct trustee on investments); *Estate of Benjamin Lowenstein* (1944) 3 TC 1133, acq 1944 Cum Bull 18 (grantor as trustee could invest principal of trust in any manner whatsoever in his sole discretion); *Carroll L. Griffith* (1945) 4 TCM 317 (power to trade on margin). The regulations presume this result. Treas Reg §1.675-1(c). Thus, unless the trust contains express authority to deal with the grantor for less than adequate and full consideration in money or money's worth, determination of grantor trust status will be a factual question. Moreover, the very existence of the power in the hands of a person other than the grantor or the grantor's spouse is probably sufficient to make that person adverse, because it is, in reality, the power to take the trust's assets. See Treas Reg §1.675-1(b)(1); *Laura E. Huffman* (1939) 39 BTA 880 (grandson, secondary beneficiary, was adverse party because he held power to amend trust in his favor, as well as power to revoke and allow trust to revert to grantor).

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.117 b. Power to Borrow

§13.117 b. Power to Borrow

Internal Revenue Code §675 restricts the power of the grantor or the grantor's spouse to borrow from the trust. Section 675 contains four different borrowing rules, described in §§13.118-13.119.

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§13.118 (1) Restrictions on Power to Borrow

The first two of the borrowing rules arise from IRC §675(2) and prohibit retention of the untrammeled power to borrow. First, the trust may not grant the grantor or any nonadverse party a power that enables the grantor to borrow the trust corpus or income, directly or indirectly, without furnishing adequate interest or security. If the trust does contain such a provision, the grantor will be treated as the owner of the portion of the trust subject to the power. IRC §675(2); Treas Reg §1.675-1(b)(2). Second, the trust may authorize the trustee to make loans to any person without regard to interest or security, but if the grantor or the grantor's spouse is the sole trustee holding that power, he or she will be treated as the owner of the portion of the trust subject to the power. Conversely, the grantor or grantor's spouse while acting as sole trustee may have the power to determine the adequacy of interest rates and security, but not the power to act without regard to either. IRC §675(2); Treas Reg §1.675-1(b)(2).

A trust may, of course, grant a trustee other than the grantor or the grantor's spouse the power to lend without regard to the adequacy of interest or security, but the grantor who establishes a trust containing that power runs the risk that the trustee will take the trust at its word and actually do so to the detriment of the beneficiaries and the despair of the grantor. Thus, the likelihood that this power will be granted is small. Moreover, unless the trust expressly relieves the trustee from obtaining adequate interest and security and from the duty to act in a fiduciary capacity, few trustees will make such loans, and if and when such a loan is made, the trustee will likely require, as a practical matter, some form of indemnification. See, *e.g., Estate of Alice Gwynne Preston* (1950) 14 TC 1391, 1393, aff'd (2d Cir 1951) 187 F2d 531 (secured loan at adequate interest to grantor of entire corpus by independent corporate trustee).

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§13.119 (2) Restrictions on Actual Borrowing

The third and fourth of the borrowing rules are unusual in that they deal not with the existence of a power, but with the actual borrowing activity of the grantor or the grantor's spouse. IRC §675(3). See, *e.g., Larry W. Benson* (1981) 76 TC 1040; *Mau v U.S.* (D Hawaii 1973) 355 F Supp 909. Under these rules, the actual borrowing of the trust corpus or income by the grantor without furnishing adequate interest or security will cause the grantor to be treated as an owner, even if the trustee is not the grantor and acts under a broad general lending power that allows the trustee to make similar loans to anyone. In addition, even when the grantor has furnished adequate interest and security for the loan but the trustee is the grantor or a related or subordinate party, the grantor will be treated as an owner unless the loan is repaid before the beginning of the taxable year. IRC §675(3); Treas Reg §1.675-1(b)(3); *Mau v U.S., supra*.

Because it is possible, and even likely, that a grantor will want to preserve the right to borrow from the trust should circumstances require, and because a general lending power in the trustee does not cause a grantor to be treated as owner, most irrevocable trusts will grant the trustee the power to lend, leaving general fiduciary principles to measure the fairness of the loan. Internal Revenue Code §675(3) recognizes this by deeming any loan that carries adequate interest and security, made by an independent trustee to a grantor, or grantor's spouse, as not sufficiently beneficial to the grantor to cause the grantor to be treated as an owner. IRC §675(3). See Treas Reg §1.675-1(a), (c); *Estate of Alice Gwynne Preston* (1950) 14 TC 1391, aff'd (2d Cir 1951) 187 F2d 531.

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§13.120 c. General Powers of Administration

Internal Revenue Code §675(4) lists three types of powers of administration that, if exercisable in a *nonfiduciary* capacity by *any person* without the approval or consent of someone in a fiduciary capacity, will cause the grantor to be treated as the owner of the property subject to the power. The prohibited powers of administration are (IRC §675(4)):

- The power to vote or to direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;
- The power to control investment either by directing investments or vetoing proposed investments of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; and
- The power to reacquire the trust corpus by substituting other property of an equivalent value.

The regulations also narrow the scope of the statute by indicating that ownership turns on the exercise of the prohibited powers by any *nonadverse party* rather than by "any person," which makes sense because an adverse party who holds one of these powers is not likely to exercise it primarily for the benefit of the grantor. Treas Reg §1.675-1(b)(4).

Internal Revenue Code §675(4) does not mention partnerships, limited liability companies, or other entities in which managerial control could be retained by the grantor. While the same rules that apply to corporations should apply to these entities, it is difficult, or perhaps impossible, to hold a power to direct the management of a partnership or limited liability company without being subject to the fiduciary obligations that such status entails. The regulations articulate the policy behind these prohibitions, namely that the grantor will be treated as the owner of any portion of a trust that by its terms may be exercised primarily for the benefit of the grantor rather than the beneficiaries of the trust. Treas Reg §1.675-1(a).

The regulations presume that powers held by *a trustee* will be exercised in a fiduciary manner. Treas Reg §1.675-1(b)(4). If the power may be exercised by someone other than a trustee, the determination of whether it has been exercised in a fiduciary capacity hinges on the other terms of the trust and on the facts and circumstances surrounding the "creation and administration" of the power. Treas Reg §1.675-1(b)(4). Thus, grantor trust status may initially be avoided by expressly requiring that the prohibited administrative powers be exercised *only* in a fiduciary capacity. Conversely, expressly stating that the prohibited administrative powers *are exercisable in a nonfiduciary capacity* will invoke grantor trust status. The determination of whether IRC §675(4) powers are exercisable in a fiduciary or nonfiduciary capacity is probably not based, however, on the fact that the powers exist, but rather on the actual administration of the trust. See IRS Letter Ruling 200709011.

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§13.121 d. Power to Revoke

As might be expected, a grantor will be treated as the owner of any portion of a trust that the grantor, the grantor's spouse, or any nonadverse party can revest in the grantor unless the power can only be exercised with the consent of an adverse party. IRC §676; Treas Reg §1.676(a)-1. See *Carkhuff v Commissioner* (6th Cir 1936) 83 F2d 626, cert denied (1936) 299 US 568 (trust revocable with concurrence of corporate trustee). Thus, if state law allows the grantor and all beneficiaries to join to terminate a trust (see, *e.g.,* Prob C §15404), the grantor will not be treated as an owner by reason of possible revocation, because some or all of the beneficiaries will be adverse. In certain instances, these rules may be used to good effect. For example, when the grantor fears loss of capacity, it may be appropriate to make the trust irrevocable but give the grantor a power of revocation exercisable in conjunction with a nonadverse party such as a trustee or friend to prevent importuning relatives or others from badgering the grantor to change the trust. Retention by multiple grantors of a power of revocation that is exercisable only in conjunction with the other holders is a power of revocation as to the holders' proportionate interests. See *DeAmodio v Commissioner* (3d Cir 1962) 299 F2d 623.

The power to revoke need not be express. Courts have held, under prior law, that powers to reacquire part of the corpus on payment of a small sum (see *Charles T. Fisher* (1933) 28 BTA 1164) or to direct sales of trust property to the grantor or others (see *Mather v Commissioner* (6th Cir 1946) 157 F2d 680, cert denied (1947) 330 US 819) or to direct sales of trust property to the grantor at a price of his choosing (*Chandler v Commissioner* (3d Cir 1941) 119 F2d 623) are tantamount to a power to revoke. Of course, under current law, these powers run afoul of IRC §675(1), which prohibits dealing with the trust for less than adequate and full consideration. On the other hand, when state law holds that a trust will be revocable unless expressly made irrevocable, the good intentions of the grantor will not save him or her from being treated as the owner of a trust that is not expressly irrevocable. *Gaylord v Commissioner* (9th Cir 1946) 153 F2d 408. But see *Flitcroft v Commissioner* (9th Cir 1964) 328 F2d 449 (10-year trust retroactively amended by state court action was irrevocable).

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§13.122 4. Income for Benefit of Grantor

Internal Revenue Code §677 treats a grantor as the owner of any portion of a trust whose income, without the approval or consent of an adverse party, may be handled in any of the following ways:

- Distributed to the grantor or the grantor's spouse. IRC §677(a)(1).
- Held or accumulated for future distribution to the grantor or the grantor's spouse. IRC §677(a)(2). See Rev Rul 54-306, 1954-2 Cum Bull 240 (income accumulated for grantor while war clause in effect was taxable to grantor); Rev Rul 57-363, 1957-2 Cum Bull 326 (grantor owner of income accumulated for possible later distribution to trust beneficiary or to grantor).
- Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse that are not irrevocably payable to charity. IRC §677(a)(3).

The grantor is treated as the owner only if the distributions can be made to the grantor or the grantor's spouse without the consent of an "adverse party" as defined in IRC §672(a). See §13.72. For example, an irrevocable trust that provides for distributions to be made either by the grantor in conjunction with a distribution committee or by the distribution committee alone to a class that includes the members of the committee will not be treated as owned by the grantor for income tax purposes but may be included in the grantor's estate under IRC §2036. IRS Letter Rulings 200647001, 200502014, 200247013, 200148028. Such trusts are sometimes used for asset protection purposes in jurisdictions (not California) that provide protection from a grantor's creditors even if the grantor can receive discretionary distributions, but also may be useful outside the context of asset protection if a client has low-basis assets and will not have an estate tax problem. Income tax liability can be shifted to family members in lower tax brackets. For further discussion, see Scroggin, *The Estate Defective Trust*, 83 Taxes 69 (Jan. 2005). However, the IRS has issued a news release (IR-2007-127) in which it indicates that these letter rulings may not be consistent with Rev Rul 76-503, 1976-2 Cum Bull 275, and Rev Rul 77-158, 1977-1 Cum Bull 285. These revenue rulings discuss Treas Reg §25.2514-3(b)(2) concerning the rule that jointly held powers to appoint to holders of the powers are not general powers if they can only be exercised with the consent of persons having a substantial interest in the property adverse to the exercise of the power. See §§9.17-9.21. In both rulings, the IRS noted that a deceased power holder would be replaced by a successor rather than the remaining power holders, as in the letter rulings. See discussion in 29 CEB Est Plan Rep 51 (Oct. 2007).

In keeping with the "grace period" of IRC §673(d), possession of one or more of the foregoing powers will not cause trust ownership if exercise of the power cannot affect beneficial enjoyment of the income for a period that would preclude reversionary interest treatment under IRC §673. IRC §677(a) flush language. See Treas Reg §1.677(a)-1(e) (which has not been amended to reflect the 1986 changes to IRC §673). Similarly, the fact that the grantor acting as a trustee or co-trustee, or another person acting individually or as trustee, has the power to distribute funds to beneficiaries whom the grantor is obligated to support (other than the grantor's spouse), will not cause the grantor to be treated as an owner except to the extent that the funds are actually so distributed. If the distribution is made from accumulated income or corpus, however, the grantor is not treated as an owner but as a beneficiary. IRC §677(b). Internal Revenue Code §677 is not applicable, however, if the income is taxable to the grantor's spouse in respect of divorce or separation. Treas Reg §1.677(a)-1(a)(1), (b)(2). See IRC §§71, 682.

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§13.123 a. Direct Distribution to Grantor or Spouse

If a grantor creates a trust reserving the income interest for life, it seems logical to tax the grantor on the income received by reason of the reserved interest. What is perhaps less logical is the fact that, under subpart E, the grantor is not treated as a beneficiary but rather as an owner, and as such takes into account the income, deductions, and credits attributable to the portion owned. IRC §677(a). This treatment appears more logical when the grantor is not a mandatory beneficiary but a *permissible* one. For example, when a trustee may pay the net income of a trust annually to beneficiary *A* or may accumulate it for future distribution to the grantor, the income will be owned by the grantor. Rev Rul 57-363, 1957-2 Cum Bull 326 (accumulated income). Treating the grantor as an owner of the income will not cause a substantially different result from that which would obtain were the grantor treated as an income beneficiary, because the amount taken into account is that which would be taken into account by an income beneficiary. Treas Reg §1.671-3(c). However, if the income must be paid to the income beneficiary but the corpus will revert to the grantor on termination of the trust, the grantor will be treated as the owner of the corpus and of any capital gains allocated to the corpus (Rev Rul 75-267, 1975-2 Cum Bull 254), a result that differs from taxing realized capital gains to a trust under subparts A through D.

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§13.124 b. Distributions for Benefit of Grantor or Spouse

The grantor also may be treated as the owner of any portion of the trust whose income may be indirectly applied for the grantor's benefit. Treas Reg §1.677(a)-1(c). Perhaps the most obvious example of this is the creation of a trust, the income of which may be used to satisfy the grantor's personal debts or other legal obligations. While the income is not distributed to the grantor directly, it is clearly owned by the grantor under IRC §677, because the effect is the same as if the funds were directly distributed. Of course, few estate planning trusts direct payment of the grantor's obligations. More commonly, one must determine if and when a grantor's obligations may be satisfied, which depends in part on the terms of the trust and in part on the form of obligation. See, *e.g., Jack Wiles* (1972) 59 TC 289, acq 1973-2 Cum Bull 4, aff'd (5th Cir 1974) 491 F2d 1406 (payment by short-term trust of mortgage on which grantor remained liable); Rev Rul; 54-516, 1954-2 Cum Bull 54. For example, if the grantor expressly or impliedly contracts to pay his children's college tuition and establishes a trust, the income of which may be used to pay the tuition, the grantor will be treated as the owner of the income that is actually used to pay tuition. *Morrill v U.S.* (D Me 1964) 228 F Supp 734. As might be expected, similar results obtain when other debts of the grantor or the grantor's spouse are satisfied by payments of trust income. See, *e.g., John Koehrer* (1945) 4 TCM 219 (taxes); *Chandler v Commissioner* (3d Cir 1941) 119 F2d 623 (rent and assessments). The portion of the trust owned in these cases of constructive distribution is most likely the dollar amount of income used to satisfy the obligation, unless it is so large that the entire trust, or all income, must be used. While the statute speaks in terms of ownership if income "is, or… may be" distributed, ownership by reason of constructive distribution presumes the existence of an obligation to satisfy. IRC §677(a); Treas Reg §1.677(a)-1(c).

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§13.125 (1) Net Gifts

Net gifts to trusts are an additional form of constructive distribution and arise when a grantor makes a gift in trust but requires that the trustee pay the gift taxes generated by the transfer from the assets of the trust. The grantor is treated as the owner of the trust income that is used to pay those gift taxes. See, *e.g., Sheaffer v Commissioner* (8th Cir 1963) 313 F2d 738, cert denied (1963) 375 US 818 (income used to pay gift taxes taxable to grantor); *Staley v Commissioner* (5th Cir 1943) 136 F2d 368, cert denied (1943) 320 US 786 (income equal to gift taxes paid directly to grantor). However, if the trustee is sophisticated enough to borrow funds and use the borrowed funds to pay the tax, thus extinguishing the obligation prior to the trust's earning any income, the income used to retire the loan will not be treated as owned by the grantor. *Victor W. Krause* (1971) 56 TC 1242; *Estate of J. A. Morgan* (1962) 37 TC 981, aff'd (6th Cir 1963) 316 F2d 238, cert denied (1963) 375 US 825; *David B. Keith* (1941) 45 BTA 644, acq 1942-1 Cum Bull 10 (grantor not taxable after debt extinguished). But see Rev Rul 57-564, 1957-2 Cum Bull 328 (trust income used to repay borrowed funds used to pay gift tax is taxable to grantor).

The result is the same if assets transferred to the trust are sold to pay the gift tax: the capital gains realized, to the extent of the gift tax payable, are owned by the grantor. If borrowed funds are used to pay the gift tax, however, and thereafter the capital gains are realized, nothing is owned by the grantor. However, the Supreme Court has partially foreclosed this option by holding that the transfer of appreciated assets to the trust causes the grantor to realize gain to the extent that the amount of gift tax assumed by the trust exceeds the grantor's basis in the assets transferred. *Diedrich v U.S.* (1982) 457 US 191, 72 L Ed 2d 777, 102 S Ct 2414. Of course, if the gift tax is less than the grantor's basis in the assets transferred, ownership can be avoided by borrowing.

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§13.126 (2) Accumulation for Future Distribution to Grantor or Spouse

The fact that the income of the trust is not presently distributable to the grantor or the grantor's spouse does not end the grantor's concern. If any trust income may be distributed to the grantor or the grantor's spouse in the future, the grantor will be treated as the owner of the property subject to the power to distribute. IRC §677(a)(2). This result was common with "Clifford," or short-term (reversionary) trusts that allocated capital gains to principal under local law or the terms of the trust instrument, and can still trap the unaware. IRC §677(a)(2); Treas Reg §1.677(a)-1(g), Example 2; Rev Rul 58-242, 1958-1 Cum Bull 251. For example, if a trust funded with the grantor's separate property provides for the grantor's children during the grantor's lifetime, but adds the grantor's spouse as a discretionary income and/or principal beneficiary after the grantor's death, any ordinary income or capital gains retained in the trust may be used for the spouse's benefit after the grantor's death and the grantor will be treated as the owner of both the income accumulated and the capital gains. IRC §677(a)(2); Treas Reg §1.677(a)-1(f).

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.127 (3) Payment of Life Insurance Premiums

§13.127 (3) Payment of Life Insurance Premiums

Although the income tax and the gift and estate taxes are not in pari materia (see *Farid-Es-Sultaneh v Commissioner* (2d Cir 1947) 160 F2d 812), the particular emphasis given the treatment of life insurance (and in this connection the emphasis given the payment of premiums due on life insurance policies insuring grantors) can only be ascribed to the zeal of the Treasury Department to limit the use of irrevocable trusts as owners of life insurance on grantors' lives. See, *e.g.,* Field Service Advice 20062701F, in which the IRS attempted to impute to the grantor of a trust the creation by the trust of a second trust that was a foreign trust and owned life insurance as part of an offshore deferred compensation arrangement. While the goal of increasing the fisc may be laudable, the complexity introduced by IRC §677(a)(3), which treats grantors as owners of those portions of trusts whose income may be applied to the payment of premiums on policies of life insurance on the life of the grantor or the grantor's spouse that are not irrevocably payable to charity, seems hardly worth the effort.

The courts have limited the scope of the statute to ownership of premiums *actually* paid by the trust on policies owned by the trust during the taxable year in question. See, *e.g., Lorenz Iversen* (1944) 3 TC 756, 774 ("may be applied to the payment of premiums" language of the predecessor of IRC §677(a)(3) construed as meaning may be applied to current year's premiums on existing policies); *Joseph Weil* (1944) 3 TC 579, 583, acq 1944 Cum Bull 29 (same); *Frank C. Rand* (1939) 40 BTA 233, acq 1939-2 Cum Bull 30, aff'd (8th Cir 1941) 116 F2d 929, cert denied (1941) 313 US 594 (same). While the foregoing cases predate the 1986 Code and their precedential value as to the *portion* of the trust owned by the grantor is arguably limited, each was decided under statutes using almost identical substantive language. Compare §219 of the Revenue Act of 1924 with 1939 IRC §167(a)(3) and with 1954 IRC §677(a)(3) and IRC §677(a)(3). Thus, when a trust owns no life insurance policies, but is not prevented by its terms from purchasing life insurance, the grantor will not be treated as the owner of trust income that might be used to pay premiums on life insurance policies on the grantor's life. See *Genevieve F. Moore* (1939) 39 BTA 808, acq 1939-2 Cum Bull 25 (trust income not taxable to grantor in years in which no policies insuring grantor's life were owned by trust).

PRACTICE TIP: As might be expected, indirect use of trust income to pay premiums on life insurance not owned by the trust on the grantor's life has received intense scrutiny from the Service. Thus, when a beneficiary agrees to use trust income to pay premiums on life insurance policies on the life of the grantor, those premiums will be treated as being owned by the grantor. See Rev Rul 66-313, 1966-2 Cum Bull 245 (beneficiaries agreed to have trust income applied to premium payments); *L. B. Foster* (1947) 8 TC 197, 205, acq 1947-1 Cum Bull 2 (trust income distributed on understanding that wife would pay premiums on policies on grantor's life owned by trust). See also *Henry A.B. Dunning* (1937) 36 BTA 1222, 1230, nonacq 1938-1 Cum Bull 40 (wife paid premiums with trust funds at grantor-insured's "suggestion"). Conversely, when the beneficiary has the right to use the premiums as she desires, and it is the volitional act of the beneficiary that causes the premiums to be paid, the grantor has not been treated as the owner of the trust's income. *George F. Booth* (1944) 3 TC 605, acq 1944 Cum Bull 3 (wife could use trust income as she wished); *Stephen Hexter* (1942) 47 BTA 483, acq 1942-2 Cum Bull 9 (same). The Service will also closely scrutinize trusts created by third party owners of life insurance on the life of a grantor. For example, when a father gives securities and a life insurance policy on his life to his son and the son transfers the securities and policy into a trust, the Service will examine the transfer carefully to determine whether or not the transfer in trust was made pursuant to an arrangement. If the transfer to the trust was the volitional act of the donee, the income of that trust will not be deemed owned by the insured. See *Central Hanover Bank & Trust Co. v Hoey* (SD NY 1947) 74 F Supp 770; *Rockwell v Granger* (WD Pa 1945) 62 F Supp 907.

If a trust does not receive income, no portion is owned by the grantor under IRC §677(a)(3) even if principal is used to pay premiums on policies of insurance owned by the trust on the grantor's life. See *Percy M. Chandler*, 41 BTA 165, aff'd (3d Cir 1941) 119 F2d 623. Similarly, insurance dividends received by a trustee and used to pay premiums on policies held in trust, not being taxable income but a return of premiums paid, cannot cause grantor-trust treatment,

because they are not income of the trust. The result is the same with respect to amounts contributed by a grantor to pay premiums: not being income, they are not taxable to the grantor. If trust income (ordinary income or capital gains) is used to pay premiums on life insurance on the grantor's life that is owned by the trust, the portion of the trust owned by the grantor will be a dollar amount equal to the premiums so paid from income. Treas Reg §1.671-3(c).

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§13.128 (4) Use of Income for Support of Dependents

The grantor will not be treated as the owner of any portion of a trust that may be distributed in satisfaction of the grantor's obligation to support the grantor's spouse or dependents unless the funds are actually so distributed, or unless the grantor holds this power in a nonfiduciary capacity. IRC §677(b); Treas Reg §1.677(b)-1(a). See Rev Rul 61-223, 1961-2 Cum Bull 125 (grantor does not have reversionary interest in trust that may use income and corpus for support of grantor's minor children). If ordinary income is so used, the grantor will, of course, be treated as an owner. If, however, accumulated income or corpus is used to satisfy the obligation of support, the grantor is not treated as an owner but as a beneficiary. Treas Reg §1.677(b)-1(b). This seemingly illogical distinction relates back to the time when the throwback rules applied to domestic trusts. Treatment of the grantor as a beneficiary ensured that the accumulated income or gain would be subject to tax in the grantor's hands.

If the power to distribute for the support of a dependent of the grantor is lodged in the grantor and the grantor is *not* the trustee, the grantor will be treated as the owner of that portion of the trust necessary to generate that income. Treas Reg §§1.677(a)-1(d), 1.677(b)-1(e). A similar result obtains if the trust income is required to be distributed for the support of the grantor's dependents. Treas Reg §1.677(b)-1(f).

The questions raised by this exception are two: first, whom is the grantor obligated to support, and, second, what is the extent of the grantor's obligation? Both are answered by local law, which may vary from state to state. See Rev Rul 56-484, 1956-2 Cum Bull 23. Compare *Brooke v U.S.* (9th Cir 1972) 468 F2d 1155 and *Wyche v U.S.* (Ct Cl 1974) 36 AFTR2d 5816 (private schooling, dance lessons, orthodontia, music lessons, etc. not part of support obligation) with *Christopher Stone,* TC Memo 1987-454, aff'd (9th Cir 1989) 867 F2d 613 (unpublished opinion) (private schooling part of California grantor's support obligation). See also *Frederick C. Braun, Jr.,* TC Memo 1984-285 (private secondary school and college tuition was part of grantor's support obligation under New Jersey law); *Mairs v Reynolds* (8th Cir 1941) 120 F2d 857 (same under Minnesota law).

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§13.129 5. Persons Other Than Grantor Treated as Owner

Internal Revenue Code §678 reaches beyond grantors to treat other persons as owners of trust income. To qualify for this treatment, the person must either (a) have a power, exercisable *alone,* to acquire trust principal or income, or (b) have had such a power but partially released or otherwise modified it in a manner such that, while no longer able to acquire the corpus or income, the person still retains such control of the trust as would cause a grantor to be treated as an owner under IRC §§671-677. IRC §678(a); Treas Reg §1.678(a)-1(a). Internal Revenue Code §678 also creates priorities as to its application, so that if a grantor and a person other than a grantor are both treated as owners of a particular portion of the trust, the grantor is the one who bears the burden of the ownership. IRC §678(b); Treas Reg §1.678(b)-1. Thus, if both the grantor and a third party have a power to withdraw corpus or trust income, the grantor is the one treated as owner of the portion of the trust subject to the withdrawal power. In IRS Letter Ruling 200606006, the IRS ruled that a trust was a grantor trust in its entirety under IRC §677(a) because the grantor's spouse could receive discretionary distributions (see §13.123) despite the fact that the grantor's spouse had a *Crummey* power that would normally cause a portion of the trust income to be taxed to the spouse. See IRS Letter Ruling 9321050 (beneficiary who formerly possessed a lapsed *Crummey* power was not treated as the owner of the income or corpus of the trust). As with grantors, a person other than a grantor who holds a power as trustee to distribute income in satisfaction of an obligation of support will be treated as an owner to the extent that current income is so applied; if corpus or accumulated income is used to satisfy the obligation of support, the power holder will be treated as if he or she were the beneficiary who received the distribution. IRC §678(c); Treas Reg §1.678(c)-1. See §13.128. Finally, if a power to acquire trust principal or income is renounced within a reasonable time after the power holder becomes aware of its existence, the former power holder will not be treated as an owner. IRC §678(d); Treas Reg §1.678(d)-1.

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§13.130 a. Right to Take Corpus or Income

If a person has the power, exercisable alone, to vest trust principal or income in herself, she is treated as the owner of the portion of the trust subject to the power. IRC §678(a)(1); Treas Reg §1.678(a)-1(a). Thus, for example, a beneficiary's right to require the trustee to distribute all of the trust income to her will make that beneficiary the owner of the income portion of the trust, as will be the case if a beneficiary who is the sole trustee has the power to sprinkle the trust income among a group that includes herself. If the power granted the trustee-beneficiary also includes the power to withdraw principal, she will be treated as the owner of the entire trust. *Ella E. Russell* (1941) 45 BTA 397. Another, perhaps more common, example of the right to take corpus or income is that of the trust beneficiary who has the right to withdraw the greater of $5000 or 5 percent of the trust assets each year. In this case, the beneficiary is treated as owning a fractional portion of the trust's income and corpus. Rev Rul 67-241, 1967-2 Cum Bull 225. As might be expected, if a beneficiary has the right to withdraw all or some lesser part of the trust, as is often the case with marital deduction power of appointment trusts (IRC §2056(b)(5); Treas Reg §20.2056(b)-5), the beneficiary will be treated as the owner of the entire trust, or of the lesser portion subject to that power. See *Emery v Commissioner* (1st Cir 1946) 156 F2d 728, cert denied (1946) 329 US 772.

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§13.131 (1) Sole Right to Exercise

To avoid ownership under IRC §678, one need only have another acting with the holder (*i.e.,* a joint holder of the power). Rev Rul 67-268, 1967-2 Cum Bull 226 (co-trustee with power to take income not owner under IRC §678). This will be the case even if the power holder is a minor (Rev Rul 81-6, 1981-1 Cum Bull 385), or if the income cannot be withdrawn until the end of the calendar year. See *Grant v U.S.* (5th Cir 1949) 174 F2d 891.

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§13.132 (2) Ascertainable Standard

While IRC §678 speaks in absolute terms of the *power* to take possession of principal or income, at least one court has interposed a fiduciary standard requirement and has held that where state law limits the power of a life tenant to consume the principal solely for maintenance and related needs, the requisite absolute ownership of the corpus is absent and IRC §678(a)(1) is not applicable. *U.S. v DeBonchamps* (9th Cir 1960) 278 F2d 127. See Rev Rul 61-102, 1961-1 Cum Bull 245. Conversely, where the power to consume is unlimited, the holder has been treated as the owner. *Hirschmann v U.S.* (2d Cir 1962) 309 F2d 104 (life estate with "unrestricted possession and enjoyment"); *Ella E. Russell* (1941) 45 BTA 397 (right of grantor's wife to withdraw from minor child's share for "her own use or the maintenance, education, care and support of children and issue as she shall determine"). No ascertainable standard rule has yet been imposed on the power to withdraw ordinary income, although the portion owned has been limited in cases under prior law to the amounts necessary for the power holder's support. See *Funk v U.S.* (3d Cir 1950) 185 F2d 127 (trustee beneficiary not owner of all income where income could only be distributed in accordance with husband and wife's respective needs, of which trustee was sole judge); *Eva V. Townsend* (1945) 5 TC 1380, acq 1946-1 Cum Bull 4 (beneficiary not taxable on amounts in excess of amounts she deemed necessary for her support). In contrast, IRC §2041(b)(1)(A) expressly provides that a power that is subject to an ascertainable standard is *not* a general power of appointment for estate tax purposes.

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§13.133 b. Obligations of Support

A person, other than a grantor, who holds a *fiduciary* power to apply the income of a trust for the support of someone whom the person is obligated to support is treated as an owner only to the extent that such support distributions are actually made. IRC §678(c); Treas Reg §1.678(c)-1(a). If distributions that satisfy the support obligation are made from accumulated income or corpus, the trustee-power holder is not treated as an owner but as a beneficiary. A person, other than a grantor, who holds a *nonfiduciary* power to apply the income or principal of a trust to the support of someone whom the person is obligated to support is treated as an owner of the portion of the trust subject to the power. Treas Reg §1.678(c)-1(b). Internal Revenue Code §678 does not apply to income that is *required* to be distributed in support of a person's dependents: those distributions are taxable to the obligor as if the obligor were a beneficiary. Treas Reg §§1.662(a)-4, 1.678(c)-1(c).

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§13.134 c. Transfers With Retained Control

Internal Revenue Code §678 also applies when a power holder other than a grantor partially releases or otherwise modifies a power to acquire principal or income so that he can no longer vest the corpus or income in himself, but nevertheless retains sufficient control of the trust as would make him an owner had he been the grantor. IRC §678(a)(2); Treas Reg §1.678(a)-1(a). While this rule seems reasonable on its face, its application has never been clear, in part, because what constitutes a *partial* release or modification is not clear. The distinction between a partial and a complete release is not defined by the regulations under IRC §678, and the legislative history is not helpful.

The lapse of power to acquire corpus or income is properly treated as a partial release contemplated by the statute when the power holder continues to have an interest in the trust if the power held would have caused the holder, if a grantor, to be treated as an owner under IRC §677(a)(1).

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§13.135 E. Intentionally Defective Trusts

While most grantors will not want to retain ownership of property transferred in trust for income tax purposes, on occasion there is good reason to do so. A trust that a grantor owns for income tax purposes is a trust that the grantor may sell assets to or purchase assets from without having the transaction treated as a taxable event. In addition, grantor treatment requires that the grantor take some portion or all of the trust's income, deductions, and credits into account. Thus, the grantor pays the income taxes on transactions occurring in the trust, possibly at a lesser tax rate than the trust's, and relieves the trust from the responsibility of paying those taxes, thereby increasing the trust's net value. Alternatively, ownership for income tax purposes allows the grantor to utilize deductions that would be wasted in the hands of the trust but that can be used by the grantor, reducing the cost of some estate planning transactions.

This section discusses various methods of intentionally subjecting a trust to the grantor trust rules and the consequences of using various "tainting" powers discussed in §§13.93-13.109. The preferred taints are probably (1) giving a nonadverse party the power to terminate the trust and revest it in the grantor, (2) giving a nonadverse trustee the power to loan all trust assets to the grantor without requiring adequate security or interest, or (3) giving a nonadverse party who is not a trustee the power to allow the grantor to deal with the trust assets for less than adequate and full consideration. Even these powers, however, must be used with great caution. Unintended outcomes are abundant. The subsequent discussion explores retaining preferred subpart E powers or granting them to a nonadverse party, and the gift and estate tax consequences of so doing.

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§13.136 1. Reversionary Interests

Because a reversionary interest will cause the trust property to be included in the grantor's estate under IRC §2033 or §2037, and because a reversionary interest will cause the entire amount of the gift to be subject to gift tax by reason of IRC §2702 unless all of the intervening interests are qualified interests (IRC §2702(b)(3); Treas Reg §25.2702-3(f)(1)(iv)), using a reversionary interest as a method of making a trust a grantor trust for income tax purposes extracts a high cost. On the other hand, inserting a contingent reversionary interest into a personal residence trust (PRT) (IRC §2702(a)(3)(A)(ii); Treas Reg §25.2702-5(b)), or a qualified personal residence trust (QPRT) (IRC §2702(a)(3)(A)(ii); Treas Reg §25.2702-5(c)) that returns the trust's assets to the grantor if he or she dies before the termination of the trust, does not increase the estate tax burden because the death of the grantor during the trust's term causes estate tax inclusion under IRC §2036 in any case. Conversely, inserting a contingent reversion with a value greater than 5 percent makes the trust entirely owned by the grantor under IRC §673, allowing the grantor to deal with the trust without income tax consequences, and allows the residence to return to the grantor's estate to be used to satisfy a marital deduction or other gift should death occur before the expiration of the trust's term.

A contingent reversion may also be used in a qualified annuity trust to assure grantor trust treatment. Its use, however, does not increase the value of the interest retained by the grantor or concomitantly reduce the value of the taxable gift of the remainder, because the contingent reversion has a zero value for gift tax purposes. See IRC §2702(a)(2)(A), (b)(3); Treas Reg §§25.2702-3(e), Example 1, 25.2702-3(f)(1)(iii). Similarly, a contingent reversion may be used in a grantor retained income trust (GRIT) established for "non-family" members, such as nieces and nephews, to invoke grantor trust status and to reduce the amount of the gift, because IRC §2702 is not applicable. See IRC §§2702(e), 2704(c)(2).

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§13.137 2. Powers to Control Beneficial Enjoyment

Most of the exceptions to the power to control beneficial enjoyment of a trust do not lend themselves to incurring grantor trust status. For example, if a nonadverse party holds the IRC §674(b)(1) power to apply income for the support of a dependent of the grantor, the grantor will be treated as an owner only if distributions are made, and then only as an owner of the income portion. Moreover, the power only applies as long as the grantor has dependents to support, and if the grantor dies during the term, some portion of the trust will be included in the grantor's estate. See *Richards v Commissioner* (10th Cir 1967) 375 F2d 997. The IRC §674(b)(7) power to withhold income during a beneficiary's disability suffers from similar defects, because the trust will be a grantor trust only if there is a beneficiary who is under the age of 21 or is otherwise disabled. Furthermore, because this power affects trust income, it must be used in conjunction with another power if ownership is to extend to the entire trust.

The following sections treat in detail only the most useful exceptions that can be readily manipulated to cause grantor treatment, without the concomitant problems of estate inclusion, misuse by power holders, or vulnerability to changed circumstances.

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§13.138 a. Testamentary Powers

Giving the grantor's spouse or other nonadverse party the power to dispose of the trust by inter vivos exercise of a power of appointment so as to avoid the IRC §674(b)(3) exception will cause the grantor to be treated as the owner of the portion of the trust subject to the power. A literal reading of the statute suggests that the power can actually be testamentary if it may only be exercised in an instrument other than a will, and this is the position taken by the regulations under IRC §664. See Treas Reg §§1.664-2(a)(4), 1.664-3(a)(4) (grantor may retain power exercisable *only by will* to revoke or terminate the interest of any recipient other than an IRC §170(c) organization). The practical problem is, however, trust and confidence in the power holder, because he or she might exercise the power in a manner adverse to the grantor's wishes. If the power is tailored to the specific situation, as for example, giving a daughter the power to accelerate distribution of a generation-skipping trust's assets to the grantor's grandchildren, the "non-exception" may fit the grantor's plan exactly. In this case, the existence of the power not only allows the grantor to be treated as the owner of the trust for income tax purposes, but also provides a safety valve should it become desirable to terminate the trust. If the daughter's power is a special power of appointment (as would be the case in the example), it will not cause inclusion of the property subject to the power in the daughter's estate, and as the power will not have been retained by the grantor, the trust assets will not be included in the grantor's estate.

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§13.139 b. Power to Distribute Corpus According to a Defined Standard

The IRC §675(b)(5)(A) power to distribute corpus to income beneficiaries or remaindermen according to a defined standard deals primarily with ownership of the corpus portion of the trust. However, a power to accumulate income ensures grantor treatment of the trust's ordinary income. Distributions to be made according to a definite standard are subject to the complaint that they are externally enforceable and thus take control away from the grantor. Nevertheless, if there are beneficiaries that the grantor would want to protect by inserting a defined standard in the trust instrument in any event, ownership can easily be achieved by adding as a permissible distributee under that standard one who is not otherwise a beneficiary.

EXAMPLE: Assume a trust that accumulates income until the youngest child of the grantor attains age 30, at which time the trust terminates and distributes principal equally to the grantor's children. If the grantor or a nonadverse party has a power of invasion that is subject to a defined standard that includes the grantor's mother as well as the grantor's children in the permissible class of "invadees," the grantor will be treated as the owner of the entire trust (*i.e.,* accumulated ordinary income and capital gains added to principal) under IRC §674(a) by reason of the trust's failure to qualify under IRC §674(b)(5)(A).

The power to distribute corpus according to a defined standard may be held by the grantor, the grantor's spouse, or any other nonadverse party largely without gift or estate tax problems. The gift is complete, because the property subject to the power has passed from the grantor's control (see Treas Reg §25.2511-2(g)), and the ascertainable standard protects the power from causing inclusion in the grantor's estate if the grantor is the trustee (see *Jennings v Smith* (2d Cir 1947) 161 F2d 74). The drawback here is that if the power is deemed to satisfy a support obligation of the grantor, some portion of the trust will be included in the grantor's estate, whether the grantor, the grantor's spouse, or a nonadverse party is the power holder. Treas Reg §20.2036-1(b)(2); *Estate of Richards v Commissioner* (10th Cir 1967) 375 F2d 997.

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§13.140 c. Power to Withhold Income Temporarily

The IRC §674(b)(6)(A) exception allows anyone to hold a power to withhold income from or to distribute income to an income beneficiary if the accumulated income must ultimately be payable to that income beneficiary.

Internal Revenue Code §674(b)(6)(B) excepts the power to accumulate income if, on termination of the trust, the accumulated income must be distributed to the current income beneficiaries in specified shares.

Both IRC §674(b)(6) exceptions are intertwined with many of the other exceptions to IRC §674(b), and their application and efficacy often turn on minute differences in trust provisions or language. For that reason, and because there are other, "cleaner" taints, the IRC §674(b)(6) powers are best avoided.

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§13.141 3. Powers Exercisable by Independent Trustee

One of the easiest ways to cause grantor treatment for the entire trust is to run afoul of IRC §674(c) by giving a related or subordinate party the power to sprinkle principal and income among the beneficiaries. The grantor's spouse, by definition a nonadverse party, is a good first choice unless the trust will be funded with community property. When a trust contains community property, the spouse is a grantor as to one-half of the community property transferred in trust, and IRC §§2036 and 2038 will cause that one-half of the trust to be included in the spouse's estate if the spouse holds an IRC §674(c) power. If a trust contains community property, use of the IRC §674(c) power becomes problematic because it is difficult to find persons who are related or subordinate parties with respect to both husband and wife. If one trustee is related or subordinate to the grantor and one to the grantor's spouse, the "no more than half" rule has not been violated. If both spouses own a business, or if the business is community property, a subordinate employee could be used. Otherwise look to someone who works for both of them, such as the butler or the gardener!

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§13.142 4. Power to Allocate If Limited by Ascertainable Standard

Internal Revenue Code §674(d) allows any trustee other than the grantor or the grantor's spouse, if living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or a class of beneficiaries if the power is limited by a reasonably definite standard. Ownership of the trust accounting income is readily accomplished by having the grantor's spouse hold this power, but not if the trust contains community property (see §13.141) and not if the beneficiaries are persons that the spouse is obligated to support. See IRC §§674(b), 677(b). If all trust income is to be owned, the trust instrument can direct that capital gains be treated as trust accounting income so that "corpus income" is also subject to the power. If the grantor's spouse is not available or if the trust contains community property, a nonadverse trustee can be given the nondiscretionary power to distribute trust income; that is, a power not limited by a reasonably definite standard. However, this power will be protected by IRC §674(c) unless the trustee is a related or subordinate party, with attendant problems if the trust contains community property. See §13.141. For this reason, other powers are preferable.

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§13.143 5. Power to Add Beneficiaries

Internal Revenue Code §§674(b)(5), 674(b)(6), 674(c), and 674(d) contain an additional prohibition; namely, that the exceptions to ownership under IRC §674(a) do not apply if any person can add beneficiaries other than after-born or after-adopted children. Most grantors will not want to give someone the power to add beneficiaries, because someone might do that. However, limiting the class of permissible additional beneficiaries to persons such as the grantor's nieces and nephews or named charitable organizations may be acceptable. See *Bernard Madorin* (1985) 84 TC 667; IRS Letter Ruling 9010065 (independent trustee's power to designate IRC §170(c)(2) organizations as beneficiaries caused grantor to be owner). Because transfers to a trust that gives someone other than the grantor the limited power to add beneficiaries will be completed gifts and will not cause the trust to be includable in the grantor's estate, this power provides a reasonable method of assuring grantor trust treatment.

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6. Administrative Powers

§13.144 a. Powers to Self-Deal and Borrow

If a trust expressly authorizes the grantor or a nonadverse party to deal with the assets of the trust for less than adequate and full consideration, IRC §675(1) treats the grantor as the owner of the property subject to that power. Similarly, if the grantor may borrow all of the trust assets without furnishing adequate interest and security, IRC §675(2) treats the grantor as the owner of the property subject to that power. A grantor will not want to hold these powers, because they will make transfers to the trust incomplete and cause the portion of the trust subject to the power to be included in the grantor's gross estate. A grantor will not want a nonadverse party to hold these powers, because the nonadverse party might use them, and they will probably be a general power of appointment in the nonadverse party's hands (making the holder an adverse party, imposing income and estate taxation on her). However, if a nonadverse party has the express power to direct the trustee to deliver the entire trust to the grantor or the grantor's spouse for less than adequate and full consideration or to lend the trust estate to the grantor or the grantor's spouse without adequate interest or security, the grantor will own the entire trust without adverse gift or estate tax consequences. See Treas Reg §1.675-1(a), (b)(1), (b)(2). Granting this power is essentially the same as granting a nonadverse party the power to revoke the trust and vest the trust estate in the grantor. See §13.146. The grantor then need only worry whether the power holder will actually grant him or her that power in a fit of pique, and about the adverse gift and estate tax consequences that would follow. The estate planner should be forewarned, however, that corporate trustees will, in many cases, refuse to accept a trust with such a provision, citing excessive liability concerns.

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§13.145 b. Holding General Powers of Administration

Internal Revenue Code §675(4) lists three types of powers of administration that, if exercisable in a nonfiduciary capacity by *any person* without the approval or consent of anyone in a fiduciary capacity, will cause the grantor to be treated as the owner of the property subject to the power. See §13.120. The best use of these powers to ensure grantor treatment without estate inclusion is for the grantor personally to eschew the powers and have them held instead by a nonadverse party, with a preference for the power to swap assets for ones of equivalent value, because that power most readily assures ownership of the entire trust. The determination of whether IRC §675(4) applies is probably not based, however, on the fact that the power exists, but rather on the actual administration of the trust. See IRS Letter Ruling 200709011. However, some commentators have suggested that a power to vest the grantor with the power to reacquire trust assets is not literally the power to reacquire specified in IRC §675(4)(C).

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§13.146 7. Power to Revoke

A power to revoke makes the grantor the owner of the property subject to the power, but unless the trust is intended to be revocable, holding this power offers the grantor no economic advantage. However, granting a nonadverse party the power to revoke the trust and revest the trust estate in the grantor without the approval of an adverse party will make the grantor the owner of the entire trust, or the portion subject to the power (Treas Reg §1.676(a)-1), without adverse gift or estate tax consequences. See Treas Reg §§20.2038-1(a)(3), 25.2511-2(b).

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§13.147 8. Power to Distribute Income

If income will or may be distributed to the grantor or accumulated for the grantor's benefit, the trust will be included in the grantor's gross estate at the grantor's death, and the full value of the trust will be subject to gift tax under IRC §2702 if the trust is for members of the grantor's family. Distribution to or accumulation for the grantor's spouse does not have the same disastrous effect, unless the trust was funded with community property. Thus, a trust that has the grantor's spouse as a permissible future beneficiary of income and/or corpus will cause the grantor to be treated as its owner. However, the death of the spouse will remove the taint from the trust, so a back-up power is advisable.

Lesser powers, such as the power to satisfy the grantor's spouse's obligations or to use income to pay premiums on insurance policies on the grantor's (or spouse's) life, are more tenuous, because they assume the existence of obligations of a determined amount, with the result of ownership of less than the entire trust. Nevertheless, because the grantor will be treated as the owner of the income used to pay premiums on life insurance policies on the grantor's life or the life of the grantor's spouse that are owned by a trust, using a funded insurance trust that has sufficient assets to generate the premium amount increases the estate planning benefit of the trust by making the grantor the owner of the dollar amount used to pay the premium and subjecting that amount to tax in the grantor's hands rather than in the hands of the trust.

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§13.147A 9. Ownership by Person Other Than Grantor

While creating a defective trust for the grantor is relatively easy, putting a taint on a nongrantor trust so that it becomes a grantor trust as to the beneficiary is not. Trusts that contain withdrawal powers are the obvious choice as long as the trust is not a grantor trust with respect to the "real" grantor (*i.e.*, settlor of the trust). See discussion in §13.129. If the settlor who established the trust is deceased or has no power that will cause her to be treated as owning the trust, the withdrawal power will cause that beneficiary to be treated as a grantor. For example, a surviving spouse who has a present power to withdraw any portion of a trust will be the owner of the trust's ordinary income and corpus. IRC §678(a)(1). In contrast, if the surviving spouse holds a general power to appoint the trust assets at his death (the usual case when an IRC §2056(b)(5) power of appointment trust is created to qualify for the estate tax marital deduction), he will not be treated as the owner of the entire trust even if capital gains are required to be allocated to trust income.

In the latter case, the surviving spouse is a beneficiary, receiving distributed amounts under IRC §662, and while the result may be similar with respect to taxable income (including capital gains), not all deductions will necessarily be taken into account by the spouse, nor will tax credits. Since a power of withdrawal is a general power of appointment that causes estate tax inclusion, no estate tax harm will come from giving a surviving spouse that power since the marital deduction trust will be included in his estate anyway. Giving a power of withdrawal to a beneficiary other than a surviving spouse, however, obviously has adverse tax consequences if the trust (for example, an exempt generation-skipping trust as discussed in chap 11) is intended to pass tax-free to succeeding generations.

As discussed in §13.130, a beneficiary who holds a power of withdrawal will be treated as an owner of the portion of the trust subject to that power (if the trust is not treated as owned by the settlor of the trust). Following the annual lapse of the withdrawal power, if the beneficiary has a continuing interest in the trust, the beneficiary will own an additional portion of the trust. IRC §678(a)(2). See IRS Letter Ruling 200022035, discussed in 22 CEB Est Plan Rep 22 (Aug. 2000); Dennis-Strathmeyer, *Power Play: Evaluating Opportunities Under IRC §§2041, 2514, and 678*, 19 CEB Est Plan Rep 100, 105 (Feb. 1998); Westfall, *Lapsed Powers of Withdrawal and the Income Tax*, 39 Tax L Rev 63 (1983). Grantor treatment in this case, however, is not without substantial complexity. For example, if the trust must accumulate all trust accounting income that has not been withdrawn for future distribution to another beneficiary, the ownership portion of the beneficiary holding the withdrawal power remains the same since the fraction is "self-adjusting:" as the corpus increases, so too does the income from it and the portion owned. If, however, the power holder has any other interest in the trust, such as a power to invade principal for her benefit, further ownership is indicated. In the latter case, the income that is not withdrawn is a contribution to the trust by the power holder that may later be used for her benefit (*i.e.,* an IRC §677(a)(2) power). Thus, the power holder's ownership extends not only to the fractional share of the trust equal to the scope of the withdrawal power (*e.g.*, the greater of $5000 or 5 percent of trust corpus), but also to the unwithdrawn amount "contributed," an increasing fraction the numerator of which is the lapsed income (including previously lapsed income amounts) and the denominator of which is the value of the trust corpus at the beginning of the trust year. A similar analysis obtains if the power is solely over corpus, or over both income and principal. In each case, however, ownership of the entire trust will be difficult or impossible to achieve unless the withdrawal power equals the entire amount contributed each year (*e.g.*, $5000 contributed but fully subject to withdrawal). Note that withdrawal powers may have estate tax consequences and open the trust to claims of the beneficiary's creditors. Prob C §682.

A better solution to making a beneficiary's trust defective for income tax purposes—and one that can apply to existing trusts—is to have the trustee contribute the trust assets to an existing S corporation (or one established by the trustee) and make the necessary elections to treat the trust as a qualified subchapter S trust (QSST). IRC §1361(d)(1)(B). See discussion in §13.152. QSSTs require separate trusts for each beneficiary, or trusts with separate shares. Thus, not all trusts will be able to take advantage of this option. A further drawback of doing this is that all income distributed by the QSST to the trust will be required to be distributed to the trust beneficiary, a result that may be undesirable from a family standpoint. Additionally, once the trust assets have been contributed to the S corporation

those assets become subject to all the vagaries of corporate taxation, albeit S corporation taxation. If the trust cannot qualify as a QSST, another option would be to contribute the trust assets to an S corporation and elect to have the trust treated as an electing small business trust (ESBT). See discussion in §13.155. Because the taxation of ESBTs is so constrained by the statute, however, use of an ESBT for this purpose will be unusual, even though the beneficiary will be accorded grantor treatment. Treas Reg §1.641(c)-1(c).

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IV. SPECIAL TRUSTS

§13.148 A. Charitable Remainder Trusts

Charitable remainder unitrusts and annuity trusts are separate trusts for income tax purposes. Each must have its own taxpayer identification number and file its own special tax returns (Form 5227). This is because charitable remainder trusts (CRTs) are exempt from income taxation. IRC §664(c). Thus, they pay no tax on ordinary income or capital gains tax that they generate unless they have unrelated business taxable income (UBTI). See IRC §512. However, if a CRT distributes appreciated property in kind in satisfaction of a current beneficiary's ("recipient's") right to a unitrust or annuity trust amount, the CRT will realize (but not recognize) "*Kenan*" gain on the difference between the basis of the asset in the hands of the CRT and its fair market value. See *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. The realized gain is then available to be treated as distributed to the recipient in years in which ordinary income is insufficient to cover the unitrust or annuity trust amount.

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§13.149 1. Excise Tax

The Code imposes draconian excise taxes on CRTs that engage in prohibited transactions. See IRC §4947(a)(2). Prohibited transactions include "self-dealing" transactions between the CRT and a disqualified person*, e.g.,* a sale, lease, or other transfer of property between the trust and the disqualified person. See IRC §4941; Treas Reg §53.4941(d)-1. A disqualified person is the trustee or grantor of a CRT or any substantial contributor to the CRT or any person related to one or more of the foregoing. IRC §4941. Other prohibited transactions include influencing elections or legislation (IRC §4945), making investments that jeopardize the charitable purpose of the trust (IRC §4944), and holding excessive interests in a controlled business (IRC §4943).

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§13.150 2. Unrelated Business Taxable Income

Unrelated Business Taxable Income (UBTI) is gross income generated by a trade or business that is not substantially related to the charity's exempt purpose. IRC §§512(a), 513(a). The concept originated in response to complaints that tax-exempt charities were competing with taxable businesses (*e.g.,* commercial winemaking by a religious order). The CRT does not lose its tax exemption and is not taxed as a complex trust. However, a 100-percent excise tax is imposed on the UBTI and the excise tax is treated as a principal charge and is not deductible in determining taxable income distributed to a beneficiary. IRC §664(c)(2); Treas Reg §1.664-1(c)(1).

While CRTs are unlikely to engage in a trade or business (and are not usually authorized to do so), debt financed income can be a problem because it is considered UBTI. Thus, a CRT cannot borrow to purchase securities, commercial real property, or life insurance, but can sell assets for cash and a note; nor can it invest in a partnership that runs a business. Moreover, transfer of encumbered property to a CRT is treated by the Code as a "bargain sale," with the result that unless the grantor's basis in the property equals its fair market value, some taxable gain will be recognized.

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§13.151 3. Taxation of Recipients

Internal Revenue Code §664(b) establishes a specific hierarchy for taxation of the unitrust or annuity trust amounts distributed each year to the trust's current beneficiaries. The amounts are taxed in the following order:

(1) Income includable in the trust's gross income (*i.e.,* taxable income—current or accumulated);
(2) Current or accumulated capital gains;
(3) Other current or accumulated income (usually tax-free income); and
(4) Trust principal.

Within each category, the highest-tax class income is taxed first. Thus, items of ordinary income taxed at 35 percent are taxed before qualifying dividends taxed at 15 percent, and gains taxed at 28 or 25 percent are taxed before long-term capital gains taxed at 15 percent, although qualifying dividends are taxed ahead of gains taxed at 28 or 25 percent. See Treas Reg §1.664-1(d)(1).

While capital gains realized by CRTs are not subject to tax at the trust level, many planners forget that reinvestment of those funds in income-producing assets, because of the four-tier system, converts capital gains into ordinary income. Of course, it is possible to invest the proceeds in tax-free investments, but capital gain rather than the resulting tax-free income will be first distributed to the recipients. Accordingly, estate planners with clients who are solely tax motivated should use CRTs with extra caution.

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B. S Corporation Trusts

§13.152 1. QSSTs

Originally, no trusts were allowed as shareholders of S corporations. Over time, grantor trusts were allowed to hold S corporation stock on the theory that the grantors, not the trusts, were the ultimate owners of the stock. The Subchapter S Revision Act of 1982 (Pub L 97-354, 96 Stat 1669) added a new form of trust as an S corporation shareholder: the Qualified Subchapter S Trust or QSST. Logically extending the prior trust qualification rule, a QSST is deemed to be a grantor trust, and the beneficiary of the trust is deemed to be the owner, under IRC §678, of the portion of the trust holding the S corporation stock. IRC §1361(d)(1). In order to qualify as a QSST, a trust must have only one income beneficiary who is a United States citizen to whom all trust income must be distributed currently, whose interest in the trust will terminate on the earlier of the beneficiary's death or the termination of the trust, and to whom the trust assets will be distributed if the trust terminates other than by reason of the beneficiary's death. IRC §1361(d)(3). Numerous trusts naturally fit the QSST mold, such as QTIPs and even IRC §2503(c) minors' qualifying trusts if all income must be distributed currently.

PRACTICE TIP: While a QSST may only have one current income beneficiary, the QSST need not be a separate trust. If the trust has substantially separate and independent shares, as described in IRC §663(c), it may qualify as a QSST. IRC §1361(d)(3), flush language. See §13.28 for a discussion of separate shares. As a practical matter, even a sprinkling trust can qualify as a QSST if it has a way to direct that the income generated by the S corporation stock be distributed to the income beneficiaries in fixed proportions, *e.g.,* a trust committee that has the power to control distributions. It may also be possible for the trustee of a sprinkling trust to irrevocably commit to payment of all income of the QSST portion of the trust to the beneficiary or beneficiaries, because IRC §1361(d)(3)(B) only requires that all of the income be distributed currently.

If the trust is a true sprinkling trust that can sprinkle principal as well as income, the trustee may be able to irrevocably commit to distributing a fixed portion of the QSST corpus to a beneficiary if the trust terminates during his or her lifetime. However, the Service has ruled that even a separate share trust cannot qualify if there is a remote possibility that principal could be distributed to someone other than the current income beneficiary. Rev Rul 93-31, 1993-1 Cum Bull 186. A better alternative in this case is the Electing Small Business Trust (ESBT). See §13.155.

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§13.153 a. Income Taxation of Trust and Beneficiary

The QSST portion of the trust, and only the QSST portion, is treated as a grantor trust. IRC §1361(d)(1)(A); Treas Reg §1.1361-1(j)(7). The beneficiary then takes into account the income, deductions, and credits of the QSST that an owner under IRC §678 would take into account. IRC §1361(d)(1)(B); Treas Reg §1.1361-1(j)(8). This, of course, means all such items, because the beneficiary is the owner of the entire QSST portion. By implication, the remainder of the trust is taxed under the normal rules of subparts A through D of subchapter J. If, however, the S corporation stock is sold, QSST status terminates and the gain is recognized at the trust level, not at the beneficiary level. Treas Reg §1.1361-1(j)(8). However, the sale will be treated as a disposition by the beneficiary for purposes of applying the passive activity loss rules in IRC §469. Treas Reg §1.1361-1(j)(8). See §13.19.

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§13.154 b. QSST Election

In order to qualify as a QSST, the beneficiary must elect to be so treated. IRC §1361(d)(2)(A). The election must be made with respect to each S corporation stock held by the trust and, once made, applies to all successive beneficiaries, unless they affirmatively refuse to consent to the election. IRC §1361(d)(2)(B). The election is irrevocable (IRC §1361(d)(2)(C)) and must be coordinated with the corporation's election to be treated as an S corporation. See Treas Reg §1.1361-1(j)(6)(iii). Failure to properly elect may cause termination of S corporation status, although Rev Proc 2003-43, 2003-1 Cum Bull 998, offers some relief if the trust beneficiary's failure to elect was inadvertent, and Rev Proc 2004-48, 2004-2 Cum Bull 172, provides a simplified method to request relief for a late corporate classification election intended to be effective on the same date as the S corporation election. An additional simplified method is provided in Rev Proc 2007-62, 2007-41 Int Rev Bull 786.

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§13.155 2. ESBTs

In response to complaints that QSSTs were too restrictive, Congress authorized an additional "qualifying" S corporation trust, the Electing Small Business Trust, or ESBT. See IRC §1361(c)(2)(A)(v). To qualify as an ESBT, a trust must have an election in place and must have individuals, estates, or qualified charities as beneficiaries. IRC §1361(e)(1)(A)(i), (iii); Treas Reg §1.1361-1(m)(1)(i)-(ii). A trust does not qualify as an ESBT if any beneficial interest was acquired by purchase. IRC §1361(e)(1)(A)(ii); Treas Reg §1.1361-1(m)(1)(iii). Neither a charitable trust nor a QSST may be an ESBT. IRC §1361(e)(1)(B); Treas Reg §1.1361-1(m)(1)(iv). An ESBT can have multiple beneficiaries and may be a sprinkling trust.

ESBTs are taxed under special rules set forth in IRC §641(c), which isolate any S corporation stock and treat it as being held by a separate trust. IRC §641(c)(1)(A); Treas Reg §1.641(c)-1(a). The tax on this separate trust is at a flat rate that is the highest rate applicable to trusts and estates. IRC §641(c)(2)(A); Treas Reg §1.641(c)-1(e)(1). No exemption is allowed with respect to any alternate minimum tax. IRC §641(c)(2)(B). The only income, deductions, and credits to be taken into account are those passed through to S corporation shareholders (IRC §641(c)(2)(C)(i)), state or local income taxes and administrative expenses (IRC §641(c)(2)(C)(iii)), and gain or loss attributable to its sale (IRC §641(c)(2)(C)(ii)). Capital losses (presumably at the corporate level) are allowable only to the extent of capital gains. IRC §641(c)(2)(D); Treas Reg §1.641(c)-1(d)(3). Thus, there is no $3000 offset against income or ability to use capital losses against other capital gains. Moreover, there is no deduction for amounts distributed to beneficiaries (IRC §641(c)(2)(C), flush language), but distributions to beneficiaries are tax-free in their hands. The non-S corporation portion of any ESBT is allowed a deduction for distributions to beneficiaries made by the S corporation portion of the trust, but not in excess of the non-S portion's distributable net income. Treas Reg §1.641(c)-1(i). This means that if the ESBT has no non-S portion, distributions to beneficiaries are tax-free in their hands. The regulations also authorize a deduction by the ESBT under IRC §642(c) for its share of charitable contributions made by the S corporation. Treas Reg §1.641(c)-1(d)(2)(ii).

The non-S portion of an ESBT is taxed under the normal rules of subchapter J, excluding the items taken into account with respect to the ESBT. IRC §641(c)(3). On termination of the S corporation and thus of the ESBT, any carryovers or excess deductions are taken into account by the whole trust. IRC §641(c)(4); Treas Reg §1.641(c)-1(j).

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§13.156 C. Foreign Trusts

Foreign situs trusts are, by definition, trusts sited outside the jurisdiction of the United States or, as stated by the Code, any trust that is not a United States person. IRC §7701(a)(31). A trust is a United States person if it is subject to the jurisdiction of a United States court and if a United States person controls all substantial decisions of the trust. IRC §7701(a)(30)(E). Foreign trusts have been touted as tax shelters and as a means of deferring United States income tax, but changes in the law have, for all practical purposes, eliminated those advantages, leaving only asset protection and/or managing foreign investments not easily available to United States citizens or residents as ostensible reasons for establishing a foreign trust. Because foreign trusts have only limited use for estate planning purposes, the following is a very brief overview of their tax treatment. For a more thorough discussion, see Zaritsky & Rosen, U.S. Taxation of Foreign Estates, Trusts and Beneficiaries, Tax Management Portfolios 854-3d (2008). See also chap 16.

Foreign trusts are usually classified as "inbound" or "outbound." Inbound trusts are foreign situs trusts established by nonresident aliens (1) in anticipation of moving to the United States; (2) for the benefit of one or more United States beneficiaries; and (3) somewhat illogically, established with United States assets for foreign beneficiaries. Outbound trusts are (1) foreign situs trusts created by United States persons or (2) domestic trusts that migrate offshore.

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1. Inbound Trusts

§13.157 a. Foreign Grantor Trusts

Prior to 1996, it was common for nonresident aliens, particularly businesses, to establish United States grantor trusts in tax-free jurisdictions as a means of moving offshore income to subsidiaries or individuals. See Rev Rul 69-70, 1969-1 Cum Bull 182. Internal Revenue Code §672(f)(1) now prevents this ploy by foreclosing grantor status to persons who are not United States citizens or residents. Similarly, nonresident aliens planning to move to the United States could in the past transfer assets to a foreign third party to use to establish a trust for the original transferor's benefit. If the trust were defective, the third party (presumably in a non-tax jurisdiction), not the former nonresident alien, would be taxable on the income. Internal Revenue Code §672(f)(5) now prevents this ploy. Thus, the grantor trust rules apply only to portions of trusts treated as owned by a United States citizen, resident, or corporation. The other portions of the trust are subject to the rules of subparts A through D of subchapter J. See Treas Reg §1.672(f)-1. Of course, if the offshore trust is revocable by a nonresident alien grantor or a related or subordinate party, it is a grantor trust and its income, deductions, and credits (or those attributable to the revocable portion) are taken into account by the grantor. IRC §672(f)(2)(A)(i); Treas Reg §1.672(f)-3(a)(1).

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b. Nongrantor Foreign Trusts

§13.158 (1) Taxation of Trust

A nongrantor foreign trust determines its tax in the same manner as does a nongrantor domestic trust, through the medium of its DNI. The DNI of a nongrantor foreign trust, however, includes not only its United States source income, but also its foreign source income and its net capital gains. IRC §643(a)(6); Treas Reg §1.643(a)-6(a). See Treas Reg §1.643(a)-6(b), Example (1). United States source income falls into three categories: (1) income effectively connected with a United States trade or business; (2) gains from the sale of United States realty; and (3) other United States income, including "fixed or determinable annual or periodic income" and other capital gains.

The trust's income from a United States trade or business is determined in essentially the same manner as is similar income earned by a domestic trust, with the same deductions, etc., generally at the source (*i.e.,* the business). IRC §871(b). Distributions by the business to the nongrantor foreign trust are subject to a 30-percent withholding tax, with some exceptions. See IRC §1441. Gains from the sale of United States realty (or interest in a realty holding company) are similarly subject to tax as if the seller were a United States citizen or resident. IRC §897. Withholding at the source is also required. IRC §1445. Net capital gains realized from sale of United States assets other than realty and not connected to a United States trade or business are *not* taxable unless the trustee or other fiduciary is present in the United States for at least 183 days. IRC §871(a)(2); Treas Reg §1.871-7(d).

Fixed or determinable annual or periodic income not effectively connected to a United States trade or business is subject to a 30-percent flat tax rate (unless a treaty specifies otherwise) on the *gross* amount of income. IRC §871(a)(1)(A). Fixed or determinable annual or periodical gains, profits, and income include interest, dividends, rents, and annuities, as well as wage-related items such as salary, compensation, remuneration, and emoluments not usually seen by trusts. IRC §871(a)(1)(A). The 30-percent tax applies to gross rentals (unreduced by management fees, real property taxes, etc.), unless the trust elects to treat the rents as United States source income. IRC §871(d). Portfolio interest (unless received by a person who owns 10 percent or more of the voting stock of a corporation), interest on deposits with banks or insurers that are not connected with the conduct of a United States trade or business, and dividends from a United States corporation that meet a narrow foreign business income test are excluded from taxation. IRC §871(h), (i). Similar items are excluded from the taxable estate of a nonresident alien. IRC §2105(b). See §16.18. Gambling winnings from wagering at blackjack, roulette, baccarat, and craps are also excluded from the application of the tax as are certain dividends received from regulated investment companies. IRC §871(j)-(k).

Like a domestic trust, a nongrantor foreign trust is entitled to a deduction for distributions to its beneficiaries. Thus, if the trust is a simple trust, all of its income will be taxed to the beneficiaries (to the extent of DNI received); if complex, the trust will be taxed on the income not distributed (to the extent of DNI retained).

As might be expected, nongrantor foreign trusts are subject to the alternative minimum tax (AMT). The trust calculates its alternative minimum taxable income in the same manner as does a domestic trust. The income is then allocated between the trust and its beneficiaries on the basis of their respective shares of DNI. A nongrantor foreign trust apparently may credit its minimum tax liability against subsequent years' AMT. See IRC §53.

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§13.159 (2) Taxation of Beneficiary

United States beneficiaries of nongrantor foreign trusts are taxed on the trust's current income, from sources from inside or outside the United States, in a manner similar to that of beneficiaries of domestic trusts: if the trust is a simple trust, they will take into account the lesser of the trust's net income or the amount of DNI (IRC §652(a)); if the trust is complex, they will take into account the lesser of the income distributed to them or their share of DNI (IRC §662(a)). A special rule applies, however, to loans of cash or marketable securities to beneficiaries of foreign trusts. Internal Revenue Code §643(i) treats such loans as distributions. Because capital gains are included in the DNI of a nongrantor foreign trust, a distribution to a United States beneficiary in a year in which the trust has ordinary income and capital gains will include a proportionate share of each, based on the amount of each entering into the determination of DNI. See Treas Reg §1.643(a)-6(b), Example (1). As might be expected, the income or gain retains its character in the beneficiary's hands. IRC §662(b).

Distributions to United States beneficiaries of nongrantor foreign trusts in excess of current year's DNI (an "accumulation distribution") will either be a nontaxable distribution of principal or a throwback. While Congress eliminated throwback for domestic trusts in 1997, it did not do the same for foreign trusts. IRC §665(c)(2)(A). Throwback*, i.e*., the taxation of a distribution of accumulated income in the hands of a United States beneficiary as if it had been taken into account by the beneficiary when earned, is treated more harshly for foreign trusts than it was for domestic trusts. For example, United States beneficiaries of foreign trusts are subject to unlimited throwback of accumulated income*, i.e.,* of income no matter when accumulated, and distributions from a foreign trust are subject to an interest charge on the accumulation distribution. The calculation of the throwback tax, a separate tax, is complex. See Zaritsky & Rosen, U.S. Taxation of Foreign Estates, Trusts and Beneficiaries, Tax Management Portfolios 854-3d §V(E) (2008).

A foreign beneficiary of a nongrantor foreign trust is subject to tax on the trust's United States source income. This determination is ostensibly made at the trust level, but really occurs at the source because the United States has no jurisdiction over the trust or the beneficiary and thus no power to tax.

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§13.160 2. Outbound Trusts

Transfers to foreign trusts by United States persons or movement of United States trusts offshore for purposes of avoiding or deferring United States taxation are effectively hampered by IRC §§679 and 684.

Internal Revenue Code §679(a)(1) treats a United States person who directly or indirectly makes a lifetime transfer of property to a foreign trust that has a United States beneficiary as a grantor under subpart E of subchapter J, whether Sections 673 through 678 apply to the trust or not. See Treas Reg §1.679-1(a). A United States person includes a nonresident alien who becomes a resident within 5 years after transferring property to the foreign trust. IRC §679(a)(4)(A); Treas Reg §1.679-5. Internal Revenue Code §679(a)(5) also treats a United States person who transferred property to a domestic trust that later becomes a foreign trust as an owner under subpart E. See Treas Reg §1.679-6(a). In each case, the grantor will be required to take into account the income, deductions, and credits of the foreign trust to the extent attributable to the grantor's contributions. IRC §671. As might be expected, if the grantor dies and leaves property to a foreign trust that has one or more United States beneficiaries, the grantor is not treated as an owner. IRC §679(a)(2)(A). Nor does a sale at fair market value of property to a foreign trust that has one or more United States beneficiaries cause the seller to be treated as a grantor. IRC §679(a)(2)(B). If the trust has no United States beneficiary, it is treated as an inbound trust as discussed above (see IRC §679(c)), but is subject to the recognition of gain rule of IRC §684.

Internal Revenue Code §684 requires that gain be recognized on any transfer of appreciated property by a United States person to a foreign trust or nonresident alien. The amount of gain recognized is the excess of the fair market value of property over the transferor's adjusted basis. IRC §684(a); Treas Reg §1.684-1(a)(1). No loss, however, may be recognized. Treas Reg §1.684-1(a)(2). This rule would be draconian at best were it combined with the rule of IRC §679; fortunately, no gain is recognized by a United States person who is treated as an owner under IRC §671. IRC §679(b). This is, of course, of no benefit to one who transfers appreciated property to a foreign trust that does not have a United States beneficiary. Moreover, termination of grantor trust status will likely cause recognition of gain if the trust holds assets subject to loans in excess of basis (see Rev Rul 87-61, 1987-2 Cum Bull 219 (termination of grantor trust status required recognition of gain under former IRC §1491)) and may cause recognition of any gain. See Williams & Layman, *Section 684—Grantor/Nongrantor Trust Conversions—Nuances and Enigmas*, 33 Tax Mgmt Int'l J 509 (Sept. 2004). In IRS Letter Ruling 200338015, however, the Service ruled that IRC §684 did not apply to a donor who established residency in the United States within 5 years after establishing a trust with a foreign trustee and, as a result, became a United States person who had established a foreign trust under IRC §679 when a domestic trustee was later named and the trust ceased to be a grantor trust.

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Source: Estate Planning/California Estate Planning/13 Taxing Income of Estates and Trusts/§13.160A D. Qualified Revocable Trusts: IRC §645 Election for 'Administrative Trust'

§13.160A D. Qualified Revocable Trusts: IRC §645 Election for "Administrative Trust"

Upon the death of the settlor of a qualified revocable trust (QRT), the executor of the decedent's estate or the successor trustee of the QRT (depending on the circumstances) may elect to treat the trust as part of the decedent's estate for income tax purposes during the post-death trust administration period under IRC §645.

NOTE: Before the enactment of IRC §645, it was common to create an "administrative trust" to report the trust's post-death income based on Rev Rul 57-51, 1957-1 Cum Bull 171, which allowed the now irrevocable trust to report on a fiscal-year basis. Although the §645 election eliminates the need to create a new trust and adds benefits not otherwise attainable under the old administrative trust regime, it is still common to call trusts that have made the §645 election "administrative trusts."

A QRT is any trust (or portion of a trust) that was owned by the decedent on the decedent's death because he or she possessed the power to revoke the trust or that portion of the trust. See Treas Reg §1.645-1(b)(1). See also IRC §672(e). On the benefits of taxation as an estate, see §13.160B. On potential disadvantages of the election, see §13.160C. On making the election, see §13.160D. On termination of the election, see §13.160E.

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§13.160B 1. Benefits of Taxation as Estate

If no IRC §645 election is made, all post-death income is taxable directly to the trust's beneficiaries or its succeeding trusts, even if they are not yet funded by the time the income tax return is due. If, instead, the election is made, the decedent's trust can take advantage of some of the benefits that are available to taxation as an estate. These include the ability to do the following:

- Use a fiscal tax year (which often allows the executor to defer beneficiaries' income tax obligations);
- Hold S corporation stock without invalidating the subchapter S election (IRC §1361(b)(1)(B));
- Use the charitable set-aside deduction (IRC §642(c));
- Recognize loss on satisfaction of a pecuniary bequest with assets that have a basis below fair market value (IRC §267(b)(13));
- Waive active participation requirements under the passive loss rules for taxable years ending less than 2 years after the decedent's death (IRC §469(i)(4));
- Ensure no estimated tax payments must be made for 2 years after the decedent's death (IRC §6654(*l*)(2));
- Receive deductions for amortization of reforestation expenditures (IRC §194(c)(4); Treas Reg §1.194-1(a)); and
- Provide beneficiaries the opportunity to contemplate a qualified disclaimer without concern for the trustee's need to close the administration at the end of a calendar year, before the end of the 9-month disclaimer period (IRC §2518(b)).

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§13.160C 2. When Election May Be Inappropriate

Although most practitioners routinely make the IRC §645 election, there may be instances when it is not appropriate. For example, if the entire trust administration will be completed within the calendar year of the decedent's death, the allocation of income to the beneficiaries or succeeding trusts should be relatively straightforward; not making the election saves the trustee from filing an additional fiduciary income tax return. An election also may be inappropriate if the beneficiaries' income tax brackets are lower than the trust's and the trust is unable to make preliminary distributions of income (*i.e.,* there is "phantom income"). Even in situations when not making the §645 election seems appropriate, the trustee should make sure there are no other reasons for making the election—for example, if the trust holds stock in an S corporation.

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§13.160D 3. Making the IRC §645 Election

How to make the IRC §645 election depends on whether the trustee alone is making the election or whether the trustee and executor are both involved in making the election and reporting trust income.

- If the trustee alone is making the election, the trustee reports all income on a return for the "electing trust." IRC §645(b)(1); Treas Reg §1.645-1(b)(2).
- If the trustee and the executor of the decedent's estate are making the election together, the executor reports the income of both the electing trust and the "related estate" on one return. See Treas Reg §1.645-1(b)(5).
- If the trustee makes the election and an executor is later appointed, the trustee reports the electing trust's income for all periods prior to the executor's appointment, and the executor reports the income of both the related estate and the electing trust on one return after the executor's appointment. Treas Reg §1.645-1(g)(2)(ii).

The §645 election is actually made by the appropriate personal representative filing Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, with the Internal Revenue Service no later than the time prescribed for filing Form 1041, U.S. Income Tax Return for Estates and Trusts, for the first taxable year of the related estate, including extensions, *regardless of whether there is sufficient income to require the filing of that return*. See Treas Reg §1.645-1(c). See also IRC §6072(a) regarding deadlines for filing Form 1041 (the 15th day of the fourth month following the close of the taxable year). Under Rev & T C §17751, any election made under IRC §645 shall also apply for California income tax reporting purposes. For an extended discussion of how to make the §645 election, see De Francisco & Calleton, *Pennies From Heaven: Proper Use of the Section 645 Election Effectively Provides Revocable Trusts With the Same Income Tax Benefits as Estates*, 30 Los Angeles Lawyer 20 (Mar. 2007) (available on the Los Angeles County Bar Association website at http://www.lacba.org).

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§13.160E 4. Termination of IRC §645 Election

An IRC §645 election terminates on the earlier of the day on which all related estate (if any) and QRT assets are distributed or one day before the "applicable date." IRC §645(a); Treas Reg §1.645-1(f)(1). The applicable date varies depending on whether the size of the decedent's gross estate requires the filing of a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. See IRC §645(b)(2). See also IRC §6018(a).

- If a Form 706 is not required, the applicable date is the day that is 2 years after the date of the decedent's death. Treas Reg §1.645-1(f)(2)(i).
- If a Form 706 is required, the applicable date is the later of the day that is 2 years after the decedent's date of death, or the day that is 6 months after the date of final determination of liability for estate tax. Treas Reg §1.645-1(f)(2)(ii).

Although the date of final determination varies, in most circumstances when Form 706 must be filed, the applicable date will be the later of 2 years after the decedent's date of death or the day that is 12 months after the issuance of an estate tax closing letter. Thus, although trustees are allowed a reasonable period of time to "perform the duties necessary to complete the administration of the trust," the §645 election may terminate prior to the completion of the trust administration. See Treas Reg §1.641(b)-3(b).

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§13.161 V. CALIFORNIA FIDUCIARY INCOME TAX

California (and some out-of-state) fiduciaries are subject to California personal income tax law set forth in Chapter 9 of Part 10 of Division 2 of the California Revenue and Taxation Code (Rev & T C §§17731-17779). Fortunately, California law incorporates most of the rules of subchapter J of the Internal Revenue Code (see Rev & T C §17731) and regularly conforms most of its income tax provisions to changes made in the Internal Revenue Code. This conformity makes preparation of the California fiduciary income tax return (FTB Form 541) "relatively" straightforward for those familiar with federal fiduciary income taxation. Nevertheless, there is a time lag between the effective date of changes to federal fiduciary income tax law and the adoption of conforming legislation by the California Legislature, so federal law cannot be slavishly followed. Current conformity is with federal changes effective January 1, 2005, but conformity to later federal changes can reasonably be anticipated. See Stats 2005, ch 691. Despite conformity, there are differences between the federal and California fiduciary income tax laws: those caused by the legislature's decision not to conform and those provisions that cannot be conformed. This chapter discusses some of those differences.

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§13.162 A. Taxable Income

California uses the federal definition of gross income found in IRC §61, that is, "all income from whatever source derived." See Rev & T C §17071. The federal definitions of adjusted gross income and taxable income have also been incorporated into California law, subject, however, to some modifications. Rev & T C §17062-17063. The most important adjustments are that California does not tax interest on bonds and other obligations of either the United States and its territories (including Puerto Rico) or the State of California. See Rev & T C §17143. Obligations of federally backed organizations like the Federal National Mortgage Association (Fannie Mae) are not treated as United States obligations and are subject to California income tax. See FTB Publication 1001, Supplemental Guidelines to California Adjustments, p 2.

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§13.163 1. Decedent's Estates

Perhaps the most difficult question faced by fiduciaries concerns just what income is subject to California fiduciary income taxation. For executors and administrators of estates of decedents who were domiciled in California, the answer is simple: All of the estate's undistributed income is subject to California income tax even if the executor or administrator is not a California resident. Rev & T C §17742(a). Estates of nonresident decedents are subject to tax only on income derived from California sources ("California source income"). Rev & T C §17951(a); 18 Cal Code Regs §17742(a).

California source income is that derived from sources within California such as real property and businesses located in California. Rev & T C §17953; 18 Cal Code Regs §§17951-2—17951-4. California source income does not include income from stocks, bonds, and other intangible personal property unless it has acquired a business situs within California, which occurs when sales or purchases are regularly, continuously, and systematically made within the state. Rev & T C §17952. Because most trades are made through the New York offices of brokerage firms and because most clearing houses are in New York City, regular, continuous, and systematic sales or purchases are infrequent in California.

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§13.164 2. Trusts

Trusts are treated similarly to decedent's estates, as discussed in §13.163. If all trustees and beneficiaries reside in California, all of the trust's undistributed income is subject to California income tax. Rev & T C §17742(a). This rule should also apply to a revocable trust created by a California decedent that has elected under IRC §645, and a fortiori under Rev & T C §17751(a), to be treated as an estate during the period of administration. Trusts with no California trustees or beneficiaries are subject to tax only on California source income. Rev & T C §17951(a); 18 Cal Code Regs §17742(a). The residence of a corporate trustee is determined by the place that it conducts the major part of the trust's administration. Rev & T C §17742(b).

Taxation becomes more complex if not all trustees or beneficiaries are California residents. The Revenue and Taxation Code (and regulations) attempts to apply some logic to the various permutations, according to the following rules:

- If there are multiple trustees, one or more of whom is not a California resident, the undistributed trust income subject to California income tax is apportioned according to the "number of fiduciaries resident in the state." Rev & T C §17743. Thus, if a trust has one California resident trustee and one nonresident trustee and no California resident beneficiaries, one-half of the trust's net undistributed income will be subject to California income tax in addition to all California source income. 18 Cal Code Regs §17743, Example 1.
- If no trustee is a resident of California, but one or more of the beneficiaries is a California resident, and the interests of the beneficiaries are "noncontingent," the California source income is subject to California income tax and the remaining undistributed net income of the trust is apportioned according to the "number of beneficiaries resident in the state." Rev & T C §17744. Thus, if a trust has one California resident and one nonresident noncontingent beneficiary and no California resident trustee, one-half of the trust's net undistributed income will be subject to California income tax in addition to all California source income. 18 Cal Code Regs §17744, Example 1.
- If there are resident and nonresident trustees and resident and nonresident noncontingent beneficiaries, the non-California source income is allocated proportionally, first using the ratio of resident trustees to all trustees and then using the ratio of resident noncontingent beneficiaries to all noncontingent beneficiaries. See FTB Legal Ruling 238 (Oct. 27, 1959). Thus, if a trust has one California resident trustee and two nonresident trustees and one resident and one nonresident noncontingent beneficiary, the non-California source income is first divided proportionately according to the number of California trustees (one-third); then the part that was not attributed to the California trustee (two-thirds) is divided proportionately according to the number of California noncontingent beneficiaries (one-half); with the result that two-thirds (⅓ + (½ × ⅔)) of the non-California source income is taxable in addition to all California source income.

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§13.165 3. Beneficiaries

California beneficiaries of resident or nonresident estates and trusts must include all income distributed to them whether it has a California source or not. See Rev & T C §17041(a). Nonresident beneficiaries of California estates or trusts must include in their income California source income that is deductible by the estate or trust. Rev & T C §17041; 18 Cal Code Regs §17951-1(c). Income deductible by the estate or trust means distributable net income, or as stated in the Beneficiary's Instructions for Schedule K-1 (FTB Form 541) at p 31 of the California Fiduciary Income Tax Booklet, the beneficiary's "distributive share of the fiduciary's income distribution deduction for the taxable year."

Beneficiaries who were or become resident in California for only part of the year are taxed on part of the trust or estate income distributed to them, generally on the basis of the number of days resident in California. FTB Publication 1100, Taxation of Nonresidents and Individuals Who Change Residency, p 31, states that the allocation of income between the period of residency and that of nonresidency is to be made on the basis of realization (presumably, for cash basis taxpayers, when received). If the actual date of realization is not determinable, the beneficiary is to allocate the annual amount on a proportional basis using a daily prorata method.

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§13.166 4. Throwback Rules

California has conformed to federal law repealing the throwback rules for domestic trusts. IRC §665(c). However, if a trust that has a California contingent beneficiary did not pay California tax on that beneficiary's share of the income (presumably because it was retained in trust and taxed to the nonresident or other trust), the accumulated or otherwise undistributed income is included in the California beneficiary's tax in the year it becomes distributable or is actually distributed. Rev & T C §17745(b)-(c).

Contingent interests are those subject to a condition precedent, such as survivorship. 18 Cal Code Regs §17742(b). Beneficiaries of discretionary trusts also have contingent interests. Nevertheless, whatever the reason that the California beneficiary did not receive current distribution of trust income, it will be subject to tax when distributed. See *McCulloch v Franchise Tax Bd.* (1964) 61 C2d 186, 390 P2d 412, appeal dismissed (1964) 379 US 133. A California resident beneficiary cannot avoid the tax by leaving the state; Rev & T C §17745(e) provides that any beneficiary who was resident in California during the period of accumulation and leaves the state within 12 months before the distribution and returns within 12 months after the distribution is presumed to have remained a California resident.

Nonresident beneficiaries are subject to California throwback tax only on the portion of the accumulation distribution attributable to California source income. See California Schedule J (FTB Form 541), Trust Allocation of an Accumulation Distribution, side 2.

The beneficiary's tax on previously accumulated or undistributed income retained by resident or nonresident trusts is determined through the mechanism of throwback. Throwback has not applied to domestic trusts for federal fiduciary income tax purposes since the latter part of 1997, although it still applies, for federal purposes, to foreign trusts. Throwback income is reported by the trustee on Schedule J (541), which follows the rules set forth in IRC §§665-668. The tax attributable to the inclusion of the throwback income is the "aggregate of the taxes which would have been attributable to that income had it been included in the gross income of that beneficiary ratably for the year of distribution and the 5 preceding taxable years, or for the period that the trust accumulated or acquired income… [if] shorter." Rev & T C §17745(d). The beneficiary computes the actual tax to be paid on Form 5870A, Tax on Accumulation Distribution of Trusts. Beneficiaries are entitled to a credit for taxes imposed by other states on amounts subject to California tax in an amount not to exceed the tax paid the other state. Rev & T C §18005; FTB Legal Ruling 375 (1974). There is no separate credit for taxes deemed distributed as part of the accumulation distribution, since they are taken into account when determining the tax. See IRC §667(b)(1).

Income accumulated before the beneficiary attained age 21 does not count as part of the throwback. See IRC §§665, 667(c); Schedule J (541), p 2; FTB Form 5870A. If the trust was a simple trust for any "preceding taxable year," the income of that year is not taken into account by the beneficiary unless it was "outside income," namely, amounts included in the trust's income that were required to be allocated to principal (such as IRD). See Treas Reg §1.665(e)-1A(b).

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§13.167 B. California Tax Rates

California fiduciary income tax rates are the same as those for single residents and married residents filing separately and are set forth in Rev & T C §§17041(e), 17043. The regular income tax brackets are recomputed annually (after August 1) by multiplying the preceding year's bracket amount by an inflation-adjustment factor derived from the increase in the California Consumer Price Index during the period from June of the prior calendar year through June of the current year. Rev & T C §17041(h). The 1-percent mental health surcharge on incomes in excess of $1 million is not adjusted for inflation. Rev & T C §17043(c)(2). For individuals with smaller taxable incomes, the Franchise Tax Board is required to supply tax tables to be used to determine the amount of tax, but these tables may not be used by estates or trusts. Rev & T C §17048. California has no separate rate schedule for capital gains. Accordingly, capital gains (and qualified dividends) are taxable in the same manner as ordinary income, even if capital gains are allocated to the principal account.

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§13.168 1. Regular Tax Rates

The regular California income tax rates applicable to estates and trusts in 2009 are as follows.

Taxable Income	*Tax Rate*
$0 to $7060	1.25 percent
$7060 to $16,739	$88.25 plus 2.25 percent of amount over $7060
$16,739 to $26,419	$306.03 plus 4.25 percent of amount over $16,739
$26,419 to $36,675	$717.43 plus 6.25 percent of amount over $26,419
$36,675 to $46,349	$1358.43 plus 8.25 percent of amount over $36,675
over $46,349	$2156.54 plus 9.55 percent of amount over $46,349

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§13.169 2. Alternative Minimum Tax

An alternative minimum tax (AMT) of 7.25 percent (in 2009-2010) applies to California estates and trusts. Rev & T C §17062. As with the federal AMT, the tax is imposed on the excess of the tentative minimum tax for the taxable year over the regular tax determined under Rev & T C §17041. Rev & T C §17062. The tax is computed in the same manner as provided by IRC §§55-59. See §13.20.

The "exemption amount" for California estates and trusts in 2009 is $39,407, reduced by 25 percent of the amount by which the alternative minimum taxable income exceeds $147,781. Thus, for estates or trusts that have alternative minimum taxable income in excess of $305,409, the tentative minimum tax is simply 7.25 percent of its alternative minimum taxable income. The exemption amount and phaseout amount are recalculated each year in the same manner as the income tax brackets. See Rev & T C §17062(b)(7).

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§13.170 C. California Estimated Tax

California estates and trusts are required to make estimated tax payments in the same manner as individual taxpayers. Rev & T C §19136(a); IRC §6654(*l*)(1). However, estates, and qualified revocable trusts electing under Rev & T C §17751, need not make estimated tax payments during the first 2 years after the decedent's or deceased settlor's death. Rev & T C §19136(a); IRC §6654(*l*)(2). In all other cases, estates and trusts must make quarterly estimated tax payments unless one of the following applies:

- 100 percent or more of the estate's or trust's preceding year's tax (110 percent if the estate's or trust's adjusted gross income exceeded $150,000) was paid by withholding, or 90 percent or more of the estate's or trust's current year's tax will be paid by withholding. Rev & T C §19136(a); IRC §6654(d). This exception is, of course, unlikely unless the estate or trust is receiving large amounts of IRD, such as distributions from retirement plans from which the tax is withheld.
- The prior year's tax was less than $500 or the current year's tax will be less than $500. Rev & T C §19136(c).

The fiduciary calculates estimated taxes on FTB Form 541-ES, which contains detailed instructions regarding payment dates and filing an early return rather than paying a fourth installment of estimated tax, and even information for those estates or trusts that receive two-thirds of their gross income from farming or fishing.

Penalties for underpayment of estimated taxes also apply to California estates and trusts. Rev & T C §19136(a). No penalty applies, however, to underpayments of tax resulting from changes wrought by legislation that was chaptered during the current tax year. Rev & T C §19136(g).

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§13.171 D. Filing Requirements

No California fiduciary income tax return need be filed if there are no California fiduciaries, noncontingent beneficiaries, or California source income. The (or one of the) fiduciaries of a decedent's estate must file a California fiduciary income tax return if the estate has (1) gross income of more than $10,000 (regardless of the amount of taxable income); (2) taxable income of $1000 or more; or (3) any alternative minimum tax liability. Rev & T C §18505(d), (f).

Similarly, the (or one of the) trustees of a trust must file a California fiduciary income tax return if the trust has (1) gross income of more than $10,000 (regardless of the amount of taxable income); (2) taxable income of $100 or more (note the distinction here between estates and trusts); or (3) any alternative minimum tax liability. Rev & T C §18505(e)-(f).

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§13.172 E. Fiscal Year

California estates and qualified revocable trusts may elect fiscal years, as may charitable trusts exempt from taxation under IRC §501(a) or charitable remainder trusts described in IRC §4947(a)(1). Rev & T C §17551. The tax year of an estate commences with the date of the decedent's death and ends either on December 31, if a calendar year is used, or on the last day of any month ending within 12 months of the decedent's death.

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§13.173 F. Fiduciary Liability

As might be expected, fiduciaries are liable for paying the tax due from California estates and trusts. Rev & T C §19071. Failure to pay the tax due may subject the fiduciary to personal liability for the tax. Rev & T C §19516. Fiduciaries must also withhold California tax on California source income that is paid to nonresident beneficiaries. Rev & T C §18662(a). Failure to withhold or remit the tax withheld may also result in personal liability. Rev & T C §18662(d). Fiduciaries of California estates must give notice of any court-supervised estate administration to the Franchise Tax Board. Prob C §9202(c)(1). Fiduciaries of estates that exceeded $1 million in value at date of death must obtain a tax clearance certificate from the Franchise Tax Board on Form FTB 3751 under Rev & T C §19513, if distributions aggregating $250,000 are to be made to nonresident beneficiaries of California estates. 18 Cal Code Regs §19513; Cal Rules of Ct 7.551. Failure to obtain the certificate will prevent approval of the fiduciary's final account by the probate court (see Rev & T C §19513) and will prevent the fiduciary from claiming a deduction for the nonresident beneficiary distributions on the fiduciary income tax return under Rev & T C §17735.

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§13.174 G. Tax Credits

California grants numerous credits against taxes.

- *Personal exemption credit*. In lieu of the personal exemption or the IRC §642(b) deductions in lieu of exemptions, California allows estates and qualified revocable trusts a credit of $10 against the tax payable, and allows other trusts, except qualified disability trusts, a $1 credit. Rev & T C §17733. Qualified disability trusts are allowed a $98 credit. Rev & T C §17054.
- *Taxes paid to other states*. California allows a credit for income taxes paid to another state, not to exceed the amount actually paid to that state. Rev & T C §18001(a). A credit is also allowed for sales taxes paid to another state, not to exceed the tax that would have been made had the purchase been made in California (an unlikely credit because California sales taxes exceed those of almost every other state). Rev & T C §17053.70. Of course, purchases in other states may subject the estate or trust to California use taxes.
- *Miscellaneous credits*. California also allows numerous other credits against the income tax. Among these are credits for the prior year's alternative minimum tax, an environmental tax credit, and a natural heritage preservation credit, most of which will not apply to estates and trusts. Practitioners should first check the Instructions for FTB Form 541 for the applicable year, and then the website of the Franchise Tax Board, http://www.ftb.ca.gov, to ascertain current credits and conformity (search for "conformity").
- *Voluntary contributions*. Schedule C of FTB Form 541 allows an estate or trust to make a voluntary contribution of $1 or more to a number of listed charitable funds, including Alzheimer's, rare and endangered species, prevention of child abuse, and breast and prostate cancer research. Rev & T C §§18701-18872. Of course, unless the trust or will specifically authorizes gifts to these organizations, or discretionary gifts to charity, making a voluntary contribution will be a breach of trust for which the fiduciary may be surcharged. Caveat donor.

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14

State Death Taxes

James R. Birnberg

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I. CALIFORNIA ESTATE TAX

§14.1 A. State Death Tax Credit Amount and Limitation

The California inheritance tax was repealed by Proposition 6 on June 8, 1982. See Rev & T C §13301. At the same time, an estate tax (called a pickup tax) was imposed in its place. The pickup tax requires that whenever federal estate tax is payable to the United States, California estate tax is imposed equal to the maximum allowable federal credit for state death taxes attributable to property located in California. The combined federal and California estate tax liability may not exceed the estate tax liability to the United States that would result if the California estate tax were not imposed. Rev & T C §13302. Because the California estate tax is tied to the amount of the IRC §2011 state death tax credit, the California estate tax does not apply to estates of decedents dying after 2004. See §14.4. Independent state estate taxes may continue to apply to estates of decedents with property in other states with estate taxes that were computed in the same manner as a pickup tax, but were not worded in a manner that would automatically incorporate changes in federal law. See Estate Planning for Special Assets, chap 5 (Cal CEB 2004).

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§14.2 B. Federal State Death Tax Credit

California permits estate taxes only to the extent there is an available federal credit for state death taxes. See Rev & T C §13302. The current federal credit rates are set out in IRC §2011(b)(1). The federal credit is allowable for any estate, inheritance, or succession tax paid to a state or to the District of Columbia.

With certain exceptions, the credit is allowed only for taxes actually paid, and the credit must be claimed within 4 years after filing the federal estate tax return. IRC §2011(c). Special adjustments exist for certain deductions from death taxes permitted under IRC §2053(d). See IRC §2011(e). In addition, there is a limitation that the state death tax credit cannot exceed the amount of the estate tax imposed less the unified credit. IRC §2011(f). Finally, there are special provisions in IRC §2011(c) for non-payment of interest when tax is refunded solely because of the state death tax credit, and in IRC §2016 for the recovery of estate tax without any statute of limitation when credited tax is refunded by the state.

Credits for foreign death taxes are governed by IRC §2014, rather than §2011.

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§14.3 C. Generation-Skipping Transfer Tax Credit

In addition to the pickup estate tax, California has a pickup generation-skipping transfer (GST) tax equal to the credit allowed against the federal GST tax for payments of state GST tax. Rev & T C §16710. See IRC §2604. The credit is limited to 5 percent of the amount of federal GST tax. IRC §2604(b). It resembles in concept the credit against federal estate tax under IRC §2011 for state death taxes paid.

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§14.4 D. Changes Caused by the Economic Growth and Tax Relief Reconciliation Act of 2001

A provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) phased out the IRC §2011 state death tax credit. The otherwise allowable credit was reduced by 25 percent for estates of decedents dying in 2002, 50 percent for estates of decedents dying in 2003, and 75 percent for estates of decedents dying in 2004, and the credit is repealed for estates of decedents dying after 2004. See IRC §2011(b)(2), (g). Estates of decedents dying after 2004 are allowed a federal estate tax deduction for payments of state death taxes. IRC §2058. The 5-percent credit under IRC §2604 (see §14.3) does not apply to generation-skipping transfers occurring after 2004. See EGTRRA-2001 §532(c)(10). The act includes a sunset provision effective in the year 2011. See EGTRRA-2001 §910. Accordingly, it is theoretically possible that the California estate tax will apply to estates of decedents dying after 2010.

Some states impose state death taxes in amounts that are not automatically reduced by changes in the allowable IRC §2011 state death tax credit. When all or a portion of an estate is subject to state death tax in such a state, the total federal and estate tax may increase as a result of the phaseout of the federal credit. Absent voter approval, the California legislature cannot enact a tax that is not tied to the federal credit. See Cal Const art II, §10(c) (limiting amendments to statutes enacted by initiative).

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E. Calculating State Death Tax Credit

§14.5 1. Credit Rate Tables

The state death tax credit is calculated using the "adjusted taxable estate," which is the "taxable estate" reduced by $60,000. IRC §2011(b)(3). Before taking into account the phaseout of the credit, the maximum credit may be calculated using the following table.

Table for Computation of Maximum Credit for State Death Taxes

(A) Taxable estate equal to or more than	(B) Taxable estate less than	(C) Credit on amount in column (A)	(D) Rates of credit on excess over amount in column (A) (percent)
$ 40,000	$ 90,000	———	0.8
90,000	140,000	$ 400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3.040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000	———	1,082,800	16.0

The result produced by the table is then reduced by 25 percent for estates of decedents dying in 2002, 50 percent for estates of decedents dying in 2003, and 75 percent for estates of decedents dying in 2004. See IRC §2011(b)(2). No credit is allowed for estates of decedents dying after 2004. See §14.4.

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§14.6 2. Other Federal Credits

The last sentence of Rev & T C §13302 (see §14.1) specifies that "in no event shall the estate tax hereby imposed result in a total death tax liability to the State of California and the United States in excess of the death tax liability to the United States which would result if this section were not in effect." This means that California's estate tax can in some instances be less than the amount calculated using the rate table. Accordingly, the tax preparer has to determine the amount of state death tax credit after considering reduction of the federal estate tax by credits for gift taxes paid (see IRC §2010), taxes on prior transfers (see IRC §2013), or foreign death taxes (see IRC §2014). See discussion in §§10.59-10.65.

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§14.7 F. California Estate Tax Return

A California estate tax return (Form ET-1) must be filed for every estate subject to California estate tax that is required to file a federal estate tax return. Rev & T C §13501. The return and any taxes owed generally will be due 9 months after the date of death. Rev & T C §13501; IRC §6075. For nonresident decedents, an Affidavit Concerning Residence (Form IT-2) must be attached to the return.

On the estate tax return filing requirements and deadlines, see 3 California Decedent Estate Practice, chap 34 (2d ed Cal CEB 2009). See also California Trust Administration §§12.64-12.69 (2d ed Cal CEB 2001).

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Source: Estate Planning/California Estate Planning/14 State Death Taxes/§14.8 G. Issues Involving Former State Inheritance Tax

§14.8 G. Issues Involving Former State Inheritance Tax

California has had a transfer tax since 1893, when it adopted a tax on inheritances by so-called "collateral" relatives, as distinguished from "direct" relatives. The tax was expanded into the inheritance tax law, for transfers to direct family members as well as to collateral relatives and strangers, with progressive rates for each of the various statutorily defined classes of beneficiaries and with each beneficiary's tax being separately calculated. The inheritance tax law was codified in 1943 as part of the Revenue and Taxation Code and thereafter was amended repeatedly.

The former California inheritance tax was computed on the value of property passing to each transferee. Different tax rates applied depending on the transferee's family relationship to the decedent, with the highest rates being imposed on transferees who were not closely related. The tax rates were progressive. The statute defined the transfers subject to tax and provided various deductions. The rules were often inconsistent with federal law, but in other cases, the California statutes were expressly modeled on the comparable federal law. See, *e.g., Estate of Cohen* (1971) 4 C3d 41, 92 CR 684 concerning post-1965 general powers of appointment.

In addition to the inheritance tax, California also had a "pickup" estate tax that applied to the extent the inheritance tax failed to absorb the full amount of the IRC §2011 state death tax credit.

In 1943, California adopted a gift tax law that paralleled the inheritance tax law. The gift tax law became effective July 1, 1945. Finally, in 1977, California adopted a generation-skipping transfer tax to absorb the state tax credit afforded under the federal generation-skipping transfer tax. Regulations were adopted in 1941 and readopted in 1959, and have been amended periodically.

As part of the so-called "tax revolt" in the late 1970s and because California did not seem to be keeping up with the broadening exemptions made under the federal estate tax, legislative attempts and finally statutory initiatives were made for the repeal of the state inheritance tax. On June 8, 1982, the voters approved Initiatives 5 and 6, precluding the imposition of "any gift, inheritance, succession, legacy, income, or estate tax, or any other tax, on gifts or on the estate or inheritance of any person or on or by reason of any transfer occurring by reason of a death" (Rev & T C §13301, adopted by Proposition 6, Initiative Statute), but at the same time imposing a "California estate tax equal to the portion, if any, of the maximum allowable amount of the credit for state death taxes, allowable under the applicable federal estate tax law, which is attributable to property located in the State of California." (Rev & T C §13302, first sentence, adopted by Proposition 6, Initiative Statute) and authorizing the legislature to provide for collection and administration of the tax imposed (Rev & T C §13303, adopted by Proposition 6, Initiative Statute). See the initial annotation to Division 8 of the Revenue and Taxation Code for the complete copies of the texts of the two initiative measures.

Although the California inheritance tax law was repealed as of June 8, 1982, it continues to be applicable for estates of decedents who died prior to June 8, 1982. See *Estate of Austin* (1988) 206 CA3d 1249, 254 CR 372. Practitioners might confront the former inheritance tax law when title to real property or securities has not been cleared for pre-repeal deaths and the fact comes up on sale of the asset or the death of a subsequent decedent. The former law might also come up in escheat recoveries for pre-repeal deaths. It may also occasionally be applicable when reviewing federal gift tax filings for decedents.

PRACTICE TIP: If issues concerning the former inheritance tax law arise, it is recommended that the practitioner contact the State Controller's Office in Sacramento for forms and to file returns. For inheritance lien releases, the practitioner should contact a probate referee either in the county where the decedent died or, if the decedent was a nonresident, in the county where real property is located. Some attorneys may still have the inheritance tax forms and instruction materials.

Sources on the substantive law and administrative practice include the former administrative regulations in 18 Cal Code Regs §§13303-16563; 2 CCH Cal Tax Rep ¶31-252 (2001) (discussion of prior law); Barnett, *California Inheritance and Gift Taxes: A Summary*, 43 Cal L Rev 49 (1955); Birnberg, *Current Developments in California Inheritance Taxation*, 33 S Cal Tax Inst, chap 15 (1981); Keeler, *The California Inheritance Tax Scheme: 1981 Version*,

8 W State Univ L Rev 21 (1981).

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§14.9 II. MULTIPLE-JURISDICTIONAL ISSUES

Planners are occasionally confronted with situations in which efforts should be made to avoid death tax claims by a particular jurisdiction. This may be done in order to achieve more favorable tax rates or to avoid having multiple jurisdictions attempting to tax the same assets. Multiple claims related to the same assets can occur if more than one jurisdiction can claim to be the jurisdiction of the decedent's domicile or if a jurisdiction other than the jurisdiction of domicile can claim a right to tax property based on the situs of that property at the same time that another jurisdiction claims a right to tax the property based on either situs or domicile.

Planners need to be aware that the death taxes of a particular state may be significantly different from California's current estate tax. States have been collecting a transfer or succession tax since the 19th century. Originally these taxes were inheritance taxes, under which each beneficiary was separately taxed on the value of the property received from a decedent, or an estate tax computed on the value of the taxable estate as a whole and based on the decedent's right to transmit property. See generally *All-State Treatise*, CCH Inheritance, Estate & Gift Tax Reporter ¶¶1000-1001. During the 20th century, virtually all states had some form of death tax, consisting of an inheritance tax or an estate tax with stand-alone rates and exemptions, or an estate tax that merely absorbed the amount of the credit for state death taxes allowed under the federal system (hence the commonly used terms "sponge" tax or "pickup" tax). In the two decades before the enactment of legislation phasing out the IRC §2011 state death tax credit (see §14.4), many states abandoned their inheritance taxes or stand-alone estate taxes in favor of merely relying on the federal state death tax credit. The repeal of the federal credit is likely to prompt new changes in state taxes. For a summary of the laws of the various states, see Estate Planning for Special Assets, chap 5 (Cal CEB 2004). For further discussion, see *View From the California Tax Haven: The Estate Tax Decoupling Mess*, 24 CEB Est Plan Rep 81 (Feb. 2003). See also Steiner, *Coping With Decoupling of State Estate Taxes After EGTRRA*, 30 Est Plan 167 (Apr. 2003); Fox, Pomeroy, & Abbott, *Ramifications for Estate Planners of the Phase-Out of the Federal State Death Tax Credit*, 29 ACTEC J 26 (Summer 2003); Rubenstein, *Impact on States of Federal Estate Tax "Repeal,"* 28 ACTEC J 221 (Winter 2002). It cannot be stressed too strongly that the practitioner must review or confer with local counsel about the current status of the estate tax and inheritance tax laws in effect in any jurisdiction in which real property and tangible personal property is located. The practitioner should not make any assumptions about the transfer tax laws in other states, because the laws in many states are being changed to undo the state revenue effects of EGTRRA-2001. See generally Cooper, Ivimey & Vincenti, *State Estate Taxes After EGTRRA: A Long Day's Journey Into Night*, 17 Quinnipiac Prob LJ 317 (2004).

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§14.10 A. Multiple Claims to Property

Although more than one state can tax intangible personal property based on a reasonable nexus (see *State Tax Comm'r v Aldrich* (1942) 316 US 174, 86 L Ed 1358, 62 S Ct 1008), most issues have been resolved through statutes that exempt or exclude intangible personal property owned by a person domiciled in another state. The remaining problems primarily concern characterization of interests in real property. These problems involve questions such as whether the situs state may characterize what would otherwise be real property as an intangible (*e.g.*, so-called Illinois land trusts; see *Estate of Tutules* (1962) 204 CA2d 481, 22 CR 427); application of the doctrine of equitable conversion when there is a mandatory direction for sale (see Prob C §21107; *Estate of Reid* (1938) 26 CA2d 362, 79 P2d 451); and executory contracts for sale.

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§14.11 1. Situs of Assets

In determining the situs of assets (except for the special treatment of nonresident citizens; see §14.14), the following principles are generally accepted:

- Taxation of intangible personal property at the place of domicile;
- Taxation of real property in the state where the property is located; and
- Taxation of tangibles in the state where they are permanently located.

See, *e.g., Treichler v Wisconsin* (1949) 338 US 251, 94 L Ed 37, 70 S Ct 1 (Wisconsin domiciliary's real and tangible personal property located in Illinois and Florida was not subject to Wisconsin inheritance tax); *Frick v Pennsylvania* (1925) 268 US 473, 69 L Ed 1058, 45 S Ct 603 (tangible personal property of Pennsylvania decedent with situs in New York and Massachusetts was not subject to Pennsylvania estate tax).

Intangible personal property may be taxed by several states. See, *e.g., Graves v Elliott* (1939) 307 US 383, 83 L Ed 1356, 59 S Ct 913 (where New York domiciliary created a Colorado situs trust with a Colorado trustee, bonds held in the trust were subject to death taxes in both jurisdictions); *Curry v McCanless* (1939) 307 US 357, 83 L Ed 1339, 59 S Ct 900 (stocks and bonds held by Alabama trustee for Tennessee beneficiary were subject to tax in both jurisdictions). This problem is now usually resolved by statutes that exempt intangibles owned by decedents domiciled in other states. However, when the exemption applies only if the other jurisdiction reciprocates, the laws of both states must be examined, both in the planning and in the administrative stages.

NOTE: While the general rule is that intangibles are taxed in the state of domicile, there are exceptions. For example, some states tax intangibles of nondomiciliary decedents if they have a "business situs" in the state. Likewise, approaches may vary and sometimes conflict in the application of equitable conversion of real property. See Birnberg, *Equitable Conversion in the Context of Estate Planning and Death Taxation*, Title Insurance & Trust 33rd Annual Tax & Prob Forum (1981). Therefore, the attorney needs not only to be familiar with local law, but must also have competent advice as to how the other state will apply its law.

The most common device for avoiding death taxes in the nondomiciliary state is to convert real property into an intangible, such as creating a partnership or a corporation to hold title. See *Blodgett v Silberman* (1928) 277 US 1, 72 L Ed 749, 48 S Ct 410 (decedent's interest in partnership holding real property was a chose in action and therefore intangible); *In re Estate of Havemeyer* (1966) 17 NY2d 216, 217 NE2d 26 (same under Uniform Partnership Act). Nevertheless, a comparison of the tax treatment of a non-California asset under California law and under the other state's law needs to be made to determine whether the attorney should plan to obtain a particular situs for real, tangible, or intangible property, rather than merely assuming that it is desirable to avoid taxation in the other state. Of course, if the other state has either an inheritance tax or a stand-alone estate tax that is greater than the state death tax credit, the choice of converting real or tangible property into intangible property becomes more obvious. For nonresident citizens, it is preferable to have intangibles located outside of California, unless, of course, there is no other state that can use the credit.

PRACTICE TIP: With the phasing out of the state death tax credit under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) and with the California legislature prevented from readopting a death tax that will survive the extinction of the state death tax credit (see §14.4), it may be desirable to have a California situs for assets, if that can be achieved.

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§14.12 2. Proration Among States

California and other states have statutory or regulatory formulas to determine the manner by which state death tax credits should be apportioned as against the federal estate tax when the decedent has property in more than one state. California's proration statute is found in Rev & T C §13304. Under that statute, the credit is apportioned based on the value the gross assets in California bear to the total federal gross estate. Other states may have different methods that are not proportional for domiciliary decedents (*e.g.*, calculating the entire credit and subtracting from that the amount of a recomputed credit based only on the nondomiciliary assets). If a decedent had property in California and another state with such a nonproportional method, then, absent any constitutional infirmity in the other state's method, California's share of the credit should be a lesser amount because of the limitation in Rev & T C §13302, which requires that the total tax liability to California and the United States may not exceed the tax liability to the United States that would result if no California tax were imposed. The Controller does not necessarily share this view. See Dennis-Strathmeyer, *The New California Estate Tax Return: Illegal Taxation of Multistate Estates?* 4 CEB Est Plan Rep 119 (June 1983).

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§14.13 3. Location of Property for Non-U.S. Decedents

When the decedent is a nonresident of the United States, California has a special rule defining what constitutes property located in California for the purpose of determining the proportion of the credit allocable to California. Under Rev & T C §13402(b), all the intangible personal property in California included in the gross estate of a nonresident decedent is subject to the California estate tax.

Therefore, the amount of the state death tax credit apportioned to California (but subject to any other state's apportionment because of Rev & T C §13302; see §14.12) includes all such intangibles in addition to real property and tangible personal property, and California may claim some or all of the credit.

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§14.14 B. Multiple Claims of Domicile

A common problem arises when more than one state claims that the decedent was domiciled in that state. The determination of one state is not binding on other states. The classic case is that of the estate of John Dorrance, in which the courts in Pennsylvania and New Jersey held the decedent was a domiciliary, resulting in double taxation. See *Estate of Dorrance* (NJ 1934) 170 A 601; *In re Dorrance's Estate* (Pa 1932) 163 A 303. Normally interpleader is not available. Compare *Worchester County Trust v Riley* (1937) 302 US 292, 82 L Ed 268, 58 S Ct 185 (federal interpleader not permitted) with *Texas v Florida* (1939) 306 US 398, 83 L Ed 817, 59 S Ct 563 (claims of four states exceeded total value of estate, giving rise to original jurisdiction in nature of interpleader). Because of the conversion of most states to a pickup or "sponge" tax, the problem of interpleader or original United States Supreme Court jurisdiction under the rationale of *Texas v Florida*, *supra,* is unlikely to reoccur. If such a situation were ever to exist, however, the experience with the estate of Howard Hughes illustrates the confusion in the federal court system over this issue. See *California v Texas* (1982) 457 US 164, 72 L Ed 2d 755, 102 S Ct 2335 (original jurisdiction accepted); *Cory v White* (1982) 457 US 85, 72 L Ed 2d 694, 102 S Ct 2325 (interpleader rejected); *California v Texas* (1978) 437 US 601, 57 L Ed 2d 464, 98 S Ct 3107 (original jurisdiction declined; federal interpleader suggested).

California has enacted the Uniform Act on Interstate Arbitration of Death Taxes (Rev & T C §§13820-13820.13), as well as a statutory scheme entitled Determination of Domicile by Arbitration: Alternative Method (Rev & T C §§13830-13830.13). Other states have variants of these statutes, but procedures under them are awkward and rarely used. The most common method of resolution of multiple domicile cases is by direct settlement either with the personal representative, with the other state, or with both under the Uniform Act on Interstate Compromise of Death Taxes (Rev & T C §§13801-13810.4).

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§14.15 1. "Domicile" Contrasted With "Residence"

The language of Rev & T C §13402(b) (see §14.13) refers to "residence," as does the Affidavit Concerning Residence (Form IT-2) that nonresidents must file with the California estate tax return (see §14.8). Nevertheless, the issue involved in determining entitlement to the state death tax credit for intangibles generally is "domicile," rather than "residence." See, *e.g. Whittell v Franchise Tax Bd.* (1964) 231 CA2d 278, 41 CR 673 (income taxes). Domicile is a question of fact, dependent on both physical presence and intent, and is ascertained both from declarations and actions. There are a number of factors in determining domicile, no one of which is determinative. For a discussion of these elements, see *People v McCleod* (1997) 55 CA4th 1205, 64 CR2d 545.

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§14.16 2. Planning for Clients With Multiple Domiciles

Because a person's domicile is a question of fact and because there are so many variants to the factual bases under which more than one state might claim a formerly ambulatory decedent as a domiciliary, it is important that the estate planning attorney carefully evaluate all of the client's nondomiciliary contacts and eliminate those that could potentially cause another state to claim domicile. This may forestall the possibility that two or more states are entitled to claim the state death tax credit on intangibles.

Actions the client may take include:

- Ceasing to vote in the former state;
- Reregistering automobiles;
- Transferring assets to institutions in the new domicile;
- Filing the correct state income tax returns;
- Terminating continuing business interests and residential leases; and
- Redrafting estate planning documents to indicate the current domicile.

PRACTICE TIP: To assist the attorney in planning for a client who is changing his or her domicile to another state, it is useful to look at the California Affidavit Concerning Residence (Form IT-2) and similar questionnaires by other jurisdictions to evaluate the elements that can be considered.

See Acker, Domicile Selection for a Retiring Client, 59 Ill Bar J 760 (1971); Jacobowitz, *Retiring to a New Domicile—An Estate Planning Tax Shelter*, 9 U Miami Inst Est Plan ¶700 (1975); Zabel, *Domicile, Wills and Tax Problems of Migrating Clients Transplanted to Florida*, 10 U Miami Inst Est Plan ¶1400 (1976).

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15

California Real Property Tax

Frayda L. Bruton

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§15.1 I. REAL PROPERTY TRANSFER PLANNING

Estate planners devote most of their attention to the federal transfer tax system, and typically pay somewhat less attention to income taxes and very little attention to California property taxes and documentary transfer tax. The first concern of many clients, however, is the effect planning techniques will have on property taxes. For example, when the planner describes the need to transfer the family residence to a revocable trust, the client invariably asks whether the transfer will result in a reassessment for property tax purposes. Similarly, when the planner recommends transferring the family residence or vacation home to a qualified personal residence trust, the client asks whether the property will be reassessed. This chapter discusses the basic reassessment rules and exclusions that are important to planners.

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§15.2 II. FUNDAMENTAL CONCEPTS

Real property that is not entitled to special assessment treatment or exemption is valued at the lower of (1) fair market value on the lien date of the year in question, or (2) a base-year value determined under Proposition 13 guidelines, adjusted for inflation. The property tax rate is generally 1 percent of assessed value. Cal Const art XIIIA; Rev & T C §§50-51, 93, 110. The assessed value cannot be increased by more than 2 percent per year. Rev & T C §51(a)(1)(D). However, at least one court has held that when assessed value was previously lowered as a result of declining property values, upon a determination that the property is no longer subject to the lower assessed value, the assessor can re-enroll the property using its original base year value plus 2 percent per year—increasing the assessed value by more than 2 percent in the year in which such a reassessment is made. *County of Orange v Bezaire* (2004) 117 CA4th 121, 11 CR3d 478. The base-year value is the assessed value of the property on March 1, 1975, or the fair market value on a later date when a present interest in the property is transferred or improvements are newly constructed. Rev & T C §110.1. The critical event and inquiry therefore becomes when a "change in ownership" occurs. See §15.3.

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§15.3 A. Change in Ownership

Revenue and Taxation Code §60 defines "change in ownership" broadly as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." For these purposes, a life estate generally has been considered an interest equivalent in value to the fee interest. See 18 Cal Code Regs §462.060(a); *Leckie v County of Orange* (1998) 65 CA4th 334, 76 CR2d 426. In *Steinhart v County of Los Angeles* (Feb. 4, 2010, S158007) 2010 Cal Lexis 869, the California Supreme Court held that the creation of a life estate in real property held in a revocable trust on the death of the settlor is a change in ownership. The court noted that the settlor transferred not just a life estate, but the entire fee interest in the property to the life beneficiary and remainder beneficiaries of the trust on her death. See also *Reilly v City & County of San Francisco* (2006) 142 CA4th 480, 498, 48 CR3d 291 (change in ownership occurs when one sole life income beneficiary of trust dies and is replaced by successor sole life income beneficiary; court limited its holding to cases in which estate is for life of person receiving estate).

Revenue and Taxation Code §61 describes, generally, what a "change in ownership" includes. The death of an owner of real property is a change in ownership on the date of death. See 18 Cal Code Regs §462.260(c). Because the statute employs such a broad definition, the exceptions and exclusions become critical to its practical application. Revenue and Taxation Code §§62-69.5 specify the transfers that are excluded from the definition of "change in ownership." See §15.4.

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§15.4 B. Excluded Transfers

Transfers excluded from "change in ownership" include:

- Transfers in which proportional ownership interests remain the same before and after transfer. Rev & T C §62(a).
- Transfers to revocable trusts. Rev & T C §62(d).
- Transfers reserving a term interest or life estate in the transferor. Rev & T C §62(e). Termination of the interest is a change of ownership unless otherwise excluded.
- Interspousal transfers. Rev & T C §63. See §§15.11-15.13.
- Registered domestic partner transfers. Rev & T C §62(p); 18 Cal Code Regs §462.240(k). See §§15.11-15.13.
- Parent-child (or grandparent-grandchild) transfer of a personal residence plus $1 million of "full cash value" of other property (as defined in Rev & T C §110.1). Rev & T C §63.1. See §§15.14-15.19.
- Transfers of ownership interests in legal entities. Rev & T C §64(a). See §15.20. Exceptions to this rule include:
- Transfer of stock in a cooperative housing corporation. Rev & T C §61(i).
- Transfer resulting in a "change of control" of more than 50-percent interest in the entity. Rev & T C §64(c).
- Cumulative transfer of more than 50-percent interest in the entity if transfer to create entity after March 1, 1975, was excluded under Rev & T C §62(a). Rev & T C §64(d).
- Joint tenancy transfers among original joint tenants. Rev & T C §65(b); 18 Cal Code Regs §462.040. See §15.10.
- De minimis transfers of interests in real property (not interests in legal entities) with market value less than 5 percent of value of total property and less than $10,000. Rev & T C §65.1.
- Base-year value transfers to replacement property for persons over age 55, and disabled persons, persons displaced by governmental action or eminent domain, and property substantially damaged or destroyed by a disaster. Rev & T C §§68-69.5. See §15.23.

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§15.5 III. TRUST TRANSFERS

For property tax purposes, trust beneficiaries are treated as the owners of real property held in trust. Transfers to or among trusts are changes in ownership unless (see Rev & T C §§61(h), 62(d), 63, 63.1; 18 Cal Code Regs §462.160(b)(5)):

- The trust is revocable;
- The transferor is the sole beneficiary or the beneficiaries qualify for an exclusion;
- The transferor retains the reversion and the beneficial interest of others does not exceed 12 years; or
- There is no change in the proportional interests of the beneficiaries.

NOTE: For property tax purposes, the trustee is never viewed as the "owner" of the trust property, even though the trustee has legal title and the power to sell. See 18 Cal Code Regs §§462.160, 462.240.

A change in ownership occurs when (1) the trustor-transferor of a revocable trust dies, and the trust becomes irrevocable, or (2) the trust is irrevocable at the time of its creation, and the beneficiaries receive present beneficial use of the property or present income from the property. *Steinhart v County of Los Angeles* (Feb. 4, 2010, S158007) 2010 Cal Lexis 869; *Allen v Sutter County Bd. of Equalization* (1983) 139 CA3d 887, 189 CR 101. A further change in ownership will occur when the sole life income beneficiary of an irrevocable trust dies and the beneficial use of the property passes to another life income beneficiary or to a remainder beneficiary. *Reilly v City & County of San Francisco* (2006) 142 CA4th 480, 48 CR3d 291; *Leckie v County of Orange* (1998) 65 CA4th 334, 76 CR2d 426 (life income interest in trust owning real property is equitable interest equivalent to life estate). When this occurs, the State Board of Equalization takes the position that the trustor remains the transferor unless the life income beneficiary has a general power of appointment. Letter to Taxpayer (Dec. 26, 1990) Annotation No. 220.0771, citing *Estate of Thorndike* (1979) 90 CA3d 468, 473, 153 CR2d 487 (treating grant of general power of appointment as equivalent to grant of absolute ownership). Revocable trusts are discussed in §15.6. Irrevocable trusts are discussed in §§15.7-15.9.

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§15.6 A. Revocable Trusts

Most transfers to or from trusts involve revocable trusts in which the trustor (settlor/grantor), the trustee, and the beneficiary are the same person. The transfer of real property by the trustor-transferor to a trust revocable by the trustor-transferor is not a change in ownership because, for property tax purposes, the present interest is not transferred. If the trustor-transferor revokes the trust, no change of ownership occurs because the present interest is not transferred.

At the death of the trustor-transferor, either (1) the trust terminates, and the property is transferred to the remainder beneficiary, or (2) the trust continues but becomes irrevocable. In either case, there is generally a change in ownership subject to reappraisal unless the remainder beneficiary or the beneficiaries of the trust that has become irrevocable are persons who qualify for an exclusion, *e.g.,* a surviving spouse or registered domestic partner or child. Rev & T C §§61(h), 62(p), 63, 63.1; 18 Cal Code Regs §462.160(b)(2), (c).

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§15.7 B. Irrevocable Trusts

When a trustor-transferor transfers real property to an irrevocable trust, a change in ownership occurs unless:

- The trustor-transferor retains the reversionary interest, and the beneficial interest of others does not exceed 12 years in duration. Rev & T C §62(d); 18 Cal Code Regs §462.160(b)(1)(B).
- The trustor-transferor is the sole present interest beneficiary of the trust, *e.g.*, a qualified personal residence trust (QPRT). Rev & T C §62(d); 18 Cal Code Regs §462.160(b)(1)(A).
- The present interest beneficiaries are persons other than the trustor-transferor who qualify for an exclusion from change of ownership, *e.g.,* spouse, registered domestic partner, children, or eligible grandchildren. Rev & T C §§62(p), 63, 63.1; 18 Cal Code Regs §462.160(b)(4).

WARNING: When a trustee has discretion to distribute income and principal to a number of potential beneficiaries ("spray" or "sprinkle" trust), the property is subject to reappraisal unless all potential beneficiaries have an available exclusion, because the trustee could potentially distribute income or principal to a non-excludable beneficiary. 18 Cal Code Regs §462.160(b)(1)(A), Examples 1-2.

Charitable trusts are discussed in §15.8. Personal residence trusts are discussed in §15.9.

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§15.8 1. Charitable Trusts

A transfer of real property to a charitable remainder trust under IRC §642(c) will not result in a change in ownership if the trustor-transferor retains the present right to income. 18 Cal Code Regs §462.160(b)(1)(A). A transfer to a charitable lead trust is a change in ownership on the date of the transfer. 18 Cal Code Regs §462.160(a). However, the termination or distribution of the property from the charitable lead trust is not a change in ownership if the remainder beneficiaries are a spouse, children, or eligible grandchildren. Rev & T C §§63-63.1; 18 Cal Code Regs §462.160(d)(1).

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§15.9 2. Personal Residence Trusts

A personal residence trust or qualified personal residence trust (QPRT) under IRC §2702(a)(3) is an irrevocable trust in which the trustor-transferor retains the present interest for a term of years with a gift of the remainder interest in his or her personal residence or vacation property to children or other beneficiaries. There is no change in ownership on the creation of and transfer of real property into a personal residence trust or QPRT. Rev & T C §62(d). However, at the expiration of the term (or at the death of the trustor-transferor before the expiration of the term if the property is transferred to the named beneficiaries rather than to the trustor-transferor's estate), there is a change in ownership of the real property, unless an exclusion applies. See 18 Cal Code Regs §462.160(c), (d).

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§15.10 IV. JOINT TENANCY TRANSFERS

A change in ownership includes a joint tenancy interest transferred from one owner to another owner on creation, transfer, or termination of a joint tenancy. Rev & T C §65(a). A newly created joint tenancy (*e.g., C* conveys to *A* and *B* as joint tenants) results in a change in ownership because *C* is not among the joint tenants. However, the creation or transfer of a joint tenancy interest (*e.g.*, C conveys to C and A as joint tenants), including the transfer to a trust under 18 Cal Code Regs §462.040, is not a change of ownership if after the creation or transfer of the joint tenancy interest an original transferor is among the joint tenants. Rev & T C §65(b). C is an original transferor, but A does not become an original transferor. The regulations provide that joint tenancy interests may include interests in trusts. Accordingly, any joint tenant may become an original transferor by transferring his or her joint tenancy interest to the other joint tenant through his or her revocable trust, if the trust names the other joint tenant as the present beneficiary. 18 Cal Code Regs §462.040(b)(1).

EXAMPLE: *A* and *B*, unrelated parties, own property as tenants in common and transfer the property to themselves as joint tenants. *A* and *B* are "original transferors." *A* and *B* transfer their joint tenancy interests to their respective trusts. *A*'s trust leaves the property to *B*; *B*'s trust leaves the property to *A*. *A* and *B* are still considered to be "original transferors." Result: No change in ownership if either *A* or *B* predeceases the other. The result is the same if *A* first transfers the property to *A* and *B* as joint tenants. See Letter to Assessors 2003/077 (Dec. 18, 2003); Letter to Assessors 2004/042 (July 6, 2004).

The California Assessors Association has objected to the provision in 18 Cal Code Regs §462.040(b)(1) that includes "the transfer to a trust" to obtain original transferor status. However, proposed amendments in Letter to Assessors 2007/010 (Feb. 23, 2007) to eliminate the "loophole" in the joint tenancy rules described in the above Example have been postponed indefinitely. See Letter to Assessor 2007/025 (May 21, 2007). See also 28 CEB Est Plan R 140 (Apr. 2007) (questioning the validity of the regulation).

Transfers between spouses qualify for the interspousal exclusion under Rev & T C §63 and transfers between registered domestic partners qualify for a separate exclusion under Rev & T C §62(p). See §15.11. Accordingly, if the spouse or registered domestic partner of an original transferor is added as a joint tenant after the acquisition, the spouse or partner becomes an original transferor. See 18 Cal Code Regs §462.040(b)(1).

On termination of a joint tenancy interest held by an original transferor, there is a change of ownership unless one of the transferees is an original transferor. Rev & T C §65(c). On termination of a joint tenancy interest held by a joint tenant other than an original transferor, there is no reappraisal if the interest is transferred to an original transferor or to all remaining joint tenants provided that one of the remaining joint tenants is an original transferor. Rev & T C §65(d).

EXAMPLE: *A* and *B* transfer their interest in Greenacre to *A*, *B*, and *C* as joint tenants. *C* is an unrelated third party. Result: No reappraisal because *A* and *B* are original transferors. *A* dies. Result: No reappraisal because *B* is a surviving joint tenant and is an original transferor. *B* dies. Result: 100 percent reappraisal because *C* is "other than original transferor."

The assessor also may consider persons holding joint title, such as tenants in common, as joint tenants and original transferors if there is reasonable cause to believe the parties intended to create a joint tenancy and each person was a transferor among the persons holding title. 18 Cal Code Regs §462.040(d).

There is a rebuttable presumption that all joint tenants holding an interest in real property on March 1, 1975, are original transferors. Rev & T C §65(e). If *A* transferred to *A* and *B* as joint tenants in 1956 and *A* dies after March 1, 1975, there is no change in ownership because *B* is presumed to be an original transferor, unless the county assessor chooses to rely on recorded deeds, in which case there is a change in ownership because *B* is not, in fact, an original transferor.

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§15.11 V. INTERSPOUSAL AND DOMESTIC PARTNER TRANSFERS

A change of ownership does not include any interspousal transfers (Cal Const art XIIIA, §2(g); Rev & T C §63) and transfers between registered domestic partners (Rev & T C §62(d), (p); 18 Cal Code Regs §462.240(k)). Interspousal and domestic partner transfers include transfers of interests in real property, transfers through the medium of a trust (see §15.12), and transfers at death.

Domestic partners may obtain a reversal of reassessment for transfers that took place on or after January 1, 2000, and before January 1, 2006, by filing a claim with the county assessor no later than June 30, 2009. Rev & T C §62(p)(2). The reversal restores the inflation-adjusted base-year value of the property in the assessment year in which the purchase or transfer took place for assessment years beginning with the year in which the claim is filed. Rev & T C §62(p)(2)(F). There will be no property tax refunds for any prior assessment years. Rev & T C §62(p)(2)(E). See Letter to Assessors 2007/043 (Nov. 16, 2007).

NOTE: The sponsors of the legislation that created domestic partnerships took the position that the legislature could not enact a statute exempting transfers between domestic partners from reassessment without voter approval. This understanding is reflected in Fam C §297.5(i), which states that "[t]his section does not amend or modify any provision of the California Constitution or any provision of any statute that was adopted by initiative" (*i.e.*, Proposition 13). In *Strong v State Bd. of Equalization* (2007) 155 CA4th 1182, 66 CR3d 657, however, the court held that the legislature had the authority to create an exclusion for registered domestic partners. The court further held that 18 Cal Code Regs §462.240(k) was ratified by the subsequent action of the legislature in enacting Rev & T C §62(p).

Under Rev & T C §63, transfers of interests in real property include joint tenancy transfers, receipt of the deceased spouse's community property interest by the surviving spouse, gift of a life estate, or transfers in connection with dissolution of a marriage. Interspousal transfers also may include transfers of interests in legal entities. 18 Cal Code Regs §462.220.

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§15.12 A. Transfers Through Medium of Trust

Transfers through the medium of a trust require looking through the trust to determine the beneficial owner of the property. For example, a transfer to a revocable trust that becomes irrevocable on the death of the deceased spouse or registered domestic partner will be excluded under the trust exclusion in Rev & T C §62(d) and the interspousal transfer exclusion in Rev & T C §63 or domestic partner transfer exclusion in Rev & T C §62(p) if the surviving spouse or partner enjoys the exclusive right to trust income, regardless of the trustee's power to distribute principal. Property also will be transferred to the spouse or partner to the extent that the spouse or partner has a power of appointment over trust principal. See §15.13.

NOTE: The power of the trustee to distribute principal among spouse and issue does not destroy the interspousal transfer exclusion because issue do not share a present interest with the income beneficiary; the issue's interest is a "mere expectancy." See *Estate of Johnson* (1961) 198 CA2d 503, 510, 17 CR 909; *Estate of Canfield* (1947) 80 CA2d 443, 451, 181 P2d 732.

If the trustee has the power to sprinkle income to the surviving spouse or registered domestic partner and issue, the trust may not qualify if "issue" includes grandchildren who have at least one living parent, but the trust will qualify under the interspousal or domestic partner and parent-child exclusions if the sprinkle power is limited to the spouse or partner and children. 18 Cal Code Regs §462.160(b)(1).

PRACTICE TIP: If the client is concerned about property tax increases following the death of the first spouse, when taxes could create a material financial burden, and the bypass trust will own real property, the surviving spouse should have the sole income interest in the bypass trust. This objective is inconsistent with the federal transfer tax planning goal of minimizing the survivor's estate by granting the trustee a "sprinkle" power over income. To reconcile this goal, consider allocating the real property to the QTIP trust.

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§15.13 B. Effect of "5 or 5" Power

A power in a bypass trust held by the surviving spouse to appoint to himself or herself the greater of $5000 or 5 percent of trust principal each year under IRC §2041(b)(2) and Treas Reg §20.2041-3(d)(3) will be deemed to be exercised every year. Five percent of the assessed value of real property held in the bypass trust thus shifts to the surviving spouse each year for purposes of applying the deceased spouse's parent-child exclusion. See Annotations 625.0210, 625.0230, 625.0234 (available on the State Board of Equalization website at http://www.boe.ca.gov); see §15.19 for discussion.

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§15.14 VI. PARENT-CHILD AND GRANDPARENT-GRANDCHILD TRANSFERS

Each "transferor" may transfer a personal residence plus property with no more than $1 million of "full cash value" to the transferor's children (or parents) without a change in ownership. Cal Const art XIIIA, §2(h); Rev & T C §63.1. Two parents may each transfer $1 million to their children. Therefore, the total exclusion is $2 million per couple. For these purposes, "full cash value" means assessed value, not fair market value. Cal Const art XIIIA, §2(a); Rev & T C §110.1; *City & County of San Francisco v County of San Mateo* (1995) 10 C4th 554, 41 CR2d 888. In some cases, property may be transferred from grandparents to grandchildren, but not from grandchildren to grandparents. See §15.18.

PRACTICE TIP: When donor parents (or children) have owned low base-year value property for a long time, or property values have appreciated faster than assessed values, the owners may transfer a great deal more than $2 million of fair market value property.

There appears to be no authority on the question of whether a residence remains the decedent's personal residence for these purposes when decedent's spouse has a life estate in the property and the property is later transferred to a child on the death of the spouse. Similarly, when a parent transfers $1 million in other property at death to one child for life with remainder to a second child, it is uncertain whether the exclusion applies to the second transfer. Arguably, the answer to both questions should be yes, on the theory that the property reverts to the transferor on the second death and so may be given again as if the first gift had never been made.

Eligible children include children adopted by age 18 and foster children who were not adopted by the foster parent because of a legal barrier. Rev & T C §63.1(c)(3)(E). The exclusion also applies to transfers from adopted or foster children to parents, but the exclusion does not apply to transfers from a foster child to a biological parent if the foster child received the property from a foster parent. Rev & T C §63.1(a)(1)(B).

A child born to a parent with a registered domestic partner is eligible for the parent-child exclusion for property transferred by the birth parent or by the partner as second parent. The parent-child exclusion is also available to a child legally adopted by the registered domestic partner of the birth parent if the child was under age 18 at the time of the adoption. Letter to Assessors 2005/017 (Mar. 3, 2005). The child of a registered domestic partner born or adopted during the domestic partnership is considered the natural child of both partners, and even the children of unregistered partners may be considered the natural children of both partners. Fam C §§297.5, 7611; *Elisa B. v Superior Court* (2005) 37 C4th 108, 33 CR3d 46.

NOTE: To preserve the full parent-child exclusion and avoid creating undivided interests (when undivided interests are not otherwise desirable for future estate planning purposes), the trustee or personal representative may need to encumber the decedent's property before distribution. For example, if trust property consisting of $250,000 in cash and an unencumbered residence with a fair market value of $750,000 is to be divided equally between two children, and the trustee mortgages the property for $250,000 and then distributes the encumbered property (with a net value of $500,000) to one child and $500,000 in cash to the other, then 100 percent of the residence will be exempt from reassessment because the distribution of the residence will be treated as a parent-child transfer, provided that the trust instrument does not prohibit the trustee from making nonprorata distributions. See Letter to Assessors No. 91/08 (Jan. 23, 1991). If instead the trustee distributes $250,000 in cash and a one-third interest in the residence (with a value of $250,000) to one child and distributes a two-thirds interest in the residence (with a value of $500,000) to the other, and the child receiving the two-thirds interest acquires the remaining one-third interest in the property from the other in exchange for a $250,000 promissory note, then one-third of the property will be reassessed because the child will be treated as receiving one-third of the property from the other child rather than the parent. See Annotation 625.0235.005 (available on the State Board of Equalization website at http://www.boe.ca.gov). The Board has given informal advice that the trustee may borrow the money needed to fund the cash gifts from the recipients of the gifts in exchange for promissory notes secured by a deed of trust on the property but the trustee may not take back a deed of trust from the child receiving the property and assign the deed of trust to the other children in lieu of cash gifts. See §15.16.

A claim for exemption must be filed within 3 years after the transfer or within 6 months after the mailing of a notice of supplemental or escape assessment, although a prospective claim for exemption may be filed after these dates if the property has not been transferred to a third party. Rev & T C §63.1(e). A claim for exemption must be filed within 45 days after an assessor's notice of potential eligibility; if the claim is not filed, the assessor may send a second notice to the effect that no claim has been filed and reassessment will commence within 60 days after the second notice, and the assessor may charge a fee for a successful exemption claim filed after the 60 days. Rev & T C §63.1(j).

PRACTICE TIP: Check with the county assessor to see whether certified birth certificates need to be filed with the claim for exemption. The practice among counties is not uniform. Certified birth certificates may also be necessary for grandchildren's parents as well if the exemption is claimed for transfers to grandchildren. See §15.18.

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§15.15 A. Exclusion Applies Only to "Undivided Interests" in Real Property

The parent-child exclusion does not apply to transfers of partnership interests, shares of stock, or membership interests in LLCs. Rev & T C §63.1(c)(8). Interests in trusts are subject to the exclusion because trusts are *not* treated as legal entities. See Rev & T C §63.1(c)(9).

PRACTICE TIP: For an example of how *not* to do a parent-child transfer—*i.e.,* transfer property to a partnership and then gift more than 50 percent of the partnership interests—see *Penner v County of Santa Barbara* (1995) 37 CA4th 1672, 44 CR2d 606. Rather, parents should gift real property interests to children, who may then contribute the interests to the partnership in exchange for proportional percentage partnership interests. See §15.17.

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§15.16 B. Nonprorata Allocation of Property

The parent-child exclusion does not apply to a sibling transfer even if the property is transferred directly to the child from the estate or trust. Generally, a devise of property to more than one person vests property in them as tenants in common. A transfer of interests among tenants in common is a change in ownership unless an exclusion applies. 18 Cal Code Regs §462.020. Therefore, nonprorata allocation of property to children may result in reassessment.

EXAMPLE 1: Decedent leaves Whiteacre to decedent's child *A*. Parent-child exclusion applies.

EXAMPLE 2: Decedent leaves Whiteacre to decedent's children *A*, *B*, and *C*. By agreement, decedent's estate (or trust) distributes Whiteacre to *A* only. The will (or trust) does not permit nonprorata allocations. Result: There is a "change of ownership" with respect to two-thirds of the property (*B*'s and *C*'s undivided interests). See Letter to Assessors No. 91/08 (Jan. 23, 1991).

If the trust instrument permits nonprorata allocations, provided each beneficiary receives an amount equal to the beneficiary's share of trust assets, the transfer will be treated as a direct transfer from parents to children. See 18 Cal Code Regs §462.160(d)(5).

EXAMPLE 3: Decedent leaves trust with assets worth $500,000 to decedent's four children, *A*, *B*, *C*, and *D*, "share and share alike." Each child is to receive $125,000 in assets. The trust instrument does not limit the trustee's power to distribute assets. Under Prob C §16246, the trustee has the power to distribute sole ownership of any asset or fractional interest in any asset to any of the children. The trustee deeds decedent's principal residence worth $112,500 with no outstanding loans to *A*. Result: No change in ownership under Rev & T C §63.1 because net value of property is less than *A*'s share of the trust. If the property had been worth more than $125,000, a partial change in ownership would have occurred.

Two points bear repeating, because of confusion on the issue of nonprorata allocations. First, only the fiduciary, *i.e.*, the trustee or personal representative, may encumber the property. If the beneficiary obtains a loan and secures the loan repayment using the property as collateral, that beneficiary is considered to have received the entire interest in the property. Any subsequent transfer of the property to another beneficiary will result in a change in ownership as a transfer between siblings to which the parent-child exclusion in Rev & T C §63.1 does not apply.

Second, the distributee of the property may *not* make a loan to the trust or estate to equalize the distribution by providing either cash or a note secured by the property. Such transactions are deemed to be a sale between siblings resulting in a change in ownership. To avoid this result, the loan must be made by a third-party lender or by the sibling/beneficiary who is *not* receiving the property.

Thus, as long as the distribution is equalized by a loan from a third-party lender or the non-distributee beneficiary, the encumbrance is not deemed a sale between beneficiaries.

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§15.17 C. Step Transaction Doctrine Disregarded

The legislative history of Rev & T C §63.1 provides that the "step transaction doctrine" is disregarded for purposes of applying the parent-child exclusion. See Stats 1987, ch 48, §2. See also *Penner v County of Santa Barbara* (1995) 37 CA4th 1672, 44 CR2d 606.

EXAMPLE: XYZ Corporation, wholly owned by *H* and *W*, dissolves. *H* and *W* convey real property held in XYZ Corporation to themselves. They subsequently deed undivided interests in the property to children, *C1*, *C2*, and *C3*. *H*, *W*, *C1*, *C2*, and *C3* then form HW Family Limited Partnership, taking back proportional partnership interests. Result: No change in ownership. Because the "step transaction doctrine" does not apply, the parent-child exclusion (Rev & T C §63.1) would exclude the transfer of interests to *C1*, *C2*, and *C3*. The proportional interest exclusion of Rev & T C §62(a)(2) (discussed in §15.20) would exclude the transfers of interests from XYZ Corporation and into HW Family Limited Partnership.

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§15.18 D. Transfers to Grandchildren

An exclusion from change in ownership also applies to transfers from grandparents to grandchildren on or after March 26, 1996, when all parents of the grandchildren are deceased as of the date of sale or transfer. Cal Const art XIIIA, §2(h); Rev & T C §63.1(a)(3). All of the grandchildren's parents who qualify as children of the transferor, not including stepparents, must be deceased, or the transfer does not qualify. Rev & T C §63.1(c)(2).

The definition of "children" does not include a son-in-law or daughter-in-law whose marriage to the parent's child has been "terminated by divorce." When a daughter-in-law or son-in-law of the transferor is a surviving spouse of a deceased child, the definition of "children" lasts only until remarriage. Rev & T C §63.1(c)(3)(C). Thus, a stepparent of the transferor's grandchild who is a surviving spouse of a deceased child remains a child of the transferor until remarriage for purposes of the parent-child exclusion for transfers to the stepparent, but the stepparent need not be deceased to qualify a transfer to the transferor's grandchild for the exclusion. The definition of "children" also does not include a parent who was neither a spouse nor a registered domestic partner of the deceased parent. Thus, the parent-child exclusion always applies to a transfer to a grandchild who is the child of a deceased single parent.

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§15.19 E. Application to Typical Family Revocable Trust

Property interests transferred to children (or grandchildren) by a marital trust or bypass trust on the death of the surviving spouse are generally excluded by the parent-child exclusion of Rev & T C §63.1. Transfers eligible for Rev & T C §63.1 exclusion are claimed from the *deceased* spouse's estate. Property interests transferred by the surviving spouse, *i.e.,* from a survivor's trust, qualify for the surviving spouse's exclusion amount.

NOTE: The deceased spouse's parent-child exclusion applies only to property the deceased spouse owned at death. If a bypass trust bought new property during administration, the newly acquired property may not qualify for a parent-child exclusion on the death of the surviving spouse. Even though the surviving spouse's parent-child exclusion may be applied to the transfer, because the surviving spouse is considered the present beneficial owner of the property, the value of the new property combined with the surviving spouse's own property may exceed the surviving spouse's $1 million exclusion.

If the deceased spouse's property is transferred to a bypass trust and the surviving spouse possesses a "5 or 5" power, the surviving spouse's $1 million exclusion available for property outside the trust will be reduced by the value of property that *could have* been transferred under the power, multiplied by the number of years the surviving spouse possessed the power, because that portion of the property is treated as transferred by the surviving spouse. See §15.13. While the Board's analysis could be questioned (because the rule implies that the spouse will own the entire property after 20 years, but the spouse only acquires 5 percent of the portion of the property not already owned by the spouse each year for federal tax purposes and so will never own the entire property), the rule suggests an opportunity to change the transferor of the property by giving the spouse a power of appointment over the entire property that lapses at a rate of 5 percent per year. Assuming the spouse lives 20 years, the property will pass to the child with no further estate or gift tax on (or before) the death of the spouse, and the spouse will remain the transferor of the property for property tax purposes. This technique may be useful if the deceased spouse's $1 million exclusion has been exhausted.

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§15.20 VII. LEGAL ENTITY TRANSFERS

Generally, the transfer of interests in real property to or by a legal entity is a change in ownership unless the proportional ownership interests of the transferors and the transferees are exactly the same before and after the transfer. Rev & T C §62(a)(2); 18 Cal Code Regs §462.180(b)(2). Transfers of real property between or among affiliated corporations, including transfers used to achieve corporate reorganization, however, do not trigger reappraisal. Rev & T C §64(b).

PRACTICE TIP: The transfer of real property must be proportional as to "each and every piece of real property transferred," or a change in ownership of the disproportionally transferred property will result. *Munkdale v Giannini* (1995) 35 CA4th 1104, 41 CR2d 805.

When a transfer is excluded from reassessment under Rev & T C §62(a)(2), the holders of the ownership interests in the transferee legal entity are defined as "original co-owners" for purposes of determining whether a change in ownership of the real property has occurred on the subsequent transfer of ownership interests in the legal entity under Rev & T C §64(a). See §15.21.

NOTE: *Munkdale v Giannini* stands for the proposition that an individual partner does *not* enjoy the beneficial use of the property owned by the partnership. 35 CA4th at 1111. The decision in *Fashion Valley Mall, LLC v County of San Diego* (2009) 176 CA4th 871, 886, 98 CR3d 327, confirms the application of the analysis to the members of a limited liability company.

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§15.21 A. Transfers of Interests in Legal Entities

Transfers of interests in legal entities generally do not result in a change in ownership of the underlying real property. Rev & T C §64(a). The general rule is subject to the following exceptions (Rev & T C §64(c), (d); 18 Cal Code Regs §462.180(d)):

- Transfers resulting in any person obtaining, directly or indirectly, majority ownership (control) of a legal entity. See §15.21A.
- Transfers resulting in cumulative transfer of more than 50 percent of "original co-ownership" interests. See §15.22.

Form will not prevail over substance. If multiple transfers can be compressed into one transaction resulting in a change of ownership, the transfers will be ignored and a change of ownership will be found. See *Shuwa Invs. Corp. v County of Los Angeles* (1991) 1 CA4th 1635, 2 CR2d 783 (100-percent change in ownership when one partner sold its partnership interest to the buyer, the buyer and the other partner liquidated the partnership, and the other partner sold its property interest to the buyer). See also *McMillin-BCED/Miramar Ranch N. v County of San Diego* (1995) 31 CA4th 545, 37 CR2d 472.

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§15.21A B. Change in Control

A change in control resulting in a change of ownership under Rev & T C §64(c) will occur if a corporation, partnership, LLC, or other legal entity or person obtains through indirect ownership more than 50 percent of the total capital or profits interests in a partnership or LLC. 18 Cal Code Regs §462.180(d)(1)(B).

NOTE: There is no attribution of ownership between spouses who acquire interests in a legal entity. Thus, no change in control of *XYZ* (an LLC) would occur under Rev & T C §64(c) if *A* and *B*, who are married to each other, acquire 100 percent of the ownership interests in *XYZ* as community property. See 18 Cal Code Regs §462.180(d), Example 7.

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§15.22 C. Cumulative Transfers

When there is a transfer resulting in cumulative transfers of more than 50 percent of the ownership interests in the entity, there is a change in ownership of 100 percent of the real property previously excluded from a change in ownership under Rev & T C §62(a)(2), irrespective of the property interests actually transferred. Rev & T C §64(d); 18 Cal Code Regs §462.180(d)(2).

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§15.23 VIII. BASE-YEAR-VALUE TRANSFERS

Persons over age 55 or who are severely and permanently disabled may transfer the base-year value of a residence to a replacement dwelling in the same county, or in another county if the board of supervisors of that county adopts an ordinance granting base-year-value relief to replacement dwellings when the original dwelling was located in another county. Rev & T C §69.5(a).

NOTE: As of this writing, seven counties (Alameda, Los Angeles, Orange, San Diego, San Mateo, Santa Clara, and Ventura) have ordinances granting base-year-value relief to replacement dwellings when the original dwelling was located in another county under Rev & T C §69.5(a).

The original dwelling must have been the person's residence and must have been eligible for the homeowner's exemption (whether or not claimed) within 2 years before the purchase or new construction of the replacement dwelling. Rev & T C §69.5(b)(5). The claimant must not have been granted relief previously, except in a case involving a person over age 55 who subsequently becomes disabled. Rev & T C §69.5(b)(7).

To receive the base-year-value transfer, the taxpayer must file a claim form with the assessor within 3 years of the date the replacement property is purchased or new construction is completed. Rev & T C §69.5(f)(1).

The assessor is permitted to grant, on a prospective basis, a base-year-value transfer with respect to property to which a transfer of base-year value was available but for which a timely claim was not filed. The statute does not provide for the refund or cancellation of taxes that accrued before the prospective application of the base-year-value transfer. Rev & T C §69.5(f)(2).

For transfers of base-year value that were not claimed on a timely basis, the effective date of the base-year-value transfer would be the lien date of the assessment year in which the claim is filed. For example, a late-filed claim in 2008 would first be effective for the January 1, 2008, lien date that would appear on the tax year associated with the 2008-2009 fiscal year.

PRACTICE TIP: For any claim not timely filed before January 1, 2008, the claimant may refile a claim with the assessor.

Base-year-value transfers for replacement property not limited to dwellings are available for persons displaced by governmental action or eminent domain proceedings (Rev & T C §68; 18 Cal Code Regs §462.500) and for property substantially damaged or destroyed by a disaster (Rev & T C §§69, 69.3).

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§15.24 IX. DISCLAIMERS OF PROPERTY INTERESTS

A disclaimed interest passes as if the beneficiary had predeceased the disclaiming party, and the date of the disclaimer relates back to the date of death of the creator of the disclaimed interest. Prob C §282(a). A disclaimer can be used to establish an exclusion from a change of ownership. If, for example, a testamentary trust allows the trustee to sprinkle income and principal to the decedent's child and grandchild, both of whom are living, and the trust is funded with real property, there will be a change of ownership because a grandchild whose parent is living has been included as a trust beneficiary. See §§15.12, 15.18. If the grandchild files a disclaimer with respect to his interest in the property, and if under the terms of the trust, the property will pass to the decedent's child, the child is treated as the owner of the property as of the date of the decedent's death, and the parent-child exclusion applies, assuming that all requirements are met. See Letter to Assessors 98/23 (Apr. 22, 1998).

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Source: Estate Planning/California Estate Planning/15 California Real Property Tax/§15.25 X. REPORTING REQUIREMENTS

§15.25 X. REPORTING REQUIREMENTS

A change in ownership statement must be filed for each transfer of real property and on the death of the owner. Rev & T C §§480-480.2. The transferee must file a preliminary change of ownership report concurrent with recordation of any document effecting a change in ownership of the property. Rev & T C §§480.3-480.4.

PRACTICE TIP: If the transfer is excluded from reassessment, explain on the preliminary change of ownership report form (using an attachment, if necessary) what transfers are occurring, and why the transfers are excluded from reassessment. Although a claim for refund based on an erroneous change of ownership can always be filed, the property tax must be paid as a condition of filing the claim for refund, and it takes 1 year or longer to obtain a hearing date. Consequently, a preliminary change of ownership report form that clearly states the reasons for the exclusion and convinces the assessor of the basis for the exclusion will be of substantial benefit to the client.

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§15.26 A. Transfers on Death

The personal representative must file a change in ownership statement with the county recorder or assessor in each county in which the decedent owned real property before or at the time the inventory and appraisal is filed; in all other cases, including a transfer through a trust, the form is to be filed by the trustee or transferee within 150 days of the decedent's death. Rev & T C §480(b).

PRACTICE TIP 1: Send a copy of the form, with the original to the assessor, with a self-addressed, stamped envelope, and ask for a date-stamped copy.

The change in ownership statement must be filed in order to file the property tax certification required under Prob C §8800(d).

PRACTICE TIP 2: Whenever a document is recorded that changes who manages the trust (*e.g.,* a resignation of trustee and acceptance of nomination of successor trustee), no matter how innocuous, use a preliminary change of ownership report form. See Rev & T C §480.4. The recorder usually will insist on identification of the affected real property by assessor's parcel number and often will require a reference (by instrument number and date) to the recorded deed that places title to the property in the trustee. It is sensible to comply, because compliance is straightforward.

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§15.27 B. Statute of Limitations

The statute of limitations on supplemental assessments is 4 years (6 years for penalty assessments under Rev & T C §504) if a change in ownership statement is filed, or a preliminary change of ownership report is filed under Rev & T C §480.3, and unlimited if a statement or report is not filed. Rev & T C §75.11. The statute of limitations on escape assessments is 4 years if any document evidencing a change of title or ownership is recorded (8 years for penalty assessments under Rev & T C §504), and 8 years for any unrecorded change for which a statement or report was not filed. Rev & T C §532.

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16

Basic International and Noncitizen Transactions

Maria E. Núñez
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I. INTERNATIONAL ISSUES ENCOUNTERED BY ESTATE PLANNING PRACTITIONERS

§16.1 A. Scope of Chapter

Even practitioners who do not practice international estate planning encounter international issues. More important, many practitioners who encounter international issues do not recognize them, which results in substantial risk to their clients and themselves. This chapter is not intended to be an exhaustive analysis of international estate planning issues. Rather, it is a general discussion and summary of some of the issues domestic estate planners are most likely to encounter so that these issues can be recognized and addressed through additional research and analysis and, when appropriate, through the association of competent United States and foreign international tax and estate planning counsel.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGGTRA-2001) (Pub L 107-16, 115 Stat 38) includes some specific provisions that apply to non-U.S. citizens in connection with the repeal of the estate tax in 2010 (see chap 10):

- Nonresidents who are not U.S. citizens may increase the basis of property only by up to $60,000 and cannot increase basis by the unused losses and loss carryovers allowed under IRC §1022(b)(2)(C).
- A nonresident alien's estate does not get the benefit of the full $3 million of additional basis for spousal property. Under IRC §1022(a)(1), "property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift." Thus, IRC §2523(i) should apply, which could limit the additional basis to the annual exclusion for a qualified transfer to a noncitizen spouse to $134,000 (in 2010).
- A transfer of U.S. sited assets from a U.S. person (which includes U.S. trusts, estates, and entities) to a nonresident alien is treated as a sale or exchange of the assets for their fair market value. IRC §684(a). Lifetime transfers are excluded. IRC §684(b)(2).

In addition, planners should be aware that qualified domestic trusts (QDOTs) are not available during the repeal of the estate tax because the QDOT provisions are part of the repealed estate tax portion of the Internal Revenue Code. However, distributions made from QDOTs during 2010 continue to be taxable. The deferred estate tax will be imposed on any distribution made from a QDOT until January 1, 2021. IRC §2210(b). See §§16.38, 17.77.

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§16.2 B. Increasing Globalization

Increasing globalization (through improved communications, more accessible technology, easier and more affordable travel, etc.) means that more and more estate planning practitioners will encounter clients with international connections, such as foreign relatives, assets in more than one jurisdiction, or even residence changes through employment or otherwise. Since the mid-1990s, the transfer of funds across international borders has been the focus of much attention. Several countries, including the United States, Mexico, and Canada, have enacted significant legislation dealing with the taxation of and reporting of information with respect to foreign investment, foreign trusts, and related international topics.

In addition, many countries in virtually every region of the world are modernizing and expanding their money-laundering legislation. In some jurisdictions, tax evasion (including foreign tax evasion) is starting to be included in the list of money-laundering offenses. In many cases, professional advisors who assist those involved in what turns out to be money laundering are also being targeted and aggressively prosecuted. Estate planning practitioners, even those who believe their practices are purely domestic, must know their clients and must be alert to international issues they may face so that they can effectively and competently assist their clients, minimize their malpractice exposure, and minimize their risk of being involved in what may later turn out to be criminal conduct.

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§16.3 C. Due Diligence

As is the case with any legal representation, practitioners must have all relevant information to competently assist clients. To thoroughly identify potential international issues the client may be facing, however, estate planning practitioners need to gather far more information than they might be accustomed to doing. Counsel should not assume, for example:

- That a person who is a citizen or resident of one country is not also a citizen or resident of another;
- That the children of a client who is a United States citizen and resident are all United States citizens and residents or are married to only United States citizens and residents;
- That a resident United States citizen client's parents or relatives, from whom a gift of inheritance may be expected, are all resident United States citizens;
- That a client who fails to disclose foreign assets does not have them; or
- That the client's cousin who is named as successor trustee of a trust is a United States citizen and resident and that the trust is and will always be a domestic trust.

Nothing can be taken for granted and facts should never be assumed. As will be shown later in this chapter, each of the above factual inaccuracies can and most likely will result in erroneous or incomplete advice, with serious consequences for the practitioner and client.

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§16.4 D. Risk Minimization

Estate planning practitioners should in all cases consider (1) having an engagement letter with a clearly defined scope of engagement, (2) accompanying legal advice with a summary of the facts on which the practitioner relied to reach his or her conclusions, and (3) associating competent counsel to assist with any area the practitioner is not competent to handle. When associating local counsel in another jurisdiction, a practitioner should verify that that counsel is not only knowledgeable and experienced in the relevant local law issues but has sufficient experience in cross-border matters. Two or more competent local practitioners from different jurisdictions often may not make a sufficiently competent and effective international estate planning team.

An attorney who advises clients on international estate and tax planning matters is an international lawyer. International legal practice is distinguished from a nation-oriented practice by requiring the attorney often to work in more than just the attorney's own legal, cultural, and political system.

In the United States, the law regarding the duties and responsibilities of the referring lawyer has promoted the internationalization of legal practice. The New York Court of Appeals decision in *In re Roel* (1957) 165 NYS2d 31, 144 NE2d 24, stands for the proposition that foreign law is the exclusive domain of the New York lawyer asked by a client for advice, and it also implicitly establishes the proposition that New York counsel is responsible for the selection and supervision of foreign counsel. The decision states: "When counsel who are admitted to the Bar of this State are retained in a matter involving foreign law [both another state and international], they are responsible to the client for the proper conduct of the matter, and may not claim that they are not required to know the law of the foreign State." 165 NYS2d at 37, 144 NE2d at 28. The California Supreme Court has made clear that giving legal advice regarding the law of a foreign country thus constitutes the practice of law. *Bluestein v State Bar of Cal.* (1974) 13 C3d 162, 174, 118 CR 175 (lawyer aided and abetted unauthorized practice of law when lawyer introduced layperson as associate, even though case involved referral to foreign jurisdiction).

As a result, an attorney who does not work with foreign co-counsel could be caught between the proverbial rock and a hard place, particularly in an area of foreign law where the attorney does not have "the legal knowledge." For an American lawyer, ignorance of foreign law is no excuse. See Janis, *Comment: The Lawyer's Responsibility for Foreign Law and Foreign Lawyers*, 16 Int'l Law 693 (1982).

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§16.5 E. Understanding Defined Terms

To understand and correctly apply international tax and trust rules, the terms that are used must be clearly understood and their meaning should never be assumed. Some terms have different meanings for different purposes. For example, the term "residence" has different meanings for immigration law purposes and income tax purposes, and differs from the term "domicile" for estate and gift tax purposes. A person who is a resident for tax purposes may not be a resident for immigration purposes and vice versa, and a resident for income tax purposes may not be a domiciliary for estate and gift tax ("transfer tax") purposes. See §16.6.

In addition, as the international estate planning area has evolved, certain terms have been redefined. See, for example, the discussion concerning foreign and domestic trusts in §§16.48-16.84E. In many cases, the same term has a different meaning in different jurisdictions. When performing research and analysis in any new or unfamiliar area, practitioners should first satisfy themselves that they clearly understand and can properly apply all relevant terms.

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§16.6 II. CLIENT IS NOT UNITED STATES CITIZEN

If the client is not a United States citizen, the practitioner must determine the client's residence because different tax rules (filing requirements, tax consequences, planning opportunities and pitfalls) apply to residents and nonresidents of the United States. Advising a nonresident under the incorrect assumption that he or she is a resident or vice versa could have disastrous consequences to both the taxpayer and the advisor. The determination of residence in the various contexts should not be left up to the client or someone else. A client's determination of his or her own residence may be based on:

- Immigration concepts, which are probably familiar because they had to be addressed before the person entered the United States;
- The person's home-country concept of residence;
- Income tax concepts if income tax filing requirements have been addressed;
- Where the person currently lives; or
- A distorted understanding of any of the above concepts.

To apply the proper rules and determine the correct answers to the questions at hand, counsel should carefully analyze the applicable tests to determine residence in the different contexts in which the term is relevant. Residence for income tax purposes is discussed in §§16.7-16.14. Residence (or domicile) for transfer tax purposes is discussed in §§16.15-16.19A.

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§16.7 A. Determining Residence for Income Tax Purposes

Under IRC §7701(b)(1)(A), an individual who is not a United States citizen is treated as an income tax resident of the United States and a United States person for income tax purposes (IRC §7701(a)(30)) for a given calendar year if:

- He or she is a lawful permanent resident of the United States at any time during the calendar year (the "green card test") (see §16.8);
- He or she meets the "substantial presence" test of IRC §7701(b)(3) (see §16.9); or
- He or she makes a "first year" election under IRC §7701(b)(4) to be treated as a resident.

All other noncitizens are nonresident aliens and are not United States persons for income tax purposes. IRC §7701(b)(1)(B). If a person is determined to be a resident of the United States and another country in the same year, applicable provisions of relevant treaties can be used to ensure that the person is taxed as a resident of one country only.

NOTE: Although a detailed discussion is beyond the scope of this chapter, persons who are residents of a country (such as the United States) but are taxed as nonresidents of that country solely by virtue of a tax treaty may still be considered residents of that country for other purposes (*e.g.,* reporting purposes).

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§16.8 1. Green Card Test

A lawful permanent resident of the United States is someone who, for immigration purposes, has been admitted to the United States as a permanent resident, which means the person has received an alien registration card or "green card." This prong of the income tax residence test is commonly known as the "green card test." For income tax purposes, a green card holder will continue to be a resident of the United States even if he or she has left the United States and, for immigration purposes, has forfeited his or her right to be treated as a resident. Many people leave the United States with their green cards in their back pockets and incorrectly assume that they are no longer United States residents for income tax purposes. To effectively abandon his or her residence for income tax purposes, a taxpayer must actually relinquish his or her green card. Treas Reg §301.7701(b)-1(b).

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§16.9 2. Substantial Presence Test

An individual satisfies the "substantial presence test" if the individual is physically "present" in the United States for 183 or more days during a 3-year period that includes the current calendar year, and more than 30 days during the current year. The 183-day presence calculation is made by adding the following numbers:

(1) All the days present in the United States in the current year;

(2) One-third of the days present in the United States in the first preceding year; and

(3) One-sixth of the days present in the United States in the second preceding year. Treas Reg §301.7701(b)-1(c).

Individuals who are present in the United States while validly holding certain types of visas, such as student visas, trainee visas, etc., are considered "exempt individuals" and their days of presence in the United States under those visas are excluded for purposes of the substantial presence test calculation. Treas Reg §301.7701(b)-3.

Even if a person meets the substantial presence test, certain exceptions may apply to cause the person not to be treated as a resident of the United States for income tax purposes. For example, if a person meets the substantial presence test but maintains a tax home in a foreign country and has a closer connection with that country, and the person is present in the United States for fewer than 183 days in the current year, the person may meet the closer-connection exception to the substantial presence test and successfully establish nonresidence for income tax purposes. Treas Reg §301.7701(b)-2.

The closer-connection exception is available only if the person who otherwise meets the substantial presence test actually claims it, however, which means that the person must make a filing admitting that the substantial presence test is otherwise met. Treas Reg §301.7701(b)-8(a)(1).

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§16.10 B. Income Taxation of United States and Non-United States Persons

United States persons (see §16.7) are generally subject to income tax on their worldwide income. IRC §61. Non-United States persons are subject to income tax only with respect to "United States source income" (see §§16.11-16.12) and income that is "effectively connected" with a United States trade or business (see §§16.13-16.14). IRC §872. United States resident donors are generally permitted to claim estate and gift tax deductions for gifts to foreign charities, but not income tax deductions. See §§16.15-16.16.

With certain exceptions, aliens may not depart the United States unless they procure a certificate from the IRS that shows they have complied with income tax obligations. For the tax year of the intended departure, resident aliens and nonresident aliens without United States taxable income must file Form 2063, U.S. Departing Alien Income Tax Statement, and nonresident aliens with United States taxable income must file Form 1040-C, U.S. Departing Alien Income Tax Return. In addition, all returns must be filed and all taxes must be paid for prior tax years. IRC §6851(d); Treas Reg §1.6851-2.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.11 1. Determination of United States Source Income

§16.11 1. Determination of United States Source Income

Complex rules govern the determination of whether an item of income is from a United States source. Generally, United States source income includes (IRC §861(a)):

- Interest income, if it is payable by the United States government or a state or local government, or by a noncorporate United States resident or a domestic corporation.
- Dividend income paid (1) by a domestic corporation, or (2) by a foreign corporation, if at least 25 percent of its income in the prior 3 years was effectively connected with the conduct of a United States trade or business.
- Income from personal services performed in the United States.
- Rents and royalties from property located in the United States (in the case of tangible or real property) or used in the United States (in the case of intangible property).
- Gain from the sale of United States real property interests, which include either direct ownership in real property located in the United States or an ownership interest in an entity that directly or indirectly owns significant amounts of United States real property.

Special rules for taxation of United States source income are discussed in §16.12.

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§16.12 2. Taxation of United States Source Income

Under IRC §871(a)(1)(A), non-United States persons are generally taxed at a flat 30-percent rate (though tax treaties often reduce this rate) on the following types of United States source income determined under IRC §861 (see §16.11): interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and other "fixed or determinable annual or periodical gains, profits, and income" (FDAP income).

Under a major exception to this rule, United States source "portfolio investment interest," which generally includes most interest received from unrelated borrowers, and interest earned on bank deposits is not subject to United States tax. IRC §871(h), (i).

A non-United States person's United States source capital gains are generally exempt from United States tax, unless the non-United States person is physically present in the United States for 183 days or more during the year in which those gains are realized. IRC §871(a)(2).

United States real property interests are subject to special rules. In general, a non-United States person can elect to treat rents and other income from a United States real property interest as income effectively connected with a United States trade or business and to have that income taxed accordingly. IRC §871(d). Gain from the sale or exchange of a United States real property interest is treated as income from a United States trade or business, and taxed accordingly. IRC §871(b); Treas Reg §1.861-6. See §16.14.

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§16.13 3. Income Effectively Connected With United States Trade or Business

There is no clear definition of what constitutes a United States trade or business income. Rather, to determine whether a trade or business exists, courts and the IRS have generally looked to whether a person's activities (whether personally or through employees or agents) are "regular, continuous, and substantial" or "incidental and sporadic." It is clear, however, that the performance of personal services in the United States for compensation exceeding $3000 constitutes a United States trade or business (IRC §864(b)(1)), and that the United States activities of a partnership, trust, or estate are attributed to its partners or beneficiaries to determine if those individuals are engaged in a United States trade or business (IRC §875). However, no income tax returns are required for nonresident aliens with effectively connected wages below the personal exemption amount under IRC §151 ($3650 in 2010). See Notice 2005-77, 2005-46 Int Rev Bull 951 (IRS will amend Treas Reg §1.6012-1(b)).

If a non-United States person is engaged in a United States trade or business, an analysis must be made to determine the income and deductions "effectively connected" with that trade or business. United States source FDAP income (including portfolio interest) (see §16.12) is effectively connected with a United States trade or business if either (1) the income is derived from assets used in or held for the trade or business, or (2) the activities of the trade or business were a material factor in the realization of the income. IRC §864(c)(2).

All other United States source income is deemed to be effectively connected with the trade or business. IRC §864(c)(3). Non-United States source income generally is not effectively connected with a United States trade or business, unless the foreign person has a fixed place of business in the United States to which that foreign income is attributable, and that income consists of (1) rents or royalties from intangible property derived in the active conduct of the trade or business; (2) dividends or interest derived from the active conduct of a banking or financing business in the United States; or (3) gains from certain inventory sold outside the United States. IRC §864(c)(4).

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§16.14 4. Taxation of United States Trade or Business Income

Non-United States persons (other than foreign corporations) who realize income that is effectively connected with a United States trade or business (see §16.13) are taxed at the graduated income tax rates (and preferential tax rates for long-term capital gains) that apply to United States persons rather than at the flat 30-percent rate applicable to other types of United States source income (see §16.12). IRC §871(b).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.15 C. Determining Residence for Transfer Tax Purposes

§16.15 C. Determining Residence for Transfer Tax Purposes

As is the case for income tax purposes with respect to noncitizens who are residents and nonresidents, different transfer tax rules apply to noncitizen individuals who are domiciliaries or nondomiciliaries of the United States. IRC §§2001, 2101 (estate tax), 2511(a) (gift tax), 2652(a) (generation-skipping transfer (GST) tax applies to transfers subject to estate or gift tax). See §16.16.

NOTE: The Internal Revenue Code provides that "a tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen *or resident* of the United States." IRC §2001(a) (emphasis added). However, this discussion uses the term "domiciliary" in the context of transfer taxes to distinguish the concept of residence for estate tax purposes from the concept of residence for income tax purposes.

The definition of domiciliary for transfer tax purposes is different from the definition of resident for income tax purposes (see §16.7) and is not affected by whether the person in question is or is not a resident for income tax purposes. A person will be treated as a United States domiciliary for transfer tax purposes if, at the time of the relevant testamentary or inter vivos transfer, that person is domiciled in the United States. A person acquires domicile in a place by living there, for even a brief period of time, with no definite present intention of leaving. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. Treas Reg §§20.0-1(b)(1), 25.2501-1(b). As courts have stated: "[D]espite the fact that the terms residence and domicile are often used synonymously, residence is not a synonym for domicile, and its meaning in a particular statute is subject to differing construction, depending on the context and purpose of the statute in which it is used." *Milton H. Greene Archives, Inc. v CMG Worldwide, Inc.* (CD Cal 2008) 568 F Supp 2d 1152, 1180, quoting *Kirk v Regents of Univ. of Cal.* (1969) 273 CA2d 430, 434, 78 CR 260.

The definition of domicile can be broken down into a three-pronged test:

- An individual must have an intent to make the United States the place of his or her permanent home.
- The individual must be physically present in the United States at a time when he or she intends to remain permanently in the United States.
- The individual must have the ability to make an informed and intelligent decision about his or her domicile.

Although the intent element of the test is subjective, the objective and outward expressions of intent are carefully reviewed to determine a person's intent.

A person acquires a domicile in a place by living there, for even a brief period of time, with no definite intention of later moving from there. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. *Estate of Barkat A. Khan*, TC Memo 1998-22, citing *Mitchell v U.S.* (1874) 88 US 350, 353; *Jan Willem Nienhuys* (1952) 17 TC 1149, 1159, acq 1952-1 Cum Bull 3 (decedent in *Khan* was domiciliary because decedent (1) lived in United States and (2) intended to remain indefinitely). See also *Estate of Glassford* (1952) 114 CA2d 181, 186, 249 P2d 908 (person always has domicile and does not lose one until another is acquired).

Among the facts and circumstances the IRS considers are the following:

- Duration of stay in the United States and other countries, and the frequency of travel between the United States and other countries;
- Size, cost, and nature of the individual's homes and whether those homes are owned or rented;
- Area in which the homes are located;
- Location of expensive and cherished personal possessions;
- Location of the individual's family and friends;
- Age of any children and the location of their schools;
- Location of the individual's business and the location of the spouse's business;
- Places where the individual maintains church and club memberships;

- Declarations of residence or intent made in visa applications for reentry permits, wills, deeds of gifts, trust instruments, letters, and oral statements;
- Location of a burial plot; and
- Motivation for being in the United States.

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§16.16 D. Transfer Taxation of Residents and Nonresidents

In general, United States citizens, no matter where they reside, and persons who reside in the United States, no matter what their citizenship (see §16.15), are subject to United States transfer tax with respect to all of their assets or interests in assets whether within or outside of the United States. IRC §§2001(a), 2511(a). In contrast, nonresidents (or nondomiciliaries) who are not United States citizens are subject to transfer tax only with respect to those of their assets or interests in assets that are situated or deemed situated within the United States. IRC §§2101(a), 2103, 2511(a). An important exception to this rule is that, in the case of a nonresident who is not a citizen, the gift tax does not apply to the transfer of intangible assets even if those assets are situated in the United States, unless the donor lost United States citizenship within the previous 10 years and avoidance of taxes was one of the principal purposes of the loss. IRC §2501(a)(2)-(3). Although nonresidents can take advantage of gift-tax exclusions, such as the IRC §2503(b) annual exclusion and the special IRC §2523(i) annual exclusion for gifts to noncitizen spouses (see §16.23) or the IRC §2503(e) exclusion for medical and educational expenses, gift-tax deductions such as the IRC §2523 marital deduction for gifts to United States citizen spouses, and estate-tax deductions such as the IRC §2056 marital deduction for transfers to United States citizen spouses and qualified transfers to noncitizen spouses (see §§16.25-16.40), they can make only $60,000 worth of taxable transfers for estate tax purposes without incurring an estate tax and they can make no taxable transfers for gift-tax purposes without incurring a gift tax. IRC §§2102, 2106(a)(3), 2505.

United States resident donors are generally permitted to claim gift tax deductions for lifetime gifts to foreign charities and estate tax deductions for testamentary gifts to foreign charities, but not income tax deductions. A charitable income tax deduction is generally allowed only for transfers made or treated as made to corporations and associations created or organized in the United States, or to trustees for use in the United States. IRC §170(c)(2). However, the geographical area in which deductible contributions may be used is not restricted, and the gift can be used in a foreign country. See Rev Rul 63-252, 1963-2 Cum Bull 101, as amplified by Rev Rul 66-79, 1966-1 Cum Bull 48 (individual donors). See also Rev Rul 69-80, 1969-1 Cum Bull 65 (unrestricted corporate gifts). A U.S. estate or gift tax deduction will be allowed for a direct contribution to a foreign charity under IRC §2522(a) and IRC §2055(a), respectively, if (1) the donee is organized for IRC §170(c) purposes (*i.e.*, religious, charitable, scientific, literary, educational, and other specified exempt purposes); (2) no part of its net earnings inures to the benefit of any individual; and (3) the donee does not violate the prohibitions against self-dealing and involvement in lobbying and political campaigns in IRC §§4940-4948. Regardless of where the foreign charity is located, an estate or gift tax deduction will be available if the foreign charity has obtained a determination of tax-exempt status under IRC §501(c)(3) from the IRS.

Although the transfer tax base for United States and non-United States residents is different, residents and nonresidents are subject to the same transfer tax rates with respect to taxable transfers. IRC §§2001(c), 2502(a), 2641.

For the definition of United States situs assets, see §16.17. Specific exemptions apply to certain United States situs assets. See §16.18. Special rules apply to transfers with retained interests. See §16.19.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.17 1. United States Situs Assets

§16.17 1. United States Situs Assets

Only certain assets of a noncitizen who is not a domiciliary constitute U.S. situs assets for transfer tax purposes, and are subject to U.S. transfer taxes. Note that the rules vary between estate and gift taxes. The gift tax applies to transfers by nonresident aliens only if the property is situated within the United States (IRC §§2501(a)(1), 2511(a)), and even if the property is situated within the United States, the gift tax does not apply to "transfers of intangible property by a nonresident not a citizen of the United States." IRC §2501(a)(2). That is not necessarily the case with the estate tax, which generally applies to all property situated in the U.S. (IRC §§2103-2104) with certain exceptions (IRC §2105; see §16.18), as illustrated by the following (non-exclusive) table.

Table: Assets Subject to Estate and Gift Tax

Type of Asset	Estate Tax	Gift Tax
Real estate	Yes, if located in U.S. (see Treas Reg §20.2104-1(a)(1))	Yes, if located in U.S.
Tangible personal property	Yes, if located in U.S. (see Treas Reg §20.2104-1(a)(2)), except works of art on temporary loan (IRC §2105(c))	Yes, if located in U.S.
Stock	Yes, if stock of a U.S. corporation (IRC §2104(a))	No (shares of stock are considered intangible property and gifts of shares are not taxable transfers for gift tax purposes)
Intangible property	Yes, if enforceable against U.S. person (see Treas Reg §20.2104-1(a)(3))	No (see IRC §2501(a)(2))
Debt	Yes, if the primary obligor is U.S. person or governmental organization, except portfolio debt obligations (see IRC §§871(h), 2104(c), 2105(b)(3)); see §16.18	Yes
U.S. life insurance	No, unless life of another person is insured (see IRC §2105(a); Treas Reg §20.2105-1(g))	No
U.S. life insurance—cash surrender value	Yes	No
Annuities	Yes (see fn 1 below)	No

Retirement plan	Yes	No
Currency in U.S. safe deposit box	Yes	Yes
Cash deposit in bank (including checking, savings accounts, and CDs)	No, if interest received is not effectively connected with conduct of trade or business within U.S. (see IRC §2105(b)(1)); see §16.18	Yes (cash is tangible property)
Mortgage	Yes	No
Partnership or LLC interest	No (see fn 2 below)	No (see fn 3 below)

1. But see IRS Letter Ruling 200842013, in which a U.S. citizen owned three annuity contracts that provided that the annuity amounts were to be paid to the U.S. citizen during his lifetime, and at his death were payable to decedent, a foreign person, as the named beneficiary. Decedent died before claiming or being paid any portion of the annuity proceeds and accrued interest. Decedent's will left his entire estate to a foreign person. The IRS concluded that the annuity proceeds, including accrued interest through decedent's date of death, were not assets situated in the United States in determining the property includible in decedent's gross estate under IRC §2103 because the annuity proceeds were held by the insurer that issued the annuities and constituted deposits under IRC §871(i)(3), the interest on which would not be subject to tax under IRC §871(i)(1). Therefore, the annuity proceeds were not deemed property situated within the United States under IRC §2105(b)(1).

2. See IRS Letter Ruling 7737063, in which the IRS lists partnership interests as an example of intangible property; however, the IRS could take the position that a partnership will be ignored for this purpose and that the nature of the underlying assets determines the situs of the gift.

3. The IRS ordinarily will not rule on whether a partnership interest constitutes intangible property for gift tax purposes. Rev Proc 2009-7, §4.01(27), 2009-1 Int Rev Bull 226.

WARNING: The decision in *Estate of Noordin M. Charania* (2009) 133 TC No. 7 highlights the importance of asset situs. The court ruled against the estate of a U.K. citizen, resident of Belgium, whose estate owned 250,000 shares of Citigroup stock, and ordered the estate to pay over $2 million in U.S. estate taxes. Citigroup is a U.S. corporation and its stock is a U.S. situs asset and, as such, part of the decedent's gross estate taxable in the U.S. under IRC §2104(a). The result could have been avoided with proper planning. For example, the stock could have been held through a non-U.S. entity or offshore trust, or the stock could have been gifted to family members because shares of stock are considered intangible property for gift tax purposes. See Chief Counsel Advice 201003013 (shares of Canadian mutual funds that owned shares of U.S. corporations and were held in Canadian retirement plan of decedent who was a Canadian resident, citizen, and domiciliary at the time of his death were not included in decedent's gross estate).

Chief Counsel Advice 201003013 illustrates the same issue. A Canadian citizen and resident had a Canadian registered retirement savings plan (RRSP), which is classified as a trust for U.S. tax purposes. The RRSP held shares of Canadian mutual funds, which in turn owned shares of U.S. corporations. The IRS determined that all the Canadian mutual funds held in the RRSP would be classified as foreign corporations for U.S. tax purposes. Thus, the memorandum concluded that no portion of the RRSP was includable in the Canadian citizen's estate, notwithstanding that the mutual funds were invested in U.S. companies.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.18 2. Estate Tax Exempt Assets

§16.18 2. Estate Tax Exempt Assets

Some assets that are clearly situated in the United States (see IRC §2103) nonetheless may not be subject to estate tax in the hands of a non-United States person as a result of a specific exemption. Examples of these assets are works of art on temporary loan (IRC §2105(c)), stock in a regulated investment company (IRC §2105(d)), and the following (IRC §2105(b)):

- U.S. bank deposits, the interest from which is not effectively connected with the conduct of a United States trade or business; and
- Debt obligations issued after July 18, 1984, the interest from which qualifies as "portfolio investment interest" and therefore is not subject to United States income tax.

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§16.19 3. Transfers With Retained Interests

An often overlooked or misunderstood rule dealing with retained interests provides that property transferred, by trust or otherwise, within the meaning of IRC §§2035-2038, is deemed situated in the United States if so situated at the time of transfer or death. Accordingly, if a non-United States resident makes a transfer (with a retained interest) of a United States situs asset to a trust and that person later dies, the asset subject to the retained interest will be includable in the non-United States resident's estate as a United States situs asset even if that asset had been exchanged for a non-United States situs asset between the date of transfer to the trust and the date of the decedent's death. IRC §2104(b); Treas Reg §20.2104-1(b).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.19A 4. Effect of Transfer Tax Treaties

§16.19A 4. Effect of Transfer Tax Treaties

The general rules regarding domicile, residence, and situs of assets may be changed by tax treaties between the United States and various foreign countries. The United States has entered into estate tax treaties with the following countries.

Table 1: Estate Tax Treaties

Australia	Germany	Norway
Austria	Greece	South Africa
Denmark	Ireland	Sweden
Finland	Italy	Switzerland
France	Japan	United Kingdom
	Netherlands	

The United States also has entered into gift tax treaties with the following countries.

Table 2: Gift Tax Treaties

Australia	Germany
Austria	Japan
Denmark	Sweden
France	United Kingdom

Although Australia abolished its transfer tax system in 1979, the U.S.-Australia estate and gift tax treaties have not been terminated.

Italy and Austria repealed their estate and gift taxes effective October 2001 and August 2008, respectively, but those treaties remain unchanged. Italy reintroduced a gift and estate tax regime in 2007 but the rates are low. The estate and gift tax treaties with Sweden, on the other hand, were terminated effective January 1, 2008, in response to Sweden's abandonment of its transfer tax regime in December 2004. The U.S. Treasury has stated that, since Sweden abolished its tax on inheritance and gifts, the treaty is no longer needed to prevent double taxation with respect to taxes on estates, inheritances, and gifts.

NOTE: A treaty with Canada was terminated as to decedents dying on or after January 1, 1985, after Canada replaced its estate tax with a tax on unrealized capital gains at death. In 1995, the U.S.-Canada income tax treaty was amended by a Protocol that addressed double taxation under the U.S. estate tax and Canadian capital gains tax and other issues.

Older transfer tax treaties (Australia, Finland, Greece, Ireland, Japan, Norway, South Africa, and Switzerland) allow "domicile" to be determined initially under the domestic law of each contracting state. The law is taken as given; the convention does not assess or modify the criteria used by a contracting state for its determination. The more recent treaties (Austria, Denmark, France, Germany, the Netherlands, and the United Kingdom) contain detailed rules, which are intended to avoid the assertion of domicile by both countries.

Under the first type of treaty, an estate may be subject to taxation on worldwide assets by two countries, but those treaties all contain provisions under which the tax authorities of the signatory states will allow credits on property situated in the other country. The newer type of treaties have a tie-breaker rule that basically states that, if an individual is viewed by both countries as a domiciliary of that country, the individual will be treated by both countries as a

domiciliary of the country of citizenship if he or she resided in the other country for less than a certain period of time (7 of 10 years, or 5 of 7 years) before death or the gift in question. If this rule is inapplicable, domicile is fixed by reference to specified rules, which are applied in descending order rather than simultaneously (permanent home, center of vital interest, habitual abode and citizenship) and, if no clear result is reached under any of these tests, the matter is decided by mutual agreement of the tax authorities of the signatory states.

If a non-U.S. citizen (or the estate of a non-U.S. citizen) takes a reporting position for U.S. tax purposes based on a U.S. tax treaty that purportedly overrules or modifies any provision of the Internal Revenue Code, and that position results in a reduction of U.S. tax, the individual or the estate must disclose the position on IRS Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b). The form must be attached to the noncitizen's U.S. income or estate or gift tax return. If no tax return would otherwise be required, the noncitizen individual or the estate must nonetheless file a return with the noncitizen's name, address, and taxpayer identification number and attach Form 8833 to it. See IRC §§6114, 7701(b) (definition of nonresident alien). Form 8833 requires the person taking the treaty-based position to identify the treaty relied on, cite the specific articles of the treaty relied on, and explain the treaty provision, including the relevant facts and the amount covered by the treaty benefit.

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III. CLIENT IS CITIZEN OF UNITED STATES AND OTHER COUNTRIES

§16.20 A. Client Is United States Resident

The United States is one of the few countries that taxes on the basis of citizenship rather than residence. IRC §§1, 2001(a), 2501(a); Treas Reg §1.1-1. Accordingly, if the client is a United States resident, in most cases it will make no difference that the client has a citizenship other than his or her United States citizenship.

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§16.21 B. Client Is Non-United States Resident

If a United States citizen is a resident of a country other than the United States, he or she will face tax and other issues in the country of residence. As discussed in §16.20, the client will generally still have the same exposure to United States income and transfer taxes as if he or she were a United States resident. There is no exception for nonresident citizens. Foreign tax credits allowable in the United States or the country of residence and tax treaties between the United States and the country of residence may at least in part address potential double tax issues that may exist. For example, there is an estate tax credit for foreign death taxes paid on property situated in a foreign country under IRC §2014. See chap 10.

Although a detailed review is beyond the scope of this chapter, there are limited income tax benefits available to United States citizens living abroad. See, *e.g.,* IRC §911.

An issue that arises frequently, but certainly not exclusively, in the context of United States citizens living abroad is the issue of possible expatriation. Although a detailed discussion of this topic is beyond the scope of this chapter, a general overview can be found in §§16.85-16.90A.

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§16.22 IV. CLIENT WANTS TO MAKE TRANSFERS TO NON-UNITED STATES CITIZEN SPOUSE OR CLIENT IS NON-UNITED STATES CITIZEN SURVIVING SPOUSE

Whether advising a client who is married to a person who is not a United States citizen or a surviving spouse who is not a citizen, a good understanding of IRC §§2056(d), 2056A, and 2523(i) is essential to minimizing the transfer tax burden attributable to transfers to or for the benefit of a spouse who is not a citizen. For purposes of this discussion, an almost qualified transfer is a transfer that would have qualified for the marital deduction if the recipient spouse had been a United States citizen at the time of the transfer. See §§16.23-16.40. For further discussion of marital deduction planning for spouses who are not citizens, see chap 17.

PRACTICE TIP: Practitioners should advise noncitizen clients and clients with noncitizen partners to complete the formalities required to achieve marital status for the noncitizen, if that is the desired result. Otherwise, questions may arise regarding whether a particular nonresident, non-United States citizen was the surviving spouse of the decedent. The law of the place of marriage ordinarily controls the question of its validity. *Colbert v Colbert* (1946) 28 C2d 276, 280, 169 P2d 633. In *Rosales v Battle* (2003) 113 CA4th 1178, 7 CR3d 13, the court held that a person determined to be the decedent's "concubina" by a Mexican court was not the decedent's surviving spouse under Fam C §308 for purposes of California's wrongful death statute. Although her status provided many legal rights under Mexican law, including the right of inheritance, it did not provide all the rights of a spouse.

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A. Inter Vivos Transfers

§16.23 1. Annual Exclusion

If the donee spouse is not a United States citizen, the gift-tax marital deduction is not allowed for transfers made to that spouse; however, the annual exclusion for a qualified transfer to such a spouse is $134,000 (in 2010) rather than the $13,000 annual exclusion allowable in the case of transfers to nonspouse donees. IRC §2523(i)(2). See Rev Proc 2009-50, 2008-45 Int Rev Bull 617.

The higher annual exclusion for gifts to spouses who are not citizens can be a significant planning tool because excluded transfers will not be subject to gift tax and, in cases in which the donee spouse is not a United States resident, the transferred assets may not be subject to United States transfer tax at all. At the same time, practitioners must remain attentive and properly advise clients of the nontax consequences of transfers made to achieve certain tax results to ensure that clients are fully informed. Practitioners also must be alert to inadvertent transfers. See §16.24.

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§16.24 2. Inadvertent Transfers

Practitioners must pay close attention to direct and indirect, intentional and inadvertent transfers between spouses when one spouse is a non-United States citizen to avoid unintended transfer tax consequences. A common scenario is one in which one spouse purchases a home with his or her separate property and takes title with a non-United States citizen spouse either as joint tenants or community property. The purchase results in a gift to the spouse and, if the amount of the gift exceeds the donor's available annual exclusion amount, the perhaps unintended consequence will be a taxable gift. Unlike a transfer by death that can be qualified for the marital deduction after the fact (see §16.25), transfers by gift that do not qualify for the marital deduction at the time of the transfer cannot be so qualified.

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B. Testamentary Transfers

§16.25 1. Transfers to Non-United States Citizen Spouses

Transfers to non-United States citizen spouses do not qualify for the marital deduction unless special requirements, discussed in §16.26, are met. If those requirements are not met, a transfer to a non-United States citizen spouse will be taxed like any other taxable transfer. In *Estate of Hon Hing Fung* (2001) 117 TC 247, aff'd (9th Cir 2003) 2003-1 USTC ¶60,460, 91 AFTR2d 1228, the court held that the estate was entitled to a marital deduction for only three-eighths of the decedent's United States property because the estate failed to prove that a settlement agreement giving the spouse all of the property was a bona fide recognition of her right to three-eighths of the residue of the decedent's worldwide estate. It is important to remember that the more onerous marital deduction requirements will need to be met only in the case of estates relying on the marital deduction to defer the payment of estate tax with respect to assets not otherwise covered by the deceased spouse's IRC §2010 applicable exclusion amount. When the rules were first enacted, many couples whose estates did not exceed their lifetime exemptions became unnecessarily worried about the application of the rules. Ways of qualifying transfers exceeding the applicable exclusion amount are discussed in §16.27.

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§16.26 2. Marital Deduction Requirements if Surviving Spouse Is Not United States Citizen

If the surviving spouse is not a United States citizen (irrespective of the citizenship or residence of the deceased spouse), the marital deduction otherwise allowed by IRC §2056(a) for property passing to or for the benefit of the decedent's surviving spouse is generally disallowed under IRC §§2056(d), 2056A, unless:

- The transfer would have qualified for the marital deduction if the surviving spouse had been a United States citizen (it is an almost qualified transfer), *and*
- One of the following conditions is met:
- The surviving spouse becomes a citizen before the date on which the federal estate tax return is made;
- An appropriate election is made with respect to property that passes to (or under) a trust that meets the requirements of a qualified domestic trust (QDOT);
- An appropriate election is made with respect to property that passes to (or under) a trust that does not meet the requirements of a QDOT but is reformed after the decedent's date of death to meet those requirements;
- An appropriate election is made with respect to property that passes to the surviving spouse by outright bequest or devise, by operation of law or under the terms of an annuity or other similar plan or arrangement, and that the surviving spouse then transfers or irrevocably assigns to a QDOT before the decedent's federal estate tax return is filed and during the time the QDOT election may be made; or
- The requirements contained in Treas Reg §20.2056A-4(c) are satisfied with respect to a plan, annuity, or other arrangement (whether qualified or not), the payments of which are not assignable or transferable to a QDOT under federal, state, or foreign law or the terms of the plan or arrangement itself.

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§16.27 3. Qualifying Almost Qualified Transfers

Practitioners faced with an almost qualified transfer must react swiftly and carefully, but the rules are benign. The overall theme, as it should be, is that the marital deduction will be available as long as the end result is a QDOT under IRC §2056A or other arrangement that secures the ultimate payment of transfer tax. The various ways in which an almost qualified transfer can be qualified for the marital deduction are discussed in §§16.28-16.35. Requirements for QDOTs are discussed in §16.36. The taxation of QDOTs is discussed in §§16.37-16.39. Practical considerations for the decision to establish a QDOT are discussed in §16.40.

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§16.28 4. Surviving Spouse Becomes United States Citizen

Under IRC §2056(d)(4), if the decedent's surviving spouse was not a United States citizen on the date of the decedent's death, the marital deduction will nonetheless be available with respect to an almost qualified transfer if:

- The surviving spouse becomes a United States citizen before the decedent's federal estate tax return is filed; and
- The surviving spouse was a resident of the United States for transfer tax purposes (*i.e.,* a domiciliary) at all times after the death of the decedent and before becoming a United States citizen.

As a practical matter, this alternative is most likely to apply if the surviving spouse had already applied for United States citizenship at the time of the deceased spouse's death or the surviving spouse lives in a jurisdiction in which the naturalization process can be completed within a few months. If the naturalization process is not completed in time and the due date of the return arrives, a QDOT can be established under IRC §2056A using any of the alternatives described in §16.30.

Distributions made from the QDOT after the surviving spouse becomes a United States citizen will not be subject to the QDOT tax imposed by IRC §2056A(b). Therefore, it is important to keep the QDOT as flexible as possible so that when the surviving spouse becomes a United States citizen, any restrictions included solely to qualify the trust as a QDOT can be removed. If the surviving spouse becomes a United States citizen after the filing of the deceased spouse's federal estate tax return, notice that the surviving spouse has become a United States citizen and elections regarding the treatment of distributions on which the tax was previously imposed, if applicable, must be filed by April 15 of the year following the year in which the surviving spouse becomes a United States citizen. Treas Reg §20.2056A-10. If the notice or elections are not filed in time, it is possible to seek relief under Treas Reg §301.9100-3.

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§16.29 5. Outright Transfers to Spouse

Property otherwise qualifying for the marital deduction and passing from a decedent to his or her noncitizen surviving spouse, either outright (by testamentary bequest or devise or by operation of law) or under an annuity or other similar plan or arrangement, is treated as passing to the surviving spouse in a QDOT (solely for purposes of IRC §2056(d)(2)(A)) if that property is either actually transferred or irrevocably assigned to a QDOT before the decedent's federal estate tax return is filed and during the time that the QDOT election may be made. IRC §2056(d)(2)(A). The transfer or assignment of property to the recipient QDOT may be made by the surviving spouse or the surviving spouse's legal or personal representative. Treas Reg §20.2056A-2(b)(2)-(3). See §§16.30-16.32.

The transferred assets are deemed to pass from the decedent to the surviving spouse solely for marital deduction purposes. For all other purposes, the surviving spouse is the transferor unless the transfer is a qualified disclaimer under IRC §2518. Treas Reg §20.2056A-4(b)(5). If the surviving spouse retains sufficient interests in the recipient QDOT (including the power to revoke the trust as discussed above) to cause the transfer to be an incomplete gift, however, there will be no adverse gift-tax consequences to the transfers.

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§16.30 a. QDOT Options

The transferee QDOT may be a QDOT previously established by the decedent for the transfer of other assets (see §§16.33-16.34) or may be established by the decedent's executor or the surviving spouse. The property must be transferred to the trust before the decedent estate tax return is filed and on or before the deadline for making the QDOT election (see §16.35) or irrevocably assigned to the trust under a written assignment made on or before the date the decedent's estate tax return is filed and on or before the last date for making the election. Because the decedent placed no restrictions on the transfer to the surviving spouse, the establishment of the QDOT should not have the effect of depriving the surviving spouse of flexibility or control. The surviving spouse may establish a very flexible trust and retain the power to invade the trust and withdraw trust assets so that the surviving spouse can determine when distributions will be made and thereby choose the timing of the payment of transfer tax or permit tax-free distributions if the surviving spouse has become a United States citizen. If no property other than the property passing to the surviving spouse from the decedent is transferred to the QDOT, the transferee QDOT need not be in a form that would have otherwise qualified for the marital deduction under IRC §2056(a), and the QDOT can certainly be revocable by the surviving spouse. Treas Reg §20.2056A-4(b)(1).

PRACTICE TIP: In the context of nonjudicial reformations, discussed in §16.33, QDOTs that are revocable by the surviving spouse or are subject to the spouse's general power of appointment must provide that no person (including the spouse) has the power to amend the trust so that it would no longer qualify as a QDOT. Treas Reg §20.2056A-4(a)(2). Although this requirement appears only in the portion of the regulations dealing with reformation, it may be wise to include this language in any revocable QDOT.

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§16.31 b. Qualifying Property

If a transfer or assignment under Treas Reg §20.2056A-4(b)(2) is of a specific asset or group of assets, only assets passing from the decedent and included in the decedent's gross estate (or proceeds from the sale, exchange, or conversion of those assets) may be transferred or assigned to the QDOT. Treas Reg §20.2056A-4(b)(3). The surviving spouse may not fund the QDOT with property owned by the surviving spouse at the time of the decedent's death. Note that with respect to joint tenancy property, the IRC §2040(a) (contribution tracing rule) rather than the IRC §2040(b) rule applies to determine the portion of the assets includable in the decedent's gross estate if the surviving spouse is not a United States citizen. IRC §2056(d)(1)(B). If, as a result of the application of this rule, only a portion of the property interest is includable in the decedent's estate, only the portion so includable may be transferred to the recipient QDOT. Because the assets of the QDOT will be subject to the QDOT tax, it is very important to accurately determine which assets are includable in the decedent's gross estate and which assets should be transferred to the QDOT. In the event of uncertainty, a protective assignment may be made in some circumstances. Treas Reg §20.2056A-4(b)(8). Special rules apply to pecuniary assignments. Treas Reg §20.2056A-4(b)(4).

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§16.32 c. Nonassignable Annuities

A nonassignable plan, annuity, or other arrangement that would otherwise qualify for the marital deduction is treated as meeting all marital deduction requirements if either (1) the surviving spouse agrees to pay annually the deferred tax due on the corpus portion of each payment received, or (2) the surviving spouse agrees to roll over the corpus portion of each payment received, within 60 days of receipt, to a QDOT, whether created by the decedent's will, the decedent's executor, or by the surviving spouse (see §16.30). The regulations contain detailed requirements that must be met to qualify these annuities for the marital deduction, including specific information statements and agreements to be entered into by the surviving spouse. Treas Reg §20.2056A-4(c).

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6. Transfers in Trust

§16.33 a. Trusts Revocable by Spouse

If property passes to a trust that is revocable or subject to the surviving spouse's general power of appointment or power of amendment, the trust can be amended by the surviving spouse in accordance with the reformation provisions of the statute and the regulations. IRC §2056(d)(5); Treas Reg §20.2056A-4(a)(1). If the trust consists of both assets passing from the decedent to the surviving spouse and the surviving spouse's own assets, the trust should be divided into two separate trusts so that the surviving spouse's assets are not subject to the more restrictive provisions applicable to QDOTs. Alternatively, the surviving spouse can exercise his or her power to withdraw trust assets and treat the transfer from the decedent as an outright transfer. See §16.29.

If the transfer is treated as an outright transfer and specific assets are transferred to a QDOT, keep in mind the rule that prevents the surviving spouse from transferring to the QDOT assets that the surviving spouse owned at the time of the decedent's death (*i.e.* community property interests or other co-ownership interests). See §16.31.

It is important not to give up flexibility unnecessarily. The regulations provide that the reformed trust may be revocable by the spouse, or otherwise be subject to the spouse's general power of appointment, provided that no person (including the spouse) has the power to amend the trust so that it would no longer qualify as a QDOT. Treas Reg §20.2056A-4(a)(2). As noted in §16.30, counsel should probably include this provision in every QDOT that is revocable by the surviving spouse. The restriction is innocuous in light of the spouse's power of revocation.

A nonjudicial reformation must be completed by the time prescribed (including extensions) for filing the decedent's estate tax return. Treas Reg §20.2056A-4(a)(1). To minimize problems on audit, counsel should file a thorough return with a copy of the amended trust and all other relevant documents and information.

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§16.34 b. Irrevocable Trusts

If the trust is irrevocable (*i.e.,* a QTIP trust), and no person has the power to amend the trust to include the provisions to qualify the trust as a QDOT, the trust may be reformed by judicial reformation. IRC §2056(d)(5)(A). Such a reformation is permitted if it is commenced on or before the due date (including extensions actually granted) for filing the decedent's estate tax return, regardless of the date the return is actually filed. The applicable rules for marital trusts for United States citizen surviving spouses also must be satisfied before the trust may be reformed. Treas Reg §20.2056A-2(b)(1).

PRACTICE TIP: If reformation proceedings are commenced, the period for assessing a deficiency attributable to the failure of the trust to qualify as a QDOT does not expire until 1 year after the date on which the IRS is notified that the trust has been changed under that final proceeding or that that proceeding has been terminated. IRC §2056(d)(5)(B). Special attention is required to avoid overlooking this postfiling requirement.

Before the time the judicial reformation is completed, the trust must be treated as a QDOT. If, for any reason, the judicial reformation proceeding is terminated before being completed, the decedent's estate is required to pay any estate tax, interest, and penalties attributable to the trust's failure to qualify as a QDOT and a claim for refund may be filed to recover any QDOT tax paid before termination of the reformation proceeding. Treas Reg §20.2056A-4(a)(2).

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§16.35 c. Deadline for Making QDOT Election

An irrevocable QDOT election must be made with respect to the trust no later than 1 year after the due date (including extensions) for filing the decedent's federal estate tax return. IRC §2056A(d); Treas Reg §20.2056A-3(a). Under specified circumstances, an extension of time for completing the conveyance, or waiver of the actual conveyance, may be requested by the decedent's estate under Treas Reg §301.9100-1(c). See, *e.g.,* IRS Letter Rulings 200842018, 200146015, 9228001.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.36 C. Requirements for QDOTs

§16.36 C. Requirements for QDOTs

In general, a trust must satisfy the following requirements to qualify as a QDOT under IRC §2056A (Treas Reg §20.2056A-2(a), (d)):

- The trust must be an ordinary trust as defined in Treas Reg §301.7701-4(a);
- The trust must be maintained under the laws of a state of the United States or the District of Columbia, and the administration of the trust must be governed by the laws of a particular state of the United States or the District of Columbia;
- The trust instrument must require that at least one trustee (United States trustee) be an individual United States citizen or a domestic corporation, subject to regulatory exceptions when foreign countries prohibit trusts or prohibit trusts from having United States trustees;
- The trust instrument must provide that no distribution, other than a distribution of income, may be made from the trust unless the United States trustee has the right to withhold the QDOT tax imposed on that distribution; and
- Detailed additional requirements to ensure collection of the deferred estate tax must be satisfied. These requirements include governing instrument requirements for using a United States bank trustee, bond, or letter of credit if the QDOT has assets in excess of $2 million (excluding $600,000 for a personal residence and related furnishings) and reporting requirements for QDOTs owning foreign real property if these security requirements do not apply.

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§16.37 D. Taxation of QDOTs

A deferred estate tax is imposed under IRC §2056A(b)(1) on the occurrence of a taxable event as defined in Treas Reg §20.2056A-5(b). See §§16.38-16.39.

The deferred estate tax generally will be equal to the estate tax that would have been imposed if the amount involved in the taxable event had been included in the decedent's taxable estate and had not been deductible under IRC §2056. IRC §2056A(b)(2); Treas Reg §20.2056A-5(a).

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§16.38 1. Taxable Events

The code and regulations define three taxable events for QDOT trusts:

- With limited exceptions described in §16.39, the deferred estate tax is imposed on any distribution from the QDOT before the surviving spouse's death. IRC §2056A(b)(1)(A). The amount subject to tax is the amount of the distribution (amount of money and fair market value of property distributed in kind), including any amount withheld by the United States trustee to pay the deferred estate tax. See §16.36. If the tax is not withheld but is paid by the United States trustee out of other assets of the QDOT, the tax so paid is treated as an additional distribution to the spouse in the year that the tax is paid. Treas Reg §20.2056A-5(b)(1).
- The deferred estate tax is imposed on the value of the property remaining in a QDOT on the date of the surviving spouse's death (or alternate valuation if applicable). IRC §2056A(b)(1)(B). Any corpus portion amounts remaining in a QDOT on the surviving spouse's death and any residual payments resulting from a nonassignable plan or arrangement that, on the surviving spouse's death, are payable to the spouse's estate or to successor beneficiaries are subject to the QDOT tax. Treas Reg §20.2056A-5(b)(2).
- The deferred estate tax is imposed if a QDOT ceases to meet statutory and regulatory requirements imposed on QDOTs. IRC §2056A(b)(4). The amount subject to the deferred tax is the fair market value of the trust assets on the date of disqualification. Treas Reg §20.2056A-5(b)(3).

Notwithstanding the repeal of the estate tax in 2010, the deferred estate tax will continue to be imposed on any principal distribution (other than on account of hardship) from a QDOT before January 1, 2021. IRC §2210(b)(1). The deferred estate tax will not apply on the death of a surviving spouse after December 31, 2009 (and before January 1, 2011). IRC §2210(b)(2).

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§16.39 2. Distributions Not Subject to Tax

The following distributions are not subject to the tax on QDOT trusts.

- Distributions of income to the surviving spouse. IRC §2056A(b)(3)(A). For this purpose, "income" is defined by reference to IRC §643(b) and Treas Reg §1.643(b)-1; however, income does not include capital gains or other items allocable to principal under applicable local law even if the trust instrument contains provisions to the contrary. The word "income" includes principal allocated to income as a result of a trustee's exercise of a statutory power to make such an adjustment. Under Prob C §16336, such adjustments are permitted in specified circumstances. The word "income" also may include a unitrust amount in the range of 3-5 percent, as provided by Prob C §§16328, 16336.4-16336.6. Treas Reg §20.2056A-5(c)(2).
- Distributions of principal to the surviving spouse on account of hardship. IRC §2056A(b)(3)(B). These are distributions of principal to the surviving spouse in response to an immediate and substantial financial need relating to the spouse's health, maintenance, or support, or the health, maintenance, or support of any person the surviving spouse is legally obligated to support, unless the amount distributed may be obtained from other reasonably available sources. Treas Reg §20.2056A-5(c)(1).
- Miscellaneous distributions and dispositions specified in Treas Reg §20.2056A-5(c)(3):
- Payments for ordinary services and necessary expenses of the QDOT (including bond premiums and letter of credit fees).
- Payments of income taxes due by the QDOT (but not payments of the IRC §2056A estate tax on principal distributions; if the QDOT pays this tax, it is considered a further distribution of principal to the surviving spouse).
- Sales and exchanges of trust assets by the trustees for full consideration (including a sale of QDOT assets for full value to the surviving spouse, which is not prohibited).
- Amounts paid from the QDOT to reimburse a surviving spouse for any federal income tax that he or she paid on any items of QDOT income that the surviving spouse was not entitled to receive. See IRC §2056A(b)(15).

Distributions made after the surviving spouse becomes a United States citizen are not subject to tax if certain conditions are met. Treas Reg §20.2056A-10. See §16.28.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.40 E. Practical Considerations

§16.40 E. Practical Considerations

As illustrated by the discussion in §§16.28-16.39, QDOTs can be more cumbersome to establish and administer than the average marital trust. In addition, unlike United-States-citizen surviving spouses who receive assets qualifying for the marital deduction, noncitizen surviving spouses who benefit from a QDOT may not withdraw and consume principal from the trust without transfer tax consequences. A QDOT is, therefore, *only* a transfer tax deferral technique.

Before advising a client to establish a QDOT and transfer foreign or domestic assets to the trust, consider the following:

- Whether the surviving spouse is and will continue to be a United States person for transfer tax purposes;
- The types of assets includable in the decedent's estate;
- Which assets or portions of assets are eligible for transfer to the QDOT;
- The cost of establishing and maintaining the QDOT;
- The appreciation potential of the assets;
- The overall transfer tax projected to be paid in both the deceased spouse's estate and the surviving spouse's estate;
- The probability that tax-free distributions can be made (under the hardship exemption or otherwise);
- The loss of control attributable to the requirement that a QDOT have a United States trustee;
- Whether the tax deferral alone is worth the trouble and additional expense; and
- Whether an applicable transfer tax treaty provides an alternative regime to the QDOT. See §16.19A.

A QDOT may hold foreign property of any kind, *e.g.*, stock of a foreign corporation. IRS Letter Ruling 9032014. A QDOT with less than $2 million in assets must either (1) contain a provision that no more than 35 percent of the fair market value of its assets will be invested in real property located outside the United States at any time, or (2) meet any one of three requirements for trusts over $2 million, *i.e.*, using an institutional trustee, posting a bond, or providing a letter of credit. Treas Reg §20.2056A-2(d)(1)(ii). See §17.76.

Most foreign civil law countries with laws based on the Napoleonic Code do not recognize trusts, and many of these countries do not permit a trust to hold an property located in that country. Many of these countries do, however, have a concept of a life interest or "usufruct" which has many similarities to a trust. It is recommended to allow the trustee of the QDOT to transfer foreign assets to a corporation or partnership, and then transfer the stocks or partnership interests to the QDOT. However, the planner must make sure that the transfer is allowed under local law and will not have adverse tax consequences. See, *e.g.*, IRS Letter Ruling 199918039, in which the surviving spouse proposed to transfer a building located in a foreign country to a corporation formed under the laws of the foreign country. The spouse proposed to transfer 94.9 percent of her interest in the corporation to a QDOT that she would establish with a bank as the U.S. trustee. The IRS concluded that the proposed trust satisfied the QDOT requirements, and that the interest in the corporation could be transferred or assigned to the trust under IRC §2056A. The ruling is interesting for another reason, because the IRS also concluded that, if the trust were classified as a foreign trust, this classification would not cause the trust to fail to qualify as a QDOT.

It is also important not to lose sight of the fact that, given that the marital deduction (especially in the case of a noncitizen surviving spouse) is nothing more than a mechanism to defer tax, in many cases a cost-benefit analysis will lead one to conclude that payment of all or a portion of the transfer tax on the death of the deceased spouse is a better alternative. It is important to keep an open mind and to thoroughly review the tax and nontax costs and benefits of each alternative.

If the decision is made to establish a QDOT, to ensure qualification of the transfer for the marital deduction, counsel should give special attention to:

- Drafting requirements;
- The procedural rules set forth in the statute;
- The regulations concerning the deadline to make the assignment or transfer of assets to the QDOT;

- The form of the transfer or assignment; and
- The special rules applicable to pecuniary and protective assignments.

Counsel should pay particular attention to those requirements that need to be met after the decedent's estate tax return is filed because they are the ones most likely to be overlooked once the pressure of the filing deadline has passed. The fact that the rules are benign and designed to help taxpayers and their advisors get it right (if not before, then after the decedent's death) means that the failure to get it right creates even greater risks for the advisor. The fact is that there are many rules to follow, many requirements to meet, and many places to go wrong.

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§16.40A F. Foreign Community Property

Several civil law countries recognize a system of "community property" that deems all property acquired during the marriage to be one-half owned by each spouse. The interest of one spouse in the property brought to the marriage or acquired during the marriage by the other spouse, in the absence of an agreement between them, is generally determined by the laws of their domicile. *Lars E. Westerdahl* (1984) 82 TC 83, 86. If marital laws of the foreign country embody a community property system having attributes consistent with the principles of property ownership in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington (the American community property systems recognized for federal income tax purposes under *Poe v Seaborn* (1930) 282 US 101, 75 L Ed 239, 51 S Ct 58), the foreign jurisdiction can be recognized as a community property jurisdiction for federal tax purposes. 82 TC at 87.

Thus, only one-half of the value of the U.S. situs property may be included in the gross estate of a decedent nondomiciliary if the marital laws of a foreign country are equivalent to the American community property system. For example, courts have found that Swedish law (*Lars E. Westerdahl* (1984) 82 TC 83) and the laws of Uruguay (*Alejandro Zaffaroni* (1976) 65 TC 982) and Cuba and Mexico (*Edith Rosenkranz* (1976) 65 TC 993) can be considered community property laws. In addition, France allows spouses to elect a community property regime. *Estate of Jeanne Lepoutre* (1974) 62 TC 84, 89.

Even though the court in *Otto A. Angerhofer* (1986) 87 TC 814 declined to classify the German marital regime as community property, German domiciliaries (unless they are U.S. citizens) can claim a similar treatment under Article 10(4) of the transfer tax treaty between the United States and Germany (Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation With Respect to Taxes on Estates, Inheritances, and Gifts).

Accordingly, when a nondomiciliary in a community property country dies owning property with a U.S. situs (*e.g.,* shares in a U.S. corporation) and leaves such property to his or her nondomiciliary spouse, generally only one-half of the value of the shares owned by the decedent are includable in the U.S. gross estate. But see *Estate of Noordin M. Charania* (2009) 133 TC No. 7, in which 100 percent of the shares of a U.S. corporation were included in the estate of the deceased spouse when the court held that the community property laws of the decedent's residence (Belgium) did not apply because the "matrimonial domicile" was in the United Kingdom.

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V. CLIENT HAS FOREIGN RELATIVES FROM WHOM GIFTS/BEQUESTS ARE EXPECTED

§16.41 A. Tax Consequences

Under United States transfer tax principles, a transferor who makes a transfer for less than full and adequate consideration is the one potentially subject to transfer tax and reporting obligations attributable to the transfer made. See chap 10. The transferee, on the other hand, is not subject to transfer tax regardless of the value of the transferred property. The transferee also is not subject to United States income tax as a result of the transfer. IRC §102. Accordingly, a properly structured gift or bequest, no matter how large, can be made by a non-United States person for transfer tax purposes to a United States person without any United States tax consequences directly attributable to the transfer.

This does not mean, however, that the transfer could not have adverse United States tax consequences if it is made without further planning. For example, assume a United States resident who otherwise does not have an estate that would be subject to United States estate tax receives a nontaxable gift of $10 million from a foreign donor. While the transfer has no immediate tax consequences, the donee now has a $10-million estate that is potentially subject to United States transfer tax. If, on the other hand, the transfer was made to a properly structured generation-skipping trust, with discretionary distribution rights and limited powers of appointment, the donee and the donee's descendants could benefit from the $10 million without being subject to United States transfer tax. See chap 12.

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§16.42 B. Reporting Requirements

The receipt by a United States person of nontaxable gifts from foreign sources must, in some cases, be reported, and the failure to report those gifts may have serious tax consequences. IRC §6039F(a), (c). See §§16.43-16.46.

For purposes of these rules, the term "foreign gift" means any amount actually or constructively received from a person, other than a United States person, that the recipient treats as a gift or bequest, but does not include (IRC §6039F(b)):

- Amounts paid on behalf of the donee as tuition to a qualified educational organization for the education or training of the donee, or paid to any person who provides medical care with respect to the donee as payment for that medical care, that are qualified transfers under IRC §2503(e).
- Distributions to United States persons from foreign trusts (such distributions are subject to a different set of reporting rules under IRC §6048(c) discussed in §§16.73-16.79).

Contributions of property by foreign persons to domestic or foreign trusts that have United States beneficiaries are not required to be reported, unless the United States beneficiaries are treated as receiving the contribution in the year of the transfer. Reporting is required only if the United States donee knows or has reason to know that the donor is not a United States person (*i.e.,* is an individual who is neither a resident nor a citizen of the United States, or a foreign estate, a foreign partnership, or a foreign corporation). Notice 97-34, 1997-1 Cum Bull 422, 430.

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§16.43 1. Reporting Thresholds

Although IRC §6039F(a) provides that reporting is required if the value of the aggregate foreign gifts received by a United States person (other than a qualified charitable organization) during any taxable year exceeds $10,000 plus cost-of-living adjustments ($14,139 in 2009), the IRS recognizes that the rule would result in the filing of far too many returns and that different reporting thresholds are warranted for gifts received from different types of foreign taxpayers. Accordingly, in Notice 97-34, 1997-1 Cum Bull 422, the IRS gives taxpayers additional guidance with respect to the transfers that would be subject to the reporting requirements:

- In the case of gifts from individuals who are not United States persons or from foreign estates, a United States person is required to report only aggregate gifts from a single donor or estate that exceed $100,000 during the taxable year. (This amount has not been indexed for inflation.) Once the $100,000 threshold is met, the donee is required to separately identify each gift in excess of $5000, but is not required to identify the donor.
- In the case of gifts from foreign corporations or foreign partnerships, a United States person is required to report all gifts from all such entities if the aggregate of the gifts from all such entities exceeds $10,000 plus cost-of-living adjustments ($14,139 in 2009) during the taxable year. Once the threshold is met, the recipient must separately identify each gift and disclose the identity of the donor (including the name, address, and taxpayer identification number).

To determine whether a particular reporting threshold has been met, the United States donee must aggregate gifts from foreign persons or entities that he or she knows or has reason to know are related, within the meaning of IRC §643(i)(2)(B), whether or not each gift independently exceeds the threshold.

EXAMPLE: A gift of $8000 (below the $14,139 reporting threshold) from a foreign corporation and a gift of $8000 (below the $100,000 reporting threshold) in 2009 from a foreign individual who is related to the foreign corporation both must be reported because, when the gifts are aggregated, the total of $16,000 exceeds the $14,139 reporting threshold. Similarly, two gifts of $60,000 from foreign individuals who are related must be reported because, when the gifts are aggregated, the total of $120,000 exceeds the $100,000 threshold.

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§16.44 2. Procedural Requirements

United States persons who receive reportable foreign gifts in any taxable year as described in §16.43 must report those gifts (including the date of the gift, a description of the property received, and the fair market value of the property) on Part IV of IRS Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Form 3520 must be filed with the Internal Revenue Service Center in Ogden, Utah, by the due date for filing the person's income tax return, including extensions. The form is not filed with the return.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.45 3. Penalties for Failure to Report

§16.45 3. Penalties for Failure to Report

If a United States person fails to furnish the required information with respect to any foreign gift within the time prescribed (see §16.44), the United States person will be subject to severe civil penalties. First, the IRS will determine the tax consequences of the receipt of the gift; *i.e.,* the IRS may determine that the amount received is taxable income to the recipient rather than a nontaxable gift. IRC §6039F(c)(1)(A). Second, the United States person will be required to pay, on demand by the IRS, an amount equal to 5 percent of the amount of the foreign gift for each month for which the failure continues (not to exceed, in the aggregate, 25 percent of the amount of the gift). IRC §6039F(c)(1)(B).

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§16.46 C. Practical Issues

Given the significant tax and nontax advantages of planning and properly structuring the receipt of a foreign gift (see §16.41), and meeting the reporting requirements associated with receipt of such a gift (see §§16.42-16.45), it is critical for practitioners to discuss with their clients whether they expect to receive a gift or bequest and whether that gift or bequest is likely to be from foreign sources. Of course, in many cases, a person who expects a bequest or gift may not be in a position to discuss that expectancy with the prospective donor. Understanding the planning possibilities and reporting requirements, however, will enable the client to comply with the reporting requirements and discuss the planning opportunities with the prospective donor if the opportunity arises in the future.

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§16.47 VI. CLIENT HAS NON-UNITED STATES CHILDREN

In the situation of a client who has children who are not United States citizens or residents, even if the client is a United States person for income and transfer tax purposes and has only United States assets, a plan that fails to take into account planning opportunities and pitfalls associated with transfers to the children who reside in other countries is potentially inappropriate for the client and exposes the advisor to a potential claim for malpractice. Many countries, including the United States, permit inbound transfers to be structured in a way that confers substantial tax and nontax benefits to its beneficiaries. See §16.41. Although a United States estate planner would not be expected to know or understand the rules applicable in other jurisdictions, he or she certainly would be expected to associate competent counsel or to advise the client to retain that counsel.

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§16.48 VII. CLIENT HAS CONNECTIONS WITH FOREIGN TRUST OR ACCOUNT

Since the mid-1990s the United States has enacted important legislation about the taxation of foreign trusts and reporting of information with respect to those trusts and foreign bank accounts, and there is now significant guidance and authority dealing with these issues. The rules are far-reaching, and even practitioners whose practices can be characterized as purely domestic must have a good enough understanding of the new rules to be able to identify clients and/or trusts that may be affected by them. Foreign bank account reporting (FBAR) requirements are discussed in §§16.84A-16.84E.

EXAMPLE: United States client establishes a revocable trust under the laws of California and transfers to that trust United States assets for the benefit of her United States beneficiaries. She names herself and her son (who is a Canadian resident) as cotrustees. In accordance with the rules described in §§16.49-16.57, the trust is a foreign trust and the transfers by the trustor to the trust are subject to the reporting requirements described in §§16.66-16.72. In addition, in accordance with the rules described in §§16.80-16.83, the trust is a grantor trust and the trustor must comply with the grantor trust reporting requirements described in §§16.58-16.65. Further, distributions from the trust must be reported under the rules described in §§16.73-16.79. If the trustor's advisor fails to recognize that the trust is a foreign trust because he or she was not aware that the trustor's son who is serving as cotrustee is not a United States person, the advisor will presumably fail to advise the client of the significant tax and reporting requirements associated with the establishment of the trust and the transfer of assets to the trust. Failure to meet these reporting requirements could trigger the penalties described in §16.84. In addition, using a foreign trustee can trigger foreign income taxes (*e.g.,* in Canada) that create an even larger tax liability for the foreign trust in this example.

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§16.49 A. Determining Whether Trust Is Foreign or Domestic

To comply with the extensive tax and reporting rules dealing with foreign trusts (discussed in §§16.58-16.72), taxpayers and their advisors must first be able to determine whether a particular trust is foreign or domestic. The IRS will not help with the determination because it ordinarily will not issue an advance ruling regarding whether a trust is a foreign trust under IRC §7701. See Rev Proc 2009-7, §4.01(28), 2009-1 Int Rev Bull 226.

Under IRC §7701(a)(30)(E), the term "United States person" means any trust for which (1) a court within the United States is able to exercise primary supervision over the administration of the trust (court test), and (2) one or more United States persons have the authority to control all substantial decisions of the trust (control test). See §§16.50-16.57. A trust will be treated as a United States person on any day that the trust meets both these tests. Treas Reg §301.7701-7(a)(2). For purposes of the regulations, the term "domestic trust" means a trust that is a United States person. Treas Reg §301.7701-7(a)(2). The terms of the trust instrument and applicable law must be applied to determine whether the court test and the control test are met. Treas Reg §301.7701-7(b).

NOTE: Many civil law jurisdictions do not use trusts. Nevertheless, the tax treatment reserved for foreign trusts may apply to such creatures of foreign law, in particular, to so-called Stiftungen (Foundations) created in Switzerland, Liechtenstein, or Austria (other jurisdictions include Panama, Costa Rica, or the Netherlands Antilles). It appears that U.S. courts will treat a Stiftung either as a corporation (if it is created primarily for commercial purposes) or as a trust (if it is created primarily for the support of beneficiaries). See *Estate of Oei Tjong Swan v Commissioner* (2d Cir 1957) 247 F2d 144, 147.

Under IRC §7701(a)(31)(B), the term "foreign trust" means any trust other than a trust described in IRC §7701(a)(30)(E). For purposes of the regulations, the term "foreign trust" means any trust other than a domestic trust. Treas Reg §301.7701-7(a)(3).

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§16.50 1. Court Test

A trust will meet the court test under IRC §7701(a)(30)(E)(i) if a court within the United States is able to exercise primary supervision over the administration of the trust. Treas Reg §301.7701-7(a)(1)(i). For purposes of this test (Treas Reg §301.7701-7(c)(3)):

- "Court" means any federal, state, or local court;
- "United States" includes only the states of the United States and the District of Columbia (for purposes of the court test, a court within a territory or possession of the United States or within a foreign country is not a court within the United States);
- "Is able to exercise" means that court has or would have authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust;
- "Primary supervision" means that a court has or would have authority to determine substantially all issues regarding the administration of the entire trust (irrespective of whether another court has jurisdiction over a trustee, beneficiary, or trust property); and
- "Administration of the trust" means the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions.

Recognizing that it may be difficult to determine whether a court of a particular state would assert primary supervision over the administration of a particular trust, the regulations provide a safe harbor for the court test. See §16.51. The regulations also provide a nonexclusive list of trusts that meet the court test. See §16.52. A trust that provides for automatic migration, however, will not meet the test. See §16.53.

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§16.51 a. Safe Harbor for Court Test

Under the safe harbor, a trust will satisfy the court test if (1) the trust instrument does not direct that the trust be administered outside of the United States, (2) the trust in fact is administered exclusively in the United States, and (3) the trust is not subject to an automatic migration provision (see §16.53). Treas Reg §301.7701-7(c)(1). An example is provided in Treas Reg §301.7701-7(c)(2).

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§16.52 b. Trusts That Satisfy Court Test

The following trusts meet the court test:

- A trust meets the court test if the trust is registered by an authorized fiduciary in a court within the United States under a state statute substantially similar to Article VII, Trust Administration, of the Uniform Probate Code. Treas Reg §301.7701-7(c)(4)(i)(A).
- A trust created under the terms of a will probated within the United States (other than in an ancillary probate) meets the court test if all fiduciaries of the trust have been qualified as trustees by a court within the United States. Treas Reg §301.7701-7(c)(4)(i)(B).
- Trusts, other than testamentary trusts, meet the court test if the fiduciaries or beneficiaries take steps with a court in the United States that cause the administration of the trust to be subject to the primary supervision of the court (see §16.50). Treas Reg §301.7701-7(c)(4)(i)(C).
- A trust meets the court test if both a United States court and a foreign court are able to exercise primary supervision over the administration of the trust. Treas Reg §301.7701-7(c)(4)(i)(D).

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§16.53 c. Automatic Migration Rule for Court Test

Notwithstanding any other provision of the regulations, a trust will not meet the court test if the trust instrument provides that a United States court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly will cause the trust to migrate from the United States. A very limited exception to this rule provides that a trust will not fail to meet the court test solely because the trust instrument provides that the trust will migrate only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States. Treas Reg §301.7701-7(c)(4)(ii).

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§16.54 2. Control Test

A trust will meet the control test under IRC §7701(a)(30)(E)(ii) and Treas Reg §301.7701-7(a)(1)(ii) if one or more United States persons have the authority to control *all* substantial decisions of the trust. Treas Reg §301.7701-7(d). To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries. It is important to note the breadth of what is considered a "substantial decision" because almost any power or authority in the hands of a non-United States person will cause an otherwise domestic trust to become a foreign trust with all the consequences that characterization entails. For purposes of the control test:

- "United States person" means a United States person within the meaning of IRC §7701(a)(30). Treas Reg §301.7701-7(d)(1)(i).
- "Substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. "Ministerial decisions" include decisions regarding details such as bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries. Substantial decisions include, but are not limited to, decisions concerning (Treas Reg §301.7701-7(d)(1)(ii)):
- Whether and when to distribute income or corpus;
- The amount of any distributions;
- The selection of a beneficiary;
- Whether a receipt is allocable to income or principal;
- Whether to terminate the trust;
- Whether to compromise, arbitrate, or abandon claims of the trust;
- Whether to sue on behalf of the trust or to defend suits against the trust;
- Whether to remove, add, or replace a trustee;
- Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited so that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and
- Investment decisions; however, if a United States person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor's power to make investment decisions at will.
- "Control" means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto the substantial decisions. Treas Reg §301.7701-7(d)(1)(iii).

The regulations provide a safe harbor for the control test. See §16.55. Trusts are allowed a 12-month grace period to meet the test in the event of an inadvertent change in any person that has the power to make a substantial decision of the trust that causes the residency of the trust to change. See §16.56. A trust that provides for automatic migration, however, will not meet the test. See §16.57.

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§16.55 a. Safe Harbor for Control Test

Provided that United States fiduciaries control all of the substantial decisions made by the trustees or fiduciaries, the following trusts are deemed to satisfy the control test:

- Qualified trust described in IRC §401(a);
- Trust described in IRC §457(g);
- Individual retirement account described in IRC §408(a);
- Individual retirement account described in IRC §408(k) or IRC §408(p);
- Roth IRA described in IRC §408A (see chap 21);
- Education savings account described in IRC §530 (see chap 21A);
- Voluntary employees' beneficiary association described in IRC §501(c)(9); and
- Such additional categories of trusts as the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin.

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§16.56 b. Twelve-Month Grace Period After Inadvertent Change in Trust Residence

In the event of an inadvertent change in any person having the power to make a substantial decision of the trust that would cause the domestic or foreign residency of the trust to change, the trust is allowed 12 months from the date of the change to make necessary changes, either with respect to the persons who control the substantial decisions or with respect to the residence of those persons to avoid a change in the trust's residency. An inadvertent change means the death, incapacity, resignation, change in residency, or other change with respect to a person having the power to make a substantial decision of the trust that would cause a change to the residency of the trust but that was not intended to change the residency of the trust. If the necessary change is made within 12 months, the trust is treated as retaining its prechange residency during the 12-month period. If the necessary change is not made within 12 months, the trust's residency changes as of the date of the inadvertent change. Treas Reg §301.7701-7(d)(2)(i).

If reasonable actions have been taken to make the necessary change to prevent a change in trust residency but, owing to circumstances beyond the trust's control, the trust is unable to make the modification within 12 months, the trust may provide a written statement to the district director having jurisdiction over the trust's return setting forth the reasons for failing to make the necessary change within the required time period. If the district director determines that the failure was due to reasonable cause, the district director may grant the trust an extension of time to make the necessary change. Whether an extension of time is granted is in the sole discretion of the district director and, if granted, may contain such terms with respect to assessment as may be necessary to ensure that the correct amount of tax will be collected from the trust, its owners, and its beneficiaries. If the district director does not grant an extension, the trust's residency changes as of the date of the inadvertent change. Treas Reg §301.7701-7(d)(2)(ii).

Given the potential tax and reporting consequences associated with the change in a trust's residence (some of which are discussed in §§16.58-16.72), practitioners must avoid or promptly cure inadvertent changes in trust residence.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.57 c. Automatic Migration Rule for Control Test

§16.57 c. Automatic Migration Rule for Control Test

Notwithstanding any other provision of the regulations, United States persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons. Treas Reg §301.7701-7(d)(3).

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§16.58 B. Client Establishes Foreign Trust or Makes Transfers to Foreign Trust

The establishment or transfer of assets to a foreign trust by a United States person has both tax and reporting implications. Under IRC §679, the transferor may be treated as the owner of the transferred assets. See §§16.59-16.61. Under IRC §684, there may be recognition of gain with respect to certain transfers to certain foreign trusts and estates. See §16.62. Reporting obligations exist both with respect to the establishment or transfer of assets to a foreign trust and with respect to the ongoing reporting obligations of the person treated as the grantor of the trust. See §§16.63-16.72.

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§16.59 1. Grantor Trust Rules of IRC §679

Under IRC §679(a)(1), unless one of the exceptions described below applies, a United States person who directly or indirectly transfers property to a foreign trust (other than deferred compensation and charitable trusts described in IRC §6048(a)(3)(B)(ii)) will be treated as the owner for his taxable year of the portion of the trust attributable to the transferred property if, for that taxable year, there is a United States beneficiary of any portion of the trust. Treas Reg §1.679-1(a). This rule applies irrespective of whether the transferor retained any interest in or powers over the trust or the transferred assets that would have caused the grantor trust rules of IRC §§671-678 to apply. Treas Reg §1.679-1(b). The general rule does not apply to any transfer by reason of the death of the transferor (IRC §679(a)(2)(A); Treas Reg §1.679-4(a)(1)) or to any transfer of property in exchange for consideration of at least the fair market value of the transferred property (IRC §679(a)(2)(B), (a)(3); Treas Reg §1.679-4(a)(4), (b)).

For purposes of IRC §679(a)(1), a trust is treated as having a United States beneficiary for the taxable year unless, under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and if the trust were terminated at any time during the taxable year, no part of the income or corpus of that trust could be paid to or for the benefit of a United States person. Reg §1.679-2(a)(1). Amounts paid to or accumulated for a controlled foreign corporation (defined in IRC §957(a)), a foreign partnership of which a United States person is a partner, or a foreign trust or estate with a United States beneficiary are defined as payments to a United States beneficiary. IRC §679(c)(2); Treas Reg §1.679-2(b). When applying IRC §679 with respect to any transfer of property to a foreign trust, a beneficiary who first became a United States person more than 5 years after the date of the transfer will not be treated as a United States person. Treas Reg §1.679-2(a)(3). Special rules apply to preimmigration trusts and outbound migration of trusts. See §§16.60-16.61.

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§16.60 a. Preimmigration Trusts

If a non-United States person becomes a resident of the United States within 5 years after directly or indirectly transferring property to a foreign trust, IRC §679 and the reporting obligations discussed in §16.63 will apply as if the individual transferred to the trust on the residency starting date (defined by reference to IRC §7701(b)(2)(A)) an amount equal to the portion of the trust attributable to the transferred property. IRC §679(c)(3); Treas Reg §1.679-5(a). Undistributed net income for periods before the transferor's residency starting date will be considered property transferred by the transferor to the trust but will not otherwise be taken into account. Treas Reg §1.679-5(b).

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§16.61 b. Outbound Migration of Trusts

If an individual who is a citizen or resident of the United States transfers property to a domestic trust that becomes a foreign trust while the transferor is alive, IRC §679 and the reporting obligations discussed in §16.63 will apply as if the transferor transferred to the trust, on the date the trust becomes a foreign trust, an amount equal to the portion of the trust attributable to the transferred property. IRC §679(a)(4); Treas Reg §1.679-6(a). Undistributed net income for periods before the trust became a foreign trust will be considered property transferred by the transferor to the trust but will not otherwise be taken into account. Treas Reg §1.679-6(b).

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§16.62 2. Recognition of Gain on Transfer of Assets to Foreign Trust

Any transfer by a United States person to a foreign estate or trust (unless the transferor is treated as the grantor of the trust) will be treated as a sale or exchange of the transferred property and result in recognition of any unrecognized gain. IRC §684(a). A domestic trust that becomes a foreign trust will be treated as having transferred, immediately before becoming a foreign trust, all of its assets to the foreign trust. Treas Reg §1.684-4. For the definition of foreign trust, see §16.49.

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§16.63 3. Annual Reporting Required in Case of Foreign Trust With United States Grantor

Under IRC §6048(b)(1), a United States person who at any time during a taxable year is treated as the owner of any portion of a foreign trust under the grantor trust rules is responsible to ensure that, by the fifteenth day of the third month after the end of the trust's tax year, the trust:

- Files a return (Form 3520-A, Annual Information Return of Foreign Trust With a United States Owner) for the year setting forth a full and complete accounting of all trust activities and operations for the year, the name of its United States agent (see §16.64), and such other information as the IRS may prescribe. Penalties for failure to file are discussed in §16.84.
- Furnishes that information to each United States person (1) who is treated as the owner of any portion of the trust (see §16.65) or (2) who receives (directly or indirectly) any distribution from the trust (see §16.79).

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§16.64 a. Appointment of United States Agent

The amounts required to be taken into account by a United States person under the grantor trust rules with respect to a foreign trust of which the United States person is an owner (see §16.63) will be determined by the IRS, unless the trust agrees to authorize a United States person to act as the trust's limited agent solely for purposes of applying IRC §§7602, 7603, and 7604 with respect to (1) any request by the IRS to examine records or produce testimony related to the proper treatment of amounts required to be taken into account under the grantor trust rules, or (2) any summons by the IRS for those records or testimony. IRC §6048(b)(2)(A)-(B). If the agent resigns or is an entity that liquidates, or if its responsibility as an agent of the trust is terminated, the United States owner of the foreign trust must ensure that the foreign trust notifies the IRS within 90 days by filing an amended Form 3520-A with the Internal Revenue Service Center in Ogden, Utah. This notification must contain the name, address, and taxpayer identification number of the new United States agent, if any. Even if the foreign trust identifies a United States agent on Form 3520-A, the foreign trust may be treated as providing incorrect information and, therefore, the United States owner may be subject to penalties (see discussion in §16.84), if either the United States agent or the foreign trust fails to comply with its obligations under the agreement. Notice 97-34, 1997-1 Cum Bull 422, 428. Rules similar to IRC §6038A(e)(2), (4), dealing with enforcement of requests for certain records of foreign-owned corporations, are applicable in the event of noncompliance. IRC §6048(b)(2)(C).

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§16.65 b. Owner Reporting Requirements

In addition to being responsible for ensuring that the foreign trust files its annual information return, the United States owner of a foreign trust must:

- Include all items of income and deductions attributable to the portion of the trust he or she owns on his or her income tax returns for the taxable year;
- Complete and file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, providing all documents and information requested (see Instructions to Form 3520, Part II); and
- File a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR) to report the trust's foreign bank accounts.

If the foreign trust complied with its reporting obligations (see §16.63), the United States owner must include with his or her own return and Form 3520 the documents and information he or she received from the foreign trust.

If the foreign trust did not comply with its reporting obligations, the United States owner must provide the information requested to the best of his or her ability and must file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR) to notify the IRS that the United States owner did not receive adequate information from the foreign trust. Similarly, if the United States owner, on his or her income tax returns, and the foreign trust, in its return, treat certain items differently, the United States owner must file Form 8082 to report the inconsistency. IRC §§6034A(c), 6048(d)(5). Penalties for failure to file are discussed in §16.84. FBAR requirements are discussed in §§16.84A-16.84E.

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§16.66 4. Reporting Establishment of and Transfers to Foreign Trust

Under IRC §6048(a)(1), the "responsible party" (see §16.72) must report certain transfers made by a United States person to a foreign trust. The types of transfers that are reportable are only "gratuitous transfers" (see §§16.68-16.71) that have been specifically defined as "reportable events." See §16.67.

The responsible party must report a gratuitous transfer to a foreign trust on Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, which requires disclosure of the amount of money or other property transferred to the trust in connection with the reportable event, the identity of the trust and of each trustee and beneficiary (or class of beneficiaries) of the trust, and any other information the IRS may require. IRC §6048(a)(2). The instructions to Form 3520 make clear that the responsible party is the person who must ensure that the required information is provided or pay the appropriate penalties. See §16.84.

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§16.67 a. Reportable Event

The term "reportable event," as defined in IRC §6048(a)(3)(A), includes any of the following events:

- Creation of any foreign trust by a United States person;
- Transfer of any money or property (directly or indirectly) to a foreign trust by a United States person, including a transfer by reason of death; and
- Death of a citizen or resident of the United States if the decedent was treated as the owner of any portion of a foreign trust under the grantor trust rules or any portion of a foreign trust was included in the gross estate of the decedent.

Creation of a foreign trust includes a change in residence of a trust from domestic to foreign. Notice 97-34, 1997-1 Cum Bull 422, 424.

The term "reportable event" does not include any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property (see §16.68), or any transfer or other event with respect to a deferred compensation trust or charitable trust described in IRC §501(c)(3). IRC §6048(a)(3)(B).

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§16.68 b. Gratuitous Transfer

A "gratuitous transfer" qualifying as a "reportable event" (see §16.67) is a transfer other than (Notice 97-34, 1997-1 Cum Bull 422, 424):

- Transfer for fair market value (see §16.69);
- Corporate distribution described in IRC §§301, 302, 305, 355, or 356; or
- Partnership distribution described in IRC §731.

A transfer to a foreign trust may be considered a gratuitous transfer regardless of whether the transfer was treated as a gift for gift tax purposes. A distribution from one trust to another trust that is a beneficiary of the distributing trust is a gratuitous transfer. In addition, a domestic trust that becomes a foreign trust will be deemed to have made a gratuitous transfer of all of its assets immediately before becoming a foreign trust. Finally, a gratuitous transfer also includes any direct or indirect transfer that is structured with a principal purpose of avoiding the application of IRC §§679 and 6048.

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§16.69 (1) Transfer for Fair Market Value

The term "transfer for fair market value" includes only transfers in consideration for property received from the trust, services rendered by the trust, or the right to use property of the trust, and only to the extent that the property, services, or right to use property received is equal to the fair market value of the property transferred. Any obligations (other than "qualified obligations" (see §16.70)) issued by a related foreign trust or any person related to the trust will be disregarded in determining whether fair market value was received by the transferor. A United States person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. Notice 97-34, 1997-1 Cum Bull 422, 423.

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§16.70 (2) Qualified Obligation

An obligation will be treated as a "qualified obligation" only if:

- The obligation is reduced to writing by an express written agreement;
- The term of the obligation does not exceed 5 years;
- All payments on the obligation are denominated in United States dollars;
- The yield to maturity of the obligation is not less than 100 percent of the IRC §1274(d) applicable federal rate and not greater than 130 percent of the applicable federal rate;
- The United States transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding to a date not earlier than 3 years after the maturity date of the obligation; and
- The United States transferor reports the status of the obligation, including principal and interest payments, on Form 3520, for each year that the obligation is outstanding.

If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation, the United States transferor will be treated as making a gratuitous transfer to the trust as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. The rules for qualified obligations apply to an obligation of a related foreign trust (or of a person related to the trust (see §16.71)) if the obligation was issued or significantly modified after February 6, 1995. Notice 97-34, 1997-1 Cum Bull 422, 424.

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§16.71 (3) Related Person

A person is related to a foreign trust if that person, without regard to the transfer at issue, is a grantor of the trust, an owner of any portion of the trust under IRC §§671-679, or a beneficiary of the trust, or is related to any grantor, owner, or beneficiary of the trust under IRC §§267, 707(b). Treas Reg §1.679-1(c)(5).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.72 c. Responsible Party

§16.72 c. Responsible Party

Under IRC §6048(a)(4), the responsible party is:

- The grantor in the case of the creation of an inter vivos trust;
- The transferor in the case of the transfer of assets to a trust, other than a transfer by reason of death; or
- The executor of the decedent's estate in the case of a transfer of assets to a trust by reason of death.

The instructions to Form 3520 indicate that the responsible party in the case of a change in residency of a trust from domestic to foreign under IRC §679(a)(5) is the United States individual who transferred property to the trust while it was a domestic trust and is alive when the trust becomes a foreign trust, or the trustee in all other cases.

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§16.73 C. Client Receives Distributions From Foreign Trust

A United States person who receives, directly or indirectly, a distribution from a foreign trust must be able to determine the proper characterization of the distribution for United States income tax purposes to be able to comply with both tax and reporting obligations arising from the distribution. See §§16.74-16.79.

A distribution from a foreign trust can be anything from a tax-free gift that simply has to be reported to an accumulation distribution with potentially disastrous tax consequences (with a range of other possibilities in between). In any case, practitioners must be aware of whether their clients are receiving distributions from a foreign trust so they can properly advise or seek proper advice for their clients. Knowing whether a client is receiving a distribution from a foreign trust implies that the trust can be properly characterized as a domestic trust or foreign trust in the first place (a characterization that will often require more than an examination and analysis of the trust document itself). Counsel should note the broad meaning that is given to the term "distributions from a foreign trust." If the client is receiving constructive distributions from a trust, he or she is not likely to respond affirmatively to the question of whether he or she is receiving distributions from the trust. More probing questions may be required to elicit the information needed by a practitioner to properly characterize a particular transaction.

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§16.74 1. Distributions From Foreign Trust

The term "distribution from a foreign trust" for purposes of reporting under IRC §6048(c) (see §16.79) includes:

- Gratuitous transfer of money or property from a foreign trust, whether or not the trust is owned by another person;
- Receipt of trust corpus and the receipt of a gift or bequest described in IRC §663(a);
- Distributions constructively received, *e.g.,* credit card charges paid by the trust; and
- Payments in exchange for property transferred to the trust or services rendered to the trust if the fair market value of the payment exceeds the fair market value of the property transferred or services rendered (to the extent of the excess).

With limited exceptions, direct or indirect loans of cash or marketable securities to a United States owner or United States beneficiary of the trust or to a person related to that owner or beneficiary will be treated as distributions to that owner or beneficiary. Reporting, however, is not required for the following distributions: (1) distributions that are taxable as compensation within the meaning of IRC §672(f)(2)(B), and (2) distributions received by IRC §501(c)(3) domestic organizations. Notice 97-34, 1997-1 Cum Bull 422, 428.

Distributions through intermediaries also may be included. See §16.75.

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§16.75 2. Distributions Through Intermediaries

For purposes of the grantor trust rules (§§16.58-16.72) and the reporting requirements of IRC §6048(c) (see §16.79), any property that is transferred to a United States person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the United States person if the intermediary received the property from the foreign trust under a plan, one of the principal purposes of which was the avoidance of United States tax. IRC §643(h); Treas Reg §1.643(h)-1(a).

This rule does not apply if:

- The transfer from the foreign trust to the intermediary or the transfer from the intermediary to the United States person is a transfer that is not a gratuitous transfer within the meaning of Reg §1.671-2(e)(2). Treas Reg §1.643(h)-1(b)(1).
- The intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. Treas Reg §1.643(h)-1(b)(2).
- During the taxable year of the United States person, the aggregate fair market value of all property transferred to that person from all foreign trusts, either directly or through one or more intermediaries, does not exceed $10,000. Treas Reg §1.643(h)-1(d).

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§16.76 3. Information Required for Proper Characterization of Distributions

In the case of a grantor trust, adequate records include a foreign grantor trust beneficiary statement (FGTBS), a detailed statement (similar to a K-1 from a partnership) that would enable the IRS to confirm that the trust is a grantor trust with a foreign grantor who is deemed to be the owner of the trust. If the United States beneficiary receives a complete FGTBS with respect to a distribution from a grantor trust during the taxable year, the beneficiary can treat the distribution as a nontaxable gift from the owner of the trust. In the case of a nongrantor trust, adequate records include a foreign nongrantor trust beneficiary statement (FNGTBS), a detailed statement that would enable the IRS to determine the United States tax consequences of the distribution from the foreign nongrantor trust. If the beneficiary receives a complete FNGTBS, the beneficiary may determine the tax consequences of the distribution and avoid the "default treatment." See §16.77. If adequate records are not provided, the entire distribution from a grantor trust or nongrantor trust may be treated as an accumulation distribution. See §16.78. Notice 97-34, 1997-1 Cum Bull 422, 429.

Special rules apply to determine whether a foreign trust is a grantor or nongrantor trust. See §§16.80-16.83.

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§16.77 a. Default Treatment

A United States beneficiary may avoid treating the entire distribution from a foreign trust as an accumulation distribution (see §16.78) if the beneficiary provides certain information regarding actual distributions from the trust for the prior 3 years. Under the "default treatment," the United States beneficiary is allowed to treat a portion of the distribution as a distribution of current income based on the average of distributions from the prior 3 years, with only the excess treated as an accumulation distribution. A beneficiary's use of the default treatment has no effect on the trust. If the United States beneficiary receives a complete FNGTBS, he or she may elect the default treatment but will be required to continue reporting under the default treatment for all future years. The only exception to this consistency requirement is that the United States beneficiary will be able to report the actual tax consequences of a distribution in the year the trust terminates, but only if the United States beneficiary receives a complete FNGTBS for that year. See Instructions to Form 3520, Schedule A.

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§16.78 b. Accumulation Distribution Treatment

If adequate records are not provided to the IRS to determine the proper treatment of any distribution from a foreign trust (see §16.76), the distribution will be treated as an accumulation distribution includable in the gross income of the distributee. IRC §6048(c)(2). Accumulation distributions are generally taxed under IRC §§665-668. Section 668(a) imposes an interest charge on accumulation distributions at the rate generally applicable to underpayments of income tax. The beneficiary may avoid accumulation distribution treatment if certain information is provided. See §16.77.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.79 4. Filing Requirements

§16.79 4. Filing Requirements

Under IRC §6048(c)(1), a United States person who receives a distribution from a foreign trust must complete and file Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. The United States person must compute the amount of the distribution to be treated as an accumulation distribution (either under the actual or default treatment) and any applicable interest surcharge. See §§16.76-16.78. The United States person must also report taxable distributions on his or her income tax return. Penalties for failure to file are discussed in §16.84.

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§16.80 D. Determining Whether Foreign Trust Is Grantor Trust or Nongrantor Trust

As discussed in §§16.76-16.78, distributions from a foreign grantor trust to United States beneficiaries can be treated as tax-free gifts from the grantor or owner of the trust. With the limited exceptions discussed in §§16.81-16.83, the grantor trust rules of IRC §§671-679 apply only to the extent that their application results in any portion of the trust being treated as owned by a United States citizen or resident or a domestic corporation. Any portion of the trust that is not treated as owned by a grantor or another person under these rules will be treated as a nongrantor trust for tax purposes. IRC §672(f)(1); Treas Reg §1.672(f)-1(a)(1). The determination of the portion of a trust treated as owned by the grantor or other person will be based on the terms of the trust, the application of the grantor trust rules, and the regulations under those rules. Treas Reg §1.672(f)-1(a)(2).

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§16.81 1. Exception Applicable to Certain Revocable Trusts

A trust will be treated as a foreign grantor trust if the grantor has the power, exercisable solely by the grantor without the approval or consent of any other person, to revest absolutely in the grantor title to the trust property to which that portion is attributable. IRC §672(f)(2)(A)(i). In the event of the grantor's incapacity, the power to revest title to trust assets in the grantor must be exercisable by a guardian or other person with unrestricted authority to exercise the power on the grantor's behalf. The grantor's power to revest trust assets exercisable only with the approval of a related or subordinate party who is subservient to the grantor will be treated as exercisable solely by the grantor. Treas Reg §1.672(f)-3(a)(1). See examples in Treas Reg §1.672(f)-3(a)(4).

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§16.82 2. Exception Applicable to Certain Irrevocable Trusts

A trust will be treated as a foreign grantor trust if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from the trust are amounts distributable to the grantor or the spouse of the grantor. IRC §672(f)(2)(A)(ii); Treas Reg §1.672(f)-3(b)(1). This exception will not apply after the death of the grantor, even if the grantor's spouse survives and the grantor's spouse would be treated as owning the trust under IRC §678. Treas Reg §1.672(f)-3(b)(4), Example 2.

Amounts distributable to discharge a legal or support obligation of the grantor or the grantor's spouse are treated as distributable to the grantor or the grantor's spouse. An obligation is considered a legal obligation if it is enforceable under the local law of the jurisdiction in which the grantor (or the grantor's spouse) resides. Treas Reg §1.672(f)-3(b)(2).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.83 3. Exception Applicable to Certain Compensatory Trusts

§16.83 3. Exception Applicable to Certain Compensatory Trusts

Except as provided in regulations, any portion of a trust distribution that is taxable as compensation for services rendered may be treated as a distribution from a foreign grantor trust. IRC §672(f)(2)(B); Treas Reg §1.672(f)-3(c).

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§16.84 E. Penalties for Failure to Comply With Foreign Trust Reporting Obligations

If any notice or return required to be filed by IRC §6048 is not timely filed, does not include all the required information, or includes incorrect information, the person required to file the notice or return is subject to a penalty equal to 35 percent of the gross reportable amount, in addition to any criminal penalty provided by law. If the failure to file continues for more than 90 days after the day on which the IRS mails notice of that failure to the person required to pay the penalty, that person will be subject to an additional penalty of $10,000 for each 30-day period (or fraction of that) during which that failure continues after the expiration of the 90-day period, but in no event more than the gross reportable amount. IRC §6677(a).

In the case of a foreign trust with a United States owner required to report under IRC §6048(b), the general civil penalty of 35 percent of the gross reportable amount is reduced to 5 percent of the gross reportable amount. Accordingly, if a foreign trust with a United States owner fails to file its required return, the United States owner is subject to a penalty equal to 5 percent of the gross value of the portion of the trust assets treated as owned by that person. IRC §6677(b).

The term "gross reportable amount" means (IRC §6677(c)):

- The gross value of the property involved in a reportable event under IRC §6048(a). See §16.66.
- The gross value of the portion of a foreign trust's assets at the close of the year treated as owned by the United States person in the case of a grantor trust's failure to file a required return under IRC §6048(b)(1). See §16.63.
- The gross amount of the distributions in the case of a United States person's failure to report distributions from a foreign trust under IRC §6048(c). See §16.79.

The penalties will not be imposed with respect to any failure that is shown to be due to reasonable cause and not willful neglect; however, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer (or any other person) for disclosing the required information is not reasonable cause. IRC §6677(d).

Note that IRC §§6211-6216 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) will not apply to the assessment or collection of the penalties. IRC §6677(e).

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§16.84A F. Reporting of Foreign Bank Accounts—Tax Compliance

International estate planners must be aware of the recordkeeping and filing requirements for U.S. persons with financial interests in, or signature or other authority over, financial accounts maintained at financial institutions in foreign countries. This is particularly true if the planner acts as executor of an estate with foreign assets or serves as trustee—or even protector—of a foreign trust or a U.S. trust with foreign assets. As stated in the IRS Workbook on the Report of Foreign Bank and Financial Accounts (FBAR) (Feb. 19, 2009):

> The FBAR rules were established because of the utility of the information required in criminal, tax, and other regulatory matters and in the conduct of intelligence or counterintelligence activities including analysis to protect against international terrorism. The reports filed as a result of this regulation provide leads to investigators that facilitate the identification and tracking of illicit funds or unreported income, as well as providing additional prosecutorial tools to combat money laundering and other crimes.

Title 31 USC §5314(a) provides that "the Secretary of the Treasury shall require a resident or citizen of the United States or a person in, and doing business in, the United States, to keep records, file reports, or keep records and file reports, when the resident, citizen, or person makes a transaction or maintains a relation for any person with a foreign financial agency." A willful failure to file the required reports is a felony. 31 USC §5322.

Every U.S. person having a financial interest in, or signature or other authority over, any foreign financial account with an aggregate value exceeding $10,000 at any time during the calendar year must report that relationship by filing Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (FBAR), in addition to disclosing the existence of such an account on Part III of Schedule B of Form 1040 and including the income from such account on the U.S. person's federal income tax return. See 31 CFR §103.24. On who must file, see §16.84B. On the definition of foreign account, see §16.84C. On the definition of financial interest, see §16.84D. On penalties for failure to file, see §16.84E. On records to be maintained by persons required to report, see 31 CFR §103.32.

Filing of FBARs has been required since the 1970s, but due to poor enforcement, many people and tax advisors remain unaware of or turn a blind eye to their FBAR obligations, despite the fact that Form 1040 highlights the duty of taxpayers to file the FBAR on Schedule B, Interest and Ordinary Dividends, line 7a.

This attitude of indifference has (one hopes) changed since the IRS's widely publicized investigation into UBS and its handling of U.S. account holders, the subsequent agreement among the United States, Switzerland, and UBS that forced UBS to hand over thousands of names of account holders to the IRS, and the voluntary disclosure involving offshore accounts that ended on October 15, 2009. An excellent review of the UBS investigation and its consequences can be found in Feld, *Undeclared Foreign Accounts, Tax Fraud and The UBS Prosecutions: Is a Voluntary Disclosure to the IRS the Right Approach?,* Tax Management Memorandum 2009 (June 8, 2009).

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§16.84B 1. Who Must File FBAR

The instructions to the "old" Form TD F 90.22-1 required "United States persons" to file a FBAR. A "United States person" was defined as a "citizen or resident of the United States, a domestic partnership, a domestic corporation or a domestic estate or trust." The FBAR form, as amended in October 2008, refers to 31 CFR §103.11(z), which, in turn, includes an individual, corporation, partnership, trust or estate, Indian tribe, and "all entities cognizable as legal personalities." Form TD F 90-22.1, General Instructions, p 6. The instructions also make clear that a branch of a foreign entity that is doing business in the United States is required to file this report even if not separately incorporated under U.S. law.

The definition of "U.S. persons" was substantially expanded in October 2008 to include "a person in and doing business in the United States." However, the IRS temporarily suspended the reporting requirement for persons who are not U.S. citizens, residents, or domestic entities on June 30, 2009. IRS Announcement 2009-51, 2009-25 Int Rev Bull 1105.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.84C 2. When FBAR Filing Requirement Applies to Foreign Account

§16.84C 2. When FBAR Filing Requirement Applies to Foreign Account

The FBAR filing requirement applies only if a U.S. person has an interest in, or signatory or other authority over, a foreign account with an aggregate value exceeding $10,000 at any time during the calendar year. Form TD F 90-22.1, General Instructions, p 6.

However, every U.S. taxpayer must report the existence of any foreign account on his or her income tax return.

Foreign accounts are accounts that are located outside of the following jurisdictions:

- United States;
- Northern Mariana Islands;
- District of Columbia;
- American Samoa;
- Guam;
- Puerto Rico;
- U.S. Virgin Islands; and
- Trust Territories of the Pacific Islands.

The accounts include bank accounts such as savings accounts, checking accounts, and time deposits; securities accounts, such as mutual funds and brokerage accounts; and securities derivatives accounts. The definition also includes accounts in which the assets are held in a commingled fund and the account owner holds an equity interest in the fund, and any other account(s) maintained in a foreign financial institution or with a person doing business as a financial institution.

The account value is the largest amount of currency and/or monetary instruments that appears on any quarterly or more frequently issued account statement for the applicable year. If a periodic account statement is not issued, the maximum account value is the largest amount of currency or monetary instruments in the account at any time during the year.

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§16.84D 3. FBAR Financial Interest

For FBAR reporting purposes, "financial interest" includes accounts for which the U.S. person is the owner of record or has legal title, whether the account is maintained for his or her own benefit or for the benefit of others, including non-United States persons. Financial interest also includes accounts in which the owner of record or holder of legal title is a person acting as an agent, nominee, or in some other capacity on behalf of a U.S. person. It includes people who own 50 percent or more of a foreign corporation.

A U.S. person has account signature authority if that person can control the disposition of money or other property in the account by delivery of a document containing his or her signature to the bank or other person with whom the account is maintained.

A person with other authority over an account is one who can exercise power that is comparable to signature authority over an account by direct communication, either orally or by some other means, to the bank or other person with whom the account is maintained.

Of special interest is the following part of the instructions to the amended FBAR (Form TD F 90-22.1, General Instructions, p 6):

> 2. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is: (a) a person acting as an agent, nominee, attorney, or in some other capacity on behalf of the U.S. person; (b) a corporation in which the United States person owns directly or indirectly more than 50 percent of the total value of shares of stock or more than 50 percent of the voting power for all shares of stock; (c) a partnership in which the United States person owns an interest in more than 50 percent of the profits (distributive share of income, taking into account any special allocation agreement) or more than 50 percent of the capital of the partnership; or (d) a trust in which the United States person either has a present beneficial interest, either directly or indirectly, in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.
>
> 3. A United States person has a financial interest in each bank, securities, or other financial account in a foreign country for which the owner of record or holder of legal title is a trust, or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed. A trust protector is a person who is responsible for monitoring the activities of a trustee, with the authority to influence the decisions of the trustee or to replace, or recommend the replacement of, the trustee.

Thus, clients who own interests in foreign corporations and/or partnerships, are beneficiaries of foreign trusts, or have power of attorney over foreign accounts may need to file FBAR forms for accounts owned by foreign entities or trusts. Planners should be aware that the appointment of an agent with a durable power of attorney can expose the agent to the filing requirement. It may be appropriate to include language in the power of attorney form either specifically to exclude non-U.S. accounts or to alert the agent about the filing requirements. Clients and attorneys who serve as executors of estates with foreign assets may also have to file the FBAR form.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.84E 4. Penalties for Nonfiling FBAR

§16.84E 4. Penalties for Nonfiling FBAR

The penalties for nonfiling can be severe; the IRS published the following chart in its IRS Workbook on the Report of Foreign Bank and Financial Accounts (FBAR) (Feb. 19, 2009):

Violation	Civil Penalties	Criminal Penalties	Comments
Negligent Violation	Up to $500.	N/A	31 USC §5321(a)(6)(A); 31 CFR §103.57(h)
Non-Willful Violation	Up to $10,000 for each negligent violation.	N/A	31 USC §5321(a)(5)(B)
Pattern of Negligent Activity	In addition to penalty under 31 USC §5321(a)(6)(A) with respect to any such violation, not more than $50,000.	N/A	31 USC §5321(a)(6)(B)
Willful Failure to file FBAR or retain records of account	Up to greater of $100,000 or 50 percent of amount in account at the time of violation.	Up to $250,000 or 5 years in prison or both.	31 USC §5321(a)(5)(C) 31 USC §5322(a); 31 CFR §103.59(b) for criminal. The penalty applies to all U.S. persons.
Willful failure to file FBAR or retain records of account while violating certain other laws	Up to greater of $100,000 or 50 percent of amount in account at the time of violation.	Up to $250,000 or 10 years in prison or both.	31 USC §5322(b); 31 CFR §103.59(c) for criminal. The penalty applies to all U.S. persons.
Knowingly and willfully filing false FBAR	Up to greater of $100,000 or 50 percent of amount in account at the time of violation.	$10,000 or 5 years in prison or both.	18 USC §1001; 31 CFR §103.59(d) for criminal. The penalty applies to all U.S. persons.

Civil and criminal penalties may be imposed together. 31 USC §5321(d).

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VIII. UNITED STATES CLIENT IS LEAVING UNITED STATES

§16.85 A. Expatriation Regime

On June 17 2008, President Bush signed into law the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) (Pub L 110-245, 122 Stat 1638). The HEART Act (also know as the HEROES Act) contains a new expatriation tax regime that applies to individuals who expatriate from the U.S. on or after June 17, 2008. The HEART Act adds new IRC §§877A, 2801.

The HEART Act includes the following new regulations applicable to "covered expatriates" as defined in IRC §877A(g)(1) (see §16.86) including "long-term residents" (see §16.87):

- Deemed sale of their property the day before the expatriation date (and consequent U.S. tax liabilities on such "gains" in excess of $600,000 plus cost-of-living adjustments) (see §16.90);
- Gift tax obligations, imposed on the recipient, on gifts and bequests from such expatriates in excess of $10,000 plus cost-of-living adjustments ($13,000 in 2009) (see §16.90A);
- Changes in the definition of and process for "relinquishment" of citizenship (see §16.89); and
- Special rules for certain relinquishing dual citizens (see §16.88).

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§16.86 B. Individuals Subject to Expatriation Regime

Internal Revenue Code §877A(g)(1)(A) continues prior law (IRC §877(a)(2)) still in effect by applying the expatriation regime to:

- Individuals with an average annual United States federal income tax liability as defined in IRC §38(c)(1) for the 5 taxable years ending before the date of loss of citizenship (or termination of permanent residency) greater than $124,000 plus cost-of-living adjustments ($145,000 in 2009);
- Individuals with a net worth of $2 million or more as of the date of that loss or termination; and
- Individuals who fail to certify under penalty of perjury that they have met the requirements of the income and transfer tax laws for the 5 preceding taxable years, or fail to submit such evidence of compliance as is required by the IRS.

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§16.87 C. Definition of Long-Term Resident

A "long-term resident" for expatriation purposes is defined as an individual who was a lawful permanent resident of the United States (had a green card) as defined in IRC §7701(b)(6) for at least 8 of the last 15 taxable years ending with the year in which the termination of residence occurs. IRC §877A(g)(2).

NOTE: Any part of a taxable year in which the individual had a green card counts as one whole year. Accordingly, a person who received his or her green card on December 31 of Year 1 would become a long-term resident on January 1 of Year 8 even though he or she was a resident of the United States during a period of only 6 years and 2 days.

An individual is not considered to be a lawful permanent resident of the United States for any year in which the individual is taxed as a resident of another country under applicable provisions of a treaty. IRC §877A(g)(2).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.88 D. Exceptions to Expatriation Regime

§16.88 D. Exceptions to Expatriation Regime

United States citizens and long-term residents (see §16.87) within certain specified categories who otherwise meet the statutory requirements for application (see §16.86) are excepted from the expatriation regime described in §16.85. See IRC §877A(c), (g).

Section 877A(g) modifies the prior law exceptions in IRC §877(c) limited to certain dual citizens and individuals relinquishing U.S. citizenship before age 18½.

- An individual born with citizenship in both the United States and another country who relinquishes U.S. citizenship is not subject to the expatriation regime if, as of the expatriation date, the individual continues to be a citizen of (and taxable as) a resident of such other country and has not been a resident of the U.S. for more than 10 of the 15 taxable years ending with the taxable year of expatriation. IRC §877A(g)(1)(B)(i).
- A U.S. citizen relinquishing his or her U.S. citizenship before age 18½ is not subject to the expatriation regime if the individual was a resident of the U.S. (determined under the "substantial presence" test of IRC §7701(b)(1)(A)(i)) for no more than 10 taxable years before such relinquishment. IRC §877A(g)(1)(B)(ii).

Note that these exceptions do not apply to individuals who become subject to the expatriation regime because of a failure to certify compliance with U.S. federal tax obligations. IRC §877(a)(2)(C).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.89 E. Timing of Expatriation

§16.89 E. Timing of Expatriation

The HEART Act (see §16.85) changes prior law that provided that an individual continued to be treated as a U.S. citizen or long-term resident for U.S. federal income tax purposes until the individual gave notice of an expatriating act or termination of residency. Such notice is no longer required for loss of citizenship (see §16.89A) or termination of permanent residency (see §16.89B).

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§16.89A 1. Loss of Citizenship

Under the HEART Act (see §16.85), an individual ceases to be a U.S. citizen for U.S. tax purposes on relinquishment of his or her U.S. citizenship, deemed to occur on the earliest of the following:

(a) The date the individual renounces U.S. nationality before a diplomatic or consular officer of the United States pursuant to paragraph (5) of §349 of the Immigration and Nationality Act (8 USC §1481(a)(5)) (provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality);

(b) The date that the individual furnishes to the State Department a signed statement of voluntary relinquishment of U.S. nationality confirming the performance of an expatriating act (again, provided that the voluntary relinquishment is later confirmed by the issuance of a certificate of loss of nationality);

(c) The date that the State Department issues a certificate of loss of nationality; or

(d) The date that a U.S. court cancels a naturalized citizen's certificate of naturalization. IRC §877A(g)(4).

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§16.89B 2. Termination of Residency

Long-term residency continues to terminate when an individual loses his or her green card status through revocation by filing Department of Homeland Security Form I-407 with a U.S. consular or immigration officer, and the Department of Homeland Security determines that, in fact, the long-term residency has been abandoned, or it has been administratively or judicially determined that the individual abandoned such status. Long-term residency now also terminates if an individual is treated as a resident of a foreign country having a tax treaty with the United States, does not waive the benefits of that treaty, and notifies the IRS of such treatment. IRC §§877A(g)(3)(B), 7701(b)(6).

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§16.90 F. "Mark-to-Market" Approach for Expatriates

The HEART Act (see §16.85) applies a deemed sale "mark-to-market" approach for expatriates by treating expatriates as having sold all their property for fair market value on the day before the expatriation date. IRC §877A(a)(1). The gain or loss from those deemed sales is to be taken into account for the taxable year in question. IRC §877A(a)(2).

For purposes of this expatriation gain calculation, expatriates are allowed a basis step up to the then-fair market value of the property owned at the time they first became U.S. residents. IRC §877A(h)(2). This tax applies only to the extent that the net gain exceeds $600,000, adjusted for inflation ($626,000 in 2009). IRC §877A(a)(3).

Expatriates may elect to defer the tax until the due date for the U.S. tax return for such deemed dispositions, but only if "adequate security" is provided to the IRS. IRC §877A(b)(1). The election to defer payment of tax is irrevocable (§877A(b)(6)) and adequate bond must be posted (§877A(b)(4)).

Special rules apply when the individual was a beneficiary of a trust treated as a nongrantor trust on the expatriation date. In the case of such an interest, no gain is recognized on the expatriation date. Instead, future distributions made by the trust to the expatriate out of its income are subject to a 30-percent withholding tax. IRC §877A(f)(1)(A). In addition, the trust is required to recognize gain on the distribution of any property the fair market value of which exceeds its basis, determined on the date of the distribution. IRC §877A(f)(1)(B). The gain recognized by the trust would increase the amount of the taxable portion of the distribution in the hands of the expatriate beneficiary. IRC §877A(f)(2).

Similar rules apply to certain qualified and nonqualified deferred compensation plans. IRC §877A(d).

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§16.90A G. Gift and Estate Taxes for Expatriates

The HEART Act (see §16.85) imposes transfer taxes on a U.S. citizen or resident on any property acquired from a covered expatriate by a gift or bequest. IRC §2801(b). The transfer tax is assessed on value of the gift or bequest at the highest marginal estate or gift tax rate applicable at the time of the gift or bequest, but is reduced by the amount of any foreign gift or estate tax paid on the gift or bequest. IRC §2801(a), (d).

In addition, the IRC §2503(b) gift tax annual exclusion applies to gifts from a covered expatriate and exempts gifts of not more than $10,000 plus cost-of-living adjustments ($13,000 in 2009) per donee per year (IRC §2801(c)), as do the rules for charitable donations and spousal transfers under the general estate and gift tax rules (IRC §2801(e)(3)), and only those assets not included on a U.S. federal estate or gift tax return will be assessed the tax (IRC §2801(e)(2)). Special rules apply if a gift is made to a trust. IRC §2801(e)(4).

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.91 IX. CLIENT HAS FOREIGN ASSETS

§16.91 IX. CLIENT HAS FOREIGN ASSETS

Although a detailed discussion of this topic is beyond the scope of this chapter, practitioners must be aware that many issues arise if a client has foreign assets. Among these issues are coordination of the estate plan and foreign tax issues. See §§16.92-16.98.

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§16.92 A. Coordination of Estate Plan

Practitioners must understand that the main issue is coordinating the client's estate plan in the various jurisdictions involved rather than forcing legal or tax principles of one jurisdiction on another. A common mistake of United States practitioners advising clients with foreign assets is to assume that the goal is to find a way to transfer those assets to the domestic trust the practitioner may have drafted to deal with the client's United States assets. See §16.93. Instead, the goal is to fully understand the client's objectives with respect to all of his or her assets, to accomplish those goals as efficiently and inexpensively as possible using whatever tools are available in the relevant jurisdictions, and to ensure that the planning in one jurisdiction does not adversely affect the planning desired in another jurisdiction. This may require association of competent local counsel. See §16.98.

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§16.93 B. Recognition of Trusts

Although more and more countries, even civil law countries, are starting to recognize trusts and pass trust legislation of their own, recognition of common-law trusts is far from universal. Accordingly, a client's trust may have limited or no use in a jurisdiction in which the client may own assets. As discussed in §16.94, careful analysis of tools available in the relevant jurisdiction will in all cases be required.

NOTE: Transfer of assets into trusts can trigger capital gain taxes in certain jurisdictions, especially if those jurisdictions have no transfer tax system (*e.g.*, Australia). Some jurisdictions are also inclined to tax trusts if a trustee is a taxpayer in the jurisdiction.

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§16.94 C. Situs Wills/Testamentary Documents

Consistent with the principle of coordination discussed in §16.92, it will frequently be necessary or advisable for the client to dispose of foreign assets with documents that are recognized in the relevant jurisdiction. Situs (local) wills, beneficiary designations with respect to certain assets, or even certain ways of holding title may be appropriate to most effectively accomplish the client's goals in the particular jurisdiction. The use of local documents, however, may not prevent the application of United States tax principles. See §16.95. Forced heirship laws also may limit estate planning options in some jurisdictions. See §16.97. Again, the key is to understand and make full use of all tools and planning available in the relevant jurisdiction and to avoid potentially disastrous pitfalls.

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§16.95 D. Qualifying Transfers of Foreign Assets for United States Tax Benefits

Even if local documents are used to dispose of assets located in other jurisdictions, practitioners must remain vigilant regarding United States tax principles that will apply to the transfer of those assets in any event. For example, assume the client is a United States citizen or is domiciled in the United States, which means that he or she will be subject to United States estate tax. If the client is married and wants to leave assets in a foreign jurisdiction to his or her spouse, the fact that the asset is located in another jurisdiction or will pass through a foreign will or trust does not mean that the transfer no longer needs to be structured so that it qualifies for the United States marital deduction if the marital deduction is desired. In that case, counsel may need to make sure that the foreign documents follow technical United States tax requirements. Foreign tax issues also must be considered. See §16.96.

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§16.96 E. Foreign Tax Issues

It is likely that the ownership of foreign assets will cause the client to be subject to income or transfer tax and reporting requirements in the jurisdiction where those assets are located. If that is the case, and the same assets are subject to United States income or transfer tax liabilities, counsel should carefully review foreign tax credit rules and the relevant provisions of applicable treaties to eliminate or minimize the burdens of that potential double taxation.

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§16.97 F. Forced Heirship Laws

Clients with foreign assets and their advisors should be aware that many civil law countries, such as France, Germany, Switzerland and Japan, have forced heirship laws. In general, forced heirship rules limit a testator's freedom of disposition and grant certain dependents the right to participate in the distribution of the estate of the decedent, even if the distribution would be against the testator's express intention. Sometimes the forced heirship rules are consistent with the client's dispositive wishes but sometimes they are not. In some cases, changes to the client's estate plan in the United States or other jurisdictions will be required to accomplish the client's global objectives.

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Source: Estate Planning/California Estate Planning/16 Basic International and Noncitizen Transactions/§16.98 G. Association of Competent Local Counsel [Deleted]

§16.98 G. Association of Competent Local Counsel [Deleted]

This section has been deleted. The need to work with foreign counsel to satisfy the obligation to provide competent representation is now discussed in §16.4.

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§16.99 X. CLIENT IS NON-UNITED STATES PERSON WITH UNITED STATES ASSETS

If a practitioner has a non-United States client with United States assets, planning to minimize the United States tax consequences attributable to those assets should take into account the consequences of that planning in the client's country of residence. Association of competent counsel or exclusion of this analysis from the scope of engagement with a written recommendation that the client seek that counsel is essential to minimize the risk of a later claim by the client that the practitioner should have known the planning was going to have adverse tax or other consequences elsewhere. An example of a situation in which this problem arises is situs planning. As discussed in §§16.6-16.19A, non-United States persons for transfer tax purposes are not subject to United States transfer tax with respect to non-United States situs assets (*i.e.,* shares of a foreign corporation). Accordingly, if the client holds United States situs assets (otherwise subject to transfer tax) through a foreign corporation (no matter where established), the same assets will escape United States transfer tax. Assume that a Mexican client owns United States situs assets through a Cayman Islands corporation. The structure works to avoid United States transfer tax, but neither the client nor the advisor may be aware that that structure has tax and reporting obligations in Mexico that the client may not like and that could land the client in jail if they are not met. In addition, the attorney must discuss with the client the U.S. income tax consequences of such a structure, in particular, the treatment of capital gains taxes and potential U.S. income tax withholding issues.

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§16.100 XI. CLIENT HOLDS ASSETS OF FOREIGN DECEDENT

Domestic and foreign financial institutions and others who hold a decedent's assets and subsequently release those assets to the person they believe in good faith is entitled to those assets may be surprised to know that, under certain circumstances, the holder can be held liable for the decedent's unpaid United States estate taxes. Effectively, if no one has been appointed and qualified as an executor under the applicable local law (defined as the United States executor in §16.101), the holder of the assets is treated as an executor of the decedent's estate for United States estate tax purposes (defined as a statutory executor in §16.102), a designation that carries with it important consequences.

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§16.101 A. United States Executor Defined

Generally, an executor is the person duly appointed under applicable law to administer a decedent's estate. If the decedent was domiciled in the United States, an executor may be appointed in the state of the decedent's domicile. If the decedent was not domiciled in the United States at the time of his or her death, an executor may be appointed by the appropriate court of a state in which the decedent held assets at the time of the decedent's death. If a person has been duly appointed and has qualified to administer the decedent's estate within the United States, that person will be the only person treated as an executor for tax purposes (United States executor). IRC §2203. If no one is appointed executor, one or more persons may be treated as statutory executor. See §16.102.

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§16.102 B. Statutory Executor Defined

If no person has been appointed and has qualified to administer the decedent's estate within the United States (there is no United States executor), any person in actual or constructive possession of any property of the decedent's estate is treated as an executor for United States estate tax purposes (statutory executor). IRC §2203; Treas Reg §20.2203-1.

For United States estate tax purposes, the legal situs or the actual physical location of the estate's property is immaterial to the determination of who is treated as a statutory executor. Therefore, even a person in actual or constructive possession of assets of the decedent that are not physically located in the United States would be treated as a statutory executor and would be responsible for discharging the duties imposed on that executor for United States estate tax purposes. See §16.103.

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§16.103 C. Filing Requirements and Payment of Tax

A statutory executor is responsible for filing the decedent's United States estate tax return and for paying any United States estate tax, interest, and penalties that may be assessed and become due. IRC §§2002, 6018; Treas Reg §20.2002-1. This responsibility exists even if other persons are in possession of estate assets and also are treated as statutory executors. A statutory executor may be personally liable for the tax. See §16.104.

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§16.104 D. Personal Liability of Statutory Executor

A statutory executor's duty to pay United States estate tax does not itself give rise to personal liability for the tax. Personal liability can, however, be imposed on a statutory executor who is deemed to act in a fiduciary capacity and who pays a debt of an estate before satisfying unpaid United States taxes for which the United States has a priority claim against the estate at a time when the estate's liabilities exceed its assets. IRC §6901(a)(1)(B); 31 USC §3713(b). For this purpose, payments made to beneficiaries are considered estate debts. Accordingly, a person who holds assets of a decedent's estate and distributes those assets to a beneficiary of the estate or the person next entitled to the assets may be held personally liable for any estate tax owed by the estate.

Although there is authority in support of the position that a statutory executor is not per se a fiduciary of the estate and acts as the executor only for purposes of filing the estate tax return and paying the estate tax (see, *e.g., Occidental Life Ins. Co.* (1968) 50 TC 726), there is also authority holding a statutory executor personally liable for unpaid United States estate taxes of an estate on the basis of the actions taken by the statutory executor (see, *e.g., David Allen,* TC Memo 1999-385). While there are not many cases that illustrate when a statutory executor might be treated as a fiduciary and therefore subject to the law that imposes personal liability for unpaid tax, it is arguable that paying estate debts or making distributions to beneficiaries or others determined to be entitled to the assets in question are actions normally taken by an executor acting in a fiduciary capacity and should render the statutory executor a fiduciary potentially subject to personal liability. See §16.105.

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§16.105 E. Avoiding Liability

A statutory executor who wishes to assure that no claim will be made against it for unpaid United States estate tax owed by the estate, as discussed in §16.104, should seek competent legal advice regarding the appropriate steps to take before releasing the estate assets in its possession. The appropriate steps to take depend on the facts and circumstances of each case. This determination is based in part on whether a United States executor has been or will be appointed. If a United States executor is appointed, the statutory executor may release the assets to the United States executor without risking personal liability for the estate's unpaid taxes. If a United States executor is not appointed, however, the statutory executor must determine whether the estate is subject to United States estate tax, and if so, whether it is more appropriate for the estate's foreign representative to file the United States estate tax return. The statutory executor also must determine whether a request for a formal discharge from personal liability provides sufficient protection from liability for the estate's unpaid taxes under the circumstances. See IRC §6905; Treas Reg §301.6905-1.

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§16.106 XII. OTHER ISSUES ENCOUNTERED BY INTERNATIONAL ESTATE PLANNING PRACTITIONERS

As stated in §16.1, this chapter is not intended to include a complete or exhaustive discussion of all issues that a practitioner might face in an international estate planning practice. The author simply selected those issues she believes are most likely to be encountered by an estate planning practitioner who does not have an international practice. The following significant areas are not covered:

- Planning for a nonresident alien who plans to immigrate to the United States;
- Treaty issues (but see §16.19A);
- The withholding tax regime;
- Money-laundering issues as they relate to tax planning/avoidance/evasion; and
- Voluntary disclosure issues for taxpayers who have not previously complied with tax and reporting obligations imposed in any jurisdiction.

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17

Marital Deduction Planning

Joel A. Levine

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§17.1 I. INTRODUCTION

Under IRC §§2056 and 2523, a deduction is allowed for qualifying transfers between spouses made during life and at death. After briefly discussing the history of the marital deduction, this chapter discusses the marital deduction requirements as a prelude to the chapter's main focus, which is planning for the marital deduction. Although the importance of the marital deduction for California domiciliaries has changed and will continue to change, currently the marital deduction and its interplay with the unified credit allowed under IRC §§2505 and 2010 form the backbone of the married client's estate plan. This interplay has many variations, which must be understood by the estate planner in order to properly assist the married client with his or her estate plan. The changes to federal and state transfer taxes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38) create uncertainties for clients that will tax the estate planner's ingenuity and drafting skills, especially in planning and drafting marital deduction provisions.

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Source: Estate Planning/California Estate Planning/17 Marital Deduction Planning/§17.2 A. Terminology

§17.2 A. Terminology

In this chapter, the following terms have the meanings set forth below:

- Deceased Spouse refers to the first spouse to die, and Surviving Spouse refers to the second spouse to die.
- Marital Estate refers to the combined federal gross estates of husband and wife during their joint lifetime.
- Unless expressly provided otherwise, the words "will" and "trust" are used interchangeably and refer to the instrument setting forth the testamentary dispositions of each spouse's share of the Marital Estate.
- Zero-Tax Formula refers to any formula that maximizes the estate or gift tax-free transmission of wealth while using the minimal amount of marital deduction.

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§17.3 B. Brief History of Marital Deduction

Since its inception, the marital deduction has been changing both in purpose and scope. When enacted in 1948, its purpose was to allow residents of common law states the same opportunity for estate splitting already enjoyed by residents of community property states. The maximum deduction equaled one-half of the decedent's adjusted gross estate. In 1976, the deduction was extended to community property in the case of very small estates. The Economic Recovery Tax Act of 1981 (ERTA) (Pub L 97-34, 95 Stat 172) effected a sea change in the marital deduction by exempting all qualifying transfers between spouses from estate and gift tax. By allowing for an unlimited marital deduction, Congress gave married couples the choice of not paying tax on the Marital Estate during their joint lifetime and shifting the tax burden to their successors.

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§17.4 1. Effect of EGTRRA-2001

With the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), Congress once again made major changes to the estate planning environment. For estate planning purposes, EGTRRA-2001 has created three different estate planning periods, each of which should be considered in connection with estate planning for the married client.

- Before 2010: During these years, there will continue to be estate, gift, and generation-skipping transfer (GST) taxes, staged increases in the unified credit for estate and GST taxes, a static unified credit for gift taxes, and a decreasing top rate for all transfer taxes.
- In 2010: Except for distributions to noncitizen spouses, which are taxable under IRC §2056A(b), the estate tax and GST tax are repealed, but the gift tax continues, with a top rate of 35 percent. However, many practitioners believe the estate and GST tax will be extended retroactively to decedents dying in 2010.
- After 2010: Under a sunset provision, all of EGTRRA-2001's estate, gift, and GST tax provisions do not apply to "estates of decedents dying, gifts made, or generation-skipping transfers, after December 31, 2010." EGTRRA-2001 §901.

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§17.5 2. Impact of Changes to Marital Deduction

With the shift in purpose and scope by ERTA and the significant increases in the applicable exclusion amounts and the potential repeal of the estate and GST taxes that is the promise of EGTRRA-2001, the marital deduction has evolved from a tax deferral tool to a tax reduction or avoidance tool. Another way to view these changes is to consider that if a Deceased Spouse transfers his or her entire estate to the Surviving Spouse, ERTA's unlimited marital deduction results in the Marital Estate being taxed once, on the death of the Surviving Spouse; and assuming that the Marital Estate is completely shielded from estate tax by EGTRRA-2001's increased applicable exclusion amounts or by a complete repeal of the estate tax, the marital deduction may result in complete avoidance of any federal estate tax on the Marital Estate.

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§17.6 C. Marital Deduction Requirements

The marital deduction is allowed for property interests passing from the Deceased Spouse to the Surviving Spouse, or from the donor spouse to the donee spouse in the case of a lifetime gift. This seemingly simple rule is laden with several rules and conditions that the planner must consider in planning successfully for the marital deduction.

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§17.7 1. Citizenship of Spouses

Any transferor spouse may qualify for the marital deduction notwithstanding his or her citizenship or residency. See IRC §§2001, 2056, 2106(a)(3); Treas Reg §20.0-1(b) (testamentary transfers); IRC §§2501(a)(1), 2502(a), 2503(a), 2523 (lifetime gifts). However, the citizenship of the transferee spouse is important. Gifts (even by citizen Deceased Spouses) to noncitizen spouses do not qualify for the marital deduction unless the property passes to the noncitizen spouse in a qualified domestic trust (QDOT). IRC §§2056(d), 2056A, 2523(i). See §§16.25-16.40, 17.74-17.78.

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§17.8 2. Definition of "Surviving Spouse"

Both survivorship and spousal status are matters that are determined under the law of the decedent's domicile. For purposes of IRC §2056(a), the term "surviving spouse" means the legal status arising from the termination of a lawful marital union by the death of the other spouse. Rev Rul 76-155, 1976-1 Cum Bull 286. See IRS Letter Ruling 200132004 (analyzing whether, under the law of the decedent's domicile, the transferee would be recognized as the common law wife of the decedent). With respect to any California Deceased Spouse, reference should be made to Prob C §78, which defines the term "surviving spouse." See also Treas Reg §1.401(a)(9)-8, A-5.

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§17.9 3. "Passing" Requirement

The "passing" requirement allows the transferor spouse to deduct property interests transferred to the transferee spouse in any number of gratuitous ways, provided that after the transfer, the transferee spouse beneficially owns the property interest transferred. For example, property interests may pass between spouses by will (bequest or devise), by inter vivos or testamentary trusts, by intestacy, by operation of law (*e.g.,* joint tenancy), or by pay-on-death contracts such as life insurance or Totten trust accounts. See IRC §2056(c); Treas Reg §§20.2056(c)-1, 20.2056(c)-2. An interspousal transfer to the Surviving Spouse solely in a trustee capacity, however, does not qualify as an interest passing to the spouse. Treas Reg §20.2056(c)-2(a).

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§17.10 4. Transferred Property Must Be "Deductible Interests"

The marital deduction regulations classify gifts between spouses as "deductible interests" or "nondeductible interests," and only deductible interests are eligible for the marital deduction. Treas Reg §20.2056(a)-2(a). "Deductible interests" are defined as any property interest that is not classifiable within one of four categories of nondeductible interests. Treas Reg §20.2056(a)-2(b).

The first category of nondeductible property interest is property not included in the decedent's gross estate. (The Deceased Spouse is not entitled to a marital deduction for property he or she does not own.) The second and third categories of nondeductible interests are property interests passing to a Surviving Spouse that are also deductible under IRC §§2053 and 2054. Designed to prevent double deductions, these two categories should be read in connection with the subsequently enacted IRC §2056(b)(9), which prohibits any double deduction for property interests passing from a decedent. The fourth and most important category of nondeductible interest is "terminable interest" property, which is defined in IRC §2056(b). See §17.12.

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Source: Estate Planning/California Estate Planning/17 Marital Deduction Planning/§17.11 a. Prohibition of Funding With Nondeductible Interests

§17.11 a. Prohibition of Funding With Nondeductible Interests

Under IRC §2056(b)(2), if the decedent's will permits the marital deduction gift to be satisfied with nondeductible interests, the marital deduction must be reduced by the aggregate value of such nondeductible interests. Probate Code §21522 provides that a marital deduction gift may be satisfied only with "property that qualifies for the marital deduction." Because other will provisions may undermine the application of Prob C §21522, however, the better practice is to expressly prohibit funding the marital deduction bequest with nondeductible interests. If the marital deduction gift is part of a Zero-Tax Formula, the provision prohibiting funding with nondeductible interests should be part of the overall funding instructions allocating assets between or among the marital and credit shelter trusts. If the marital deduction gift is made by an outright bequest to the Surviving Spouse, a stand-alone provision or a provision that is part of a savings clause may be used, which should read as follows:

Unless expressly provided otherwise herein, Nondeductible Property Interests (as hereinafter defined) will not be used to fund or otherwise satisfy any gift made by the Deceased Spouse to the Surviving Spouse that is intended to qualify for the marital deduction under Internal Revenue Code §2056. A "Nondeductible Property Interest" is any asset or group of assets included in the Deceased Spouse's federal gross estate with respect to which no deduction would be allowed under Internal Revenue Code §2056 if such asset or group of assets passed from the Deceased Spouse to the Surviving Spouse.

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§17.12 b. Terminable Interest Rule

A terminable interest is a property interest that is subject to termination because of the passage of time or because an event or contingency occurs or fails to occur. IRC §2056(b)(1). A gift of a life estate coupled with a remainder to anyone other than the Surviving Spouse is ordinarily a gift of a nondeductible terminable interest, but certain terminable interests may be deductible. See §§17.13-17.14.

Statutory exceptions to the terminable interest rule include the Life Estate/General Power of Appointment Trust (Life Income/GPA Trust), the Life Insurance or Annuity/General Power of Appointment Trust, the Qualified Terminable Interest Property Trust (QTIP Trust), and the Charitable Remainder Trust (CRT) (collectively, qualifying trusts). IRC §2056(b)(5)-(8). Of the four statutory exceptions, the QTIP trust is the most frequently used. See §§17.19-17.36.

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§17.13 (1) Deductible Terminable Interests

Not all terminable interests are ineligible for the marital deduction. For a terminable interest to be nondeductible, the property interest must pass from the Deceased Spouse to a third party (someone other than the Surviving Spouse or the Surviving Spouse's estate) for less than adequate and full consideration, and as a result of such passing, the third party must have a right to possess or enjoy a part of the property. Thus, a transfer by a Deceased Spouse to an accumulation trust for the life of the Surviving Spouse with a remainder to the spouse's estate (the estate trust discussed in §17.37) would not be a disqualified terminable interest because on the Surviving Spouse's death, no third party has a right to possess or enjoy the property.

Similarly, a survivor annuity benefit received by a Surviving Spouse under a joint and survivor annuity purchased by the Deceased Spouse, which ends without further payments to any third party on the death of the Surviving Spouse, qualifies as a deductible interest. Treas Reg §20.2056(b)-1(g), Example 3.

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§17.14 (2) Six-Month Survival Period

A requirement that the Surviving Spouse survive the Deceased Spouse by more than 6 months or until distribution of the estate creates a nondeductible terminable interest. Conversely, a 6-month survival requirement does not invalidate an otherwise qualified marital deduction. IRC §2056(b)(3). The 6-month survival rule may be used to equalize the spouses' estates when the Surviving Spouse dies shortly after the Deceased Spouse, the Deceased Spouse has a greater share of the Marital Estate, and a QTIP trust is not used. When a QTIP trust is used, estate equalization is better achieved by the inherent possibility of making the QTIP election for less than the entire trust. Assuming an executor applies for an extension of time for filing the estate tax return, the executor has 15 months after the first death in which to determine whether to make the full election. See §17.30.

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§17.15 D. Value of Marital Deduction

The value of the deduction under IRC §2056(a) is equal to the aggregate net values of the property interests transferred determined as of the decedent's date of death or alternate valuation date under IRC §§2031 and 2032. Any death taxes payable out of the marital deduction gift reduce the marital deduction. IRC §2056(b)(4)(A).

WARNING: In planning for the marital deduction, it is essential that the tax apportionment provisions of the Deceased Spouse's will and trust are coordinated so that the marital deduction gift is not inadvertently diminished, because the marital deduction gift is responsible for death taxes. See *Patterson v U.S.* (8th Cir 1999) 181 F3d 927.

The deduction is decreased by the value of any mortgage or other encumbrance on the property (IRC §2056(b)(4)(B)), unless other property in the taxable estate of the deceased spouse must be used to pay off the debt secured by the encumbrance. Reg §20.2056(b)-4(b).

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§17.16 1. Obligation to Transfer Property to Third Party

The deduction is disallowed for any transfer to a spouse to the extent the transfer carries with it an obligation that the transferee spouse transfer property to a third party, even if the property required to be transferred was owned by the transferee-spouse before the transfer. Treas Reg §20.2056(b)-4(b).

EXAMPLE: In *U.S. v Stapf* (1963) 375 US 118, 11 L Ed 2d 195, 84 S Ct 248, the Deceased Spouse forced the Surviving Spouse to elect whether to take under the Deceased Spouse's will (the "widow's election") and thereby transfer her share of community property to a trust for the couple's children, or to elect against the will and receive only her share of community property. The Surviving Spouse elected to take under the will and transferred her share of community property to a trust for the children. The Supreme Court disallowed the marital deduction, finding that the value of the property transferred by the Surviving Spouse exceeded the value of the property received from the Deceased Spouse.

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§17.17 2. Payment of Expenses

Treasury Regulation §20.2056(b)-4(d) distinguishes between "transmission expenses" and "management expenses." Transmission expenses are administration expenses that would not have been incurred but for the death of the decedent and that are related to the collection or distribution of the decedent's assets or payment of the decedent's debts. Transmission expenses include attorney fees and executor's commissions unrelated to the management of the decedent's assets, probate fees, and expenses of will contests. Treas Reg §20.2056(b)-4(d)(1)(ii). Management expenses are expenses incurred for the management and preservation of estate assets during a reasonable period of administration and include investment advisory fees, brokerage commissions, custodial fees, and interest. Treas Reg §20.2056(b)-4(d)(1)(i).

Transmission expenses paid from the marital share reduce the marital share. Treas Reg §20.2056(b)-4(d)(2). However, the marital share does not include income produced by marital deduction property unless required by local law (not in California) or the trust instrument (see §17.55). Treas Reg §20.2056(b)-4(d)(1)(iii). Thus, transmission expenses can be paid from income attributable to the marital share without reducing the marital share. Treas Reg §20.2056(b)-4(d)(5), Example 7.

If a self-adjusting Zero-Tax Formula is used, the marital deduction share increases and the credit shelter share decreases by the amount of transmission expenses taken as an income tax deduction unless the expenses are paid from income. See Treas Reg §20.2056(b)-4(d)(5), Example 5. If a self-adjusting Zero-Tax Formula is not used, transmission expenses paid from the marital deduction share reduce the marital deduction dollar for dollar and will result in estate tax owing unless deducted as an expense of administration under IRC §2053(a)(2). See Treas Reg §20.2056(b)-4(d)(5), Example 6.

PRACTICE TIP: When a self-adjusting Zero-Tax Formula is used and the Surviving Spouse's taxable estate, including the marital deduction share, is likely to be less than the Surviving Spouse's applicable exclusion amount, transmission expenses should be taken as an income tax deduction.

Management expenses that are attributable to the marital share may be paid from the marital share and deducted on the estate's income tax return without reduction of the marital deduction. Treas Reg §20.2056(b)-4(d)(3). Management expenses attributable to the nonmarital deduction share but paid out of the marital share reduce the marital deduction. Treas Reg §20.2056(b)-4(d)(4). Unless a self-adjusting Zero-Tax Formula is used or these expenses are deducted as an expense of administration under IRC §2053(a)(2), payment of these expenses from the marital share will result in estate tax payable. Treas Reg §20.2056(b)-4(d)(5), Example 3.

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§17.18 E. Interspousal Lifetime Gifts

Internal Revenue Code §2523 provides an unlimited marital deduction for inter vivos interspousal gifts with rules similar to IRC §2056, *e.g.,* the terminable interest rule discussed in §§17.12-17.14. See IRC §2523(f). The spouse must be a citizen of the United States. If the spouse is not a citizen, a special $100,000 (plus COLA adjustments) annual gift tax exclusion is allowed and normal marital deduction rules do not apply. IRC §2523(i). See §16.23. Interspousal lifetime gifts should be considered when one spouse may have insufficient assets to be able to fully utilize his or her applicable exclusion amount and the other spouse has more than enough to utilize his or her applicable exclusion amount. In connection with such discussions, the married couple must understand the nontax aspects of making gifts. Specifically, they should be warned that in the event of divorce, the property that was once the donor spouse's separate property will belong to the donee spouse.

If the wealthier spouse is otherwise disposed to transfer property to the other spouse and wishes to control the ultimate disposition of the remainder, IRC §2523(f) allows the donor spouse to create a lifetime QTIP trust. Care must be exercised in creating a lifetime QTIP trust. The QTIP election for a transfer to the trust must be made on a timely filed gift tax return. IRC §2523(f)(4)(A). The Service cannot grant an extension of time to make a QTIP election for a lifetime QTIP trust. IRS Letter Ruling 200314012. In *Wells Fargo Bank v U.S.* (10th Cir 2003) 319 F3d 1222, the court held that a transfer to a lifetime QTIP trust was a completed gift despite the fact that the subsequent failure to make a QTIP election allegedly caused the gift to be incomplete under state law because the donor's donative intent was foiled. If a QTIP trust is used, consideration should be given to using powers of appointment that would allow QTIP property to be transferred outright to the Surviving Spouse if the Surviving Spouse does not own sufficient property to allow his or her successors to fully utilize the aggregate basis increase under IRC §1022(b). For further discussion of lifetime QTIP trusts, see Drafting California Irrevocable Trusts §§2.39-2.39B (3d ed Cal CEB 1997).

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§17.19 II. QUALIFYING TRUSTS

Certain interspousal gifts made in trust qualify for the marital deduction because of a statutory exception to the terminable interest rule or because the terminable interest conveyed is not a nondeductible terminable interest. The four statutorily excepted qualifying trusts are discussed in §§17.20-17.36. The estate trust, which is not a nondeductible terminable interest, is briefly discussed in §17.37.

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Source: Estate Planning/California Estate Planning/17 Marital Deduction Planning/§17.20 A. Life Income/GPA Trust

§17.20 A. Life Income/GPA Trust

Under IRC §2056(b)(5), a gift to the Surviving Spouse of a life income interest in property (or a specific portion of property) coupled with a general power of appointment qualifies for the marital deduction as follows.

- The life estate may be but need not be in trust.
- The life income interest must be payable at least annually.
- The general power of appointment must be exercisable in favor of the Surviving Spouse or the Surviving Spouse's estate and may be a power exercisable during life or on death.
- No other person may have the power to appoint any part of the property interest or specific portion thereof to anyone other than the Surviving Spouse.

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§17.21 1. Power Exercisable in Favor of Surviving Spouse's Estate During Life or at Death

If the Surviving Spouse's power is exercisable by the Surviving Spouse in his or her own favor, it must be exercisable by the Surviving Spouse at any time after the Deceased Spouse's death. Accordingly, a power exercisable during the Surviving Spouse's lifetime in favor of his or her estate that is conditioned on a survival period would not qualify as a valid power of appointment under IRC §2056(b)(5). If the power is exercisable only at death, however, it may be conditioned on a survival period of 6 months or less. Treas Reg §20.2056(b)-5(g). A lifetime power of appointment allows the trust property to be removed from the Surviving Spouse's estate if this later becomes desirable, provided that due formalities are observed. See, *e.g.*, *Estate of Sylvia Gore*, TC Memo 2007-169 (decedent's purported withdrawal and assignment of assets of GPA trust to family limited partnership did not result in completed transfers for gift tax purposes because the GPA trust had not yet been funded and decedent retained control and use of the transferred assets).

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§17.22 2. Advantages Under EGTRRA-2001

Because of the QTIP trust's advantages (see §§17.23-17.34), since its introduction in 1981, the QTIP trust has for the most part replaced the Life Income/GPA Trust. However, the Life Income/GPA Trust may see a resurgence if the focus of estate planning shifts to maximizing the basis increase amounts after 2009 provided in IRC §1022(b)-(c). The Deceased Spouse's additional basis increase amount for transfers to a spouse under IRC §1022(c) may be applied to property held in a QTIP trust for the Surviving Spouse. Under IRC §1022(d)(1)(A), however, the Surviving Spouse must own any property with respect to which the basis increase amounts are to be applied at the Surviving Spouse's date of death. Accordingly, the basis increase amount under IRC §1022(b) cannot be applied to the Surviving Spouse's property interest held in a QTIP trust. A Life Income/GPA Trust with a general power of appointment exercisable during the Surviving Spouse's lifetime could provide the flexibility needed to take advantage of the basis increase provisions by allowing the Surviving Spouse to own the property if he or she has an insufficient amount for purposes of taking full advantage of the basis increase amounts under IRC §1022(b). This may require spouses to give up all or a portion of the dead-hand control that the Deceased Spouse has over the QTIP remainder in exchange for income tax minimization. Giving a spouse a general power of appointment also exposes the trust estate to the claims of the spouse's creditors. Prob C §682. The solution to this dilemma may be to engraft carefully tailored powers of appointment on QTIP trusts.

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§17.23 B. QTIP Trust

With the enactment of the unlimited marital deduction, ERTA also enacted IRC §§2056(b)(7) and 2523(f), which allow the marital deduction for interspousal gifts of "qualified terminable interest property." QTIP property for estate tax purposes is (1) property passing from the Deceased Spouse, (2) in which the Surviving Spouse has a "qualifying income interest" for life (see §§17.24-17.26), and (3) for which an election is made (see §17.27). IRC §2056(b)(7)(B)(i). The uses and advantages of QTIP trusts are discussed in §§17.28-17.34. Lifetime QTIP trusts are discussed in §17.18.

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§17.24 1. Qualifying Income Interest for Life

For an interest to be a "qualifying income interest" for life, it must satisfy the following requirements (IRC §2056(b)(7)(B)(ii)):

- The Surviving Spouse has rights to the QTIP trust corpus that are equivalent to the interests in a trust that the "principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust." Treas Reg §§20.2056(b)-5(f)(1), 20.2056(b)-7(d)(2).
- No one, not even the Surviving Spouse, has a power of appointment that is exercisable in favor of any person other than the Surviving Spouse during the Surviving Spouse's lifetime.

Under Treas Reg §1.643(b)-1, a qualifying income interest may include the right to a unitrust amount in the range of 3-5 percent if such an interest satisfies the definition of "income" provided by state law (as provided by Prob C §§16328, 16336.4-16336.7). See chap 24A. While many QTIP trust forms provide that the trustee is required to distribute income at least annually, it is sufficient that the Surviving Spouse be permitted to withdraw trust income at least annually. Treas Reg §20.2056(b)-5(f)(8). See Rev Rul 2000-2, 2000-1 Cum Bull 305.

PRACTICE TIP: Using a "right to withdraw provision" as opposed to a "mandatory distribution provision" can be useful when the Surviving Spouse is incapacitated, a time when it may be appropriate to allow the trustee to distribute property that may be necessary for the support, maintenance, and health of the Surviving Spouse. See §17.34. If a mandatory income distribution provision is used, a conservator may be necessary to receive and invest income. Conservatorships can be costly and embarrassing and should not be used solely for purposes of managing assets when there is already a trustee in place who is managing the Surviving Spouse's assets. The trust document should also give the spouse the power to require the trustee to convert unproductive assets into productive assets. In IRS Letter Ruling 200339003, the Service ruled that this power qualified closely held corporation stock for the marital deduction, even though the stock had never paid dividends. For a sample form of provision, see Drafting California Revocable Trusts §13.14 (4th ed Cal CEB 2003).

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§17.25 a. Termination on Remarriage

A life income interest that is terminable on the Surviving Spouse's remarriage is not a qualified income interest for life. *Roels v U.S.* (ED Wis 1996) 928 F Supp 812.

NOTE: In *Guidotti v Lockyer* (2001) 90 CA4th 1403, 109 CR2d 674, the court held that a trust provision terminating the Surviving Spouse's otherwise qualifying income interest in the event of her remarriage or cohabitation was void as an illegal restraint on marriage under CC §710. Whether the holding would be enough to validate the trust as a QTIP trust is questionable. The answer may turn on whether the decision would be determined to be what the California Supreme Court would decide and whether under California law the offending provision was void at the moment of the Deceased Spouse's death or later. See *Commissioner v Estate of Bosch* (1967) 387 US 456, 18 L Ed 2d 886, 87 S Ct 1776.

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§17.26 b. Postdeath Reformation

While the ability to make postdeath QTIP elections allows the Deceased Spouse flexibility (see §17.27), if the flexibility is to be retained, the QTIP trust must be properly drafted as of the Deceased Spouse's date of death. See *Estate of Rapp v Commissioner* (9th Cir 1998) 140 F3d 1211, in which the court disallowed QTIP trust status for a trust that failed at the Deceased Spouse's date of death because of the absence of a qualifying income interest, notwithstanding postdeath reformation to include a qualified income interest. See also *Estate of Charles N. Aronson,* TC Memo 2003-189, in which the court disallowed QTIP trust status for a testamentary trust because the will did not reflect a desire to qualify for marital deduction and the testator had a history of declaring that he would rather pay tax than give up control of his estate.

WARNING: While Prob C §21522 may reform and validate a poorly drafted QTIP, it does not do so in all cases and should not be relied on except as a last resort. See also Prob C §21525, which limits any survival requirement in a marital deduction gift to the allowable 6-month period discussed in §17.14. In *Estate of Heim v Commissioner* (9th Cir 1990) 914 F2d 1322, the court held that a devise to the spouse failed to qualify for the marital deduction because the will required the spouse to survive until distribution. In *Estate of Ralph H. Davis,* TC Memo 2003-55, the court held that a discretionary income interest did not qualify for the QTIP election even though the trustee's discretion was not limited by an ascertainable standard. In each case, the court declined to apply the relevant statute because there was no evidence that the testator or settlor intended the transfer to qualify for the estate tax marital tax deduction. But see *Sowder v U.S.* (ED Wash 2005) 407 F Supp 2d 1230, aff'd (9th Cir 2007) 2007-2 USTC ¶60,550, 100 AFTR2d 6379 (Washington state statute preserved estate tax marital deduction even though decedent's will provided for alternate disposition of marital gift if spouse failed to survive distribution). The problem may be worse in California because Prob C §21525 does not contain the Washington statute's express authorization to use extrinsic evidence to prove the required intent without first proving ambiguity.

Disclaimers may save an otherwise invalid QTIP trust that provides rights inconsistent with IRC §2056(b)(7). See Treas Reg §20.2056(d)-2(b). For example, trusts that give annual distributions of income to the Surviving Spouse and another person or that allow discretionary distributions in favor of children may be valid if the offending rights are removed by a disclaimer valid under IRC §2518. However, one can never be certain that the power holder will disclaim or be permitted to disclaim the offending power or right.

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§17.27 2. Making QTIP Election

Unlike the requirements for other qualifying trusts, to qualify for QTIP trust treatment, the executor must make a QTIP election when filing the Deceased Spouse's estate tax return. IRC §2056(b)(7)(B)(v). Elections for formula marital deduction plans should normally refer to the formula and indicate that the dollar amount shown for the election is based on reported values but is subject to change. Otherwise, the election normally will not apply to after-discovered property and property with valuation changes. See IRS Letter Ruling 200430002. The use of formula QTIP elections is expressly authorized by Treas Reg §20.2056(b)-7(h), Examples 7, 8. The elective feature of the QTIP trust gives it a considerable advantage over the other qualifying trusts in connection with postmortem planning. See §17.30.

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§17.28 3. Advantages of QTIP Trust

Internal Revenue Code §2056(b)(7) has spawned the use of the QTIP trust, which, together with the Credit Shelter Trust, is the foundation of many, if not most, marital estate plans. The appeal of the QTIP trust is threefold, as discussed in §§17.29-17.33.

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§17.29 a. Control of Disposition by Deceased Spouse

The QTIP trust allows the Deceased Spouse to control the disposition of the QTIP trust remainder. Even though the Surviving Spouse does not control the disposition of the remainder, the trust property either will be included in the Surviving Spouse's estate under IRC §2044 or will be treated as a gift by the Surviving Spouse under IRC §2519 if the income interest is disposed of during the Surviving Spouse's lifetime. Note that the inclusion of QTIP property in the survivor's estate does not result in a loss of the otherwise applicable valuation discount on the survivor's and decedent's shares of community property, because the survivor's property is not combined with QTIP property for valuation purposes. *Estate of Bonner v U.S.* (5th Cir 1996) 84 F3d 196; *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Harriet R. Mellinger* (1999) 112 TC 26, acq 1999-35 Int Rev Bull 314 (acquiescence as corrected in Announcement 99-116, 1999-2 Cum Bull 763)

QTIP property may not be included in the survivor's estate if it is later determined that the trust did not qualify for the marital deduction, but in that case the government may equitably recoup a portion of the estate tax not paid by the deceased spouse's estate. See *Estate of Vitt v U.S.* (8th Cir 1983) 706 F2d 871. See also *Estate of Buder v U.S.* (ED Mo 2005) 372 F Supp 2d 1145, aff'd (8th Cir 2006) 436 F3d 936 (recoupment limited to portion of tax that would have been borne by the same trust beneficiaries if the tax had been paid on the first death when the beneficiaries of both estates were not the same). However, courts may be skeptical of any claim that a QTIP trust should not be included in the survivor's estate because the trust did not qualify for the marital deduction. See, *e.g.*, *Warner v U.S.* (CD Cal 2006) 98 AFTR2d 6136 (although the trust did not expressly state that the income was to be paid at least annually, the intent that income should be paid at least annually could be inferred).

Under IRC §2207A(b), the Surviving Spouse has the right to recover from the deemed donee any increase in the Surviving Spouse's gift taxes for the year that results from the application of IRC §2519. The effect of this rule is to treat the Surviving Spouse's gift in the same manner as the "net gift" that results when a contract with the donor causes the donee to become liable for the gift tax on a transfer. The amount of the deemed transfer resulting from application of IRC §2519 is calculated by reducing the value of the gift by the amount the Surviving Spouse is entitled to recover under IRC §2207A(b). Treas Reg §25.2519-1(c)(4). The Surviving Spouse makes an additional gift if the Surviving Spouse fails to exercise the §2207A(b) right of recovery. Any delay in the exercise of this right is treated for gift tax purposes as an interest-free loan. Treas Reg §25.2207A-1(b). The IRS has consistently ruled that the division of a QTIP trust and the assignment or renunciation of the income interest in one of the shares will not cause a deemed gift of any interests in the other share. See IRS Letter Rulings 200530014, 200438028, 200324023, 200250033, 200137022, 200044034.

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§17.30 b. Postmortem Planning With QTIP Trust

Assuming the executor makes a timely application for an automatic extension of time to file the estate tax return, an executor has 15 months after the Deceased Spouse's date of death to file an estate tax return and make a QTIP election. IRC §§6075, 6081; Treas Reg §§20.6075-1, 20.6081-1. If the Deceased Spouse died before 2006 and the Surviving Spouse died within the 15-month period or if, at the end of 15 months, the Surviving Spouse was terminally ill, the executor might have elected to equalize both spouses' taxable estates and pay tax on the Deceased Spouse's taxable estate by making a partial QTIP election or no election at all because equalization then would have resulted in lower overall taxes than would a Zero-Tax Formula arrangement. Generally, equalization results in lower overall taxes when both estates are subject to the same rate tables and applicable exclusion amounts. However, equalization results in the same or higher overall taxes for a first death in 2006-2009 when the estate tax is a flat-rate tax. Current uses of partial QTIP elections in postmortem planning are discussed in §§17.31-17.32.

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§17.31 (1) Using Partial QTIP Election With IRC §2013 Prior Transfer Property (PTP) Credit

Note the advantage that can accrue when taxes are paid with respect to the Deceased Spouse's estate by the use of the prior transfer property (PTP) credit under IRC §2013 if a partial QTIP election or no election is made. The §2013 credit is available for interests in property such as life income interests that pass from the Deceased Spouse to the Surviving Spouse (Treas Reg §20.2013-5), provided the interest can be valued (Treas Reg §20.2013-4(a)). The IRC §2013 credit is sometimes available under a QTIP trust estate plan if the Surviving Spouse dies soon after the Deceased Spouse but was not so sick on the date of the first death that Treas Reg §20.7520-3(b)(3)(i) applied. Under that regulation, the valuation tables cannot be used to determine life expectancy if, as of the Deceased Spouse's death, there is at least a 50-percent probability that the Surviving Spouse will die within 1 year. See *Estate of Judith U. Harrison* (2000) 115 TC 161. In this situation, the personal representative of the Deceased Spouse may decline to make the QTIP election. This results in the Deceased Spouse having a taxable estate. For PTP credit purposes, the Surviving Spouse is considered to receive a transfer of the income interest. Because the PTP rules do not provide for tracing the transferred property, it will be irrelevant that the survivor's early death results in the survivor receiving little if any income from the trust. If, as a result of a partial QTIP election, the Surviving Spouse's interest in the nonexempt portion of the QTIP trust is limited to discretionary distributions, however, the IRC §2013 credit would appear to be unavailable because of the inability to value the Surviving Spouse's contingent interest in the QTIP trust as of the Surviving Spouse's date of death.

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§17.32 (2) Using QTIP Election to Obtain Step-Up in Basis

In some cases, it may be desirable to provide the Surviving Spouse with a qualifying income interest in a credit shelter trust and to allow the executor to make a partial QTIP election to increase the amount of property in the Surviving Spouse's estate under IRC §2044 that will receive a step-up in basis under IRC §1014, if death is likely before 2010 and the Surviving Spouse is unlikely to have a taxable estate in any event. This should be possible even though relief is available in other cases for inadvertent QTIP elections that did not reduce the estate tax liability of the Deceased Spouse under Rev Proc 2001-38, 2001-1 Cum Bull 1335. See IRS Letter Ruling 200729028. The revenue procedure also can be circumvented for estates that are large enough to owe tax by creating a QTIP trust that is slightly larger than the amount needed to reduce the estate tax to zero, because the IRS cannot provide relief if at least a partial election is necessary to reduce the estate tax liability to zero. See IRS Letter Ruling 200422050. This is not an option for estates having a value less than the IRC §2010 applicable exclusion amount. After 2009, however, QTIP property will not be eligible for application of the Surviving Spouse's basis increase under IRC §1022 unless the property can be distributed to the Surviving Spouse. See §17.34.

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§17.33 c. Reverse QTIP Election

Under IRC §2652(a)(3), the QTIP trust is the only marital deduction qualifying trust for which an election can be made that treats the Deceased Spouse as the transferor for purposes of the generation-skipping transfer (GST) tax even after the trust is included in the estate of the Surviving Spouse. Without such an election, it may be impossible to effectively allocate a portion of the Deceased Spouse's GST exemption if the available exemption exceeds the value of property that could pass to grandchildren and other skip persons before being included in the taxable estate of the spouse, a child, or another person who is not a skip person.

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§17.34 4. Discretionary Trustee Powers With QTIP Trusts

Discretionary trustee powers are often used with QTIP trusts. Discretionary trustee powers give the trustee authority to distribute property to or for the benefit of the Surviving Spouse for the Surviving Spouse's health, education, support, or maintenance. In addition to this "ascertainable standard" provision (see Reg §20.2041-1(c)(2)), consideration should be given to allowing the trustee to distribute property to the Surviving Spouse if the Surviving Spouse owns insufficient property to take advantage of the basis increase provision in IRC §1022. The discretionary authority could be made conditional on the applicability of IRC §1022 and should be limited to the minimum amount of QTIP trust corpus necessary for the full utilization of the basis increase amount provided for under IRC §1022 with respect to the Surviving Spouse's estate after taking account of any property owned by the Surviving Spouse that is eligible for the basis increase. Instead of timing the power to the effective date of IRC §1022 (applicable to decedent's dying after December 31, 2009), the power should be timed in a manner that would allow the trustee sufficient time in advance of the effective date to distribute property to a Surviving Spouse who is gravely ill around the time of the effective date. If the Deceased Spouse is reluctant to lose control over the QTIP remainder, the discretionary power can be limited to situations in which the Surviving Spouse is permanently incapacitated and in which the Surviving Spouse's estate plan is consonant with the Deceased Spouse's estate plan.

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§17.35 C. Life Insurance and Annuity/GPA Trust

An arrangement meeting the requirements of IRC §2056(b)(6) may provide for installment payments to the Surviving Spouse and still qualify for the marital deduction. The requirements of a §2056(b)(6) arrangement are as follows:

- Proceeds of a life insurance, endowment, or annuity contract must pass from the Deceased Spouse to the Surviving Spouse;
- Under the contract with the insurer, the proceeds or interest on the proceeds must be payable annually, commencing not later than 13 months after the Deceased Spouse's death;
- Any amount that can be paid with respect to the Surviving Spouse's share of proceeds must be payable to only the Surviving Spouse during the Surviving Spouse's lifetime;
- The Surviving Spouse must have a general power to appoint all amounts payable under the contract; and
- No one else can have a power to appoint any amount payable under the contract to anyone other than the Surviving Spouse.

The nonprobate transfers provided in IRC §2056(b)(6) can and ordinarily should be coordinated with the clients' dispositive plan by naming the trustee of the client's revocable or testamentary trust as beneficiary. While a §2056(b)(6) arrangement may be advantageous on occasion (*e.g.,* the contract may provide for an above-market interest rate or greater asset protection than does a QTIP trust), it has been supplanted by the QTIP trust for the reasons discussed in §§17.28-17.33.

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§17.36 D. Qualified Charitable Remainder Trust

Under IRC §2056(b)(8), a bequest by the Deceased Spouse to a charitable remainder trust (CRT) qualifies for the marital deduction if the Surviving Spouse is the only noncharitable beneficiary other than an employee stock ownership plan (ESOP). The CRT may be a charitable remainder annuity trust or charitable remainder unitrust described in IRC §664. The results achieved by IRC §2056(b)(8) can also be achieved, however, by using a QTIP trust that provides for a charitable remainder beneficiary.

In assessing which trust to use, CRT or QTIP, the estate planner should note that the CRT is subject to regulations that are designed to ensure that assets will pass to charity but that make the trust relatively inflexible, more difficult to administer, and more difficult for the client to understand. Unlike a QTIP trust, the trustee of a CRT cannot have a discretionary power to distribute trust corpus to the Surviving Spouse. See §17.34.

The CRT does have the advantage that the tax on capital gains generated by a CRT is deferred and paid only to the extent the gains flow to the Surviving Spouse under the tier system of IRC §664(b). See §13.151. As a result, the CRT may make sense for lifetime gifts to a Surviving Spouse of highly appreciated property. See IRC §2523(g). For further discussion, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

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§17.37 E. Estate Trust

The estate trust is a trust that, unlike the other qualifying trusts, permits accumulation of trust income until the Surviving Spouse's death, at which time any trust assets are distributable to the Surviving Spouse's estate. Treas Reg §20.2056(c)-2(b)(1)(iii). As a result, a gift to an estate trust is not a nondeductible terminable interest. See §17.13.

When trusts and estates had income tax brackets comparable to individuals, there may have been an income tax incentive to using an estate trust, but with the present compressed trust income tax brackets under IRC §1(e), that incentive no longer exists. Unlike the QTIP trust, the Deceased Spouse does not control the disposition of the estate trust remainder that is disposed of in accordance with the Surviving Spouse's estate plan. While the estate trust might be considered when the Surviving Spouse is incapacitated and does not need income, there is no reason why a QTIP trust that gives the Surviving Spouse a right of withdrawal cannot be used instead.

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§17.38 III. ELEMENTS OF ZERO-TAX FORMULA

The purpose of a Zero-Tax Formula is to determine either (1) the minimum amount or fraction of the Deceased Spouse's estate that will qualify for the marital deduction and result in no estate taxes on the Deceased Spouse's estate, or (2) the maximum amount or fraction of the Deceased Spouse's estate that is transmissible free of estate tax without regard to any marital deduction. Whichever formula may be used, the key to drafting any formula is an understanding of what credits and deductions permit the tax-free transmission of wealth and are appropriate for use in the formula and what expenses, deductions, or distributions reduce the amount or fraction that may be transmitted estate tax-free. Since EGTRRA-2001, the importance of a properly drafted Zero-Tax Formula has increased because of the potential for total estate tax avoidance (as opposed to pre-EGTRRA-2001 estate tax deferral), on account of increases in the applicable exclusion amount and estate tax repeal.

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§17.39 A. Unified Credit

Not counting the marital deduction, the applicable exclusion amount provided under IRC §2010 is the most significant factor for estate-tax-free transmission of wealth. EGTRRA-2001 increases the applicable exclusion amount from $675,000 in 2001 to $1 million in 2002-2003; $1.5 million in 2004-2005; $2 million in 2006-2008; and $3.5 million in 2009. In many cases, EGTRRA-2001's increased applicable exclusion amounts will result in the nonmarital deduction qualifying share being the only share of the Marital Estate transmissible by the Deceased Spouse under a Zero-Tax Formula.

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§17.40 B. State Death Tax Credit

Internal Revenue Code §2011 allows a maximum credit for state death taxes determined as a percentage of the decedent's adjusted taxable estate. The credit is reduced to the extent that the death taxes actually paid are less than the maximum credit. In addition, if state death taxes paid in connection with a charitable bequest are deducted under IRC §2053(d), the maximum state death tax credit is further limited to the lowest of three different computations. Treas Reg §20.2011-2.

NOTE: Under EGTRRA-2001, the allowable IRC §2011 credit is reduced by 25 percent per year in 2002-2004 and is repealed in 2005. Under IRC §2058, a deduction is allowed for state death taxes paid in 2005-2009. The current California estate tax is a "pickup" tax that will result in zero tax paid after the credit is repealed. Rev & T C §13302. The Zero-Tax Formula should take into account the deduction under IRC §2058 as it would any deduction that reduces the taxable estate.

Zero-Tax Formulas normally use the state death credit to carve out the tax-exempt portion of the Deceased Spouse's estate. However, the use of the IRC §2011 credit should be limited to the amount, if any, that results in zero federal and state estate taxes; a formula that is designed to reduce only federal estate taxes to zero, after consideration of the IRC §2011 credit, may result in the imposition of a state estate tax.

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§17.41 C. IRC §2013 Prior Transfer Property (PTP) Credit

A prior transfer property (PTP) credit is allowed for property owned by a decedent (transferee) on which an estate tax was imposed because the property was part of the estate of a decedent (transferor) who died within the period beginning 10 years before and ending 2 years after the transferee's death. The credit diminishes in relation to the length of time between the deaths of the transferee and transferor. IRC §2013(a). The credit is subject to two limitations: (1) the credit to the estate tax on the transferor's estate attributable to the property transferred is limited (IRC §2013(b)), and (2) the credit to the estate tax on the transferee's estate attributable to the property transferred is limited (IRC §2013(c)).

While the PTP credit may be used effectively in postmortem planning when spouses die within 2 years of each other (see §17.31), the PTP credit should not be used within a Zero-Tax Formula. One problem is that under the second limitation, the tax attributable to previously taxed property in the transferee's estate is computed without regard to the PTP credit, which arguably may result in zero tax (and a zero credit) being attributed to the previously taxed property in the transferee's estate. However, this problem may be addressed by a formula that is made inclusive of the PTP credit. See IRS Letter Ruling 8714001. Another, more serious, problem is that if the Deceased Spouse dies more than 2 years after the transferor, the full credit will not be available, which will result in the imposition of estate taxes with respect to the property not covered by the credit. Accordingly, the Zero-Tax Formula should clearly preclude the use of the PTP credit in cases in which the transferor predeceased the Deceased Spouse by more than 2 years. In addition, the better practice is to prohibit use of the PTP credit with respect to property transferred to the Deceased Spouse by a transferor who dies after the Deceased Spouse. See Drafting California Revocable Trusts §11.17 (4th ed Cal CEB 2003).

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§17.42 D. Administration Expenses and Nondeductible Debts

Transmission expenses that are taken as an income tax deduction and debts of the Deceased Spouse that are not deductible under IRC §2053 are no different from gifts or bequests that are not deductible. They reduce the amount of assets that can be sheltered by the unified credit. Transmission expenses payable out of the marital share and taken as an estate tax deduction reduce the marital deduction and have no effect on the credit shelter share. As discussed in §17.17, management expenses attributable to the marital share can be paid out of the marital share income and will not reduce the amount of the marital deduction.

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§17.43 E. Estate Tax Payments

The marital deduction must be reduced by the amount of estate or inheritance taxes payable out of the marital deduction property. IRC §2056(b)(4)(A). Except foreign death taxes on charitable transfers deductible under IRC §2053(d), and state death taxes deductible under IRC §2058, such death taxes are not deductible. Accordingly, a zero-tax estate plan should provide that such death taxes must be paid out of the credit shelter share; otherwise the taxes may reduce the marital deduction, which will increase the estate tax and further erode the marital deduction.

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§17.44 F. Other Credits and Deductions

Under IRC §2001(b)(2), the gift tax that would have been payable on lifetime gifts that are includable in the gross estate (*e.g.,* under IRC §§2035-2038) is subtracted from the tentative tax determined under IRC §2001(b)(1) and as such operates like a credit. Payments that are deductible on the estate tax return lower the value of the gross estate and the amount of marital deduction necessary to reduce estate taxes to zero. The deductions normally considered as part of a Zero-Tax Formula are the amounts paid for debts and administration expenses (IRC §2053), losses (IRC §2054), and charitable gifts (IRC §2055). Another deduction that ought to be considered is the reduction under Treas Reg §25.2701-5(a)(3) in the event the Deceased Spouse was an "initial transferor" who either (1) transferred an IRC §2701 interest but failed to exhaust the gift tax modification allowed under Treas Reg §25.2701-5(a)(2) before death, or (2) retained the IRC §2701 interest, in which case the full Treas Reg §25.2701-5(a)(2) reduction may be used to reduce the Deceased Spouse's taxable estate.

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§17.45 IV. PECUNIARY AND FRACTIONAL SHARE FORMULAS

There are two basic types of Zero-Tax Formulas: pecuniary and fractional share. In addition, there are three basic methods for funding pecuniary formulas and two methods for funding fractional share formulas. Each Zero-Tax Formula should be coordinated with proper funding methods to ensure that the perceived benefits of the formula are not lost. For further discussion of marital deduction formulas, see Drafting California Revocable Trusts, chap 11 (4th ed Cal CEB 2003).

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§17.46 A. Pecuniary Formulas

The pecuniary formula is usually one of two types: pecuniary marital/residuary credit shelter or pecuniary credit shelter/residuary marital. See §§17.47-17.48. But see Bilter, *Drafting Marital Deduction Formula Clauses: Heads I Win, Tails I Don't Lose*, Estate Planning 2001, chap 3 (Cal CEB 2001), which proposes disposing of the Deceased Spouse's entire estate through pecuniary formula bequests.

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§17.47 1. Pecuniary Marital/Residuary Credit Shelter

Under a pecuniary marital/residuary credit shelter formula, the first part of the formula in the Deceased Spouse's will or trust determines a pecuniary gift to the Surviving Spouse equal to the amount of the assets transmissible to the Surviving Spouse under the formula provision, which, when added to all other marital deduction gifts made under the will or outside of the will, is the smallest amount necessary to reduce estate taxes on the Deceased Spouse's estate to zero after taking into account all credits and estate tax deductions available to the Deceased Spouse's estate. A credit is not available to the extent it is needed to shelter a bequest that does not qualify for the marital deduction or a payment that does not entitle the estate to an estate tax deduction. The second part of the formula is a residuary gift that allocates the Deceased Spouse's assets remaining after all other gifts have been made under the will and after the payment of any expenses.

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§17.48 2. Pecuniary Credit Shelter/Residuary Marital

Under a pecuniary credit shelter/residuary marital deduction formula, the first part of the formula in the Deceased Spouse's will or trust determines a pecuniary gift to the credit shelter share equal to the amount transmissible under the formula, which when added to all other amounts passing by the will or outside the will that do not qualify for the marital deduction is the largest amount transmissible tax-free, taking into account all credits and estate tax deductions available to the Deceased Spouse's estate. The residuary gift constitutes the marital deduction share.

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§17.49 B. Fractional Share Formulas

There are two basic fractional share formulas, corresponding to each of the two pecuniary formulas. See §§17.46-17.48. Fractional share formulas begin with the pecuniary amount determined under a pecuniary formula, but the amount is then used as the numerator of a fraction whose denominator is the residuary estate as determined for accounting purposes under the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) as modified by the trust instrument. The fraction is then used to divide assets between the marital deduction share and the credit shelter share.

WARNING: A common mistake made in drafting fractional share formulas is to use the federal estate tax values to determine the denominator, which can result in overfunding or underfunding the marital trust. See Soled, Wolf & Arnell, *Funding Marital Trusts*: *Mistakes and Their Consequences*, 31 Real Prop, Prob & Trust J 89, 100 (1996).

Fractional share formulas may be further subdivided based on whether the residuary estate is determined before payment of death taxes ("pre-tax residuary fractional share formula") or after death taxes ("true residuary fractional share formula"). There are three types of funding methods for use with pecuniary formulas and two for the fractional share formulas. See §17.50.

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Source: Estate Planning/California Estate Planning/17 Marital Deduction Planning/§17.50 C. Funding of Marital and Credit Shelter Shares

§17.50 C. Funding of Marital and Credit Shelter Shares

Between the Deceased Spouse's date of death and the funding date or dates, an asset's value may appreciate, depreciate, or remain static. If a trustee were permitted to use date of death values for funding the marital deduction share under a pecuniary formula without regard to date of distribution values, the tax-sensitive trustee would always use assets that have depreciated in value to fund the marital deduction share, resulting in an underfunding of the marital deduction share and a lower estate tax on the Surviving Spouse's death. Seeing the potential for mischief, the Service promulgated Rev Proc 64-19, 1964-1 Cum Bull 682, which provides that if a trust allows a pecuniary marital deduction gift to be funded with noncash assets based on their federal estate tax values, the trustee must use one of two methods to allocate assets between the marital deduction share and the credit shelter share:

- The "true worth" method, which requires that the pecuniary bequest be funded with assets having aggregate date of distribution values equal to the amount of the pecuniary bequest; or
- The "fairly representative" method, which funds a pecuniary bequest with assets "fairly representative of appreciation or depreciation in the value of all property" available for distribution.

Consistent with Rev Proc 64-19, Treas Reg §26.2642-2(b)(2) requires that if a pecuniary gift for which an applicable fraction is to be determined for generation-skipping transfer (GST) tax purposes may be satisfied with property other than cash, then in order to use the pecuniary amount for the denominator of the applicable fraction, the gift must be satisfied on the basis of date of distribution values or fairly representative values. In the absence of any contrary provision in the trust, Prob C §21118 provides that if a trustee may satisfy a pecuniary gift partly or entirely with property other than cash, the trustee must use date of distribution values for such property in determining the extent to which the pecuniary gift has been funded. If the trust permits the trustee to value property at a date other than the date of distribution, in the absence of a contrary provision in the trust, Prob C §21118 provides that the property selected by the trustee to satisfy the pecuniary gift must fairly reflect net appreciation and depreciation between the valuation date and the date of distribution in all assets from which the distribution could have been made.

A pecuniary marital/residuary credit shelter may also be funded by the "minimum worth" funding method, which funds a pecuniary bequest with assets valued at the lower of date of distribution value or income tax basis, which is equal to estate tax value under IRC §1014(a) if the asset is included in the Deceased Spouse's estate.

WARNING: A minimum worth formula should not be used with a pecuniary credit shelter/residuary marital deduction formula because of the risk that the marital deduction residuary share will be underfunded, resulting in a disallowance of a portion of the marital deduction.

Fractional share formula bequests are always funded on the basis of date of distribution values. The two types of funding provisions for a fractional share formula bequest are the prorata funding provision, which applies the fraction to each and every asset; and the nonprorata funding provision, which allows the executor or trustee to fund each fractional share with different assets determined by the executor or trustee. In the absence of a contrary provision, the trustee has the power to make distributions pro rata or non-pro rata. Prob C §16246. For discussion of prorata funding, see §17.54.

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§17.51 D. Considerations in Choosing Formula

Among the factors to consider in choosing a Zero-Tax Formula are: (1) shifting appreciation and income during administration from the marital share to the credit shelter share; (2) the income tax aspects incident to funding a pecuniary bequest; and (3) ease and costs of administration.

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§17.52 1. Shifting Appreciation and Depreciation Using Pecuniary Formula With True Worth Funding

The advantage of using a pecuniary marital/residuary credit shelter formula with true worth funding is that any appreciation between the date of the Deceased Spouse's death and the date of distribution passes to the credit shelter share. This advantage can only be realized using a true worth funding provision, since the fairly representative and minimum worth funding methods will shift some of the appreciation to the pecuniary bequest. A minimum worth funding provision could shift all of the appreciation to the credit shelter share only in the unlikely case that there are enough assets with values unchanged since date of death to fully fund the pecuniary bequest. Of course, a disadvantage of using a pecuniary marital/residuary credit shelter formula with true worth funding is that any depreciation of assets between the Deceased Spouse's date of death and funding is absorbed by the credit shelter share.

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§17.53 2. Income Tax Consequences of Pecuniary Formulas

In using a pecuniary formula and date of distribution value funding, one must be aware of the income tax consequences. Satisfaction of a pecuniary bequest with appreciated property results in recognition of capital gain. See Treas Reg §1.1014-4(a)(3). In addition, satisfaction of a pecuniary bequest with an item of IRD will result in acceleration of income. See §17.72.

The capital gains problem may be minimized if the trusts are funded quickly, but such quick funding may diminish the appreciation-shifting advantage of a pecuniary marital deduction formula. If a pecuniary formula is desired and capital gains are a concern, then the choice of which pecuniary formula to use may depend on the relative sizes of the marital and credit shelter shares. In large estates in which the marital deduction share will be considerably larger than the credit shelter share, use of a pecuniary credit shelter/residuary marital deduction formula will decrease the capital gains problem, but these larger estates are also the ones that would most benefit from the use of a pecuniary marital formula in terms of transfer tax consequences.

Many planners believe pecuniary formula date of distribution value funding arrangements should be avoided in cases in which it is unlikely that the estate of the Surviving Spouse will be subject to estate tax. It such cases, the risk of gain recognition on the first death cannot be justified on the basis of possible later transfer tax savings. Administrative problems associated with fractional share funding can be minimized by prompt funding.

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§17.54 3. Using Fractional Share Formula With Prorata Funding

The advantage of using a fractional share formula with a prorata funding provision is that the trustee need not worry about whether the marital trust is overfunded or underfunded or whether the trustee has violated the duty of impartiality. Prob C §16003. Fractional share formulas can be difficult to administer, however, because the fraction constantly changes on account of distributions and tax payments. In an estate with numerous assets, a prorata funding provision can be especially difficult to administer because of the need to transfer fractional interests in many assets. This disadvantage can be mitigated by contributing assets to one or more partnerships or other entities and distributing partnership or entity interests to the trusts. See §17.66.

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§17.55 4. Allocation of Income Earned During Administration

In choosing a formula, the estate planner should consider how income earned during administration is allocated between residuary and pre-residuary gifts. Under Prob C §16340, in the absence of any provision of the will or trust allocating income to a general pecuniary gift or specifically devising property in satisfaction of a pecuniary amount, the only income allocable to such a gift would be interest payable under Prob C §12003 on a pecuniary gift that is not distributed within 1 year of the testator's death. Accordingly, a pecuniary marital/residuary credit shelter formula ordinarily will result in an allocation of income during the period of administration to the credit shelter gift. Conversely, a pecuniary credit shelter/residuary marital formula will shift income earned during administration to the marital deduction gift.

Under a fractional share formula, both the marital deduction share and credit shelter share are residuary gifts. Accordingly, they would share residuary income earned during administration pro rata. See Prob C §16341.

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V. ESTATE PLANNING PRINCIPLES

§17.56 A. Tax-Efficient Versus Tax-Driven Estate Planning

Since the marital deduction is wholly a creature of the Internal Revenue Code, it is especially important to understand its context in a properly drafted estate plan. A fundamental principle of estate planning is that an estate plan should be tax efficient but should not be tax driven. A tax-efficient estate plan allows the client to transfer assets in desired amounts to his or her intended beneficiaries using the methods (*e.g.,* outright or in trust) preferred by the client with the least possible tax cost. In a tax-driven estate plan, tax savings become the primary focus at the expense of the client's nontax goals. A tax-driven estate plan can result in assets being transferred to the wrong beneficiary or in the wrong manner. The enactment of increasing applicable exclusion amounts by EGTRRA-2001 increases the possibility of thwarting a client's nontax goals with tax-driven marital deduction formulas.

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§17.57 B. The Married Couple's General Plan

In a perfect world (one without transfer taxes), the estate planner would focus solely on the amounts to be given to each of the married client's beneficiaries and the methods for transmission of the gifts (*e.g.,* outright or in trust). For purposes of discussion, the clients' nontax oriented plan is referred to as the General Plan.

The General Plan might include trusts, but there would be no "credit shelter" or "marital deduction" trust. After making gifts of tangible personalty and some pecuniary gifts, a typical General Plan for a married client would specify what percentages of the residuary estate to leave to the Surviving Spouse and children or would provide a gift in trust life income to the Surviving Spouse and a remainder to children. Because tax-efficient planning is important, the estate planner must deal with credit shelter and marital deduction trusts and other tax-created devices. However, these tax devices can and should work within the framework of the General Plan.

The idea of using a General Plan is an extension of the idea underlying the use of noncharitable unitrusts and annuity trusts: that the estate planner should work with the client to quantify the expected monetary needs of the client's intended beneficiary. Using a General Plan, the estate planner works with the client to quantify the amount or percentage of wealth that the client wishes to transmit to a particular beneficiary and adjusts the tax devices to fit within the General Plan.

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§17.58 C. Planning for the Unknown—The Flexibility Principle

Planning for the future always involves a degree of uncertainty, and the uncertainty has increased dramatically with the passage of EGTRRA-2001. In an estate tax world in which there is a decreasing tax, no tax, and then possibly increased, decreased, or no tax, the ability to adjust to events as they unfold is important. See §17.4.

More than ever, it is important that clients execute durable powers of attorney for assets. Durable powers of attorney will empower the client's agent to change trust provisions to make them tax efficient without changing the client's General Plan. See Prob C §4264. Parallel provisions must be included in the trust instrument. Prob C §15401(c). Giving the attorney-in-fact the power to change formulas or substitute outright gifts for gifts in trust may make a substantial difference in reducing the family's tax burden. Similarly, provisions enabling the trustee or executor to make permissible postdeath changes, *i.e.,* changes that do not affect eligibility for the marital deduction, may prove quite helpful.

In this regard, because it affords significant postmortem planning possibilities, a disposition of the marital share to a potential QTIP trust should be considered, even when an outright bequest might be desired. Unlike an outright bequest, an IRC §2056(b)(5) trust, or an estate trust, a QTIP disposition allows for a "wait-and-see" approach for the 15-month period after the Deceased Spouse's date of death, which may prove valuable in reforming a tax-inefficient plan. See §17.30.

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§17.59 VI. MARITAL DEDUCTION PLANNING FOR SMALL, MEDIUM, AND LARGE ESTATES

As a result of increasing IRC §2010 applicable exclusion amounts under EGTRRA-2001, an increasing number of clients will not need to be concerned about estate taxes. The credit shelter trust may be the dominant or only trust in traditional estate plans that allocate the Deceased Spouse's estate using a Zero-Tax Formula. These developments have different planning implications for small, medium, and large estates.

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§17.60 A. Small Estate: Marital Estate Less Than Applicable Exclusion Amount

When the Marital Estate is less than the Deceased Spouse's IRC §2010 estate tax applicable exclusion amount ($2 million in 2006-2008) and when, based on the married couple's ages and the nature of their assets, it is unlikely that the Marital Estate will ever be larger than the applicable exclusion amount, consideration should be given to outright gifts to the Surviving Spouse. Alternatively, if it is important for the Deceased Spouse to control the ultimate disposition of his or her share of the Marital Estate, a single trust may be useful that provides the Surviving Spouse with a unitrust amount or a right to income, plus rights to principal for specified purposes, and a general right to principal for health, maintenance, and support. Since estate tax is not a factor, the Surviving Spouse's rights will be limited only by the Deceased Spouse's determinations regarding the benefits to bestow on the Surviving Spouse and other beneficiaries.

For the small estate in which a possibility exists that a gift to the Surviving Spouse may result in the Surviving Spouse's taxable estate exceeding the applicable exclusion amount, a single QTIP trust should be considered. Such a trust gives the Surviving Spouse such additional rights as are consistent with a QTIP trust, but is also flexible so that if a partial QTIP election is made, the portion that is not a marital deduction trust will not be included in the Surviving Spouse's taxable estate. If structured as a residuary trust, there should be no capital gains tax if funded with appreciated property. If a single QTIP trust is used, administration fees may be lower, although this is questionable if a partial QTIP election is made, the effect of which is to create two separate shares.

In small estates it is still likely that the married couple will have one or more retirement accounts (*e.g.,* IRAs). If the retirement accounts are an insignificant part of the Marital Estate, making the Surviving Spouse the designated beneficiary may be the simplest and best thing to do. If the retirement accounts are a significant part of the Marital Estate and the spouses want to control the ultimate disposition of the benefits remaining on the Surviving Spouse's death, the plan benefits can be coordinated with a Zero-Tax Formula and specially drafted designated beneficiary provisions. For further discussion, see Complete Plans for Small and Mid-Size Estates (Cal CEB 2006).

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§17.61 B. Medium Estate: Marital Estate Greater Than Deceased Spouse's Applicable Exclusion Amount and Less Than Both Spouses' Applicable Exclusion Amounts

For the couple with a Marital Estate greater than the current IRC §2010 estate tax applicable exclusion amount ($2 million in 2006-2008) but less than the likely combined future applicable exclusion amounts for both spouses, use of a Zero-Tax Formula plan creating a credit shelter trust and one or possibly two marital deduction trusts may be appropriate if consistent with the spouses' General Plan. This is likely to occur when the spouses want the marital and credit shelter trusts to have similar provisions for the Surviving Spouse, in which case it makes little difference that the credit shelter trust will vary with an increasing applicable exemption amount. However, if the provisions of the credit shelter trust would differ from the marital trust and would provide greater benefits for children and grandchildren, the standard Zero-Tax Formula could produce disastrous results for the Surviving Spouse who was counting on a larger marital deduction share with greater economic rights.

EXAMPLE: Herb and Wilma are a couple in their early 60s with a marital estate consisting of $5 million of community property. They have two children in their early 20s who have finished college and are starting to work. In broad terms, Herb and Wilma have each expressed a desire that in the event either of them dies, they want the other to be taken care of, and they certainly do not want to pay any death taxes if it can be helped. They want to be able to help their children as they have in the past, especially as the children marry and have their own children.

Before 2002, a typical pre-EGTRRA-2001 estate plan with a Zero-Tax Formula would have produced roughly a $675,000 credit shelter trust, a $1,825,000 QTIP trust, and a $2,500,000 survivor's trust. Under the pre-EGTRRA-2001 plan, while the Surviving Spouse would have had access to all three trusts if necessary, the Surviving Spouse's rights in the credit shelter trust would have been less than in the QTIP and survivor's trust, and the children might have had rights to discretionary distributions from the credit shelter trust. As a result of EGTRRA-2001, however, the credit shelter trust will vary from $2 million to $2.5 million in 2006-2009. While Herb and Wilma were willing to share a $675,000 credit shelter trust with their children, they are not willing to share a $2 million credit shelter trust or, even worse, a $2.5 million credit shelter trust. These results can be mitigated through the use of a spousal credit shelter trust. See §17.62.

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§17.62 1. Estate Planning Using Spousal Credit Shelter Trust

In the example in §17.61, Herb and Wilma can have a pre-EGTRRA-2001 type plan that works in a post-EGTRRA-2001 world. Under such a plan, the Deceased Spouse's share of the Marital Estate would be allocated as follows: Instead of one credit shelter trust, there are two—the children's credit shelter trust and the spousal credit shelter trust.

The survivor's trust and children's credit shelter trust will work much the same as before, except that the children's credit shelter trust is designed to be capped at an amount that the spouses are comfortable with*, e.g.,* the greater of $600,000 or 20 percent of the Deceased Spouse's share of the Marital Estate. Assuming no appreciation in the Marital Estate, the QTIP trust in the example will be either $500,000 or zero depending on the Deceased Spouse's year of death. (Alternatively, Herb and Wilma may decide to risk making an outright gift of the marital deduction amount rather than incurring additional complication and administration costs in connection with the QTIP trust.) The balance of the Deceased Spouse's estate, either $1,400,000 or $1,900,000, will fund the spousal credit shelter trust. While the children's credit shelter trust may provide discretionary gifts to the children, the spousal credit shelter gift will be devoted to the Surviving Spouse's sole benefit.

A pecuniary marital/residuary credit shelter formula could be used to carve out the marital share from the credit shelter share, and a fractional share formula might best be used to allocate assets between the spousal credit shelter trust and the children's credit shelter trust. Allocation of GST tax exemption is discussed in §17.63. Carryover basis considerations are discussed in §17.64.

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§17.63 2. Allocation of GST Exemption

In the arrangement described in §17.62, the Deceased Spouse's IRC §2632 generation-skipping transfer (GST) tax exemption would be allocated first to the children's credit shelter trust, then to the spousal credit shelter trust, and lastly to a reverse QTIP trust. Such a plan could be integrated with a unitrust approach designed to exhaust the three trusts in the opposite order, thereby preserving property exempted by the Deceased Spouse's unified credit and GST exemption. A disadvantage of such an arrangement is a multiplicity of trusts and the added complication and cost of having the extra trust, which could be mitigated by an outright distribution of the marital deduction amount, especially if it is a relatively small amount.

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§17.64 3. Carryover Basis Considerations

Another matter to consider is how the arrangement described in §17.62 would work in an IRC §1022 carryover basis world, which provides for adjusted basis increases for property owned by the Surviving Spouse but not for property held in trust for the benefit of the Surviving Spouse. One way of dealing with this disadvantage would be through the use of carefully crafted powers of appointment that do not allow tax benefits to impact (or allow them only to minimally impact) the Deceased Spouse's General Plan.

While pre-EGTRRA-2001 plans promoted exhaustion of the survivor's trust first, the marital trust second, and the credit shelter trust last, if it is likely that the aggregate basis increase amount will exceed the survivor's trust, it would make more sense to promote the exhaustion of the marital trust, and possibly even the spousal credit shelter trust, before the survivor's trust. In any event, flexible trustee powers that allow the trustee to make distributions to the Surviving Spouse without regard to the Surviving Spouse's other assets or that do not require exhaustion of the survivor's trust before the principal distributions from the QTIP trust or credit shelter trusts may be in order.

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§17.65 C. Large Estates: Marital Estate in Excess of Both Spouses' Applicable Exclusion Amounts

Planning for very large estates, *i.e.,* Marital Estates that are likely to be in excess of twice the IRC §2010 applicable exclusion amount at all times from 2006-2009, like planning for medium estates, should involve maximizing the utility of both spouses' IRC §2010 estate tax applicable exclusion amounts as well as their IRC §2632 generation-skipping transfer (GST) tax exemptions. The major difference in estate planning between large and medium estates lies in the areas of lifetime gifts and charitable gifts. In large estates, consideration should be given to using a portion of the unified credit and GST exemption to make lifetime gifts to children and grandchildren. A credit used today is worth more than a credit used at death. The estate planner should note, however, that the gift tax applicable exclusion amount is limited to $1 million. IRC §2505.

PRACTICE TIP: While clients with large estates should use their maximum exemption amount for gift taxes as soon as possible, making gifts beyond the gift tax applicable exclusion amount may be inadvisable with the prospect of a total estate tax repeal. Such a repeal would result in gifts on death being more favorably taxed than lifetime gifts.

It is especially important in this context to ensure that the full amount of both spouses' available applicable exclusion amounts be used at death if not before. If there is a disparity in wealth between the spouses such that the less wealthy spouse may have a gross estate of less than the applicable exclusion amount even though the combined marital estate of both spouses is more than twice that amount, this may require that the wealthier spouse make gifts to the less wealthy spouse or establish an inter vivos QTIP trust for the benefit of the less wealthy spouse. IRC §2523(f); Treas Reg §25.2523(f)-1. Otherwise, assets that could have passed tax-free on the first death may be taxed in the estate of the wealthier spouse if the less wealthy spouse dies first. For discussion of inter vivos QTIP trusts, see Drafting California Irrevocable Trusts §§2.39A-2.39C (3d ed Cal CEB 1997). Alternatively, the less wealthy spouse may be given a general power of appointment over some assets of the wealthier spouse if the less wealthy spouse dies first. As a result, those assets will be included in the gross estate of the less wealthy spouse. The wealthier spouse is treated as making a completed gift of the assets, but this is a gift to the less wealthy spouse—not the appointees—and therefore qualifies for the gift tax marital deduction. See IRS Letter Rulings 200604028, 200403094. The obvious advantage of the approach used in the rulings is that the arrangement is revocable until the first death. This revocability provides flexibility that is very helpful in a time of uncertainty concerning the future of transfer tax laws. Revocability also reduces administration expenses, eliminating the need to file an income tax return for an irrevocable trust each year. However, because the rulings are based on stated facts and other taxpayers cannot rely on private rulings, clients using this approach should consider applying for their own rulings. For example, the IRS is not precluded from later taking the position on other facts that there is an implied agreement between the spouses that so restricts the choice of appointees that the power is not really a general power.

In very large estates in which the marital deduction share is likely to be larger than the credit shelter share, if a pecuniary formula would otherwise be more advantageous than a fractional share formula, a pecuniary credit shelter/residuary marital deduction formula would be advisable in order to reduce any capital gains tax on the funding of both shares. See §17.53.

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VII. ADDITIONAL ESTATE PLANNING DEVICES

§17.66 A. Use of Entities as Trust Substitutes

For years estate planners have used family limited partnerships, limited liability companies, and closely held corporations to manage the Marital Estate and reduce estate taxes by reducing asset values. See chap 18. If estate taxes are repealed, these entities may still be quite useful in providing management and in promoting tax efficiency. Under IRC §1022(d), after 2009, the IRC §1022(b) aggregate basis increase ($1.3 million plus hypothetical loss carryforwards) and the $3 million IRC §1022(c) aggregate basis increase for property transfers to a spouse can only be applied to property that was owned by the decedent at date of death. Accordingly, property held in marital deduction or credit shelter trusts are not eligible for the aggregate basis increase on the Surviving Spouse's death. Using discretionary powers to distribute property from either trust to the Surviving Spouse may not be acceptable because of the risk of transfer by the Surviving Spouse to persons other than the Deceased Spouse's intended beneficiaries.

Consideration should be given to the use of business entities as trust substitutes in the proper circumstances. By using different equity classes and management provisions, an entity could be made to provide benefits to the Surviving Spouse and children that are economically equivalent to the beneficiary interests flowing from a trust (*e.g.,* a unitrust or annuity amount, life income interest, or a discretionary power limited by an ascertainable standard). Restrictive transfer provisions would limit the Surviving Spouse's and children's right to transfer their equity interests or convert their equity interests into nonnegotiable debt instruments. Because these restrictions lower value, the use of entities may make sense provided that the reduction in value caused by the nontransferability of the equity interest or debt instrument does not reduce the fair market value in the Surviving Spouse's estate below the amount of the IRC §1022(b) aggregate basis increase applicable to property acquired from the Surviving Spouse.

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§17.67 B. Family (Spousal) Allowance

The period of administration is unsettling for the Surviving Spouse, and the Surviving Spouse's anguish may be compounded by economic uncertainty. This is especially the case when the Deceased Spouse was the breadwinner and manager of the community estate or in second marriages when the Surviving Spouse was dependent on the Deceased Spouse. In recognition of the Surviving Spouse's financial needs during the period of administration, California's family allowance statute states that the Surviving Spouse is entitled to "such reasonable family allowance out of the estate as is necessary for the [Surviving Spouse's] maintenance according to the [Surviving Spouse's] circumstances during administration of the estate." Prob C §6540. This statutory spousal allowance can be modified or terminated by court order, but in the case of a solvent estate, the family allowance must terminate "no later than the entry of the order for final distribution of the estate." Prob C §6543.

In *Jackson v U.S.* (1964) 376 US 503, 11 L Ed 2d 871, 84 S Ct 869, the Supreme Court held that the "widow's allowance" under California's then family allowance statute, which automatically terminated on a spouse's death or remarriage, was a terminable interest, and that the estate was not entitled to a marital deduction for the widow's allowance payments made to the Surviving Spouse.

Instead of relying on the statutory family allowance, consideration should be given to will or trust provisions in lieu of or in addition to the family allowance that provide for the Surviving Spouse and minor children. In the right circumstances, a private spousal allowance can alleviate the Surviving Spouse's financial fears and, if properly drafted, qualify for the marital deduction.

In the event that _ _[*name*]_ _ is the Deceased Spouse, Surviving Spouse will be entitled to the sum of _ _[*dollar amount*]_ _ ("Spousal Allowance") payable in installments of _ _[*dollar amount*]_ _ per month for a period of _ _[*number*]_ _ months ("Administration Period") after Deceased Spouse's death. The first payment will be made as soon as reasonably possible after Deceased Spouse's date of death, and each subsequent monthly payment will be made on the first day of each calendar month during the Administration Period. In the event Surviving Spouse dies during the Administration Period, the unpaid portion of the Spousal Allowance will be added to the Surviving Spouse's estate. Despite the Spousal Allowance provided for under this paragraph, the Surviving Spouse will be entitled to any family allowance allowed under California law ("Statutory Allowance"); provided that this Spousal Allowance provision will not be interpreted or construed as precluding a court from considering the Spousal Allowance in any proceeding to grant, modify, or terminate the Statutory Allowance.

Because no one else but the Surviving Spouse's estate receives the Spousal Allowance, it is not a nondeductible terminable interest and qualifies for the marital deduction. More importantly, it will take care of the Surviving Spouse at a time when the Surviving Spouse is perhaps most vulnerable.

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§17.68 VIII. MARITAL DEDUCTION PLANNING FOR SPECIAL ASSETS AND CLAIMS AGAINST ASSETS

In planning for the marital deduction, the attorney should be aware of potential estate planning problems that occur with particular types of assets or claims against assets, which need to be addressed in connection with marital deduction planning. These include dispositions required by law or contract, IRD items, and life insurance. For discussion of marital deduction planning for retirement benefits, see chap 21.

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§17.69 A. Dispositions Required by Law or Contract

Dispositions of a decedent's assets that are imposed by statute (*e.g.,* forced or elective share rules), or on account of an agreement entered into by the Deceased Spouse before death, can significantly alter an estate plan and result in the imposition of death taxes in a zero-tax plan. Some of these required dispositions may be claims or rights held by third parties to and in the Deceased Spouse's estate. As claims, they may or may not be deductible under IRC §2053 depending on whether they were contracted for full and adequate consideration. Two instances that can result in the statutory or contractual disposition of the Deceased Spouse's assets affecting the married couple's estate plan are ownership of foreign assets (see §17.70) and dissolution agreements that impose obligations on the Deceased Spouse at death to an ex-spouse and children (see §17.71).

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§17.70 1. Foreign Assets

For married clients owning foreign assets, planning can be challenging, particularly in civil law jurisdictions in which the trust is not a juridical entity. While generally the law of the decedent's domicile controls the devolution of movables (roughly equivalent to personal property), generally the law of the situs controls the devolution of immovables (real property). A foreign jurisdiction's forced share rule may result in tax due on the most artfully drafted estate plan.

EXAMPLE: Married Couple, who are both United States citizens and California domiciliaries, have a Marital Estate of $12 million, consisting of community property and a chateau in the south of Filonia, purchased with community property for $3 million. They have three adult children. Married Couple's California will provides for a zero-tax pecuniary credit shelter trust and a residuary marital trust. Under Filonia's law of succession, a testator with three children can freely dispose of only one-fourth of his or her net estate. In the case of three children, Filonia's law of succession provides that the children have a right to the remaining three-quarters of the parental estate. Accordingly, if either spouse dies, the children will have a right to three-fourths of the Deceased Spouse's Filonia estate. If, on the death of the Deceased Spouse, the applicable exclusion amount is less than the children's forced share, United States estate taxes will have to be paid out of the marital share, thereby lowering the marital deduction and resulting in a further tax that is determinable using an interrelated computation.

Estate Planner might have suggested to Married Couple that they purchase the chateau through a Filonia LLC. Under Filonia's Limited Liability Company Act, a Filonia LLC may own nonbusiness assets such as the chateau, and under Filonia's succession laws there is no concept of deemed or attributed ownership that would result in either spouse's ownership of the chateau. Under Filonia's choice of law provisions, California law would govern the disposition of any movable, such as the LLC membership interests. Thus, if Married Couple had purchased the chateau through a Filonia LLC, they would have been able to dispose of the membership interests under California law and in accordance with their zero-tax plan.

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§17.71 2. Transfers Under Dissolution Agreements

When interviewing spouses, it is important to determine whether they are parties to any agreement that may require them to make testamentary dispositions to an ex-spouse or children from a prior marriage. This is especially important in connection with spouses who were previously married, but may also have relevance to first marriages, if either spouse is a party to a paternity settlement agreement requiring child support. Very often support orders are secured with insurance on the obligor parent, who may also have sufficient incidents of ownership to cause inclusion in the deceased parent's taxable estate. Concerned with parents who would use dissolution agreements and IRC §2053 as a means to making tax-free gifts to children, the Service and the courts tend to view these types of payments as testamentary in nature.

EXAMPLE: *H* and *W2* have been married for 3 years and have one child. *H* was divorced 5 years before and under the divorce decree is obligated to make alimony and child support payments to *W1* and *H* and *W1*'s two children for the next 10 years. If *H* dies within the 10-year term, the remaining payments are payable out of his estate at their commutated value. Alternatively the decree allows *H* to secure the payment with a decreasing term policy with an initial face value of $2 million and an average value over the 10-year term of $1 million. After talking with his agent, *H* decides to forgo the premiums and take his chances that he will live the 10 years.

When *H* and *W2* meet with Estate Planner, *H* has 7 years remaining on his obligation to *W1* and his children with *W1*. Estate Planner explains that if *H* dies during the term, any payments for his children with *W1* will not be deductible, and if the amount exceeds his applicable exclusion amount, estate taxes will have to be paid. Estate Planner then explains that if *H* buys the insurance policy through a trust, or if he pays *W1*, who purchases the policy on his life, the proceeds will be excluded from his estate.

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§17.72 B. Income in Respect of Decedent (IRD)

Using items of income in respect of a decedent (IRD), as defined in IRC §691(a), to fund a pecuniary bequest will accelerate the reporting of income, the import of which depends on the quantity of unreported income, the recipient's tax bracket, and other tax circumstances (*e.g.,* net operating losses) during the year of acceleration. Accordingly, if the estate plan uses a pecuniary/residuary Zero-Tax Formula, the only way to avoid acceleration is to specifically devise the IRD to the residue. If the amount of IRD exceeds the residue, a fractional share formula may be in order.

NOTE: Under IRC §691(c), the estate tax assigned to the IRD item and deductible for income taxes is the actual tax minus the hypothetical tax without the IRD item. If an IRD item is specifically devised to the marital deduction share and the Deceased Spouse's estate is subject to estate tax, then in performing the hypothetical tax calculation the marital deduction share must be reduced by the IRD item, thereby increasing the hypothetical tax and reducing the amount of estate tax deductible with respect to the IRD item. See *Estate of Cherry v U.S*. (2001) 133 F Supp 2d 949. The reduction of the IRC §691(c) deduction should not deter a specific devise of IRD to the marital deduction share in a Zero-Tax Plan, because there is no estate tax that would give rise to an IRC §691(c) deduction.

Another feature of IRD that is important to consider is that it is like an asset with built-in income tax liability, and thus is less valuable than other estate assets that have date of death basis and no inherent tax liability. For purposes of funding, however, the built-in tax liability is ignored, a result that makes sense using a hypothetical willing buyer/seller valuation under IRC §2031 because the hypothetical willing buyer will receive a cost basis in the IRD asset purchased under IRC §1012 and should not care if there is a built-in tax liability to the seller. Thus, if the goal is to maximize the credit shelter share and minimize the marital deduction share, items of IRD should be allocated to the marital deduction share.

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§17.73 C. Life Insurance

Generally, the devolution of life insurance proceeds on the Deceased Spouse's life can be integrated with the overall estate plan by designating the trustee of the revocable trust as the primary policy beneficiary. The Deceased Spouse's interest in any life insurance on the Surviving Spouse's life is ordinarily directed to the credit shelter trust. See Drafting California Revocable Trusts, chap 11 (4th ed Cal CEB 2003).

If the Surviving Spouse is the trustee of the credit shelter trust, someone other than the Surviving Spouse should be designated special trustee; otherwise, the trustee powers may result in the Surviving Spouse having incidents of ownership in the policy, which would cause the proceeds to be included in the Surviving Spouse's estate under IRC §2042.

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§17.74 IX. PLANNING FOR NONCITIZEN SPOUSE

In 1988, Congress enacted provisions contained in IRC §§2056(d), 2056A, and 2523(i), which generally disallow any marital deduction for interspousal transfers to a noncitizen spouse other than gifts passing to a qualified domestic trust (QDOT trust) under IRC §2056(d)(2). However, IRC §2056(d)(4) and the regulations under IRC §2056A provide several alternatives to the QDOT trust that need to be considered when dealing with interspousal gifts to the noncitizen spouse, in addition to annual exclusion gifts of $100,000 plus inflation adjustments allowed under IRC §2523(i).

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Source: Estate Planning/California Estate Planning/17 Marital Deduction Planning/§17.75 A. Purpose of QDOT

§17.75 A. Purpose of QDOT

When the unlimited marital deduction was enacted, the intent was to defer tax until the death of the Surviving Spouse. Thereafter, Congress feared that the deferred tax could be too easily avoided by the noncitizen Surviving Spouse who expatriated and removed any assets from the United States that were received from the Deceased Spouse. To prevent tax deferral from turning into tax avoidance, the QDOT trust was introduced, which is essentially a security device designed to ensure payment of tax on the death of the Surviving Spouse.

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§17.76 B. QDOT Requirements

In order for a QDOT trust to qualify for the marital deduction, it must satisfy the following requirements:

- The trust must qualify as a Life Estate/GPA Trust under IRC §2056(b)(5), a QTIP Trust under IRC §2056(b)(7), or a charitable remainder trust under IRC §2056(b)(8). Treas Reg §20.2056A-2(a).
- The trust instrument must provide that at least one trustee is a United States citizen or a domestic corporation and that a United States trustee has the right to withhold tax on any distribution from the trust other than an income distribution. Treas Reg §20.2056A-2(a)-(c). Additional requirements are imposed on QDOT trusts with assets valued at greater than $2 million. The trust instrument for a $2 million-plus QDOT must provide for one of three different security devices, any one of which may be used at any time provided that at least one of such security devices is in place at all times before the termination of the QDOT trust.
- At least one United States trustee must be a United States bank or United States branch of a foreign bank, as bank is defined in IRC §581. Treas Reg §20.2056A-2(d)(1)(i)(A).
- The United States trustee must furnish to the IRS a bond with a satisfactory surety in an amount equal to 65 percent of the fair market value of the trust assets without regard to any indebtedness against the assets. Treas Reg §20.2056A-2(d) (1)(i)(B).
- The United States trustee must furnish a letter of credit issued by a bank as defined in IRC §581 in an amount equal to 65 percent of the fair market value of the trust assets without regard to any indebtedness against the assets. Treas Reg §20.2056A-2(d)(1)(i)(C).
- The Deceased Spouse's executor must elect QDOT status on the estate tax return and once made the election is irrevocable. IRC §2056A(d); Treas Reg §20.2056A-3.

In the event a trust fails to meet the requirements for a QDOT trust, reformation is permitted under IRC §2056(d)(5), which gives the executor until the date for filing the estate tax return to cure any invalid trust or to commence a court proceeding to change the trust to a QDOT trust. For further discussion of QDOT requirements, see §§16.25-16.40.

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§17.77 C. Taxation of QDOT Trust

A tax is imposed on any principal distribution from the trust during the noncitizen Surviving Spouse's lifetime and before January 1, 2021, other than a hardship distribution. IRC §§2056A(b)(1)(A), (b)(3), 2210(b)(1). An estate tax is also imposed on the death of the noncitizen Surviving Spouse before January 1, 2010, on the value of any property remaining in the QDOT trust. IRC §§2056A(b)(1)(B), 2210(b)(2).

NOTE: The continued taxation of QDOT trust distributions after December 31, 2020, and on deaths after December 31, 2009, depends on whether EGTRRA-2001's sunset provisions ever become effective. See §17.4.

The instances when tax may be imposed are called "taxable events." IRC §2056(b)(9). The tax is computed by determining what estate tax the Deceased Spouse would have paid had the amount involved in the "taxable event" been included in the Deceased Spouse's taxable estate. Treas Reg §20.2056A-5(a). A hardship distribution is any distribution for the health, maintenance, education, or support of the Surviving Spouse or any person that the Surviving Spouse is legally obligated to support. Reg §20.2056A-5(c)(1). For purposes of determining whether a trust distribution is principal or income, the term "income" has the same meaning as the term "income" used in IRC §643(b) and Treas Reg §1.643(b)-1; however, income does not include capital gains or other items allocable to principal under applicable local law even if the trust instrument contains provisions to the contrary. The word "income" includes principal allocated to income as a result of a trustee's exercise of a statutory power to make such an adjustment. Under Prob C §16336, such adjustments are permitted in specified circumstances. The word "income" also may include a unitrust amount in the range of 3-5 percent if state law so provides. Treas Reg §20.2056A-5(c)(2). For provisions authorizing the use of a unitrust amount in California, see Prob C §§16328, 16336.4-16336.6 (discussed in chap 24A). The tax rates in effect at the Deceased Spouse's date of death are used to compute the estate tax. Treas Reg §20.2056A-6(a).

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§17.78 D. Alternatives to QDOT Trust

There are several alternatives to a QDOT trust established by the Deceased Spouse. One alternative permits the Deceased Spouse's executor or the Surviving Spouse to establish a QDOT trust that is funded with assets passing directly to the Surviving Spouse that the Surviving Spouse transfers or irrevocably assigns to the QDOT trust. Treas Reg §20.2056A-1(a)(1)(iii). Using irrevocable assignments, retirement benefits and other property passing directly to a noncitizen Surviving Spouse may qualify for QDOT treatment. IRC §2056(d)(2)(B); Treas Reg §20.2056A-4(b).

The only alternative that does not result in a QDOT arrangement is the citizenship option. Under this option, the noncitizen Surviving Spouse who becomes a United States citizen before the filing of the estate tax return is treated as a United States citizen as of the Deceased Spouse's date of death, provided such spouse was a United States domiciliary at all times between the Deceased Spouse's date of death and the date of becoming a United States citizen. IRC §2056(d)(4). This is a true alternative that extricates the Surviving Spouse from the QDOT trust and the potential taxation of distributions that, unless repealed, will remain in effect until 2021.

For further discussion of QDOT trusts established by noncitizen spouses and forms, see Drafting California Irrevocable Trusts §§2.80-2.81G (3d ed Cal CEB 1997).

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18

Business Entity Valuation Planning Strategies

Steven Murray Goldberg

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I. INTRODUCTION TO VALUATION PLANNING

§18.1 A. Overview of Family Business Entities

Family business entities are widely used in the estate plans of sophisticated clients and are an important tool for the estate planner. Family business entities may accomplish a number of goals, including (1) income, gift, and estate tax planning and tax savings through valuation discounts; (2) centralized management of assets; (3) pooling of assets; (4) asset protection; and (5) training younger generations in management of assets. The ability to meet multiple goals has contributed to the popularity of these entities. However, family business entities can be complex and expensive to implement. They are often treated by the IRS as aggressive for gift and estate tax planning and therefore subject to heightened scrutiny.

Any time a family business entity is used, consideration must be given to tax issues, including gift, estate, generation-skipping, income, and real property taxes. The structure of the entity also affects the current and future management of the entity, how well the assets may be protected from the individual owners' creditors, and certain tax advantages. These issues make planning complex and can conflict with one another. This chapter is intended to provide a discussion of these issues and the related concerns that practitioners in this area must address when utilizing a family business entity as an estate planning tool. Although the discussion focuses mainly on the valuation issues and potential tax advantages that may arise in using these entities, it is the author's opinion that family business entities should and usually do meet other, nontax goals. Practitioners must also be aware of rapidly evolving case law. The author believes it is now clear that the family business entity must have significant nontax objectives.

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§18.2 B. Popularity of Limited Partnerships and Limited Liability Companies

The closely held corporation, limited partnership (LP), and limited liability company (LLC) are all used as estate planning vehicles. Valuation discounts for estate and gift tax purposes and limited liability for most or all of the owners apply to each of these entities. The LP and LLC have enjoyed the most popularity as family business entities, due in part to the flow-through nature of these entities for income tax purposes, and in part to the flexibility in management that they can provide. In the family context, these are commonly referred to as a "family limited partnership" (FLP), and a "family limited liability company" (FLLC). Although FLPs and FLLCs are generally the entities of choice for a family's investments or businesses, the closely held corporation should not be ignored, especially in a trade or business activity. Also, in some cases, a trust may be a more appropriate vehicle for the client's planning needs. As with most planning, consideration of each client's situation is necessary before an entity is chosen.

PRACTICE TIP: *Terminology*. The author disfavors the terms "family limited partnership" and "family limited liability company." The term "family" has no legal meaning and may have acquired a pejorative connotation to some IRS personnel.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.3 C. Typical Planning Situations and Concerns

§18.3 C. Typical Planning Situations and Concerns

Family business entities can be used in a variety of situations. The typical client who uses the estate planning advantages of the FLP, FLLC, or closely held corporation is likely to have a significant net worth, often exceeding $5 million, that allows the client to comfortably give away assets that will use all or a significant portion of the client's applicable exclusion amount for gift and estate tax purposes. See chap 10. Tax savings are realized because of valuation discounts and because potential future appreciation is transferred out of the client's estate. The cost of implementing the technique can easily exceed $20,000, given that the cost of appraisals alone can exceed $10,000.

A client is often best served by using a team of advisers, including an attorney, accountant, and financial or investment adviser. In addition to advising the client, the attorney often coordinates the entire effort with specific responsibility, at the very least, for (1) drafting the partnership agreement for an LP, the operating agreement for an LLC, or the corporate formation documents for a closely held corporation; (2) preparing and filing the required state organizational forms; (3) selecting and transferring assets to the entity; and (4) interacting with the appraisers and other advisers.

PRACTICE TIP: *Annual Exclusion Gifts*. A gift of an interest in a family business entity can qualify for the IRC §2503(b) $13,000 annual exclusion for gifts, depending on the structure of the entity and the terms of the gift. See chap 10. Practitioners should be mindful that a gift must first satisfy the requirements for the annual exclusion. In *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664, the Tax Court held that gifts of LLC membership units were gifts of future interests that did not qualify for annual gift tax exclusions. The units could not be transferred without the manager's consent, and donors could not prove that there would be a current steady flow of income to the donees. But see IRS Letter Ruling 199944003 (gifts of partnership interests qualified for annual exclusion because partners had sufficient rights to make the interests qualify as present interests). In addition, a practical difficulty with gifting interests in family business entities as annual exclusion gifts is documenting the value for adequate disclosure on a gift tax return. See §18.40. Given the cost of appraisals, making gifts of such interests only as annual exclusion gifts may not be cost-effective if the client wants to utilize valuation discounts.

In a typical case, a married couple with children might contribute real property or securities, or both, to a limited partnership, receiving back all of the general and limited partnership interests. The couple then makes one or more gifts of limited partnership interests to their children. They usually want to continue to control the assets transferred to the FLP by keeping the general partner interests, although doing so may have negative estate tax consequences. See §18.37. Generally, because of valuation discounts for lack of control (minority interest) and lack of marketability, the value of a limited partner interest for gift tax purposes will be significantly less than the corresponding prorata share of the value of the underlying partnership assets.

An explanation giving the amount of and factual basis for the claimed discounts must be attached to the federal gift tax return. See §18.40. The IRS has consistently attacked the loss of value through valuation discounts, believing them to be artificially manufactured strictly for gift and estate tax purposes. As a result, specialized appraisals of the gifted interests, as well as appraisals of any hard to value underlying assets (*e.g.,* real property), are generally required to adequately document and sustain the claimed gift tax valuation.

At death, the interests in an entity included in the decedent's estate can also be entitled to valuation discounts. Unlike the valuation of gifts of partial interests of a larger whole, which are valued independently of each other, the whole of the interest included in the estate is valued for estate tax purposes even if it is devised in multiple parts. If the decedent had a controlling interest at death, or an ability to cause the entity to dissolve, the applicable valuation discounts may be reduced or eliminated. As a result, it is often advisable to make gifts during life to reduce a controlling interest to a noncontrolling interest. But see *Estate of Elizabeth B. Murphy,* TC Memo 1990-472, discussed in §18.30.

PRACTICE TIP: *Assignee Interests*. Practitioners may wish to consider advising the client to gift assignee interests only. The assignee of an LP or LLC interest generally has economic rights only, with the result that an assignee interest may be valued even lower than the corresponding LP or LLC interest. See *Adams v U.S.* (5th Cir 2000)

218 F3d 383; *Estate of McLendon v Commissioner* (5th Cir 1995) 96-1 USTC ¶60,220, 77 AFTR2d 666; *Estate of Ethel S. Nowell,* TC Memo 1999-15. But see *Jane Z. Astleford*, TC Memo 2008-128 (substance-over-form doctrine applied to treat assignee interest of general partner as general partnership interest). The author generally does not use the assignee technique because it is often not consistent with clients' nontax goals.

The tax law in the area using family business entities is evolving, and any transaction entered into may encounter changes in the statutory or case law. The IRS considers valuation discounts for interests in family business entities to be aggressive tax planning and has shown that it will challenge them on a variety of grounds. From time to time, legislation has been proposed that limits the applicability of valuation discounts to interests in these entities, and recent case law also may limit the tax savings from valuation discounts (see §18.37). Clients should be informed of the IRS's attitude, and of any proposed legislation, and cautioned that perceived gift and estate tax benefits may not occur. It is also possible that the planned estate tax repeal could make tax savings illusory. See chap 10. The clients most likely to be satisfied with organizing family business entities will thus be those who also have other business or nontax goals. See §§18.42-18.49.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.4 D. Ethical Considerations: Conflicts and Competence

§18.4 D. Ethical Considerations: Conflicts and Competence

As with any professional engagement, the attorney must identify his or her client. If the attorney is to represent multiple clients, appropriate written waivers of potential conflicts of interest should be obtained. See Cal Rules of Prof Cond 3-310(C). Estate planning attorneys should be familiar with these rules as they apply to husband and wife. When forming a family business entity, the attorney needs to be sensitive to the fact that potential clients and, therefore, conflicts, include all of the other owners of the entity and the entity itself.

Before advising a client on any matter, an attorney must have the skill and expertise to competently handle the matter. Cal Rules of Prof Cond 3-110. In addition to estate planning expertise, an attorney advising a client regarding the formation of a business entity must have competence in the substantive law regarding the various kinds of business entities, as well as expertise in other areas of law such as taxation, securities, and real property law. If an attorney does not have the requisite competence, he or she can either (1) associate with or professionally consult with another attorney who is reasonably believed to be competent, or (2) acquire sufficient learning to become competent before performance is required. Cal Rules of Prof Cond 3-110(C).

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.5 II. CHOICE OF ENTITY AND FORMATION ISSUES

§18.5 II. CHOICE OF ENTITY AND FORMATION ISSUES

Once a decision has been made to use a family business entity as an estate planning vehicle, the adviser must then help the client choose the appropriate form of business entity. Generally, the client will choose a family limited partnership (FLP) or family limited liability company (FLLC). Attorneys generally advise clients to avoid general partnerships because of the unlimited liability that each partner has for the obligations of the partnership and for acts of other partners committed within the scope of the partnership business.

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§18.6 A. Limited Partnerships

A partnership is an association of two or more persons to carry on as co-owners a business for profit. Corp C §16101(9); IRC §7701(a); Treas Reg §301.7701-2(c)(1). Limited partnerships are governed by Limited Partnership Act of 2008 (Corp C §§15900-15912.07). A limited partnership (LP) is a partnership in which one or more of the partners are general partners and one or more of the partners are limited partners. Corp C §15912.06(q). General partners have control of the limited partnership and make all management decisions. They also have unlimited personal liability for the partnership's obligations, although a creditor may be required to satisfy a judgment first from limited partnership assets. Corp C §§15904.4-15904.5. Limited partners have no control over any partnership business decisions, although the partnership agreement or state law may provide the limited partners with voting rights on certain internal partnership issues. As a consequence of the lack of control, limited partners have no personal liability for any obligations of the partnership. Corp C §15903.03. To form a limited partnership in California, the limited partnership must file a Form LP-1, Certificate of Limited Partnership, with the California Secretary of State. Corp C §15621(a). California charges LPs an annual franchise tax of $800. Rev & T C §§17935(a), 23153(d)(1). For further discussion of LPs, see Advising California Partnerships (3d ed Cal CEB 1999).

Partnerships are "flow-through" entities for income tax purposes. In general, the income of the partnership is allocated to its partners in proportion to their interests in the partnership. This allocation and numerous other partnership income tax rules are set forth in Subchapter K of the Internal Revenue Code (IRC §§701-777) and the voluminous regulations applicable to these statutes. These rules are generally considered to be some of the most complex in tax law.

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§18.7 1. Choice of General Partner

An LP must have one or more general partners. A general partner can be an individual or another entity, such as a corporation or an LLC. In family estate planning, the older generation usually wants to continue to control or manage the assets transferred to the LP by being the general partner. Sometimes, if the older generation does not want to risk the personal liability of a general partner, the older generation's members will form a corporation or LLC to be the general partner, rather than act in their individual capacity. In this way, the individuals are protected from personal liability because they have only limited liability as owners of the entity (assuming that the entity is not disregarded, *e.g.*, for not observing corporate formalities or for not being adequately capitalized).

The identity of the general partners often has a direct impact on whether a discount will be applied to a general partnership interest in the estate of a decedent. If the decedent had the unilateral power to dissolve the partnership, his or her partnership interests are likely to be valued at nondiscounted liquidation values. For this reason, many practitioners prefer to have more than one general partner, if the general partners are individuals, or one general partner that is an entity not controlled by the transferring client.

EXAMPLE: In California, a 50-percent owner of a corporation has the power to cause a voluntary dissolution of the corporation. If a corporation is the general partner of an LP, its dissolution would be treated as a withdrawal, which would cause the LP to dissolve unless there is another general partner or there is a vote of the majority in interest of the limited partners to continue the partnership. Corp C §§15906.3, 15908.01(c). Thus, if a decedent could have caused a corporate general partner to dissolve, the decedent's interest in the limited partnership is likely to be valued at nondiscounted liquidation values.

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§18.8 2. Requirement of Two or More Persons

It now seems clear that an individual and his or her revocable trust cannot meet the requirement that a partnership must have two or more partners, although it should be possible for an individual and his or her solely owned corporation to form a partnership. See Rev Rul 2004-77, 2004-2 Cum Bull 119 (partnership formed by an individual and a disregarded entity that may be valid under state law will not be taxed as a partnership under federal income tax laws). It is unclear whether a husband and wife can form a partnership through their jointly established living trust. However, it does seem clear that the sole partners of a partnership can consist of husband and wife acting individually or through a combination of separately owned trusts and jointly owned trusts. See, *e.g.*, Rev Rul 58-243, 1958-1 Cum Bull 255. See also IRC §7701(a)(1).

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§18.9 B. Limited Liability Companies

Limited liability companies are a hybrid of the corporation and the limited partnership. LLCs with two or more members are treated as partnerships for federal income tax purposes unless they elect otherwise. See Treas Reg §§301.7701-1—301.7701-3. This means that they are also "flow-through" entities for income tax purposes. See §18.6. Single-member LLCs, which are allowed in California, are ignored for federal income tax purposes unless they elect to be taxed as corporations. This format does, however, allow a single individual to establish a business entity. Treas Reg §301.7701-3. An LLC is managed by all of its members, unless the articles of organization provide that the LLC will have one or more managers who may, but need not, be members. Corp C §§17150-17151. In the family planning context, the older generation can retain control of the management of the LLC by naming themselves as the managers.

An LLC provides limited liability for all of its members, managers, and officers for any judgment, debt, obligation, or liability of the LLC (to the same extent as corporations provide for their shareholders, directors, and officers). Corp C §§17101(a)-(b), 17158(a). However, as with shareholders of a corporation, LLC members are generally subject to liability on such grounds as alter ego liability or piercing the corporate veil (*e.g.,* because of the failure to adequately capitalize). See Corp C §17101(b). Because of the lack of case law interpreting the relatively new LLC statutes, some conservative attorneys still believe that the limited liability provided by LLCs may not prove to be as protective as the limited liability of a corporation. However, the prevailing view appears to be that LLCs provide the same level of protection as a corporation.

To form an LLC in California, the LLC must file a Form LLC-1, Articles of Organization, with the California Secretary of State. Corp C §17050(a). California charges LLCs an annual franchise tax of $800, and an annual fee of $900 for LLCs with total income (gross receipts) of $250,000 or more ($2500 with total income of $500,000 or more, $6000 with total income of $1 million or more, and $11,790 with total income of $5 million or more) derived from or attributable to this state. Rev & T C §§17941(a), 17942, 23153(d)(2). For further discussion of LLCs, see Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

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§18.10 C. Corporations

Corporations have historically been used for operating businesses principally because the individual managers and owners of the corporation are not personally liable for the corporation's obligations. Corporations have also been used for passive investment activities, although various income tax rules, such as the double taxation of income (first at the corporate level and again when distributed to shareholders as dividends), discourage that use. Corporations are taxed as separate entities for income tax purposes, unless they make an election under IRC §1361 to be an "S corporation." An S corporation is treated as a pass-through entity for tax purposes under the rules of IRC §§1361-1379. California recognizes S corporation status for income tax purposes. Rev & T C §§23800-23813. There are, however, significant differences between the pass-through taxation applicable to S corporations and that applicable to partnerships. See Organizing Corporations in California, chap 1 (3d ed Cal CEB 2001). To form a California corporation, articles of incorporation must be filed with the Secretary of State, and bylaws must be prepared. For further discussion of corporations, see Organizing Corps; Counseling California Corporations (3d ed Cal CEB 2008).

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/ D. Choosing Entity/§18.11 1. Corporation versus FLP or FLLC

D. Choosing Entity

§18.11 1. Corporation versus FLP or FLLC

The choice for a family business entity usually is narrowed down to the FLP or FLLC relatively easily. The corporate form tends to be less popular for several reasons:

- A corporation is not a pass-through entity for income tax purposes unless the S corporation election is made. Even if the S corporation election is made, an S corporation is still not as flexible for income tax purposes as the LP or LLC, and there are limits on who may be a shareholder (certain trusts may not qualify or may have to make elections that subject them to higher tax rates).
- A corporation is subject to capital gains taxes on dissolution. IRC §336. (If an S corporation is going to sell the corporate assets, the dissolution tax can be minimized or eliminated).
- The corporate entity has less organizational flexibility than does either the LP or LLC. A corporation must comply with the required corporate formalities under state law, such as annual shareholders' and directors' meetings and written minutes, to ensure that the entity is not disregarded for tax, liability, or other purposes. Neither the LP nor the LLC is required to observe such formalities.

NOTE: Although some practitioners believe that the corporation may be less of a target for IRS scrutiny, several of the estate and gift tax cases regarding discounts have involved closely held corporations.

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§18.12 2. FLP versus FLLC

The choice between LP and LLC depends on a variety of individual factors. For example, although California LLCs originally were required to have two or more members, California law now allows the formation of single-member LLCs. Corp C §17050(b). This difference may make the LLC more attractive than the LP in some cases when only one person must form the entity. In addition, if limited liability is the most important factor for a family and most family members will be involved in management, the LLC may be more appropriate because limited liability is extended to all members and managers of an LLC. If a limited partner were to participate in management of an LP, he or she would lose the protection of limited liability. Although the general partner of an LLC can include family members who want to manage, greater liability protection is afforded by the LLC form.

On the other hand, the California fee on the gross revenues of an LLC above $250,000 may make the LP more attractive if the entity is expected to generate income above that amount. See §18.9.

There may be less risk in planning with LPs because there is more case law involving partnerships than the relatively newer LLC form. Perhaps more importantly, certain aspects of California law, *e.g.*, the more stringent requirements for dissolution (see §18.29), may make the LP more likely to receive a valuation discount, which can be important for gift and estate tax purposes.

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§18.13 E. Choosing Assets

In general, a family business entity can be formed with any kind of investment assets, such as securities, real property, and operating businesses. However, there are some traps for the unwary.

Investment company. The formation of an LP, LLC, or closely held corporation is a nontaxable event (IRC §§351(a), 721(a)) unless the contributions on formation are made to an entity deemed an "investment company" (IRC §§351(e), 721(b)). A contribution is treated as being made to an investment company if (1) it results in "diversification" of the transferor's interests, and (2) more than 80 percent of the value of the entity's assets are readily marketable stocks or securities (including money). Treas Reg §1.351-1(c)(1).

This limitation can be avoided in several ways. Care can be taken that marketable securities do not exceed 80 percent of the value of the entity's assets. Diversification does not occur if there is only one transferor, if there are two or more transferors who contribute identical assets (Treas Reg §1.351-1(c)(5)) and the diversification is below specified levels, or if each of several transferors transfers a diversified portfolio (Treas Reg §1.351-1(c)(6)). The identical-asset requirement will often not be difficult if a husband and wife are forming the partnership, because their assets may be identical to begin with if their estate is substantially community property. In any event, formation with closely held business interests or real property avoids the issue entirely.

Business purpose. To receive partnership tax treatment, an LP or LLC must have an investment or financial purpose. IRC §7701(a)(2). Therefore, it may be difficult to justify placing personal use assets, such as a primary residence or vacation home, in an LP or LLC, unless such assets are converted to business use through, for example, the payment of rent. (There is also an issue that the transferor's continued use of property transferred to an LP or LLC may cause the property to be included in the transferor's estate under IRC §2036. For further discussion of IRC §2036, see §18.37 and chap 10.)

Restrictions on stock. Practitioners may also encounter a variety of issues when transferring property to a family business entity. For example, if a client wants to transfer shares in a corporation to the entity, the practitioner must first determine if there are any restrictions on transferring the stock that may exist under a shareholders' agreement or securities law. This determination may require examining the corporate documents and consulting with the corporation's or other attorneys.

Encumbrances. The contribution of encumbered assets to an LP, LLC, or closely held corporation raises a number of tax issues. In particular, when the liability assumed by the entity exceeds the adjusted basis of the asset, the contribution of the property can cause the recognition of gain to the transferor. IRC §§357(c), 731(a), 752(b). Gain recognition depends on a variety of factors, including whether the obligation is recourse or nonrecourse, and whether the contributing partner remains ultimately responsible for the obligation. See Treas Reg §1.752-2(b). See also Advising California Partnerships, chaps 7-8 (3d ed Cal CEB 1999).

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III. ESTATE AND GIFT TAXES

§18.14 A. Valuation Discounts

Gift and estate taxes are excise taxes on the transfer of property from one person (the transferor) to another person, based on the fair market value of the property transferred. IRC §§2001, 2031, 2501, 2512. See chap 10. Fair market value is generally defined as the price that a willing buyer and a willing seller would agree to, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Treas Reg §§20.2031-1(b), 25.2512-1. Naturally, taxpayers and the IRS often disagree about fair market value, and valuation disputes have been part of gift and estate tax cases for decades.

The fair market value of a minority or noncontrolling interest in a closely held entity, whether a limited partnership, limited liability company, or corporation, is usually less than the corresponding proportionate share of the value of the assets of the entity. *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion); *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. The rationale for this is that the owner of a minority or noncontrolling interest suffers from a lack of control and cannot easily realize his or her investment in the entity. In addition, the market for a closely held business interest is generally limited. Thus, interests in closely held businesses are allowed valuation discounts for lack of control and lack of marketability. Appraisers may also increase the lack of marketability discount for other characteristics, such as poor portfolio diversity. Courts have allowed additional discounts in valuing the stock of corporations owning assets having a low income tax basis. See, e.g., *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, acq 1999-1 Cum Bull xix; *Estate of Artemus D. Davis* (1998) 110 TC 530. See also *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339; *Estate of Jameson v Commissioner* (5th Cir 2001) 267 F3d 366.

While the determination of fair market value for estate tax purposes in an entity may seem to save substantial sums, particular attention must be paid to the effect of IRC §2036(a). See §§18.37-18.37E.

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§18.15 1. Lack of Marketability

The discount for lack of marketability is based on the general absence of a ready market for interests in closely held entities. See *Adams v U.S.* (5th Cir 2000) 218 F3d 383; *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. This discount should apply even to a controlling owner if the assets of the entity are not liquid or are otherwise difficult to sell. *Temple v U.S.* (ED Tex 2006) 423 F Supp 2d 605 (60-percent discount allowed for gift of 76.6-percent interest in LLC that owned and operated ranch; interest held power to dissolve LLC, but court concluded there was no assurance that dissolution would result in sale of ranch rather than distribution of tenancy-in-common interests in property that could not be partitioned); *Estate of Charles Russell Bennett,* TC Memo 1993-34; *Estate of Gregg Maxcy,* TC Memo 1969-158, rev'd on other grounds (5th Cir 1971) 441 F2d 192. The IRS, however, may challenge a discount if the controlling owner can force a liquidation of the entity and if the assets of the entity are liquid assets. *Adams v U.S., supra*. Quantifying and substantiating the discount for gift and estate tax purposes will generally require an appraisal.

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§18.16 2. Lack of Control

The discount for lack of control applies to a noncontrolling interest in a closely held business. This discount reflects an inability to compel liquidation of an entity and realize a prorata share of the entity's net asset value. Often, but not always, a noncontrolling interest is a minority interest (generally thought of as less than 50-percent ownership in an entity), and the discount is often called a minority interest discount. *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion); *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57.

The concept of control seems simple but may encompass a variety of issues, including control of distributions, day-to-day and future management of the entity, and, perhaps most importantly, the ability to force a liquidation. In most planning situations, a noncontrolling interest will have none of these characteristics. This is particularly true for a limited partner who, by law, cannot participate in management. As with lack of marketability (see §18.15), quantifying and substantiating the discount for gift and estate tax purposes will generally require an appraisal. In *Estate of Godley v Commissioner* (4th Cir 2002) 286 F3d 210, the court held that the Tax Court's refusal to allow a lack-of-control discount for a 50-percent general partnership interest was not clearly erroneous. The partnership rented housing to elderly persons under government contracts that assured partnership income, and the partnership agreement mandated annual distribution of net cash flow, which could not be changed without a vote of 75 percent of the shares. Appraisal methodologies and concepts are also being challenged by the courts, and appraisers are questioning hitherto accepted principles. See, *e.g.*, *Peter S. Peracchio,* TC Memo 2003-280 (allowing 15-percent minority interest discount and 24-percent marketability discount for gifts of interests in FLP holding real estate and marketable securities); *Clarissa W. Lappo,* TC Memo 2003-258 (allowing 6-percent minority interest discount and 25-percent lack-of-marketability discount for FLP funded with cash, money market funds, and publicly traded securities). In *Estate of Helen A. Deputy*, TC Memo 2003-176, the court used a six-factor "matrix" employed by the estate's expert as a "guide" to determine the amount of a combined 30-percent discount for lack of marketability and minority interest, but did not necessarily accept the approach. Practitioners should be aware of these developments and, perhaps more importantly, choose appraisers who are also willing to adapt to these changing conditions.

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§18.17 3. Mathematics of Discounts

Discounts are generally applied in sequential fashion, as illustrated below.

EXAMPLE: Assume that a client gifts a 30-percent limited partner interest in an FLP to each of two children; the fair market value of the entity is $5,000,000; the discount for lack of marketability is 20 percent; the discount for lack of control is 30 percent; and the gift tax rate is 45 percent. Without applying any valuation discounts, the value of each gift is $1,500,000 ($5,000,000 × 0.30), the total value of the two gifts is $3,000,000, and the total gift tax (without any credits or exemptions) is $1,350,000. However, the total discounted value of the gifts, which the donor claims for gift tax purposes, is $1,680,000 ($3,000,000 less 20-percent discount for lack of marketability = $2,400,000; $2,400,000 less 30-percent discount for lack of control = $1,680,000). Thus, the discount in the aggregate is 44 percent ($1,320,000 divided by $3,000,000). The gift tax (without any credits or exemptions) is 45 percent of $1,680,000, or $756,000. Thus, the valuation discounts result in a gift tax savings of $594,000. Furthermore, an additional benefit may be realized at the client's death because the discounts could apply to the client's retained 40-percent interest. In that event, there would be additional tax savings of $396,000 ($2,000,000 initial retained value of FLP, less 20-percent discount = $1,600,000; $1,600,000 less 30-percent discount = $1,120,000; $1,120,000 × 45-percent estate tax rate = $504,000), compared to nondiscounted estate tax of $900,000 ($2,000,000 × 45-percent estate tax rate). As a result, the total transfer tax savings could be $990,000, in addition to the savings that may occur as the result of transferring potential future appreciation out of the client's estate.

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§18.18 4. Income Tax Consequences

Assuming that a valuation discount is successfully obtained by a decedent's estate for an interest in a family business entity, a potential countervailing tax issue for the recipient of the property should be considered. The value shown on the federal estate tax return will also be the basis of the interest in the hands of the recipient (and of the underlying assets in the entity with respect to that interest if an IRC §754 election is made for a partnership or LLC). IRC §1014; Treas Reg §1.1014-1(a). As a result, additional capital gains taxes may be incurred if the interest in or property of the entity is sold. In addition, basis carries over for any gifted interest in an entity, as with any other gift. See IRC §1015.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.19 B. Valuation Premiums

§18.19 B. Valuation Premiums

In some situations, the fair market value of an interest in a family business entity includes a valuation premium because the interest is a controlling interest or a minority interest with the potential of control. These valuation premiums are called the control premium and the swing vote premium.

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§18.20 1. Control Premium

Just as discounts apply to noncontrolling interests, a control premium may apply to a controlling interest in a family business entity. To some extent the control premium is simply the converse of the minority interest, and reflects that a willing buyer would pay more for a controlling interest in an entity. See *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191 (Ninth Circuit implicitly acknowledges concept of control premium, but holds that control premium cannot be applied unless it can be shown that a purchaser would be able to use the control in such a way as to assure an economic advantage).

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§18.21 2. Swing Vote Premium

A variation of the control premium is the swing vote premium, which adds value to a minority voting interest that has swing vote potential. The basis of the swing vote premium is that the owner of a minority voting interest has the potential to combine with other interest holders to gain majority voting control of the entity. See, *e.g.*, *Estate of Clara S. Roeder Winkler,* TC Memo 1989-231 (5-percent swing vote premium allowed). Conversely, a lack-of-control discount may be allowed for nonvoting interests in an entity.

For the swing vote premium to apply, the holdings of all the owners must be considered. For example, in IRS Letter Ruling 9436005, the IRS asserted that an increase in value (or at least a reduction in the minority interest discount) had to be applied to a block of shares that had swing vote potential. In this ruling, the donor had made a gift of 30-percent interests in a closely held corporation to each of his three children. The IRS ruled that the value of each gift was enhanced by the simultaneous transfers, because any two of the donees could join and control the corporation. In *Estate of Clara S. Roeder Winkler, supra,* there was a 50-percent block, a 40-percent block, and the decedent's 10-percent block. The court found additional value in the 10-percent block because a hypothetical buyer of that block could combine with one of the other two shareholders to either gain or block control of the company. However, in *Estate of Cyril I. Magnin,* TC Memo 2001-31, no swing vote premium was allowed because it could not be shown that a hypothetical buyer could combine with another shareholder and gain control.

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C. IRC Chapter 14 Valuation Rules: IRC §§2701-2704

§18.22 1. Introduction

For decades, taxpayers used various interests in corporate entities to attempt to shift some portion of the value of a group of assets to younger generations. These transactions were generally referred to as "estate freeze" transactions because the goal often was to shift all future appreciation to the younger generation while keeping a significant income interest for the older generation. A common approach was to issue preferred stock to the older generation and common stock to the younger generation. The preferred stock retained preferred distribution, liquidation, and voting rights, while the common stock had all the rights to appreciation. Usually, the common stock was valued at a very low percentage of the value of the entire entity.

Another approach was to transfer all rights except the right to vote. In *Byrum v U.S.* (SD Ohio 1970) 311 F Supp 892, aff'd (6th Cir 1971) 440 F2d 949, aff'd (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382, the district court held that the taxpayer's retention of the right to vote transferred shares was not a retention of the entire value of the shares for estate tax purposes. The IRS had asserted that retaining the right to vote was an impermissible retained interest under IRC §2036(a). In response to the *Byrum* decision, Congress enacted IRC §2036(b), which provides that retention of the right to vote shares in a controlled corporation (defined in IRC §2036(b)(2) as ownership by the decedent of at least 20 percent of the voting stock) will be considered a retained interest that causes the value of the shares to be included in the transferor's estate. Enactment of this section, however, did not stop the use of numerous other estate freeze techniques.

In 1990, Congress enacted the special valuation rules of Chapter 14 of the Internal Revenue Code (IRC §§2701-2704). In general, the Chapter 14 rules attack traditional estate freeze techniques, as well as a number of other intrafamily transactions, in which the value of a transferred interest was considered by the IRS to be undervalued for gift and estate tax purposes. The mechanics of Chapter 14 generally involve ignoring certain rights, restrictions, or retained interests when valuing a transferred interest. Despite these rules, however, gifts of interests in family business entities can still be eligible for valuation discounts if the entity is properly structured, the gifted interest is a minority or noncontrolling interest, and the interest has the same economic rights as other interests in the entity.

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§18.23 a. IRC §2701

This section applies to the valuation of interests in corporations and partnerships, and, by extension, LLCs. It generally seeks to prevent a low valuation of intrafamily transfers of such interests to a younger generation when the older generation retains a preferred interest with certain distribution, liquidation, put, call, or conversion rights. Such a retained interest is called an "applicable retained interest." Unless certain requirements are met, the value of an applicable retained interest is deemed to be zero and the value of the transferred interests will equal the value of the entire entity.

To be considered to have value, a retained interest must have a "qualified payment right." A qualified payment right requires actual payments to be made at least annually, at a fixed rate or amount, with an interest penalty attached if the payments are not made. The cash flow requirement to make the payment is unrelenting and generally makes operating within this rule unattractive.

Internal Revenue Code §2701 does not apply if (1) there are readily available market quotations to value a transferred interest or an applicable retained interest; (2) the retained interest is of the same class, or proportionally the same, as the transferred interest; or (3) the transfer proportionately reduces each class of interest held by the donor, the donor's spouse, and their ancestors in the aggregate. IRC §2701(a)(1), (2); Treas Reg §25.2701-1(c), (d). The section also will not apply if a corporation, partnership, or LLC has only one class of outstanding stock or interests. See Treas Reg §25.2701-1(c)(3).

For further discussion of IRC §2701, see chap 25.

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§18.24 b. IRC §2702

This section generally applies to interests in trusts or trust-like arrangements in which the grantor has a retained interest and has made a gift of an interest in the trust to family members. As in IRC §2701, unless certain requirements are met, the value of a retained interest is deemed to be zero for gift tax purposes. This statute has essentially eliminated the use of the "grantor retained income trust" (GRIT) among family members, which, in the IRS's view, allowed the grantor to value the gifted remainder interest in a manner that, although actuarially correct for gift tax purposes, could be undervalued when measured against actual economic performance.

The statute makes an exception, however, for a "qualified personal residence trust" (QPRT), which allows the grantor to continue living in his or her residence for a specified term following transfer of the residence to the trust. IRC §2702(a), (b). The statute also permits the continued use of the "grantor retained annuity trust" (GRAT) and "grantor retained unitrust" (GRUT). In general, GRATs and GRUTs can provide transfer tax savings if the grantor outlives the term of the trust, and if the underlying property appreciates at a rate that is higher than the applicable federal rate under IRC §7520, which is used to value the remainder interest for gift tax purposes at the time the trust is created. Treas Reg §25.2702-2(b). For further discussion of these trusts, see chap 25.

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§18.25 c. IRC §2703

This section applies to agreements among family members involving rights to acquire or use property at a price less than the fair market value of the property, or restrictions on the right to sell or use property. The rights or restrictions may be contained in options; buy-sell agreements; partnership, operating, or shareholders' agreements; or any other agreement. Under IRC §2703, these rights or restrictions will be disregarded in valuing the transferred property for transfer tax purposes, unless the option, agreement, right, or restriction meets the following requirements: (1) it is a bona fide business arrangement; (2) it is not a device to pass on wealth to members of the decedent's family at a reduced value; and (3) its terms are comparable to similar agreements among unrelated persons in arms'-length transactions. IRC §2703(b).

NOTE: Although an option or buy-sell agreement among unrelated parties can reduce the value of property for estate tax purposes, such an agreement among family members could not do so even before the enactment of IRC §2703, unless the agreement met certain requirements set forth in Treas Reg §20.2031-2(h) and case law. Under the regulation and case law, to avoid being disregarded in valuing property, buy-sell agreements had to meet the first two requirements of IRC §2703, *i.e.*, be a bona fide business arrangement and not be a device to pass on wealth at a reduced value. Many planners believed that the third requirement added in IRC §2703 (comparability of terms) would be almost impossible to meet. See *Thomas H. Holman* (2008) 130 TC 170, discussed in §18.34 (IRS expert's view that terms of agreement were not comparable to similar arrangements entered into in arm's-length transactions because no one would enter into such an agreement at arm's length).

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.26 d. IRC §2704

§18.26 d. IRC §2704

This section concerns the treatment for gift and estate tax purposes of (1) lapses of voting or liquidation rights and (2) transfers of interests with liquidation restrictions. A thorough understanding of this section is critical to the proper structuring of family business entities for gift and estate tax valuation purposes.

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§18.27 (1) IRC §2704(a)

In general, IRC §2704(a) treats the lapse of voting or liquidation rights in a business entity as either a transfer by gift or a transfer includable in the decedent's gross estate, depending on when the lapse occurs. This section applies only if the individual with the rights and his or her family (as defined in IRC §2704(c)(2)) control the entity both before and after the lapse. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(c)(1); Treas Reg §25.2701-2(b)(5). The effect of IRC §2704(a), if it applies, will often be to eliminate the discounts for minority interest or lack of marketability, or both. This rule prevents a reduction in the value of interests in closely held entities transferred by a donor whose retained interests have voting or liquidation rights that lapse after the transfer. This statute was enacted in response to *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8, in which the decedent's right to force liquidation lapsed at death and the right was not taken into account in determining the value of the estate.

Generally, IRC §2704(a) will not apply if an individual does not possess a voting or liquidation right. As a result, this section should be relatively easy to plan around.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.28 (2) IRC §2704(b)

§18.28 (2) IRC §2704(b)

In planning for valuation discounts, IRC §2704(b) is probably more troublesome than IRC §2704(a). It provides that for purposes of valuing a family business interest that is transferred to a member of the transferor's family, any "applicable restriction" will be disregarded to the extent that it is more restrictive than the limitations that would apply under federal or state law in the absence of the restriction. IRC §2704(b)(3)(B); Treas Reg §25.2704-2(b). An applicable restriction is one that (1) restricts the ability to liquidate the entity, and (2) either (a) lapses after the transfer, or (b) can be removed by the transferor or his or her family members. This section applies only if the transferor and his or her family (as defined in IRC §2704(c)(2)) control the entity before the transfer. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(b), (c)(1); Treas Reg §§25.2701-2(b)(5), 25.2704-2(b). If the donor or decedent would have the right to liquidate the entity in the absence of the applicable restriction, the effect of IRC §2704(b) will be to eliminate entity-level valuation discounts.

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§18.29 (3) Dissolution

Under California limited partnership law, except as otherwise provided in the partnership agreement, a California LP will be dissolved on the approval of all general partners and a majority in interest of the limited partners. Corp C §15908.01(b). Thus, a provision in a California limited partnership agreement requiring the approval of all limited partners to liquidate the partnership (along with the approval of all general partners) would be an applicable restriction under IRC §2704(b) because the California default rule requires approval of only a majority of the limited partnership interests. Similarly, California limited liability company law provides that the vote of a majority in interest of the members will dissolve an LLC, unless a greater percentage of the voting interests is specified in the LLC's articles of organization or operating agreement. Corp C §17350(b). However, any supermajority dissolution requirement in the organizing documents would be treated as an applicable restriction. As a result, it is the author's belief that the limited partnership rules, requiring unanimous consent of the general partners to dissolve, are more restrictive than the limited liability company rules and are, therefore, more likely to sustain valuation discounts. California corporations will be dissolved on the vote of shareholders with 50 percent or more of the voting power. Corp C §1900(a). This percentage cannot be changed.

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§18.30 2. IRS Attacks on Valuation Discounts

The IRS has consistently attacked the valuation discounts that practitioners have asserted for partnerships and other closely held enterprises, especially where the enterprises are not traditional businesses. See, *e.g.,* IRS Letter Rulings 9723009, 9725002, 9730004, and 9842003, citing *Estate of Elizabeth B. Murphy,* TC Memo 1990-472. In *Estate of Murphy*, 18 days before dying, the decedent gifted about 2 percent of her stock in a closely held corporation to her children, reducing her controlling 51-percent interest to a 49-percent minority interest. The court held that a minority discount could not be applied because the sole purpose and effect of fragmenting the control block of stock was to reduce federal tax. The court stated that nothing of substance was intended to change as a result of the transfers, and the gifts did not significantly affect the decedent's beneficial interest except to reduce estate taxes.

The IRS has also used the Chapter 14 rules as well as a host of other arguments in its attack. In Field Service Advice 200143004, the IRS reasserted several arguments against valuation discounts in family-owned entities, despite a number of defeats in the courts. The IRS position includes arguments that:

- The entity lacks economic substance and should be disregarded for gift or estate tax purposes (a substance-over-form argument);
- Internal Revenue Code §2703 requires all family business entities to be ignored for valuation purposes;
- Any restriction in excess of restrictions applicable under state law should be ignored for valuation purposes under IRC §2704(b);
- The assets of the entity are included in the estate of the transferor under IRC §2036(a);
- A gift can occur on formation of an FLP if the total value of all partnership interests, valued individually, are not equal to the total value of the underlying property (although the IRS recommended against using this argument in Field Service Advice 200143004, it remains an argument that it may raise); and
- In the alternative, the claimed discounts for lack of control and lack of marketability will be considered excessive in certain cases.

Given IRS antipathy towards the valuation of family business entities, the practitioner should advise clients forming these entities of the risks involved in entering into what the IRS regards as aggressive tax planning. The practitioner should also have a thorough understanding of the federal and state laws that affect the existence of this valuation approach. The IRS has achieved the most success in the courts using IRC §2036(a)(1) and, in a surprising turn of events, IRC §2036(a)(2). See §§18.37-18.37E.

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§18.31 3. Court Responses to IRS Arguments

A number of cases in which the IRS has challenged valuation discounts on a variety of grounds have held for the taxpayer and allowed valuation discounts for interests in family business entities for gift and estate tax purposes, although the amount of some of the discounts has been adjusted by the court.

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§18.32 a. IRC §2704(b) Argument

The IRS has argued that the existence of a term in a FLP agreement, *i.e.,* a specified date when the entity would dissolve and liquidate, is an applicable restriction under IRC §2704(b) if state law permits a limited partner to withdraw from a limited partnership that does not have a stated term. Similarly, the IRS once might have argued that there is an applicable restriction for a California limited partnership if the partnership agreement restricts the right of a majority limited partner to remove the general partner. The applicable restriction is supposedly present because the right to remove gives the majority limited partner the ability to coerce the general partner to consent to dissolution. However, under the Limited Partnership Act of 2008 (Corp C §§15900-15912.07; see §18.6), a majority of limited partners no longer has the right to remove a general partner. See generally Corp C §§15903.01-15903.07.

PRACTICE TIP: Practitioners with clients who will retain a majority interest in a partnership may wish to consider forming the partnership under the law of a state that does not give the majority partner the right to remove the general partner and that does not give a limited partner the right to withdraw from a partnership that does not have a stated term.

Although two Tax Court cases had held that the IRS could apply the applicable restriction test only to dissolution statutes in determining whether an applicable restriction exists, both cases have ultimately been resolved on other grounds and may no longer be persuasive authority. In *Baine P. Kerr* (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490, the Fifth Circuit held that IRC §2704(b) did not apply because an unrelated party, the University of Texas, was a limited partner and the family therefore did not control the partnership for purposes of §2704(b). Thus, the question of whether the term limit was an applicable restriction was not reached and the holding in the Tax Court decision now appears to be simply dictum. In *Estate of Morton B. Harper*, TC Memo 2000-202, the court relied on the Tax Court's holding in *Kerr* in reaching a similar result. However, in *Estate of Morton B. Harper,* TC Memo 2002-121, the court held that IRC §2036(a) applied to the taxpayer. See §18.37A. Thus, the result in the first *Harper* decision, although apparently still good law, is now based on dictum in another case and has been rendered moot (although apparently not overruled) by subsequent proceedings in the same case. Although the arguments raised in the two Tax Court cases may still be valid, the issues are far from settled under existing case law.

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§18.33 b. Lack of Economic Substance Argument

A second IRS argument is that an FLP should be disregarded for federal tax purposes because it lacks economic substance. This argument was dealt a defeat in *Ina F. Knight* (2000) 115 TC 506, in which the tax court refused to ignore the existence of an FLP for failure to have economic substance. Instead, the court found that state law governs the existence of property rights, that the partnership was a valid partnership under state law, and that because a potential buyer would not ignore the partnership, the partnership should be recognized in valuing the partnership interest for federal estate and gift tax purposes.

The tax court, however, agreed with the IRS and disallowed a minority interest discount for lack of economic substance in *Estate of Elizabeth B. Murphy,* TC Memo 1990-472. See §18.30. It is important to note that the court referred to several writings from the donor's professional advisers exhorting her to make the gift in order to reduce her interest for the purpose of obtaining a minority interest discount. See also *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367.

In contrast to *Estate of Murphy*, the tax court did not apply the lack of economic substance argument in *Estate of Anthony J. Frank, Sr.*, TC Memo 1995-132, in which the decedent's son, acting under a power of attorney, made a gift of more than 18 percent of the decedent's stock in a closely held corporation to the decedent's wife just 2 days before the decedent's death. The court ignored the motive for the gift because a much smaller gift would have accomplished the goal if tax avoidance had been the only motive for the gift.

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§18.34 c. IRC §2703 Argument

The IRS has argued that the partnership form itself is the restriction that must be disregarded under IRC §2703 for valuation purposes. This argument was struck down in *Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion), in which the court held that it would not disregard the taxpayer's FLP because it was validly formed under state law. See also *Estate of W.W. Jones II* (2001) 116 TC 121. But see *Smith III v U.S.* (WD Pa 2004) 2004-2 USTC ¶60,488, 94 AFTR2d 5283 (FLP agreement provision concerning partnership's right to pay purchase price in installments if it exercises right of first refusal disregarded for valuation purposes unless IRC §2703(b) safe harbor provision applies). This principle was first set forth by the Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I)*, but the court of appeals remanded the case to determine whether IRC §2036(a) applied. On remand, see *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*). See §18.37A. Thus, the precedential value of *Strangi I* is in question.

At least one court has used IRC §2703 to disregard the valuation of an appraiser who relied on the buy-sell restriction in the partnership agreement in determining the value of a limited partnership interest. See *Smith III v U.S., supra*. More recently, in *Thomas H. Holman* (2008) 130 TC 170, the court found that the buy-sell provisions of a limited partnership agreement operated to restrict the ability of the limited partners to reach their proportionate share of the underlying value of the partnership. Therefore, the court deemed the buy-sell provisions to be a device to pass wealth to other family members, even though the buy-back provisions required the units to be priced at fair market value, and held that the IRS properly ignored the restrictions when valuing the limited partnership units because the values of the interests of the remaining partners would increase if the partnership were to purchase limited partnership units transferred in violation of the agreement. (The IRS expert also took the view that the terms of the agreement were not comparable to similar arrangements entered into by persons in arm's-length transactions for the simple reason that no one would ever enter into the agreement at arm's length.) The court concluded that the restrictions were not part of a "bona fide business arrangement" in any event, as required by IRC §2703(b), because the restrictions were intended to prevent dissipation of property by the limited partners—not to preserve a business. It remains to be seen whether other courts will accept the premise that buy-sell provisions that require use of fair market value are properly characterized as a device to pass wealth to family members, or that there is a substantial difference in value when fair market value is the standard in the buy-sell agreement.

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§18.35 d. Lost Value Argument

The Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I)*, also invalidated the IRS argument that seeks to find a gift on formation of the FLP by arguing that the "lost" value has to go somewhere. The court held that there was no gift on the formation of the partnership, which occurred 2 months before the decedent's death, principally because the decedent received credit for all of his contributions in his capital account with the partnership. See also *Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion); *Estate of W.W. Jones II* (2001) 116 TC 121.

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§18.36 e. Family Attribution

To some extent, IRS complaints about valuation discounts applicable to family business entities have focused on the perception that a family will act together, and that if control is held in the family unit, discounts are illusory (this argument underlies the Chapter 14 rules). After a number of defeats in the courts, however, the IRS issued Rev Rul 93-12, 1993-1 Cum Bull 202, in which it conceded that the value of an intrafamily gift of a minority interest in a corporation is determined by looking only at the interest transferred and not by aggregating the voting power held by all family members. *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. See also *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Estate of Elizabeth M. Lee* (1978) 69 TC 860, nonacq 1980-2 Cum Bull 2. By extension, this also applies to valuations of FLP and FLLC interests.

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§18.37 4. IRS Litigation Victories Using IRC §2036(a)

Although the IRS has yet to succeed in court on any of its more esoteric theories designed to invalidate all family limited partnerships, significant IRS victories under IRC §2036(a) have had a major impact on partnership planning. See *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*); *Estate of Wayne C. Bongard* (2005) 124 TC 95 (transfer to partnership was ineffective for estate tax purposes).

Internal Revenue Code §2036(a) provides that a decedent's gross estate includes any property transferred by the decedent, excluding transfers by bona fide sale for full and adequate consideration, in which the decedent retained either (1) the possession or enjoyment of the property or right to income of the property, or (2) the right, alone or in conjunction with any other person, to designate the persons who could possess or enjoy the property or its income. See §18.37A. Most planners are now convinced that partnerships should have a legitimate and significant business or nontax purpose. See §18.37B. In addition, planners may have to take other measures to lessen the impact of these cases in any partnership where discounts are desired or gifts are made. See §18.37C. Planners also should consider the possible application of the step-transaction doctrine. See §18.37D.

Whenever a taxpayer will retain any interest in a partnership or other business entity, the practitioner will have to consider the impact of IRC §2036(a). Documenting the nontax purpose promises to be the most effective way to ensure that this section will not be applied. See §18.37E.

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§18.37A a. Application of IRC §2036(a)(1)-(2)

It has always been clear that IRC §2036(a)(1) applies if the decedent had either an express or implied agreement to retain the enjoyment of property. See *Estate of Wayne C. Bongard* (2005) 124 TC 95; *Estate of Hilde E. Erickson*, TC Memo 2007-107; *Estate of Lorraine C. Disbrow,* TC Memo 2006-34; *Estate of Austin Korby*, TC Memo 2005-103, aff'd (8th Cir 2006) 471 F3d 848; *Estate of Virginia A. Bigelow*, TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955; *Estate of Lea K. Hillgren,* TC Memo 2004-46; *Estate of Ida Abraham*, TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26, cert denied (2006) 547 US 1178; *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367, and *Estate of Morton B. Harper,* TC Memo 2002-121. Now, as a result of the Tax Court opinion in *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*), planners must also consider the effect of IRC §2036(a)(2) (not discussed in the Fifth Circuit decision).

Generally, §2036(a)(2) was thought to be more limited in scope than §2036(a)(1). Before *Strangi II*, it was believed that a general partner's duty to control and manage a partnership was insufficient to cause inclusion because of the fiduciary duties owed to the limited partners. See *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382. See also IRS Letter Rulings 9415007, 9310039. The Tax Court opinion in *Strangi II* distinguished *Byrum* stating that the fiduciary duties in *Byrum* were far more significant than the fiduciary duties in *Strangi II*. The Tax Court noted the presence of unrelated shareholders and an independent trustee in *Byrum* compared with the absence of any non-family members in *Strangi II* and the fact that Strangi essentially owned all of the partnership. Without a meaningful fiduciary duty, the court held that Strangi's 47 percent interest in the corporate general partner allowed him (through his attorney-in-fact since Strangi was actually incapacitated at the time), in conjunction with the other shareholders, to control the income of the partnership thereby justifying inclusion under §2036(a)(2) as well as having a retained income interest under §2036(a)(1). The Tax Court opinion in *Strangi II* also ignored the holding in *Estate of Cohen* (1982) 79 TC 1015, which held that IRC §2036(a)(2) did not apply to trustees of a Massachusetts business trust who had the power to declare dividends.

After *Strangi II*, and contrary to its holding on this point, the court in *Estate of Anna Mirowski*, TC Memo 2008-74, cited the general partner's fiduciary duties under Maryland law as a reason why IRC §2036(a)(2) did not apply to gifts of limited partnership units made to trusts for the decedent's daughters. See also *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257 (decedent's 50-percent interest in general partner not sufficient to make §2036(a)(2) apply). Neither case discussed the *Strangi II* language concerning intra-family fiduciary duties.

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§18.37B b. Significant Nontax or Business Purpose

Although some observers had feared that the IRS would try to apply IRC §2036(a)(2) to all family business entities, it is now relatively clear that if a taxpayer establishes a significant nontax or business purpose for the formation of the business entity, §2036, including §2036(a)(2), will not apply. See *Estate of Thompson v Commissioner* (3d Cir 2004) 382 F3d 367 (no legitimate business purpose); *Estate of Murphy v U.S.* (WD Ark 2009) 2009-2 USTC ¶60,583, 104 AFTR2d 7703 (significant nontax reasons, including centralized management and preservation of voting power); *Estate of Samuel P. Black* (2009) 133 TC No. 15 (avoiding reduction in swing vote potential of block of stock, together with other considerations, provided sufficient nontax reason for limited partnership); *Estate of Wayne C. Bongard* (2005) 124 TC 95 (one entity had business purposes, another entity did not); *Estate of Anna Mirowski*, TC Memo 2008-74 (legitimate nontax purposes included limited liability and centralized management); *Estate of Charles Porter Schutt*, TC Memo 2005-126 (significant nontax purpose found when taxpayer wished to avoid diversification of particular publicly traded company's stock); *Estate of Virginia A. Bigelow*, TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955 (no legitimate nontax purpose; gift giving is testamentary in nature and cannot be legitimate nontax purpose); and *Estate of Eugene E. Stone III*, TC Memo 2003-309 (significant nontax purpose). These courts have held that if a taxpayer has a legitimate nontax purpose, it is a bona fide transfer for adequate consideration on formation of the partnership, thereby precluding the operation of §2036. However, the purpose must be real, not theoretical, and not simply recited in the partnership agreement.

The inquiry into whether a nontax purpose rises to the level required is factual and may turn to some extent on the nature of the underlying assets of the partnership. Operating businesses, agricultural concerns, and rental real property are among the types of assets that are often commonly held in limited partnerships or limited liability companies to limit liability, regardless of estate tax consequences. As a result, the author believes it will be easier to establish legitimate business purposes for entities holding these types of assets.

Several cases have examined limited liability as a legitimate nontax purpose. Although some of the cases have held that the taxpayer did not establish that there was any liability from which protection was needed, none of them held that limiting liability was itself not a legitimate nontax purpose. See *Estate of Bigelow, supra*; *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468. Furthermore, at least two cases have specifically held that limiting liability was a legitimate nontax purpose for the particular taxpayer in question. See *Estate of Anna Mirowski, supra*; *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257. *Mirowski* involved partnership-owned patents that may have been subject to litigation, and *Kimbell* involved partnership-owned oil and gas properties, but it is not entirely clear from either opinion just how necessary the liability protection actually was. Although risks from liability connected with real property or operating businesses can be protected through insurance, clients are commonly advised to consider LPs and LLCs for additional liability protection. As a result, limiting liability should be a legitimate nontax purpose for these types of assets. See, *e.g., Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015 (purpose of protecting assets from divorce was legitimate and satisfied bona fide sale exception of IRC §2036(a)). Regardless of the type of asset, it is good practice to document the client's significant nontax purposes.

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§18.37C c. Other Strategies to Avoid IRC §2036(a)

There are also strategies that might prevent the application of IRC §2036(a)(2) even if a court does not find significant nontax purposes. For example, control over distributions might be given to a general partner other than the taxpayer while allowing the taxpayer to retain input over management issues. It is the author's belief that if other family members have significant ownership interests, fiduciary duties should be recognized, making the application of §2036(a)(2) more difficult. Nevertheless, planners must not only consider strategies designed to highlight these fiduciary duties or to isolate control over income, but must also consider how these strategies can be integrated with the client's nontax goals. In addition, because the courts have treated the transfer of too much of a taxpayer's property to a partnership as evidence of an implied agreement to retain enjoyment, taxpayers undertaking partnership planning should be advised to keep a substantial amount of their assets outside of the partnership and available to support their lifestyle and meet their obligations. See, *e.g., Estate of Virginia A. Bigelow*, TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955. One court has allowed the taxpayer to look at distributions expected from the partnership that are proportional to the taxpayer's nontransferred interest in determining whether sufficient assets were kept to meet expected obligations. *Estate of Anna Mirowski*, TC Memo 2008-74.

Some practitioners also believe that the right to vote on liquidations is a power, alone or in conjunction with others, to control the income or property of the partnership. Under the Limited Partnership Act of 2008 (Corp C §§15900-15912.07; see §18.6), it appears that California will allow restrictions on a limited partner's right to vote on liquidations. Therefore, if a practitioner believes that this voting right will be characterized as a power to control, the partnership agreement could be drafted to eliminate the right. Again, practitioners will need to consider whether such a provision will serve the client's nontax goals.

In some cases, the IRS may fail to raise the §2036(a) argument, which has produced at least one unusual result. See *Estate of Webster E. Kelley,* TC Memo 2005-235 (12-percent minority discount and 23-percent marketability discount applied even though only partnership asset was cash).

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§18.37D d. Application of Step-Transaction Doctrine

The IRS has also now successfully applied the step-transaction doctrine to gifts of partnership interests. See *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044. In *Senda,* the court found that the taxpayers made indirect gifts of stock, not gifts of partnership interests, because the transfer of partnership interests was made in an integrated transaction at the same time as the transfer of assets to the partnership. Some commentators believe the door has now been opened for application of the doctrine to a transfer of property to the partnership *followed* by a gift of partnership interests if the two actions were part of a single "integrated transaction." Therefore, it may be difficult to determine how long a practitioner should wait once assets have been transferred to a partnership before gifts or other transfers of partnership interests are made in order to avoid application of the step-transaction doctrine. *Eighth Circuit Decides to Senda Message: Step-Transaction Doctrine Can Apply to FLP Contribution/Gift Transactions*, 27 CEB Est Plan Rep 93 (Feb. 2006). However, fears that the doctrine could be broadly applied in this context may be overblown. See, *e.g., Thomas H. Holman* (2008) 130 TC 170 (gifts of limited partnership units made 5 days after formation of partnership not subject to step-transaction doctrine because of possible market fluctuations in underlying publicly held stock). But see *Heckerman v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,578, 104 AFTR2d 5551, and *Linton v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,575, 104 AFTR2d 5176, in each of which the court held that donors made indirect gifts of assets transferred to an LLC on the same day that they transferred LLC units to trusts for children. Even if there had been some evidence that the funding of the LLC occurred first, the funding of the LLC and the transfers of LLC units should be deemed to occur simultaneously under the step-transaction doctrine. The court in both cases relied on *Senda* and distinguished *Holman*.

Additional cases applying this doctrine are likely to be decided. See, *e.g., Suzanne J. Pierre* (2009) 133 TC No. 2 (application of step-transaction doctrine specifically reserved for separate decision). *Pierre* is significant for other reasons as well because the court held that gifts of membership interests in a single-member LLC were gifts of LLC interests rather than gifts of the underlying assets of the LLC. The court held that state law concepts control the nature of property interests, and therefore the IRS's disregarded-entity rules applicable to single-member LLCs do not apply for purposes of the federal gift tax.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.37E 5. Planning Responses to IRC §2036(a) Attacks

§18.37E 5. Planning Responses to IRC §2036(a) Attacks

IRS attacks using IRC §2036(a) have generated extensive discussion among estate planners using partnerships, and a number of planning responses. First and foremost, practitioners should realize that partnerships without any serious nontax objectives are unlikely to achieve the desired tax consequences. See §18.37A. In addition, practitioners need to counsel clients to take precautions to avoid the more obvious problems highlighted by these cases. Some of the precautions that should be considered are:

- *Avoid disproportionate distributions.* Prorata distributions show that all partners have a stake in the partnership. Disproportionate distributions, especially going back to the original transferor, are strong evidence of an implied agreement that the transferor may retain use of the assets.
- *Retain funds outside the partnership for personal use.* The client should retain sufficient assets to completely fund his or her lifestyle. If the client has to rely on the partnership for living expenses, a court may find it very easy to infer that there was an agreement that the funds would be available for that purpose and are therefore an impermissible retained interest. It should be noted, however, that many practitioners believe it should be permissible for the client to rely on his or her *proportionate* share of partnership income for living expenses.
- *Respect partnership formalities.* Obviously, separate partnership accounts and records should be kept. Holding meetings and taking minutes is also probably a good idea. Again, careful practitioners will admonish clients to operate the partnership as a business (even if the business is investing in passive assets) and to avoid using partnership assets for any purpose that does not benefit the partnership. In addition, contribution of property to the partnership should be properly documented and occur before any transfers of partnership interests.
- *Document business purpose and economic substance.* The partnership's investment policies and activities should be documented. The investment policy should be tailored to the partnership as a whole and not to the original owner, although the continuation of certain family investment values can be a significant nontax purpose. In some cases, the underlying activities will be ongoing businesses, which should easily satisfy the business purpose requirement, especially if the original business was not otherwise in an entity.
- *Isolate control.* The partnership can be structured so that control over distributions is held by someone other than the original owner. For example, in a partnership with two general partners, the second general partner, who should not be the client, could be given exclusive authority over distributions. This precaution may not be sufficient if the *Strangi II* holding is expanded to cover any situation in which two persons in a partnership (whether limited or general) can somehow combine to make a decision to control income. Ironically, this precaution might not ordinarily be taken in most business partnerships but might be prudent when the only members of the partnership are related, even if the underlying asset is an ongoing and active business. It may also be prudent to eliminate the right to vote on liquidations for any class of interest that the client will retain.
- *Have all partners contribute.* Having a number of partners contribute more than a *de minimis* amount at the initial formation of the partnership may help the partnership qualify for the full and adequate consideration exception to IRC §2036(a)(2). From a practical standpoint, having each partner risk some capital should also help indicate that the economic arrangement was a true partnership.
- *Consider transferring all interests.* Although some of the initial appeal of the partnership may have been the ability to retain control, it could make sense for existing partnerships to consider a transfer of all of the donor's interest in the partnership because IRC §2036(a) is an estate tax statute and has no application for gift tax purposes. Practitioners should be careful in these situations, however, to consider the 3-year rule of IRC §2035, which generally applies to gifts of retained interests under IRC §2036(a); as a result, it may be preferable to sell, rather than gift, remaining partnership interests.

These suggestions make clear that partnership planning, more than ever, must encompass nontax and business motivations. Practitioners also must be vigilant to watch for future developments in this area, as additional court rulings appear likely.

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D. Appraisals

§18.38 1. Documenting Discount

Although it is clear that the minority interest discount and the discount for lack of marketability apply to family business entities, the taxpayer has the burden of showing the amount of the discount. *Estate of Edgar A. Berg,* TC Memo 1991-279, aff'd in part and rev'd in part on other grounds (8th Cir 1992) 976 F2d 1163. For all practical purposes, the taxpayer must hire a qualified appraiser in order to prove the amount of each discount. Appraisals must address and document the particular situation and cannot merely rely on previous cases to establish the amount of discounts. Often, the presence of appraisals can present significant hurdles to the IRS or establish the bona fides of a particular transaction. See, *e.g., McCord v Commissioner* (5th Cir 2006) 461 F3d 614 (appraisal of value documenting transfer between charity and children of taxpayers validated).

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§18.39 2. Contents of Appraisal

Generally, appraisers employ a variety of methods, including the income approach, which analyzes the cash flow of the entity, and the market approach, which compares the entity in question to similar entities. Appraisers must look at the particular fact of the entity being valued and relate their conclusions to the facts. Courts are not bound to accept the opinion of any expert witness and have shown an increasing tendency to reach conclusions about value using their own analysis. See, *e.g., Thomas H. Holman* (2008) 130 TC 170, discussed in §18.34. The Tax Court in particular seems willing to substitute its own judgment for that of any appraiser, whether for the IRS or for the taxpayer, if the court believes the experts have not properly supported their conclusions. See, *e.g., Bernard Mandelbaum,* TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124. In *Mandelbaum,* a widely read case, the court decided that neither the IRS's expert nor the taxpayer's expert had presented a persuasive case. The ruling then set forth a list of ten nonexclusive factors to determine the lack of marketability discount for stock of a closely held corporation. Some appraisers have adopted the *Mandelbaum* factors, while others have criticized the court's approach. See also *Estate of Josephine T. Thompson*, TC Memo 2004-174, vacated on other grounds (2d Cir 2007) 2007-2 USTC ¶60,546, 100 AFTR2d 5792 (affirming Tax Court valuation except for double counting).

In Rev Rul 59-60, 1959-1 Cum Bull 237, the IRS set forth factors to be used to determine the fair market value of interests in closely held corporations. These factors are virtually identical to those listed in Treas Reg §25.2512-2(f)(2), and have been widely accepted in determining fair market value.

NOTE: Practitioners should carefully review appraisals for any factual inaccuracies. Although questioning certain technical issues may be difficult, practitioners should at least make sure that the appraisal is analyzing the particular company in question and not simply reaching an arbitrary conclusion. Practitioners may also want to request appraisers to consider the value of limited partnership units without regard to restrictions on transfer contained in the partnership agreement or other governing documents, as a way of taking into account the possible impact of the ruling in *Thomas H. Holman, supra*.

Appraisers also must now be aware of potential penalties for appraisals in which assets are valued at less than 40 percent of the value such assets are ultimately determined to have for transfer tax purposes. See IRC §§6662(h)(2)(C), 6695A. As noted by the court of appeals in *Estate of Josephine T. Thompson, supra,* reliance on an appraiser does not necessarily establish reasonable cause and good faith for purposes of the reasonable cause exception to the taxpayer penalty for the undervaluation. See IRC §6664(c).

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§18.40 3. Adequate Disclosure Requirement for Gift Tax Return

Gifts are reported on IRS Form 709, the federal gift tax return. The statute of limitations that applies to reported gifts is 3 years after the date of filing the return. IRC §6501(a). Once the period of limitations expires, the amount of that gift as reported on the return may not be adjusted for purposes of determining future gift and estate tax liability. IRC §6501(c)(9). Under IRC §6501(c)(9), however, a gift must be adequately disclosed on a gift tax return in order to commence the running of the period of limitations on assessment with respect to the gift. Therefore, most practitioners advise that gift tax returns should always be filed to begin the running of the statute of limitations. For further discussion of gift tax returns, see chap 10.

PRACTICE TIP: Although some transfers may not result in taxable gifts (*e.g.,* sales for fair market value when discounts are taken), a question on the IRS Form 706 estate tax return regarding transfers or sales of interests in partnerships, limited liability companies, or closely held corporations to a trust may now make it prudent to file a gift tax return for any such transfers.

The regulations under IRC §6501 provide guidance on what constitutes adequate disclosure. The information that is required includes:

- A description of the transferred property and any consideration received by the transferor;
- The identity of, and relationship between, the transferor and each transferee; and
- If an appraiser is not used, a detailed description of the method used to determine the fair market value of property transferred, including any financial data that were utilized; any restrictions on the transferred property that were considered in determining the fair market value of the property; and a description of any discounts, such as discounts for blockage, minority, or fractional interests, and lack of marketability, claimed in valuing the property; or
- If an appraiser is used, a detailed description of the information considered in arriving at the conclusion sufficient to allow replication; the valuation method used and the procedure in using the method; the appraiser's qualifications; and a statement that (1) the appraiser holds himself or herself out to the public as an appraiser, (2) the appraiser is qualified, (3) the appraiser is not the donor, related to the donor, or employed by the donor, and (4) gives the specific basis for the valuation, such as comparable sales, used in the appraisal. See Treas Reg §301.6501(c)-1(f)(2)-(3) for the complete list of requirements.

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§18.40A E. Circular 230

Practitioners must also be aware of Circular 230 (31 CFR pt 10) whenever providing tax advice on which a taxpayer intends to rely. Under 31 CFR §10.35, certain written advice (including e-mail) concerning federal tax issues must comply with detailed requirements relating to the use of reasonable factual assumptions and the need to provide a conclusion with respect to each significant issue considered in the opinion. To avoid problems under Circular 230, the practitioner may instead include a prominent disclosure that any written tax advice was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. For further discussion of Circular 230, see §2.7A.

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§18.41 IV. STRUCTURING AND FORMING THE FAMILY BUSINESS ENTITY

The structure of the family business entity will depend on the interpersonal relationships of the family and how the structure impacts value for tax purposes. Although drawing conclusions from the numerous valuation cases is perhaps difficult, practitioners must address the question of whether structuring a transaction primarily or solely for estate tax purposes is impermissible, given the attention in court opinions to estate planning recommendations by advisers to families regarding valuation issues. Some of the cases seem to indicate that an entity only need be validly formed and recognized under state law for the entity to be recognized and the transaction to be valid for transfer tax purposes. See, *e.g., Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion); *Ina F. Knight* (2000) 115 TC 506. If this is true, the tax motivation for forming the entity is irrelevant. Other cases seem to disallow transfer tax consequences to transactions when the only motivation is to reduce taxation. See, *e.g., Estate of Elizabeth B. Murphy,* TC Memo 1990-472. Accordingly, the author recommends that the contemplated family business entity have clearly documented, significant business or nontax purposes in addition to estate tax savings attributes. Internal Revenue Code §2703 must also be considered.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.42 A. Business Purpose

§18.42 A. Business Purpose

Family business entities can meet a number of goals. The possible gift and estate tax savings may attract clients, but if tax savings are the only motive, clients may ultimately be disappointed and the entity may be disregarded for tax purposes for lacking substance. At best, a family business entity accomplishes one or more of a number of nontax goals, some of which are discussed in the following sections.

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§18.43 1. Centralized Management and Control

The general partners of an FLP and the managers (or member-managers) of an FLLC manage the entity. As a result, the general partners and managers make all investment and distribution decisions, although these decisions are subject to fiduciary obligations to the other owners. This authority provides centralized management for the assets, which can be important in maintaining value. Centralized management also means that the general partners or managers have control, which is often important to clients who wish to confer wealth upon their children but are concerned about how that wealth would be managed. Control can be critical when assets are illiquid or require particular knowledge to properly manage. Of course, control over more liquid investments can also be important, when the client wishes to maintain a certain investment philosophy. An FLP or FLLC can prove useful to parents who have concerns regarding children about to become entitled to significant custodial accounts. The custodian can invest the account in the FLP or FLLC so that the asset ultimately given to the child is a limited partnership interest or nonmanaging member LLC interest that can be controlled by the general partner or managers.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.44 2. Pooling of Assets

§18.44 2. Pooling of Assets

By maintaining a larger pool of assets to invest, the family business entity may be able to obtain better investment opportunities, have a wider range of investment risk, or have more sophisticated investments.

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§18.45 3. Investment Training

Younger family members may have little or no idea regarding the investment philosophy of an older generation. The family business entity can be a training ground for the younger generation. The older generation can remain in control while educating the younger generation about managing investments or interacting with investment professionals who manage the family's wealth. Over time, the older generation may in fact wish to turn over management to the younger generation.

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§18.46 4. Family Values and Bonding

For some families, the family business entity can be an environment in which family values are reinforced and a serious pursuit—the family's financial welfare—is shared among several generations. These values may include responsible financial management, socially responsible investing, particular industry biases, and asset allocation strategies. The practitioner should be aware that if a family pays more than lip service to these ideals, serious conflicts between generations can develop or be revealed. Of course, deeper familial relationships can also be developed.

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Source: Estate Planning/California Estate Planning/18 Business Entity Valuation Planning Strategies/§18.47 5. Family Businesses

§18.47 5. Family Businesses

The family business entity can also serve as a family investment vehicle that invests in business ventures of the various owners. Although an ill-advised investment could cause serious conflicts between the owners, a well-thought-out business plan may help younger family members succeed in business.

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§18.48 6. Limited Liability

The owners and managers of a family business, other than the general partners of an LP, are not personally liable for the obligations of the entity. In situations in which some family members are in management and others are not, sharing ownership of the family business through a family business entity provides a liability shield for the nonparticipating family members.

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§18.49 7. Asset Protection

One of the more important benefits of the family business entity is that the assets of the entity are generally not subject to the creditors of its owners. Although a creditor of a limited partner or LLC member may be able to obtain a charging order or even foreclose on a partnership or membership interest, the creditor has only the rights of an assignee, which gives the creditor only the right to receive the distributions that would otherwise have been made. A charging order does not provide the creditor with the power to exercise any rights or powers of a partner. CCP §§699.720, 708.310; Corp C §§15907.02, 15907.03, 17302. Despite the general rule, a charging order may be foreclosed, because it constitutes a lien. Under foreclosure, the creditor could possibly seek a judicial determination that it is equitable to wind up the partnership business. Corp C §§15907.02, 15907.03, 17302(b). The partnership agreement will generally provide that if a charging order applies to a partner's interest, the other partners or the partnership will have an option to acquire or redeem the affected partnership interest.

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B. California Law

§18.50 1. Restrictions on Liquidation Rights

For valuation purposes, a knowledge of state default law is important in drafting organizational instruments for family business entities. Often the key issue in maintaining a valuation discount concerns restrictions on liquidation rights for the interest being valued. For example, if a partner has the right to liquidate the partnership, his or her partnership interest would generally be given a value that is equal to the prorata value of the underlying assets to the extent that the partnership is composed of easily liquidated assets. As discussed above, liquidation rights can be limited in the partnership agreement but disregarded for valuation purposes under IRC §2704(b) if state default law provides a more lenient liquidation standard. See §18.28. A gift of a minority interest in an LP, LLC, or closely held corporation will generally be entitled to valuation discounts because minority interests almost never have a right to force liquidation of the entity under the entity's governing instruments or under applicable state law.

NOTE: *Real Property.* A prorata share of a partnership composed of real property should still receive a discount because a fractional share of real property also suffers from a lack of marketability.

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§18.51 2. Restrictions on Transfers

The partnership agreement or other governing document of the family business entity will generally have provisions restricting the transferability of the interests in the entity, which functions to preclude unwanted intrusions by outsiders. Although a donor may want to completely restrict transferability, doing so may result in an inability to treat the gift of a partnership interest as a present interest for gift tax purposes. Usually, the entity can accomplish the purpose sought by such restrictions by providing for a right of first refusal exercisable by the entity or the other owners for the fair market value as determined by an appraisal. The fair market value will generally reflect valuation discounts, although the IRS may seek to disregard the impact of the restrictions on sale or the valuation discounts. The option can also provide for a lengthy installment payout to reduce the immediate cash flow issues for the buyers.

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§18.52 3. Real Property Tax

The transfer of real property to a family business entity should not be done without considering and planning for the property tax consequences of the transfer. Generally, the transfer of property to an LP, LLC, or closely held corporation will not cause a reassessment for property tax purposes as long as the transfer results solely in a change in the method of holding title to the real property, and proportional ownership interests are the same after the transfer. Rev & T C §62(a)(2). See chap 15. When a transfer is excluded from reassessment on its transfer to the entity, reassessment will occur as soon as more than 50 percent of the ownership interests in the entity are transferred on a cumulative basis. Rev & T C §64(d). When the partners consist of parents and children, a comparison between the reassessment possibilities associated with transfers to an entity and the exclusion from reassessment available through the "parent-child exclusion" should be made. The parent-child exclusion exempts from reassessment a principal residence transferred between parents and children and the first $1 million of assessed value of any other real property. Rev & T C §63.1(a)(1), (2). See chap 15. Because assessed value can be significantly less than fair market value, the exclusion can be especially beneficial.

NOTE: *Documentary Transfer Tax.* Practitioners should also consider whether a documentary transfer tax will be imposed by a county or city on the transfer of property to a family business entity. Rev & T C §11911. Generally, a transfer to an LP or LLC is exempt from documentary transfer tax to the same extent as the transaction would be exempt from real property tax reassessment. Rev & T C §11925(d).

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§18.53 4. Other Substantive Law Considerations

In addition to estate planning expertise, an attorney advising a client regarding the formation of a business entity must have competence in the substantive law regarding the various kinds of business entities, as well as expertise in other areas of law such as taxation, securities, and real property law. Except as noted above, extensive discussion of these areas is beyond the scope of this chapter. For a discussion of the ethical issues involved in determining an attorney's competence in the formation of business entities, see §18.4.

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§18.54 C. Family Business Entity Formation Combined With Other Estate Planning Techniques

The use of the FLPs, FLLCs, and closely held corporations with other estate planning techniques is beyond the scope of this chapter. However, practitioners should be aware that different combinations of estate planning techniques are often used that result in larger tax savings. For example, FLPs and FLLCs are often used in conjunction with a defective grantor trust, grantor retained annuity trust (GRAT), charitable remainder trust (CRT), or charitable lead trust (CLT). For further discussion of these techniques, see chaps 23, 25. FLPs and FLLCs can also be useful when transfers of life insurance are being considered because of the exception from the "transfer for value" rule under IRC §101(a)(2)(B). For further discussion, see chap 19.

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19

Use of Life Insurance in Estate Planning

Jon J. Gallo

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.1 I. INTRODUCTION

§19.1 I. INTRODUCTION

Life insurance is often an important element of an estate plan. It can provide liquidity to the insured's estate to pay estate taxes and other expenses. It can also be used to supplement or create an estate for the support of the insured's family in the event of the insured's death. In situations involving closely held businesses, life insurance is often used to provide the business or the other owners the funds needed to purchase a decedent's interest in the company under a buy-sell or other shareholders' agreement. Life insurance is also used by employers as a fringe benefit for employees.

However, if the insured is the owner of the policy, possesses any incidents of ownership in the policy at death, or has transferred any incidents of ownership in the policy within 3 years of death, then the insurance proceeds will be included in the insured's gross estate and subject to estate taxes. The proceeds are also includable in the insured's estate if they are payable to or for the benefit of the estate. See §§19.29-19.38. Through proper planning, inclusion in the insured's estate can be avoided if a trust or someone other than the insured is made the owner of the insurance policy. In addition, the insured's estate must not be a beneficiary of the policy, and no beneficiary must be obligated to use the proceeds to pay the insured's estate taxes or other expenses.

The following example demonstrates the use of life insurance to provide liquidity to the insured's estate, and the tax consequence if the insurance policy is owned by the insured at death.

EXAMPLE: Assume that Mary is survived by one child, Carla, to whom she leaves her $2,200,000 estate, and that the estate tax is $500,000. If there is no life insurance to provide liquidity, it will be necessary to use a portion of Mary's estate to pay the estate taxes, and Carla's net inheritance would be $1,700,000.

If Mary had owned a $500,000 life insurance policy on her life to provide liquidity to her estate to pay the estate taxes, the insurance proceeds would be included in her gross estate. Then the estate would be $2,700,000, the estate tax would be $777,000, and Carla's net inheritance would be $1,923,000.

If, instead, Carla had been the owner and beneficiary of a $500,000 life insurance policy on Mary's life, and used, but was not obligated to use, the proceeds to pay the estate taxes, it would not have been necessary to use a portion of Mary's estate to pay the estate taxes. Then Carla's net inheritance would be $2,200,000. Also, the insurance proceeds would not be subject to income tax.

A commonly used technique to avoid inclusion in the insured's estate is for the insured to create an irrevocable life insurance trust (ILIT) to own the policy. The ILIT beneficiaries are often the spouse and issue of the insured. See §§19.50-19.57. ILITs often give the beneficiaries "*Crummey* withdrawal powers" so that contributions made to the trust to pay the insurance policy premiums will qualify for the present interest annual gift tax exclusion. See §§19.58-19.69.

In addition to planning to avoid estate tax consequences for the insured, planning is also necessary to avoid other income, gift, estate, and generation-skipping transfer tax consequences for the insured, the policy owner, and the beneficiaries. This chapter discusses these tax issues, situations they arise in, and planning methods to avoid them. The chapter also discusses life insurance products, the life insurance trust, split-dollar insurance, and some estate planning techniques employing life insurance.

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§19.2 II. LIFE INSURANCE SELECTION

Before meeting with the attorney, clients may already have an insurance specialist to consult for advice on acquiring insurance as part of their estate plan. If not, the attorney should encourage the client to engage one. It is helpful if the attorney can provide names of insurance specialists who the attorney knows of or has worked with before. In either case, the attorney may need to work with the specialist and the client in determining what insurance coverage is needed, and, therefore, should have at least a basic knowledge of the various types of insurance products, insurance companies, and the factors that need to be considered in evaluating and selecting a policy. See also Drafting California Irrevocable Trusts §§11.21-11.49 (3d ed Cal CEB 1997).

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.3 A. Understanding Insurance Products and Illustrations

§19.3 A. Understanding Insurance Products and Illustrations

Present day life insurance policies are complex and there are many variations on each type. Sections 19.4-19.25 discuss the concepts the practitioner should know to have a basic understanding of these products.

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§19.4 1. Types of Insurance Products

Life insurance policies may be divided into two fundamental categories: term and whole life. In reality, all life insurance may be viewed as term insurance, with whole life treated as a combination of term insurance and an investment fund. There are numerous variations within each category, either as a result of product design and/or add-on riders.

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§19.5 a. Term Insurance

Term insurance is temporary insurance that provides coverage for a term or period of time. It provides pure insurance protection without any build-up of cash value. Term insurance is the least expensive form of insurance in early years. However, it becomes more expensive with every renewal as the risk of death increases. In addition, term insurance tends to be the most sensitive of all insurance products to fluctuations in the risk factors. Most term policies are marketed using a *current* or *illustrated* rate that results in premiums that are lower than those actually guaranteed by the company. The insurance company may increase premiums up to the maximum guaranteed rate to reflect changes in the risk factors, such as actual market return and mortality experience of the company. The maximum guaranteed premium is generally substantially higher than the premium initially illustrated by the insurance company. If the company's underwriting practices are poor and the company insures many bad risks, there is a significant risk that premiums will be substantially increased, up to but not exceeding the maximum guaranteed premium. This is a concern because the insured may no longer be insurable at a later date and therefore may not have the option of buying coverage at more competitive rates from another company.

Term insurance is either renewable or nonrenewable. The extra cost of renewable term is often offset by the increased flexibility and security of being able to maintain coverage if the insured becomes uninsurable for any reason. Most renewable policies offer a conversion rider permitting the policy to be converted to whole life without evidence of insurability. Some term policies renew to age 90, but become so expensive that they are impractical for long term estate planning solutions.

The major types of term life insurance are discussed in §§19.6-19.9.

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§19.6 (1) Renewable Term

An annual renewable term insurance policy provides fixed coverage for the present year and guarantees the right to renew for the following year at a specified rate. The premium will increase each year. Many term policies are issued for longer terms, *e.g.,* 5 years, in which case the premium is usually flat during that period. Again, the policies can usually be renewed for successive periods at higher rates.

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§19.7 (2) Level Term

A level term insurance policy is written for a fixed period of years, and total premiums for the entire period of coverage are divided into equal installments. Popular types of level term insurance include 5-year convertible and renewable term, 10-year convertible and renewable term, and term to age 65.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.8 (3) Decreasing Term

§19.8 (3) Decreasing Term

Decreasing term insurance is also known as declining balance term. Premiums remain constant over the period of coverage, but the amount of coverage decreases annually. These policies are sometimes used for mortgage protection.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.9 (4) Modified Term

§19.9 (4) Modified Term

Modified term insurance is usually set up to function as term insurance for 5 to 10 years and then to automatically convert to whole life or permanent insurance.

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§19.10 b. Whole Life Insurance

Whole life insurance features premiums that are fixed, rather than increasing with age. As a general rule, premiums are payable for the life of the insured or until the policy endows (*i.e.,* when the policy reserves equal the face value of the policy), usually at age 100. The level premium system results in the insurer collecting more in a policy's early years than the company needs to pay claims in those years. In the policy's later years, increased mortality results in less being collected than needed to pay claims, but the shortfall is covered by the earnings on the excess premiums collected in the earlier years.

Premium payments are divided between risk protection (mortality) and an investment account. The risk portion represents term insurance, and the investment portion acts as a savings account inside the policy commonly known as cash value. The cash value is a liquid asset available to the owner of the policy through borrowing or surrendering the policy. The cash value is usually free from current income taxes because of tax-favored treatment. When the policy is surrendered for its cash value, the amount received is included in gross income to the extent the amount exceeds the "investment in the contract" (*i.e.,* the aggregate amount of premiums or other consideration paid for the policy, minus the aggregate amounts received under the policy that were excludable from gross income). IRC §72(e)(1)(A), (e)(5)(A), (e)(5)(E), (e)(6). See §19.48.

In ordinary whole life, the company cannot increase the premiums to reflect actual mortality experience. However, the *illustrated* premium structure, which forms the basis on which many whole life policies are sold, assumes that the company will *credit* the cash value of the policy with annual dividends or interest in excess of the guarantee, which excess dividends or interest will be used to offset the premiums, thereby decreasing the number of years that the premium must be paid by the owner of the policy before the premiums "vanish." However, the vanish date is not guaranteed. The company may reduce the amount of dividends or interest credited to the policy to a minimum guaranteed level if it is unable to attain the illustrated investment yield, expenses increase, or it experiences increased mortality. As a result, the number of years that the premium must be paid can increase substantially over that illustrated if the policy is to be kept in force for the insured's lifetime. Moreover, if the product is "interest-sensitive" whole life insurance (see §19.12), premiums can be adjusted up to a guaranteed maximum. Similarly, poor mortality results or decreased profitability in a "blended whole life" policy (see §19.13) can also result in an increase in the annual premium attributable to the term component, with the result that the premium will once again not be fixed but may increase with age.

The major types of whole life insurance are discussed in §§19.11-19.17.

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§19.11 (1) Limited-Pay Insurance

In limited-pay whole life, the premium is designed to be payable over a period shorter than the insured's lifetime. The premiums payable for the same protection under a limited-pay whole life policy are greater than those payable under a level term policy providing the same protection. Single premium insurance is a form of limited-pay whole life.

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§19.12 (2) Interest-Sensitive Insurance

In interest-sensitive whole life insurance, also known as current assumption whole life, the premium is level for a specified period, usually 3 to 5 years. At the end of the period, the amount of the premium, and possibly the death benefit, will be redetermined based on the actual cash value of the policy, which is a function of the crediting rate declared by the insurer during that fixed period. Because the crediting rate is a function of the investment return of the insurer, as well as expenses and mortality experience, an interest-sensitive policy is actually sensitive not only to investment performance but to all risk factors, including expense and mortality experience. The policy owner has the option to continue paying premiums at the old level, which would mean an increased or decreased death benefit, or pay the new increased or decreased premium to keep the death benefit level.

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§19.13 (3) Blended Whole Life/Term Insurance

Blended whole life/term insurance is a combination of whole life (the "base") and term insurance. The dividends or interest paid on the base are used to buy additional paid-up whole life insurance that will ultimately replace the term component. A blended product is substantially more sensitive to the risk factors than an all-base product because many insurers provide that the guaranteed maximum annual premium applicable to the term component is in effect for only a limited number of years. The policy owner takes the risk that, if the company has poor mortality or investment experience after the guarantee expires, there will be insufficient funds to buy paid-up additions, and the company will substantially increase the term premium. As a result, blended products do not have the guaranteed level premium found in other whole life products.

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§19.14 (4) Joint Lives Insurance

This insurance provides "second-to-die" or "first-to-die" coverage A second-to-die policy is usually less expensive than two separate policies and is appropriate when looking for proceeds at the survivor's death. The policies can be paid up at the first death, or premiums can continue until the second death. Premiums can be paid for life or can be structured to vanish. Some companies write these policies on a term basis. Such policies usually offer a conversion feature. Some companies offer the second-to-die feature as a rider to a primary single insured. First-to-die contracts also insure joint lives but proceeds are payable at the first death. Total premium cost is usually substantially less than for separate policies on each life because only one death benefit is payable.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.15 (5) Universal Life Insurance

§19.15 (5) Universal Life Insurance

Universal life (often referred to as flexible premium adjustable life) is a type of whole life insurance in which the frequency and amount of premium payments are flexible, but the death benefit is not guaranteed unless sufficient premiums are paid. The owner may skip making premium payments as long as the cash value of the policy is sufficient to cover mortality and expenses each month. In other forms of whole life, a skipped premium would be treated as a policy loan. However, if the cash value of a universal life policy is allowed to drop to this low a level, the future contributions that will be required to keep the policy in effect will be substantially similar to the cost of annually increasing term insurance, and the cost of maintaining the policy may become prohibitive. Moreover, if the cash value is allowed to drop below the level necessary to keep a universal life policy in force, the policy terminates and a new policy must be purchased, with the premiums based on the age of the insured at the time of the new purchase. Thus, universal life does not guarantee any given death benefit beyond the first month or year of the policy unless sufficient premiums are paid to maintain the cash value (known as the accumulation account) at an adequate level. Universal life policies offer a choice between a level death benefit or a death benefit that automatically adds the current cash value to the regular proceeds. The policy owner has access to the cash values via loans or withdrawals. In traditional whole life, the policy owner only has access to the cash values via loans. Because a universal policy may be viewed as a term policy accompanied by a side fund, it is the most sensitive of all whole life products to the risk factors. See §19.19.

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§19.16 (6) Variable Life Insurance

Variable life insurance is a type of whole life in which the insurer administers the investment account, but the investment risk is shifted to the owner and the cash values are not guaranteed. All of the whole life products discussed above are *general account* policies, *i.e.,* the investment component (customarily referred to as the "cash value") of the policies is represented by assets that are part of the insurer's overall funds. In a variable policy, the cash value of the policy is represented by a separate investment account administered by the insurer but selected by the owner of the policy. The buyer should be aware that poor investment performance could actually produce a negative rate of investment return, which could cause the policy to lapse earlier than a zero percent return illustrated in the company's prospectus. The policy may be structured with fixed or (in the case of variable/universal life) flexible premiums. The death benefit may fluctuate based on the performance of the underlying investments, but, as long as the annual premium is paid, the death benefit will not drop below a guaranteed minimum, which is usually the face amount. Some variable policies have higher than average administrative costs, which tend to make them more expensive than general account policies. In theory, the extra cost will be offset by increased earnings of the investment account. Variable insurance is appropriate only if the owner is able to monitor the investments, has a tolerance for investment risk and intends to hold the policy for at least 10 years. Because the death benefit will usually increase proportionately to the cash value of the policy, variable insurance provides a hedge against inflation. The agent must have a variable annuity license, and all illustrations should be accompanied by a current prospectus.

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§19.17 (7) Variable/Universal Life

Variable/universal life insurance is a hybrid type that combines the investment flexibility of variable life with the premium and face amount flexibility of universal life.

PRACTICE TIP: A note on policy loans: As a general rule, policy loans are not subject to income taxation. However, if an insurance policy is allowed to lapse before death and the owner has borrowed against the policy in an amount in excess of basis (*i.e.,* the total premium payments made), the amount of such excess will be taxable income. If the policyholder does not wish to incur such phantom income, it will be necessary to begin to pay premiums again in an amount necessary to keep the policy in effect, as well as forgoing further borrowing. It is possible for the policyholder to get into a situation referred to as a "surrender squeeze" in which it is expensive to either keep the policy in effect or surrender it.

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§19.18 2. The Illustration

After a life insurance company has been selected, "illustrations" are presented by the company for various policies. A life insurance illustration is a scenario based on a specific set of assumptions involving the company's anticipated mortality experience, investment performance, and expenses. For example, an illustration showing the performance of a policy based on a 9-percent crediting rate illustrates the cost and performance of that policy if the company's expenses and earnings meet a specified goal each year and the company's mortality or claims experience is at least as good as projected. However, the insurance company does not guarantee that claims, expense, and investment experience in the future will be as shown in the illustration. If the company's claims, expense, and investment experience in the future are worse than illustrated, one of two possible scenarios will result: either the company will exercise a right to increase the premium it will charge for the policy, up to a guaranteed maximum, or the premium will remain level but the number of years that the premium must be paid will increase. As a general (but not absolute) rule, increases in the amount of the premium will occur with respect to the term component, while increases in the number of years that the premium must be paid will occur with respect to the whole life component.

Most insurance illustrations contain footnotes or other annotations that should divulge whether the premium being illustrated is the guaranteed maximum. If the illustrated premium is not the guaranteed maximum, or if the illustration does not permit the client to determine the guaranteed maximum, a new illustration should be requested that provides this information. As a general rule, the premium being illustrated for a *term* policy is not the guaranteed maximum. The premium being illustrated for a *whole life* policy may or may not be the guaranteed maximum. See §19.10.

PRACTICE TIP: When reviewing an illustration, the attorney should bear in mind that the illustration assumes that the company will attain a specific profit goal and will credit the policy with a certain percentage rate of return for the life of the policy. The attorney should always ask for alternative illustrations reflecting 1- and 2-percent reductions in the crediting rate. Also, using the Best's report for the company in question, he or she should determine the company's current net return. If the illustration is projecting a higher interest rate being credited than what the company is currently earning, the attorney should request a written explanation for this optimistic forecast. He or she should determine whether the rate of return that the company is earning is being computed using a portfolio or a new money basis. The portfolio approach takes into consideration all assets, while the new money approach looks to the rate at which the carrier can currently invest assets. If interest rates are declining, the portfolio approach tends to overstate probable future earnings because older assets that are producing a higher rate of return tend to average out the declining interest rates on new investments. If the market is rising, the new money approach tends to exaggerate the company's earnings because new investments will not be burdened with the lower overall return of the company.

The questions in §§19.19-19.20 should be asked with regard to an insurance illustration, especially if the policy being illustrated appears much less expensive than competing policies.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.19 a. Questions to Ask Regarding Term Insurance

§19.19 a. Questions to Ask Regarding Term Insurance

- For what period is the illustrated premium guaranteed? Some term policies guarantee the illustrated premium for only the first year. Other term policies (known as *level term* policies) guarantee the illustrated premium for the first 3, 5, 10, 15, or 20 years. Once the illustrated premium is no longer guaranteed, the company is free to raise that premium to reflect actual claims, expense, and investment experience, but not in excess of the guaranteed maximum gross premium.
- What is the maximum premium that may be charged and how often may the premium be adjusted? Some term policies permit the carrier to increase premiums on each anniversary. Adjustments are less frequent for other policies.
- Can the policy be converted to permanent coverage and up to what age?
- Does the policy provide for waiver of premiums in the event of disability? If so, does coverage continue for life or terminate at the end of the stated term of the policy?

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.20 b. Questions to Ask Regarding Whole Life Insurance

§19.20 b. Questions to Ask Regarding Whole Life Insurance

- What interest or dividend crediting rate is being assumed in the illustration?
- Is the company currently meeting that rate and has it been meeting it in prior years? For how many prior years? Based on assumptions about the state of the economy, is it reasonable to assume that the insurance company will be able to meet that interest or dividend rate assumption in future years?
- Is the yield assumption credible? If two insurers provide illustrations and one is based on a substantially higher yield assumption than the other, what facts justify the assumption that the company will be more profitable than the other?
- What will be the result if the company is unable to credit the policy with the illustrated yield? If the product is "pure" whole life and the illustration shows that the premium will "vanish" after a specified number of years, the effect of the company's failure to meet the illustrated interest or dividend rate will result in increasing the number of years the premium must be paid before it vanishes, if ever. If the product is blended whole life and the illustrated premium is not the guaranteed maximum for the term component, the failure of the company to meet the illustrated rate will result in increasing the number of years the premium must be paid, increasing the annual premium up to the guaranteed maximum, or both. The attorney should have new illustrations prepared showing the effect of decreasing the crediting rate in 1-percent drops to the guaranteed minimum.
- Is the current illustrated crediting rate being credited to existing policies? Some insurers credit new policies with a higher interest or dividend rate than existing policies. If so, the attorney should find out why. Do differences in product types justify different crediting rates or is the insurer engaged in a sharp practice of illustrating unreasonably high crediting rates during the first year in order to attract new business?
- If an interest-sensitive product is illustrated (see §19.12), is the illustrated premium the guaranteed maximum? If it is not, what is the guaranteed maximum?
- If a blended product is illustrated (see §19.13), is the illustrated premium the guaranteed maximum? If it is not, what is the guaranteed maximum?
- If a second-to-die product is illustrated (see §19.14):
- Are nonguaranteed bonus credits or termination dividends included in the illustration? In order to induce high persistency (policies that remain in effect for many years), some insurers offer "bonus" credits (extra interest being credited after the policy has been in effect for a specified number of years) or "termination dividends" (a dividend payable at surrender or death) on second-to-die policies. As a general rule, termination dividends are not guaranteed. Some bonus credits may be guaranteed. If the credits or dividends are not guaranteed, the illustration should be resubmitted without the credits and dividends.
- If the first spouse to die passes away substantially before his or her actuarial life expectancy, will otherwise "vanished" premiums reappear?

NOTE: It has been the author's experience that some illustrations for second-to-die insurance by some insurers tend to be more aggressive in their mortality, yield, and bonus assumptions than similar illustrations of the same insurers for single-life insurance.

- If a variable product is illustrated:
- What investment funds are available and what has been their performance?
- There is substantial diversity in the investment funds made available by different insurers. What has been the fund's past performance? How long has the fund been in existence? Who manages the fund and what is his/her track record?
- What are (1) the estimated gross yield and (2) the illustrated costs? Is the spread between gross and net guaranteed? Is the estimated gross yield reasonable? If the gross yield differs in different illustrated variable products, determine the reason for the difference. The illustration will show costs deducted from the gross yield. Costs include investment advisory fees, fund operating expenses, mortality and risk charges. Are the

illustrated costs guaranteed or does the insurer reserve the right to increase costs up to a guaranteed maximum?

- Are the correct investment funds illustrated? The advisory fees and other costs may differ significantly between funds.
- Is the death benefit guaranteed? Will the death benefit be payable even though the investment funds perform significantly below the illustration? Some but not all variable policies guarantee payment of the stated death benefit if a specified minimum level of premiums have been paid or if a separate rider is purchased at additional cost.

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§19.21 3. Risk Factors

The goal of every insurance company is to keep the premium dollars received invested for that period of time and at that rate of return sufficient to permit it to make a profit while maintaining adequate reserves to provide the death benefit when the insured dies. This is accomplished by pricing the policy to take into account four primary risk factors that impact company profitability: (a) mortality or claims experience, (b) investment experience, (c) lapse rates, and (d) expenses. It may be helpful to think of each risk factor as a *moving part* of the insurance contract. In large measure, contemporary policies differ from one another in how the risk factors interact and the extent to which these policies result in the risks being retained by the insurance company, shared with the insured, or passed along to the insured.

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§19.22 a. Mortality Risk

Statisticians are unable to determine individual mortality but can predict mortality with great accuracy for large groups of individuals. (For example, the probability that a 40-year-old male nonsmoker in good health will die within 20 years is 10 percent, while the probability that a 60-year-old male nonsmoker in good health will die within 20 years is 50 percent.) Such statistics are organized into mortality or life expectancy tables. Insurance companies refer to such statistics as mortality experience or claims experience.

If the majority of persons insured by a company survive to the age indicated in the life expectancy tables, the insurance company has an average mortality or claims experience. If the majority of insureds survive longer than indicated in the tables, the insurance company has a better than average mortality or claims experience.

It is important to determine if the mortality assumptions in the illustration presented by an insurance company (see §19.18) represent the actual mortality experience of the company, and, if not, to ask for alternative illustrations. For example, some insurance illustration software includes an annual decline in mortality experience, based on assumed improvements in medical care. The practitioner or client should ask if the illustrations assume future mortality improvements, and, if so, obtain an alternative illustration that does not incorporate such ongoing mortality improvements, so that the effect of such assumptions on the premium will be clearly identified.

If mortality is worse than illustrated, the insurer's increased costs are generally passed along to the insured. In term policies, adverse mortality experience is usually passed along by adjusting the illustrated premium up to, but not in excess of, the higher guaranteed premium. In most whole life products, other than variable insurance, the insurer is able to pass along adverse mortality through a decrease in the crediting rate, but not below the guaranteed rate.

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§19.23 b. Investment Risk

The insurer's investment experience directly affects the interest or dividends credited to cash value policies. Whether the insurer's investment experience is a major risk factor depends on the type of policy. At one extreme, the typical term policy, lacking in cash values, is not dependent on the insurer's investment experience, except to the extent that investment performance affects the continued viability of the insurer. At the other extreme, variable policies pass the entire investment risk to the insured. In between are all other cash value policies. For these policies, the insurer guarantees a minimum crediting rate, usually between 3 percent and 5 percent. As previously noted, crediting rates higher than the guaranteed rate are almost always used to illustrate policy performance, particularly in vanishing premium illustrations (see §19.10). The insurer bears the risk involved in meeting the guaranteed crediting rates. Most or all of the risk in meeting the higher illustrated rates is shifted to the insured. Investment risk affects not only the crediting rate but also the safety of the underlying principal. Accordingly, it is necessary to determine the degree of market risk the insurance company is assuming with invested assets. See also §19.26.

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§19.24 c. Lapse Risk

The lapse rate is also known as persistency experience. Low lapse rates increase the insurer's profitability. Insurance companies charge underwriting costs, commissions, and first-year cash values in the year the policy is issued rather than amortizing those costs over future years. This results in the insurer losing money in the first year. Insurers with low lapse rates are able to recover first-year costs over the lifetime of the policy. Moreover, most lapses in early years are by persons who are confident of their ability to obtain new insurance because persons who are uninsurable are less likely to permit policies to lapse. Companies with low lapse rates also retain a higher proportion of healthy insureds.

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§19.25 d. Expense Risk

The insurer's overhead is the least important of the risk factors. Mortality and investment performance have a greater impact on product performance. However, poor management practices can result in a decreased crediting rate. The insurer's expenses are reflected in the discussion of earnings in most rating reports.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.26 B. Selecting Insurance Company

§19.26 B. Selecting Insurance Company

In choosing a life insurance company, the ratings reports on the companies should be reviewed. Life insurance companies are rated by several services, including A.M. Best, Standard & Poor's, Moody's, Duff and Phelps, and Weiss Research. Rating reports presented for review should reflect the current financial condition of the insurer. If a presented company has recently been down-rated, the agent should be prepared to provide a satisfactory written explanation of the reasons for the reduced rating.

A.M. Best ratings reflect the relative financial strength and performance of each reviewed insurance company. Best looks for consistent growth and consistent profits by line of business. Best uses a system of letter ratings ranging from A++ to D. Standard & Poor's rates the claims-paying ability of insurance companies. In order to be rated, an insurance company must request a rating, provide both public and nonpublic data, meet with Standard & Poor's rating analysts, and subscribe to the Standard and Poor's rating service. The claims-paying ability ratings range from AAA to CCC.

Moody's assigns financial strength ratings that measure an insurance company's ability to meet its senior policyholder obligations and claims. The rating analysis is similar to Moody's bond ratings and focuses on profitability, management quality, and asset quality. Moody's assigns ratings that range from Aaa to C.

Duff and Phelps rates companies on their claims-paying ability in a manner that provides analytical and statistical information on their solvency and liquidity. The rating system is similar to Moody's but tends to involve less statistical information and more qualitative reviews. Duff and Phelps ratings range from AAA to DD.

Weiss Research attempts to rate all insurance companies doing business in the United States based on capital adequacy, investment safety, profitability, and stability of operations. As a general rule, Weiss ratings are aimed more at the general public than at the insurance professional and provide less statistical information.

Among the factors that should be considered in reviewing rating reports are the following:

- Does the carrier have adequate surplus? Surplus is the difference between the carrier's assets and liabilities. There are numerous techniques used by the insurance industry to compute surplus. The absolute amount of surplus is generally less important than whether such surplus is equal to, less than, or more than the industry average. Both A.M. Best and Moody's publish various industry surplus ratios that can be used for comparison purposes.
- What is the quality of the portfolio held by the company, because the portfolio produces the yield so important to net cost figures. In particular, what percentage of total assets are represented by problem mortgages and junk bonds, and does this percentage exceed industry averages? The typical insurance portfolio is invested as follows: (1) bonds, cash, short term investments; (2) stocks; (3) mortgages; (4) real estate; (5) policy loans; (6) others. Portfolio analysis is particularly important when dealing with second-to-die insurance because the company must perform over a longer period than many single-life policies. Portfolio analysis is beyond the normal scope of the average estate planner or insurance broker. Many of the rating services take portfolio quality and yield into consideration. If more information is needed, retain a suitable registered investment advisory firm to provide a written report on the portfolio in question.

If still more information is needed, consult the Insurance Regulatory Information Reports. Dating back to 1971, the National Association of Insurance Commissioners has prepared comprehensive reports analyzing the fiscal status of life insurance companies. These reports are routed to the various state insurance commissioners. The financial ratios presented serve as an early warning system on troubled companies. Ratios measuring such things as, *e.g.,* profitability, solvency, and liquidity, are analyzed in detail. Poorly performing companies are recommended for immediate regulatory action while others are recommended for targeted regulatory attention. High ratings are not a guarantee that a company will meet its projected earnings nor that it will survive. However, low ratings tend to highlight areas of weakness. Rating reports are most useful when used to identify trends that can be compared against industry averages. If at all possible, the attorney should review all rating reports for the same company to determine the areas of consensus.

Joseph M. Belth, former Insurance Commissioner of New Jersey, edits "The Insurance Forum," a newsletter

providing an independent, controversial, and often critical analysis of the insurance industry. In the September-October 1991 issue of The Insurance Forum, Belth suggested the following system for selecting insurance companies, which combines the ratings of A.M. Best, Standard & Poor's, Moody's, and Duff and Phelps. At any time, only a small percent of the few thousand insurance companies licensed to do business in the United States meet Belth's criteria.

The attorney should select a company meeting two criteria:

(1) The company has a very high rating from at least two of the major rating firms. Very high ratings are A++ from A.M. Best; AAA, AA+, or AA from Standard & Poor's; Aaa, Aa1, Aa2, or Aa3 from Moody's; and AAA or AA+ from Duff and Phelps.

(2) The company does not have a rating below the following from any of the major rating firms: A+ from A.M. Best; AA− from Standard and Poor's; A1 from Moody's; or AA from Duff and Phelps.

For a truly conservative approach, a third criterion may be added:

(3) The company is licensed in the State of New York.

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§19.27 C. Obtaining Information

The American Society of Chartered Life Underwriters and Chartered Financial Consultants, a national organization of insurance and financial service professionals, has developed the Life Insurance Illustration Questionnaire (IQ) as an educational tool to help professionals and consumers understand the different nonguaranteed performance assumptions used by insurance companies in the design of policies and the creation of illustrations. The IQ consists of 25 questions directed to the insurance company. An IQ can be submitted for each company on whose behalf an illustration is presented.

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§19.28 III. FEDERAL TAXATION OF LIFE INSURANCE

Special income, gift, and estate tax rules apply to life insurance proceeds under the Internal Revenue Code. To qualify as life insurance subject to the tax rules applicable to life insurance policies, insurance contracts issued after December 31, 1984, must either meet the cash value accumulation test or the guideline premium and corridor test of IRC §7702(a). Insurance contracts issued after October 21, 1988, must also meet the requirement that the mortality charges underlying the contract must be "reasonable," which means that they must not materially differ from the charges that the company actually expects to impose. For income tax purposes, policies that fail to qualify are separated into pure insurance and savings portions. The income earned on the savings portion is taxable to the policyholder on an annual basis.

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§19.29 A. Estate Taxation of Life Insurance

In general, proceeds of life insurance on a decedent's life are includable in the decedent's gross estate if (1) the proceeds are receivable by or for the benefit of the decedent's estate, or (2) the decedent possessed any incidents of ownership in the insurance at the date of death. IRC §2042; Treas Reg §20.2042-1. In addition, insurance proceeds are includable in the insured decedent's gross estate if any interest in the insurance that would have caused inclusion in the decedent's gross estate under IRC §2042 if retained by the decedent was transferred by the decedent during the 3-year period ending on the date of the decedent's death without receiving adequate and full consideration in money or money's worth. IRC §2035(a), (d). See also see §19.34.

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§19.30 1. Proceeds Payable to Estate

Insurance proceeds are receivable by or for the benefit of the decedent's estate if the beneficiary of the proceeds (whether it be the decedent's estate, trust, or any other beneficiary) is under a legal obligation to utilize the proceeds to pay the decedent's taxes, debts, or costs of administration. Thus, insurance payable to the trustee of a trust that requires the trustee to use the proceeds to pay the decedent's taxes or other debts or expenses will be included in the decedent's estate. If the insurance proceeds are community property and, as a result, one-half of the proceeds belongs to the decedent's spouse, then only one-half of the proceeds is considered to be receivable by or for the benefit of the decedent's estate. Treas Reg §20.2042-1(b)(2); *Pacific Nat'l Bank* (1939) 40 BTA 128, acq 1939-2 Cum Bull 28.

Practitioners should make sure that neither a client's estate nor revocable trust is a beneficiary of insurance on the client's life, and that any trust or other beneficiary owning insurance on the client's life is not obligated to use the proceeds to pay any estate taxes or other debts or expenses of the client.

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§19.31 2. Incidents of Ownership

The term "incidents of ownership" is not limited to a technical legal ownership of an insurance policy. The term includes any rights to economic benefits from the policy, including the power to change the beneficiaries or the time or manner of enjoyment of the policy or proceeds, to borrow against the policy, to surrender or cancel the policy, to assign or cancel the assignment of the policy, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy. Treas Reg §20.2042-1(c). The mere act of applying for a policy does not give rise to incidents of ownership. See IRS Letter Ruling 9323002, which holds that an application unaccompanied by the premium payment did not create an incident of ownership since the application clearly stated that the policy would not be issued until the premium was paid.

As a general rule, it is irrelevant whether the decedent possessed incidents of ownership individually or in a fiduciary capacity. However, Rev Rul 84-179, 1984-2 Cum Bull 195, provides for an exception for ownership in a fiduciary capacity. The ruling holds that incidents of ownership held in a fiduciary capacity by the insured as a trustee will not be imputed to the insured if (a) the insured may not exercise the powers over the policy to benefit the insured or the insured's estate; (b) the insured never transferred the policy or any of the premiums to the trust; and (c) the powers were not bestowed on the insured as part of a prearranged plan in which the insured participated. Thus, citing Rev Rul 84-179, the IRS ruled that when the trustee of a trust whose life is insured by an insurance policy held by the trust is specifically prohibited from exercising any power normally conferred on the owner of a policy, the trustee does not possess any incidents of ownership over the policy that would cause inclusion of the policy in the trustee's gross estate at death. IRS Letter Ruling 9111028. See also *Estate of Harry Bloch, Jr*. (1982) 78 TC 850. In IRS Letter Ruling 200314009, the Service ruled that a court-ordered reformation of a life insurance trust resolved an ambiguity concerning the settlor's power to appoint successor trustees and was consistent with California law. Accordingly, the settlor was not deemed to have released incidents of ownership in a policy owned by the trust.

If insurance is owned by an irrevocable trust or a custodianship, the insured should generally not serve as trustee or custodian to avoid retaining incidents of ownership in the transferred policy. IRC §2042; Treas Reg §20.2042-1(c)(4); *Rose v U.S.* (5th Cir 1975) 511 F2d 259; *Terriberry v U.S.* (5th Cir 1975) 517 F2d 286, cert denied (1976) 424 US 977; *Estate of Harry R. Fruehauf* (1968) 50 TC 915, aff'd (6th Cir 1970) 427 F2d 80; *Estate of Skifter v Commissioner* (2d Cir 1972) 468 F2d 699, nonacq 1978-2 Cum Bull 4.

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§19.32 a. Attribution Based on Trustee Removal Power

Before 1995, the IRS contended that a settlor of an irrevocable trust who retained the right to remove a corporate trustee and appoint another corporate trustee without cause would be deemed to possess the incidents of ownership possessed by the trustee. Rev Rul 79-353, 1979-2 Cum Bull 325, as modified by Rev Rul 81-51, 1981-1 Cum Bull 458. However, in *Estate of Helen S. Wall* (1993) 101 TC 300, the Tax Court refused to follow Rev Rul 79-353 and held that the power to remove and replace corporate trustees does not result in the powerholder being deemed to possess the powers of the trustee. Also see *Estate of Vak v Commissioner* (8th Cir 1992) 973 F2d 1409. In response to *Estate of Helen S. Wall,* the IRS issued Rev Rul 95-58, 1995-2 Cum Bull 191, revoking Rev Rul 79-353 and Rev Rul 81-51. In Rev Rul 95-58, the IRS ruled that a settlor will not be deemed to possess the incidents of ownership held by the trustee if the power to remove the trustee and appoint a successor trustee is limited to appointing an individual or corporate successor trustee that is not related or subordinate to the decedent/settlor within the meaning of IRC §672(c) for purposes of IRC §§2036 and 2038. Internal Revenue Code §672(c) defines the term "related or subordinate party" to mean any nonadverse party who is (1) the grantor's spouse if living with the grantor; or (2) any one of the following: the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

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§19.33 b. Corporate and Partnership Ownership

Incidents of ownership in a corporate-owned policy of life insurance will be attributed to a controlling shareholder for purposes of IRC §2042 only to the extent the proceeds are not payable to the corporation and hence are not taken into consideration in determining the value of the decedent's stock. Reg §20.2042-1(c)(6); Rev Rul 82-145, 1982-2 Cum Bull 213. The insured will be deemed to be the controlling shareholder if, at the time of his or her death, the decedent owned stock possessing more than 50 percent of the total combined voting power of the corporation.

Similarly, insurance on the life of a partner owned by and payable to the partnership is not included in the insured's gross estate. *Estate of Frank H. Knipp* (1955) 25 TC 153, aff'd (4th Cir 1957) 244 F2d 436 (when partnership in which decedent was 50-percent general partner owned ten insurance policies on decedent's life, partnership paid insurance premiums, and proceeds were payable to partnership, decedent, in his individual capacity, had no incidents of ownership in policies and, therefore, policies were not includable in decedent's gross estate); *Joyce Karbach Watson,* TC Memo 1977-268 (if partnership owned policy on decedent's life, "the decedent would still not be considered as possessing the requisite incidents of ownership merely by virtue of his control as a 50-percent partner."). But see Rev Rul 83-147, 1983-2 Cum Bull 158 (proceeds of life insurance policy on partner's life owned by partnership, but payable other than to or for benefit of partnership, are includable in deceased insured partner's gross estate).

In IRS Letter Ruling 9808024, a husband and wife owned as community property 72 percent of the stock of a holding company, which in turn owned 100 percent of a bank. Their children entered into a split-dollar plan with the bank with respect to second-to-die insurance on the husband and wife. The IRS ruled that neither spouse possessed incidents of ownership in the policy because neither owned more than 50 percent of the holding company.

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3. Transfers Within 3 Years of Death

§19.34 a. General Rule

Proceeds of an insurance policy on a decedent's life are includable in the decedent's estate if any incidents of ownership in the insurance that would have caused inclusion in the decedent's gross estate under IRC §2042 if retained by the decedent are actually transferred by the decedent within 3 years of the decedent's date of death. IRC §2035(a). If the transferee thereafter pays any of the premiums, only the portion of the insurance proceeds attributable to the percentage of the total premiums paid by the decedent are includable in the gross estate. *Estate of Morris R. Silverman* (1973) 61 TC 338, aff'd (2d Cir 1975) 521 F2d 574, acq 1978-2 Cum Bull 2; *Estate of Sidney M. Friedberg,* TC Memo 1992-310. However, insurance proceeds are not includable in the insured decedent's gross estate if an interest in the policy was transferred by the decedent in a bona fide sale with adequate and full consideration. IRC §2035(d).

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§19.35 b. Payment of Premiums

As a result of losing various court cases, the IRS no longer contends that payment of premiums can be treated as a transfer of an interest in an insurance policy. Accordingly, an insured can pay premiums within 3 years of death without the policy being included in the insured's estate under IRC §2035. *Estate of Eddie L. Headrick* (1989) 93 TC 171, aff'd (6th Cir 1990) 918 F2d 1263; *Estate of Frank Martin Perry, Sr.,* TC Memo 1990-123, aff'd (5th Cir 1991) 927 F2d 209; *Estate of Joseph Leder* (1987) 89 TC 235, aff'd (10th Cir 1989) 893 F2d 237.

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§19.36 c. Applying for Insurance Policy

As a general rule, in order for the insured to avoid having any incidents of ownership in a life insurance policy on his or her life, the insured should not be the applicant for the policy. However, a client may already have applied for a policy before consulting with his or her estate planner. In that case, the practitioner should be aware of situations in which the act of applying for an insurance policy will or will not give rise to incidents of ownership.

The act of applying for an insurance policy does not give rise to incidents of ownership in the policy if the policy will not be issued until a premium is paid. In IRS Letter Ruling 9323002, the insured submitted a policy application that did not designate someone other than herself as the proposed owner. The application contained language to the effect that the policy would be effective only with the payment of the first premium and issuance and delivery of the policy to the owner. Some months later, a supplementary application was submitted by the insured directing the company to issue two policies of $250,000 each instead of one $500,000 policy, with each policy to be owned by a child. Shortly thereafter, a premium payment was submitted by a child and the two policies were issued. The insured died a year later. The IRS ruled that the original application did not represent an incident of ownership, because the application clearly stated that the policy would not be issued until the premium was paid.

However, if an actual agency relationship exists between the insured and the trustee of an insurance trust created by the insured, *i.e.,* if the trustee is obligated by the terms of the trust to acquire a certain policy of insurance on the life of the insured, then inclusion of the insurance in the insured's estate may be required under IRC §2035(a). This was the case in *Estate of Tetsuo Kurihara* (1984) 82 TC 51. Although the trust agreement in *Tetsuo Kurihara* did not specifically obligate the trustee to purchase life insurance, the agreement referred to the decedent as the "initiator" of a specific insurance policy, which was identified by insurer and policy number. The trustee thereafter submitted what was apparently a substitute application for the policy and the decedent issued a check to the trustee in the exact amount of the premium, noting on the check that it was in payment of the premium. A substitute application attempts to change a preexisting paper trail by substituting one application for another. However, the carrier does not destroy the initial application and the substitute application does not avoid IRC §2035 if the policy was initially issued to the insured. The Tax Court found that the policy was acquired as the result of an "integrated transaction arranged and controlled by the decedent." The trustee was treated as the insured's agent and the insurance was included in the decedent's gross estate. Also see *First Nat'l Bank v U.S.* (9th Cir 1973) 488 F2d 575 (insurance policy proceeds were includable in decedent's gross estate under IRC §2035 when decedent's wife as trustee applied for policies at decedent's urging and was owner and beneficiary of policies, but decedent, directly or indirectly, paid policy premiums); *Estate of Francis M. Ronk,* TC Memo 1988-432.

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§19.37 4. Marital Deduction for Settlement Option Payments

Insurance proceeds payable under a settlement option may or may not qualify for the estate tax marital deduction under IRC §2056(a). Proceeds payable in installments or interest only at least annually to the surviving spouse for life will qualify for the estate tax marital deduction under IRC §2056(b)(6) if the surviving spouse also possesses a general power of appointment (exercisable by will or at death and in favor of at least the surviving spouse or the surviving spouse's estate) over the amounts payable to the surviving spouse during his or her life. IRC §2056(b)(6), (b)(10); Treas Reg §20.2056(b)-6. Other types of settlement options need to be analyzed on their facts.

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§19.38 5. Inclusion in Noninsured Owner's Estate

If a noninsured owner of a life insurance policy predeceases the insured, the value included in the owner's estate is the cost of a comparable policy issued by the same insurance company. If the policy has been in force for some time and premiums are still due on it, the value may be approximated by adding the interpolated terminal reserve value (which is similar but not exactly the same as the cash surrender value of the policy) at the date of death to the proportionate part of the last premium paid before the death that covers the period extending beyond the date of the death. Treas Reg §20.2031-8(a)(1)-(3), Examples 2-3. However, these valuation rules may not apply if the insured is terminally ill or no longer insurable. See §19.41.

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B. Gift Taxation of Life Insurance

§19.39 1. Valuation of Transfer of Life Insurance Policy

The transfer of all ownership rights in a life insurance policy is a taxable gift measured by the replacement cost of the policy or of comparable policies issued by the same insurance company. If the policy has been in force for some time and premiums are still due on it, the value of the gift may be approximated by adding the interpolated terminal reserve (which is similar but not exactly the same as the cash surrender value of the policy) at the date of the gift to the proportionate part of the last premium paid before the gift which covers the period extending beyond the date of the gift. Treas Reg §25.2512-6(a). However, these valuation rules may not apply if the insured is terminally ill or no longer insurable, as discussed in §19.41.

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§19.40 2. Payment of Premiums

The payment of premiums by someone other than the owner is a taxable gift to the owner. Treas Reg §25.2511-1(h)(8). If a group term policy is transferred, the employee makes a gift each time the employer pays a premium on the policy. Rev Rul 76-490, 1976-2 Cum Bull 300. See also Rev Rul 79-47, 1979-1 Cum Bull 312; Rev Rul 84-147, 1984-2 Cum Bull 201.

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§19.41 3. Effect of Secondary Market

The development of a secondary market in life insurance policies has had a profound and uncertain effect on the gift tax value of life insurance contracts. There has always been an informal secondary market in life insurance policies. Terminally ill insureds have historically borrowed from friends or relatives using their policies as collateral or in some cases have sold the policies to raise funds. But it was not until the AIDS epidemic of the 1980s that a true secondary market began to develop. Investors seeing the opportunity for high returns started to purchase life insurance policies from insureds suffering from AIDS and other diseases having predictable life expectancies of short duration. The purchase price was at a negotiated discount from the death benefit designed to provide the seller with acceptable funds and the purchaser with an acceptable rate of return.

More recently, the secondary market has expanded beyond viatical firms purchasing policies from policyholders with life expectancies of less than 2 years to include "life settlement" firms that purchase policies from individuals who are over age 65, have experienced a decline in health, and have remaining life expectancies in the range of 6-12 years. Life settlement firms often purchase policies when the beneficiary for whom the policy was originally purchased no longer needs the policy or the insured cannot afford to pay the premiums. Both viatical firms and life settlement firms pay amounts that are greater than the cash surrender value of the policy but less than the expected value of the death benefit. In response to the development of the secondary market, life insurance companies have developed accelerated death benefits (ABDs), which give policyholders the option of receiving from 25 percent to nearly 100 percent of the death benefit while still living. To qualify for an ABD, the policyholder must have a death benefit rider on the policy and must either have a dramatically reduced life expectancy (usually less than 1 year), suffer from one of a number of specified medical conditions, or require long-term care. For further discussion, see Doherty & Singer, *The Benefits of the Secondary Market for Life Insurance Policies*, 38 Real Prop Prob & Tr J 452 (Fall 2003).

In view of the secondary market, it is necessary to ask whether we can continue to rely on the examples in the Treasury Regulations to determine the value of an insurance contract for gift tax purposes? The secondary market simply did not exist when the Treasury Regulations dealing with gift tax valuation were adopted in 1958. The only place where the Regulations give us any guidance about the secondary market is by inference. The Regulations tell us that the valuation rules for insurance, discussed in §19.39, are not to be used if "because of the unusual nature of the contract," doing so does not result in a value that is "reasonably close to the full value" of the policy. Treas Reg §25.2512-6(a). The courts have relied on this exception to tell us that if the insured is uninsurable at the time of the transfer, the fair market value of the policy may be more than the amount computed under the Regulations. For example, in *James Stuart Pritchard* (1944) 4 TC 204, the Tax Court stated that an important element to consider in determining a value of a life insurance policy is its collectibility. "The nearer the insured approaches death, which is the event of collectibility, the nearer its value approaches the face amount for which it was issued." Further, the court held that under the facts of the case, where death was imminent and the insured was "obviously uninsurable," the replacement cost "would be only helpful as a criterion of the minimum value to be placed on the policies…." 4 TC at 208.

PRACTICE TIP: When a policy is to be transferred, consideration should be given to investigating whether an after-market exists for that policy. If the policy is being transferred by gift, the existence of an after-market value for the policy would result in the willing buyer/willing seller test of Treas Reg §25.2512-1 becoming applicable. If the policy is sold to a grantor trust or other purchaser exempt from the transfer-for-value rules in an attempt to avoid the 3-year rule of IRC §2035, it is imperative that the purchase price represent full and adequate consideration in order to avoid a gift element. Prudence suggests that in either situation the parties solicit statements of interest from several viatical providers. If no provider is interested in acquiring the policy, the file should reflect that fact.

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C. Income Taxation of Life Insurance Proceeds

§19.42 1. General Rule; EOLI Limitation

Proceeds of life insurance payable by reason of the death of the insured are generally not subject to income tax. IRC §101(a)(1). Any post-death interest will be taxed to the beneficiary. If the death benefit is payable over time as an annuity, the annuity will be taxed to the beneficiary under IRC §72, with the beneficiary having a basis in the annuity equal to the amount that would have been payable as a single sum at death. However, the amount excluded from gross income of an applicable policyholder (*i.e.,* a person engaged in a trade or business who is the beneficiary of a policy that covers the life of an insured employee other than a director or highly compensated employee or a related person) with respect to an employer-owned life insurance (EOLI) contract generally cannot exceed the premiums and other amounts paid by the policyholder for the policy. IRC §101(j).

Every applicable policyholder who owns one or more EOLI contracts must file a return (IRS Form 8925) showing the number of employees insured under such contracts and the total amount of insurance in force at the end of the year under such contracts together with the policyholder's annual income tax return. IRC §6039I.

Privately held companies frequently purchase life insurance on their owners' lives to finance the buyout of an equity interest from a deceased owner's estate, or to fund the payment of deferred compensation obligations to a deceased employee's estate. The limitation in IRC §101(j) creates a trap for the unwary by eliminating the favorable tax treatment for employer-owned life insurance on the lives of employees unless certain notices and consents are obtained. The limitation does not apply with respect to any policy that covers the life of a director or highly compensated employee before or after the termination of employment, provided that the policyholder notifies the insured in writing of the intent to purchase the insurance and the insured gives written consent. Coverage for rank-and-file employees cannot extend more than 12 months beyond the period of employment unless the death benefit is paid to the estate of the insured or to a family member or designated beneficiary of the insured, or is used to purchase an interest in the policyholder from one of those persons. The limitation in IRC §101(j) also does not apply to any amount paid by reason of the death of the insured to a family member of the insured, an individual who is a designated beneficiary, or a trust established for the benefit of a family member or designated beneficiary, including proceeds of most life insurance policies owned under nonequity split-dollar arrangements.

Another trap for the unwary is the reference to "related person" in the definition of "employer-owned life insurance." Under IRC §267(b), an insurance policy held by a 50-percent or more owner of the employer would qualify as "employer-owned life insurance," and cross-purchase agreements funded by insurance policies could be subject to these rules. Note further that IRC §101(j) may apply to other plans funded by life insurance, including split-dollar insurance plans, life insurance-funded deferred compensation plans, and life insurance included in a qualified retirement plan. However, the IRS has issued guidance stating that IRC §101(j) does not apply to a policy owned by a related person who is not engaged in a trade or business. Notice 2009-48, 2009-24 Int Rev Bull 1085.

It is anticipated that insurance companies will provide appropriate notice and consent forms. Nevertheless, it would be advisable to include appropriate notice and consent provisions in the buy-sell agreement, whether structured as a redemption by the company or a cross-purchase between equity owners, and any other agreement that is funded by life insurance and may be covered by the new rules. Existing agreements should be amended to include these provisions any time the insurance policies are materially modified or the death benefit materially increased. For further discussion, see Business Buy-Sell Agreements §6.29 (Cal CEB 1991).

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§19.43 2. Exception to General Rule: Transfer-for-Value Rule

If the transferee of a life insurance policy acquired the policy for consideration, the proceeds are taxable income to the transferee. The transferee may deduct the consideration paid for the policy and all premiums or other payments paid by the transferee after the transfer. IRC §101(a)(2). The IRS has ruled that the net proceeds are ordinary income even though the policy is a capital asset in the hands of the transferee because the surrender of a life insurance policy or receipt of a death benefit is not a sale or exchange. However, any gain on a resale of the policy by the transferee is a capital gain, and the transferee's basis is increased by the full amount of any additional premiums paid. Rev Rul 2009-14, 2009-21 Int Rev Bull 1031.

In IRS Letter Ruling 200636086, the IRS ruled that a sale of a life insurance policy to a grantor trust for fair market value was not a transfer for value. The IRS stated that although the transfer would be for a valuable consideration, it would be treated as a transfer to the insured, who was deemed to own the trust under the grantor trust rules. See §19.45A.

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3. Exceptions to Transfer-for-Value Rule

§19.44 a. Transfers With Carryover Basis

The transfer-for-value rule does not apply if the transferee acquired the policy by gift or through any transaction in which the transferee's basis in the policy is determined in whole or in part by reference to the transferor's basis in the policy. IRC §101(a)(2)(A).

PRACTICE TIP: It is important to avoid a tax trap posed by this exception. As a general rule, if a policy is transferred by gift, the transferee takes the transferor's basis and the transfer-for-value exception is met. However, if a policy transferred by gift is subject to a loan in excess of the transferor's basis in the policy, the transfer is considered to be part gift and part sale and the transferee's basis will be the loan amount. As a result, the transferor's basis and the transferee's basis will not be the same, and this exception to the transfer-for-value rule will not be met. The transfer will also trigger income taxation to the transferor on that portion of the loan in excess of the transferor's basis. Treas Reg §§1.1001-1(e), 1.1015-4(a); *Crane v Commissioner* (1947) 331 US 1, 91 L Ed 1301, 67 S Ct 1047; *Joseph W. Johnson, Jr.* (1973) 59 TC 791, aff'd (6th Cir 1974) 495 F2d 1079, cert denied (1974) 419 US 1040; *Estate of Aaron Levine* (1979) 72 TC 780, aff'd (2d Cir 1980) 634 F2d 12. Therefore, to avoid these tax implications, loans in excess of basis should be repaid before transferring an encumbered policy.

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§19.45 b. Transfers to Insured, Partner, Partnership, or Certain Corporations

The transfer-for-value rule does not apply if the transferee is the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. IRC §101(a)(2)(B).

Note that the IRS has announced that it will not issue rulings on whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (1) the organization will be treated as a partnership under IRC §§761 and 7701, or (2) the transfer of the life insurance policy to the organization will be exempt from the transfer-for-value rules of IRC §101, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members. Rev Proc 2008-3, §3.01(8), 2008-1 Int Rev Bull 110.

In addition, the IRS will not issue rulings on whether there has been a transfer for value for purposes of IRC §101(a) in situations involving a grantor and a trust when (1) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (2) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (3) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (4) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under IRC §§673-677. Rev Proc 2008-3, §3.01(7), 2008-1 Int Rev Bull 110.

PRACTICE TIP: This exception is often used when an insured who has established an irrevocable life insurance trust (ILIT) determines that the terms of such trust are no longer appropriate. With the consent of the trustee, the insured may use the transfer-for-value exception to acquire the policy from the ILIT and then transfer the policy to a new trust with acceptable terms. Of course, the 3-year period of IRC §2035 will begin to run with respect to the new transfer. Alternatively, the transfer could be made directly to a new insurance trust meeting one of the transfer-for-value safe harbors. For example, the transfer to an intentionally defective grantor trust can be used to transfer a policy from one insurance trust to another. In *Swanson v Commissioner* (8th Cir 1975) 518 F2d 59, the insured retained the power to alter or amend a trust but could not vest ownership in himself. The insured was accordingly the owner of the trust under IRC §674, the sale of an insurance policy to the trust was deemed to be a transfer to the insured within the meaning of IRC §101(a)(2)(B), and the proceeds were excludable from gross income under IRC §101(a)(1).

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§19.45A c. Exchange of Policies Between Grantor Trusts

The IRS has consistently ruled that an exchange of life insurance policies between two trusts that are deemed owned by the same taxpayer—usually the insured—under the grantor trust rules of IRC §§671-679 (see chap 13) will not result in a recognition of gain or loss and will not be a transfer for value under IRC §101(a)(2). The rulings explain that a grantor trust is generally disregarded for federal income tax purposes. Rev Rul 85-13, 1985-1 Cum Bull 184. Under Rev Rul 85-13, a transaction cannot be recognized as a sale or exchange for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. The exchange of policies is similarly disregarded for purposes of the transfer-for-value rule. IRS Letter Rulings 200606027, 200518061, 200247006, 200228019.

PRACTICE TIP: Rulings in this area generally do not disclose why the transferee trust is a grantor trust, but the objective of creating grantor trust status without causing the insured to have incidents of ownership in the policy under IRC §2042 (see §19.31) is often accomplished by giving the grantor's spouse a power that is treated as held by the grantor for grantor trust purposes (IRC §672(e)), but is not so treated for IRC §2042 purposes.

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§19.46 4. Transfer-for-Value Exception for Viatical Settlements

The development of a secondary market in life insurance policies (see §19.41) resulted in changes in the transfer-for-value rules, which Congress implemented by amending IRC §101 in 1996 to add new subsection (g). The sale of a life insurance policy insuring a person who is "terminally ill" or "chronically ill" to a "viatical settlement provider," as these terms are defined in IRC §101(g), is a "viatical settlement." If certain conditions are met, IRC §101(g) provides that the amount received from a viatical settlement is treated as an amount paid by reason of the death of an insured and hence is not subject to income taxation.

Before the enactment of IRC §101(g), the gain on the sale by the insured would have been taxable as ordinary income. However, the income taxation of amounts received in an aftermarket sale are less clear and not specifically addressed by the IRC. It is generally assumed that amounts received not in excess of basis constitute a nontaxable return of basis, although the IRS has ruled that the cost of the pure life insurance protection in a term policy is presumed to be equal to the total premium paid, with the consequence that the premium payments are not included in the insured's adjusted basis. Rev Rul 2009-13, 2009-21 Int Rev Bull 1029. However, the proper treatment of amounts in excess of basis is not clear. Case law and many commentators support the position that such amounts are taxable as ordinary income. See, *e.g., Arnfield v U.S.* (Ct Cl 1958) 163 F Supp 865, cert denied (1959) 359 US 943, 3 L Ed 2d 676, 79 S Ct 722; *Commissioner v Phillips* (4th Cir 1960) 275 F2d 33; *Bolling Jones, Jr*. (1962) 39 TC 404; *Edwin A. Gallun,* TC Memo 1963-167, aff'd (7th Cir 1964) 327 F2d 809; *Elbert H. Neese, Jr.,* TC Memo 1964-288. In Rev Rul 2009-13, the IRS ruled that the net amount received on surrender of a cash value life insurance policy is ordinary income under IRC §72(e). The IRS further ruled that the net amount received on a sale of a cash value policy was ordinary income under the "substitute for ordinary income" doctrine even though the policy is a capital asset. The IRS noted that the application of this doctrine is limited to the amount that would be recognized as ordinary income if the policy were surrendered.

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§19.47 5. Settlement Option Consequences

If a settlement option is selected under which proceeds are paid in installments, the interest portion of each installment is taxable income to the beneficiary. IRC §101(c)-(d). If an installment for life is selected, the portion treated as nontaxable principal is determined by dividing the discounted value of the proceeds by the beneficiary's life expectancy. The portion in excess of the amount treated as principal is treated as taxable interest.

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§19.48 6. Surrender of Insurance Policy

The amount received as a full refund, surrender, redemption, or maturity of a policy is included in gross income as ordinary income to the extent the amount received exceeds the policyholder's investment in the contract (the aggregate amount of premiums or other consideration paid for the policy, minus the aggregate amounts received under the policy that were excludable from gross income). IRC §72(e)(1)(A), (e)(5)(A), (e)(5)(E), (e)(6).

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§19.49 7. Exchange of Insurance Policies

Internal Revenue Code §1035 provides for nonrecognition of gain for three types of exchanges: (1) life for life, endowment, or annuity; (2) endowment for endowment or annuity; and (3) annuity for annuity. The exchange of a life insurance policy, endowment contract, or fixed annuity contract for a variable annuity contract also qualifies as a tax-free exchange. Rev Rul 68-235, 1968-1 Cum Bull 360; Rev Rul 72-358, 1972-2 Cum Bull 473. Internal Revenue Code §1035 applies only if the policy exchanged relates to the same insured. Treas Reg §1.1035-1(c). The exchange is usually accomplished by assigning the first contract to the issuer of the second contract. In IRS Letter Ruling 200622020, the IRS ruled that IRC §1035 did not permit the surviving settlor of a trust that received annuity proceeds on the death of the deceased spouse to treat the purchase of a new annuity in the name of the survivor as a tax-free exchange. The ruling illustrates possible disadvantages of naming a trust as a beneficiary of an annuity.

NOTE: For exchanges occurring after December 31, 2009, nonrecognition of gain also applies to an exchange of a life insurance, endowment, or annuity contract for a qualified long-term care insurance contract.

The basis of the new policy will be the same as the basis of the old policy, plus any premiums paid and less any excludable dividends received after the exchange. IRC §1031(d). No excludable exchanges are taxable under IRC §1001 to the extent of any excess of the value of the new contract plus any money or other property received, over the adjusted basis of the old contract. A partially tax-free exchange occurs when an exchange would come within IRC §1035, except that money or other property is included in the exchange. Gain is recognized up to the value of such money or other property and is taxed as ordinary income. IRC §1031(b); Rev Rul 54-264, 1954-2 Cum Bull 57; *Stanley Barrett* (1964) 42 TC 993, aff'd (1st Cir 1965) 348 F2d 916. No loss is recognized. IRC §1031(c). A policy acquired by exchange takes the basis of the policy exchanged, reduced by the amount of any money received, and increased by the amount of any recognized gain. IRC §1031(d).

The IRS has ruled that an exchange of a second-to-die policy following the death of the first insured for a single life insurance policy on the life of the surviving insured is tax-free. IRS Letter Rulings 9248013, 9330040. The IRS has not offered guidance on whether IRC §1035 is triggered when a second-to-die policy is exchanged for single life policies while the spouses are alive. To the extent that these exchanges "do not relate to the same insured," any gain or loss would be recognized. Treas Reg §1.1035-1(c); Rev Rul 90-109, 1990-2 Cum Bull 191. Also, in IRS Letter Ruling 9542037, the IRS ruled that IRC §1035 does not apply to the exchange of single life policies for second-to-die policies because the policies received in the exchange do not relate to the same insured.

PRACTICE TIP: By analogy, if two single life policies exchanged for a second-to-die policy result in taxable gain, then the reverse should be true. However, this type of exchange is also arguably within the scope of IRC §1035 because the new policy will relate to one of the same insureds as the old policy, although not both. Despite IRS Letter Ruling 9542037, many commentators argue that IRC §1035 should apply to the exchange of a single insurance policy of one spouse for a second-to-die policy for both spouses. The legislative history indicates that Congress viewed nonrecognition treatment as appropriate for "individuals who have merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." HR 1337, 83d Cong, 2d Sess 81 (1954). Because of the marital deduction, a joint life policy would seem better suited to the needs of many couples. Thus, the exchange of a first-to-die policy for a second-to-die policy insuring both spouses would arguably fall within the congressional intent of IRC §1035.

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IV. LIFE INSURANCE TRUST

§19.50 A. Purposes of Irrevocable Life Insurance Trust (ILIT)

The primary objective of an irrevocable life insurance trust (ILIT) is to avoid having the proceeds of a policy included in the estate of the insured for estate tax purposes when the insured dies. Because the value of a policy typically increases, often dramatically, when the insured dies, it is almost always the case that a better transfer tax result can be achieved by making gifts of money to a trust that will then use those gifts to pay premiums. If a client already owns a policy, the trust may be initially funded with a transfer of the policy, although the policy will still be included in the insured's estate under IRC §2035 if death occurs within 3 years of the transfer. The risk of inclusion can be avoided if the trust is established before the original application is submitted to the issuer and the trustee (rather than the insured) is the original applicant. However, there is some question whether the trustee of a typical life insurance trust has an insurable interest in the life of the settlor.

Under Ins C §280, an insurance contract is void if the insured has no insurable interest. An insurable interest is generally defined as "an interest based upon a reasonable expectation of pecuniary advantage through the continued life… of another person and consequent loss by reason of that person's death." Ins C §10110.1(a). Under Ins C §10110, persons who have an insurable interest in the settlor's life include the settlor, the settlor's dependents, the settlor's creditors or obligees, and a person with a vested estate or interest that depends on the life of the settlor. The Insurance Code does not expressly provide that the trustee of a trust has an insurable interest in the life of a beneficiary.

In *Chawla v Transamerica Occidental Life Ins. Co.* (4th Cir 2006) 440 F3d 639, the court affirmed a district court decision that an insurance contract owned by a trust created by the insured was void because of misrepresentations about the insured's health, but also because the trust had no insurable interest in the settlor's life. (The district court did not consider that the trust may have had an insurable interest in the life of the settlor because the settlor himself was a beneficiary of the trust. From the facts of the case, it does not appear that the remainder beneficiary was closely related to the settlor or had some other insurable interest.) The appellate court affirmed the district court's decision on the ground that the policy was void because of the insured's misrepresentations and did not address the insurable-interest issue. In light of the district court's decision in *Chawla,* one commentator has suggested that new trusts ideally should be created in, and funded with insurance purchased in, a state that has a statute giving a trust an insurable interest, such as Delaware; alternatively, the insured should buy the policy before creating the trust and transfer the policy to the trust—avoiding the risk of inclusion by obtaining a rider that doubles the payment if the insured dies within 3 years after acquisition of the policy. See Zaritsky, *Irrevocable Life Insurance Trusts and Insurable Interests:* Chawla *Raises Some Nasty Issues for Estate Planners*, 18 Prob Prac Rep 1 (Apr. 2006). Another possibility is for the settlor to sell the policy to the trust for fair market value. The trust should be a grantor trust to avoid possible recognition of gain under the transfer-for-value rule of IRC §101(a)(2). See §19.43.

The objective of avoiding estate tax inclusion of the policy proceeds can also be accomplished by having loved ones own the policy, but this creates a variety of problems. Relevant considerations may include the following:

- The selected loved ones may have their own estate planning problems—problems that will be aggravated if their own estates are increased by the value of the insurance proceeds.
- People die out of order and their needs change. The distribution terms of a trust can address these issues. Trustees can be given distribution discretion, and it is often possible to give a spouse or other trusted person a nongeneral power of appointment that confers broad distribution discretion.
- Life insurance trusts are established for the purpose of paying death taxes—albeit indirectly through loans to the insured's revocable trust or purchases from that trust. Attempts to accomplish tax payment objectives may fail if individual loved ones owning various policies are unable to reach agreement regarding the wide variety of business and personal issues that will likely arise immediately after the insured's death.
- The owner of a policy may die before the insured, with the consequence that policy ownership may pass to

persons who will be inclined to take the money and run rather than pay taxes attributable to other assets.

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§19.51 B. Irrevocable Life Insurance Trust (ILIT)

An ILIT is an irrevocable trust created to be both the owner and beneficiary of one or more life insurance policies. On the death of the insured, the trustee invests the insurance proceeds and administers the trust for one or more beneficiaries. If the trust owns insurance on the life of a married person, the surviving spouse and children are usually the beneficiaries of the trust. If the trust owns second-to-die insurance, then the children would be beneficiaries. Customarily, the trustee of the ILIT is authorized, but not required (see §19.30), to either purchase assets from or make loans to the insured's estate. Because the trustee of the ILIT possesses all incidents of ownership in the insurance policy, the ILIT can provide the insured's estate with liquidity while shielding the insurance proceeds or assets purchased with the proceeds from estate tax when the insured dies, provided the trust has the appropriate settlor and trustee. See §§19.53-19.55. Because the trust is irrevocable, the trust assets and insurance proceeds or assets purchased with the proceeds are also shielded from creditor claims unless the settlor made a fraudulent conveyance to the trust. In *Laycock v Hammer* (2006) 141 CA4th 25, 44 CR3d 921, the court held that evidence that the decedent indirectly borrowed money from a life insurance policy he had transferred to an ILIT was insufficient to show that the trust was revocable and therefore subject to the claims of his creditors.

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§19.52 C. Formation and Payment of Insurance Premiums

If possible, the ILIT should be created before the application for and purchase of the insurance. The trustee, who should not be the insured, should be the original applicant and owner of the insurance. If the insured transfers an existing policy to the insurance trust, the insured must survive the date of the transfer by at least 3 years, or else the insurance proceeds will be included in his or her taxable estate under IRC §2035(a). See §19.34.

Generally, the insured provides the funds for the payment of premiums by making gifts to the insurance trust. This may be accomplished in one of two ways: (1) the insured may make gifts to the insurance trust each year in the amounts needed to pay the insurance premiums, or (2) the insured may transfer income-producing assets to the ILIT and the trustee will thereafter use the trust's income to pay the insurance premiums.

- The first alternative is the more common. Annual or more frequent gifts are made to the trust by the grantor in the amount needed to pay the insurance premiums. For gift tax purposes, gifts to the ILIT are treated as gifts to the beneficiaries and may be treated as IRC §2503(b) annual exclusion gifts if the trust is a *Crummey* trust, as discussed in §19.58.
- The second alternative is referred to as creating a "funded" trust. Funded ILITs are rarely employed for three reasons. First, a large gift is usually necessary to create the trust. Second, there is the additional gift tax cost of transferring the assets to the trust. Third, because trust income can be used to pay the premiums for insurance on the life of the grantor, under IRC §677(a)(3) all the taxable income of the trust (not just the income used to pay the premiums) will be attributed to the insured and the insured will be required to report that income on his or her individual income tax return. This technique can be quite useful in some larger estates because the payment of income taxes by the insured is not a taxable gift and effectively permits the insured to increase the cash flow of the ILIT by converting a taxable return into a nontaxable return.

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§19.53 D. Settlor

As a general rule, the insured is the settlor of an ILIT. (As used in this chapter, the terms "settlor" and "grantor" are interchangeable and refer to a person who owns property and gives that property to a trust.)

If the ILIT owns insurance on the life of a married person and the noninsured spouse is a beneficiary of the trust, it is important that the noninsured spouse not be a settlor of the trust. Therefore, community property assets must not be used to pay premiums. The insured spouse should instead use separate property to pay premiums. If the insured spouse does not have separate property, community property assets should be divided into two equal shares of separate property under a written property agreement (also called a transmutation agreement) between the spouses. The insured spouse should then use only his or her separate property to pay premiums and the spouses should avoid commingling their separate property with the remaining community property. If the noninsured spouse's separate property is commingled, the IRS might contend that the property agreement is illusory and treat the noninsured spouse as the settlor of one-half of the insurance trust. This would result in inclusion of one-half of the trust corpus in the noninsured's gross estate at his or her subsequent death under IRC §2036 because the noninsured spouse will have made a transfer to a trust for the noninsured spouse's own benefit.

An analogous problem exists if an existing insurance policy insuring one spouse is owned by both spouses as community property and the parties desire to transfer the policy to an ILIT in which the noninsured spouse is a beneficiary. The insured spouse must acquire the noninsured spouse's interest in the policy as his or her separate property before the transfer. Such acquisition may be accomplished either by gift, using the unlimited marital deduction, or purchase, using separate property funds and the transfer-for-value exception.

PRACTICE TIP: Care must be taken to avoid application of the "step transaction" doctrine. Under the step transaction doctrine, if two parts of a transaction are inseparably related, the IRS may combine both parts into a single transaction. See *George A. Nye* (1968) 50 TC 203, 211, acq 1969-2 Cum Bull xxv. If the insured spouse transfers a policy to an ILIT immediately following the acquisition of the policy from the noninsured spouse, the IRS might assert the step transaction doctrine in order to treat the noninsured spouse as a settlor of the insurance trust. There is no clear guidance on how long the insured spouse needs to retain ownership of the policy. The author recommends a period of not less than 6 months.

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§19.54 E. Trustee

A third party other than the insured must serve as trustee. If the insured serves as trustee or cotrustee of an ILIT, the insured will be deemed to possess incidents of ownership in the policy. Treas Reg §20.2042-1(c)(4). The insured settlor may retain the authority to remove the third party trustee and appoint a successor individual or corporate trustee, provided that the successor is not related or subordinate to the settlor within the meaning of IRC §672(c). See §19.32.

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§19.55 F. Reciprocal Trust Doctrine

Estate planners should proceed with caution whenever both husband and wife propose to create insurance trusts and name one another as trustees or beneficiaries. If two people, *e.g.,* a husband and wife, each creates a trust for the benefit of the other, and each trust owns an insurance policy on the settlor's life, the IRS may attempt to apply the "reciprocal trust doctrine" to uncross the trusts for estate tax purposes. If the IRS was successful in this effort, the result would be that each spouse would be treated as the settlor of a trust for the settlor's own benefit and that trust would be included in the seller's estate under IRC §2036(a)(2). The requirements for the application of the reciprocal trust doctrine were at issue in *U.S. v Estate of Grace* (1969) 395 US 316, 23 L Ed 2d 332, 89 S Ct 1730. In *Estate of Grace,* the Court held that, for the doctrine to apply, the trusts did not need to be created as consideration for each other; *i.e.,* application did not require that "each trust was created as a *quid pro quo* for the other." Rather, the Court held that application of the doctrine "requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries." 395 US at 324, 23 L Ed 2d at 338.

The IRS has succeeded in applying the reciprocal trust doctrine even though the settlors did not have a beneficial interest in the trusts which they created. In *Estate of Bruno Bischoff* (1977) 69 TC 32, the settlors created trusts for four grandchildren. Each settlor created four discretionary trusts, one for each grandchild, and named the other grandparent as trustee. The Tax Court uncrossed the trusts on the basis that the trusts were interrelated, and the trustee's distributive powers over trust income and principal "are within those forbidden by sections 2036(a)(2) and 2038(a)(1)." As a result, each settlor was deemed to have the power to designate the persons to whom income was distributable and the trusts were includable in their respective gross estates.

However, the Sixth Circuit refused to follow *Estate of Bischoff*. In *Estate of Green v U.S.* (6th Cir 1995) 68 F3d 151, the IRS sought to apply the reciprocal trust doctrine for purposes of applying IRC §2036(a)(2). In *Estate of Green,* the decedent and his wife each created separate trusts for their two grandchildren. For one grandchild, the decedent was the settlor and his wife was the trustee. For the other grandchild, the wife was the settlor and the decedent was the trustee. Even though the decedent and his wife did not possess beneficial interests in the two trusts, the IRS sought to uncross the trusts based on reciprocal fiduciary powers. If each settlor was the trustee of the trust he or she had created, the trustee's discretionary powers over distributions of income and principal would have resulted in inclusion of the trust's corpus in the gross estate of the settlor under IRC §2036(a)(2). The Sixth Circuit rejected the *Estate of Bruno Bischoff, supra,* analysis on the grounds that the "same economic position" test in *Estate of Grace, supra,* required the settlor to retain a beneficial interest and that mere control of beneficial interests as trustee was not sufficient. Not surprisingly, the IRS has indicated a preference for the views expressed in *Estate of Bischoff* over those expressed in *Estate of Green*. See IRS Letter Ruling 9735025.

In IRS Letter Ruling 9643013, a husband and wife each created an irrevocable trust with separate property funds. The husband's trust named the wife as trustee and the children as beneficiaries and the wife's trust named the husband as trustee and the husband and children as beneficiaries. Each trust vested distributive discretion in an independent trustee. In view of the differences of the trust in this fact situation, the IRS ruled that the reciprocal trust doctrine did not apply.

In IRS Letter Ruling 200426008, the IRS ruled that the reciprocal trust doctrine did not apply because of differences in terms between the two trusts, based on the decision in *Estate of Herbert Levy,* TC Memo 1983-453. However, estate planners should be cautious in relying on the ruling and decision because the application of the reciprocal trust doctrine has been expanded since *Levy,* most notably in *Estate of Bruno Bischoff, supra*.

Because the courts have not clearly defined the limits of the reciprocal trust doctrine, it is desirable to avoid transactions that make it look as if one spouse purchased the action of the other. It is desirable to establish the trusts at different times and to provide different distribution terms. In many cases it will not be necessary for each trust to include the other spouse in the group trust beneficiaries.

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§19.56 G. Acquiring Insurance Policy for ILIT

If new insurance will be owned by an ILIT, the trust should be established before the original application is submitted to the insurance company, and the trustee should be the original applicant. In order to avoid an agency argument by the IRS based on *Estate of Tetsuo Kurihara* (1984) 82 TC 51, the trustee should be actively involved in dealing with the insurance agent. See §19.36. If at all possible, selection of the policy and related discussions with the agent should be conducted by the trustee without the involvement of the settlor, whose involvement should be limited to executing the trust and insurance application, naming the trust as the policy owner, and funding the trust. The trust should give the trustee broad investment discretion, but should not require the trustee to purchase insurance on the settlor's life. However, the trustee should be given the authority to purchase life insurance and exercise all incidents of ownership. Some commentators believe that it is preferable that the term "insurance trust" not be used in the trust's title. See also §19.36.

If an existing policy is to be transferred to an ILIT, income, gift and estate tax consequences may result. The transfer of an existing insurance policy to an ILIT without receiving adequate and full consideration is treated as a gift to the beneficiaries of the trust, and subject to gift tax. Treas Reg §25.2512-6(a). See §19.40. The transfer will also result in taxable income if the policy is subject to a loan in excess of basis. *Estate of Aaron Levine* (1979) 72 TC 780, aff'd (2d Cir 1980) 634 F2d 12. See Practice Tip in §19.44. In addition, the transfer will be subject to inclusion in the insured's estate under IRC §2035 if the insured transfers the policy within 3 years of death. See §19.34. Unfortunately, there is not much that can be done to avoid taxes if the insurance is acquired before execution of the trust. In the author's experience, if the policy is less than 1 year old, some insurance agents suggest using a substitute application dated after execution of the trust agreement, which shows the trustee as the original applicant and owner. A substitute application accomplishes no more than attempting to change a preexisting paper trail. It does not change the fact that the policy had been issued before execution of the trust. See discussion of *Estate of Tetsuo Kurihara, supra,* in §19.36.

PRACTICE TIP: It is important to distinguish between substituting applications and backdating the policy to a date before creation of the insurance trust. Life insurance companies compute the age of the insured according to his or her nearest birthday. Thus, 6 months after the insured's birthday, the insured becomes 1 year older for insurance purposes. Backdating results in the policy having an effective date before the insured's age change, thereby permitting premiums to be paid based on the lower age. Of course, a premium will be owing from the effective date.

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§19.57 H. Income Taxation of Insurance Trust

An ILIT is taxed on its taxable income. IRC §641. However, before the life insurance policy has matured, an ILIT whose only asset is the insurance policy usually will not have any taxable income. Note that under IRC §677(a)(3) a grantor will be treated as the owner of any portion of a trust whose income may be used (without the consent of an adverse party) to pay insurance premiums on the life of the grantor or the grantor's spouse. For a detailed discussion of taxation of trusts, see chap 13.

PRACTICE TIP: A literal reading of IRC §677(a)(3) suggests that an ILIT that does not explicitly bar the use of income for the purchase of life insurance on the grantor's life is taxed as a grantor trust. To avoid this treatment, the trust agreement should not explicitly allow such use of trust income, and it is advisable to include language prohibiting the use of trust income to pay insurance premiums on the life of the grantor or the grantor's spouse.

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§19.58 I. *Crummey* Withdrawal Power

Under IRC §2503(b), a donor may exclude from taxable gifts the first $12,000 of present interest gifts made by the donor to each donee during the calendar year. A gift of a future interest in property will not qualify for the annual gift tax exclusion. Whether a transfer to an irrevocable trust, such as an ILIT, will qualify for the present interest annual gift tax exclusion depends on the terms of the trust. The most common technique used to qualify such a transfer as a present interest is for the trust to provide that the trust beneficiaries have a "*Crummey* withdrawal power," named for *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. A typical *Crummey* withdrawal power gives a beneficiary the right to withdraw trust property of a specified value for a limited period (*e.g.,* 30 days) whenever a contribution is made to the trust. In *Crummey,* the court held that such withdrawal rights gave a powerholder a present interest in the property subject to the power, and the donor was entitled to the annual gift tax exclusion.

For further discussion of the requirements for a valid *Crummey* withdrawal power and the tax consequences, see chap 10.

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§19.59 1. Must Cash Be Kept During Withdrawal Period?

A life insurance trust typically provides the beneficiaries with *Crummey* withdrawal powers (see *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82) to qualify transfers to the trust for the IRC §2503(b) $12,000 per-donee annual gift tax exclusion. This grant of an immediate right of withdrawal is necessary because the annual gift tax exclusion is not available for gifts of future interests. Even if the trust instrument confers the necessary withdrawal power, what happens when the trustee has no way of distributing property to satisfy an exercise of the power? Does this tend to show that the withdrawal power is illusory and therefore ineffective?

This issue may arise in several contexts:

- A trustee pays the insurance premium while the withdrawal right is outstanding, and insufficient cash assets remain on hand to satisfy the withdrawal right;
- The settlor has transferred his or her interest under a group term policy to the insurance trust, and the premiums are paid by the employer; or
- The insurance trust owns a policy subject to a noncontributory split-dollar plan.

(Under the latter two circumstances, the insured is deemed to make a gift when the employer pays the premium.) The issue may also arise when an existing policy is transferred to a multi-beneficiary trust if the policy has no cash surrender value and the policy cannot be divided in kind.

In these situations, a court could decide that the net result is the same as that in *Ryerson v U.S.* (1941) 312 US 405, 85 L Ed 917, 61 S Ct 656, in which a gift of property to two or more persons was not considered to be a gift of a present interest because all owners had to join to exercise ownership rights. One or all of the beneficiaries may try to exercise their withdrawal rights, but if there is nothing to give them but a tenants-in-common interest in a policy, and the rights to the policy cannot be exercised without the other owners' consent, the beneficiary arguably still has not received a present interest gift. Counterarguments can be made (particularly if the trustee has any ability to borrow money or liquidate the policy interest), but the issue is nevertheless troublesome even though the IRS has shown little inclination to raise the issue.

The IRS, however, will not issue advance rulings that a *Crummey* withdrawal power will result in a present interest if the trust is intended to consist primarily of life insurance policies. Rev Proc 2006-3, §4.01(45), 2006-1 Int Rev Bull 122, 128.

PRACTICE TIP: As a safety precaution, the practitioner should ensure that a trust always has sufficient liquid assets to satisfy any exercises of *Crummey* powers. This can be accomplished by making cash gifts to the trust long enough in advance of the premium due date that the withdrawal powers will expire before the premium must be paid. The *Crummey* clause should expressly permit the trustee to satisfy the beneficiary's withdrawal right through recourse to trust assets other than those contributed to the trust at the time. Alternatively, the trust may authorize the trustee to distribute fractional interests in the life insurance policies by providing for discretionary distribution of fractional interests in trust assets. See Zaritzky & Leimberg, Tax Planning With Life Insurance ¶5.03[3][g] (2d ed 1998).

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§19.60 2. Term and Group-Term Insurance

Gifts of both term and group-term life insurance to an ILIT subject to a *Crummey* withdrawal power have been held to qualify for the present interest annual exclusion under IRC §2503(b). See IRS Letter Rulings 7826050, 79350911, and 7947066 for gifts of term insurance and IRS Letter Rulings 8006109, 8021058, 8103074, and 8138102 for gifts of group-term insurance. In IRS Letter Rulings 8006109 and 8103074, the initial funding consisted of group-term policies together with $1000. In neither ruling was the present interest exclusion restricted to the cash amount contributed.

Further, in IRS Letter Ruling 8134135, the IRS ruled that the settlor qualified for the present interest annual exclusion at the time the settlor's employer paid the premiums on group-term life insurance policies placed into trust, as well as at the time the trust was initially funded, and at the time of any subsequent contributions. In this ruling, an ILIT was formed with whole life, term, and group-term life insurance policies on the settlor's life. The beneficiaries had *Crummey* withdrawal powers, and the trustee was required to maintain sufficient liquid assets during each withdrawal period to enable immediate payment to any beneficiary exercising his or her withdrawal power.

PRACTICE TIP: In IRS Letter Rulings 8118051 and 8103074, the IRS stated that the present interest exclusion is available "only to the extent that there is cash, or assets reducible to cash, in the trust to satisfy any beneficiary demand rights." If the only asset of the irrevocable insurance trust is an interest in a group-term policy, the withdrawal power is arguably illusory and the present interest exclusion may not be available for employer contributions. The present interest exclusion would also appear to be unavailable if the group-term policy provides that ownership rights may not be exercised by more than one person and the *Crummey* withdrawal power is held by multiple beneficiaries. See discussion in §19.59.

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§19.61 3. Powers of Appointment

A power of appointment is a power by which a person may determine to whom property in a trust will be distributed. Powers of appointment are used to provide flexibility in the estate planning process. As a general rule, property held in an ILIT will escape estate tax at a beneficiary's death unless the beneficiary possesses a general power of appointment (defined below) over trust property. IRC §2041.

The estate tax classifies powers of appointment as either *special* or *general*.

- A *special power of appointment* (sometimes called a limited power of appointment) is a power that the donee may not exercise in his or her favor, or in favor of his or her estate or the creditors of either. Trust property subject to a special power of appointment is not subject to estate tax when the donee dies.
- *A general power of appointment* is a power that the donee may exercise in favor of any one or more of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. IRC §2041(b)(1). Trust property subject to a general power of appointment is subject to estate tax when the donee dies. For purposes of the estate tax, it is irrelevant whether a person possesses a general power of appointment individually or as trustee, or whether or not that power is actually exercised. However, an exception exists for a power that the donee may exercise in his or her own favor if it is limited by an *ascertainable standard* relating to the health, education, support, or maintenance of the donee. IRC §2041(b)(1)(A). Such a power is not treated as a general power of appointment.

For a more detailed discussion of powers of appointment, see chap 9.

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§19.62 4. *Crummey* Withdrawal Power as General Power of Appointment

A *Crummey* withdrawal power is a general power of appointment over the property subject to withdrawal. Both the exercise and the lapse of a withdrawal power may have the following gift, estate, GST, and income tax consequences to the powerholder:

- During the period that the power may be exercised, the powerholder is treated as owning the property that may be withdrawn and is taxed on the income from such property. IRC §678.
- If the donee dies during the period that the power may be exercised, the property subject to the withdrawal right will be includable in the donee's gross estate. IRC §2041.
- If the donee releases the power or a lapse is treated as a release because it is not fully protected by the "5 or 5" safe harbor, adverse estate, gift and/or GST tax consequences may occur. IRC §2514.

Because *Crummey* withdrawal powers are commonly used in ILITs to qualify gifts to the trust for the annual gift tax exclusion, it is important to understand these tax consequences to the powerholder, both while the withdrawal right is presently exercisable and after the powerholder allows the power to lapse. See also chap 10

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5. Tax Consequences While *Crummey* Withdrawal Power Is Outstanding

§19.63 a. Gift Tax Consequences

There are no gift tax consequences to the powerholder while a *Crummey* withdrawal power is outstanding.

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§19.64 b. Estate and Generation-Skipping Transfer Tax Consequences

During the period while it is exercisable, a *Crummey* withdrawal power is a general power of appointment possessed by the powerholder over trust property of a certain value. If the powerholder dies while the withdrawal right is outstanding, the property subject to the power will be included in the powerholder's gross estate. For purposes of the GST tax, inclusion of the property in the powerholder's gross estate will cause the powerholder to become the transferor of the property for GST purposes, and the powerholder's executor may need to allocate GST exemption to the included interest, if appropriate. See §19.70.

EXAMPLE: Assume that Parent (P) creates an ILIT for the benefit of Child (C) and Grandchild (GC). C dies possessed of a *Crummey* withdrawal right, thereby causing a portion of the trust to be included in C's gross estate. As a result of C's death, the trust will terminate and principal will be distributed to GC. Because GC is not a skip person with respect to C, it is unnecessary for C's executor to allocate any of C's GST exemption to the included interest. On the other hand, if the insurance trust were to continue to be administered for GC's benefit for life, followed by a distribution to GC's issue, it would be appropriate for C's executor to allocate GST exemption. For this purpose, the portion of the trust attributable to C would be treated as a separate trust. See Treas Reg §26.2654-1(a)(5), Example 5.

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§19.65 c. Income Tax Consequences

The statutory scheme governing the income tax consequences to the powerholder while the *Crummey* withdrawal power is exercisable is contained in IRC §678(a)(1), which provides: "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which… such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself…." Any income attributable to such portion would be taxable to the deemed owner under IRC §671. See, *e.g.,* Rev Rul 67-241, 1967-2 Cum Bull 225. However, this should usually not be a concern with ILITs because in many, if not most, cases, the ILIT will have no taxable income while the power is outstanding, with the consequence that IRC §678 should be irrelevant.

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6. Tax Consequences on Lapse of *Crummey* Withdrawal Power

§19.66 a. Lapses and Releases: 5 or 5 Safe Harbor

An understanding of the difference between a lapse and a release of a general power of appointment is vital to an understanding of the income, gift, estate, and GST tax consequences of the lapse of a *Crummey* withdrawal power. Under IRC §§2041(a)(2) and 2514(b), the release of a general power of appointment created after October 21, 1942, is treated as a transfer of the property subject to the power for estate and gift tax purposes, respectively. Under IRC §§2041(b)(2) and 2514(e), a lapse of a power of appointment is treated as a release to the extent it exceeds an amount known as the "5 or 5" safe harbor amount. This rule, as stated in IRC §2514(e), provides:

> The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. [This rule] shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of… (1) $5,000, or (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied.

PRACTICE TIP: In some cases, the donor may be able to give an ILIT additional cash or other assets in excess of the amount needed for the insurance premium in order to make the 5-percent amount at least as great as the amount a powerholder can withdraw under the *Crummey* power. If this is possible, the lapse will not exceed the 5 or 5 amount and there would be no gift, estate or GST tax consequences. Alternatively, if the trust has enough beneficiaries who are *Crummey* powerholders, the amount each can withdraw can be made to be no greater than the 5 or 5 amount. See discussion of naked *Crummey* powers in chap 10.

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§19.67 b. Gift and GST Tax Consequences

The exercise or release of a general power of appointment is deemed a transfer of property by the powerholder. IRC §2514(b). As discussed in §19.66, permitting a *Crummey* withdrawal power to lapse constitutes the release of a general power of appointment to the extent that the lapsed withdrawal power exceeds the 5 or 5 safe harbor amount. IRC §2514(e). If a lapsed *Crummey* power does exceed the 5 or 5 amount, whether a gift occurs is determined by viewing the release as if the powerholder had transferred his or her own assets to the trust and depends on the other trust beneficiaries, if any, the terms of the trust, and established concepts of gift taxation. If a completed gift occurs and the powerholder is a skip person, a generation-skipping transfer (GST) tax may be due because the trust is deemed to have made a distribution to a skip person who then made a gift back to the trust. Treas Reg §26.2612-1(c)(1). For further discussion of gift tax consequences of the lapse of *Crummey* withdrawal powers, see §10.112.

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§19.68 c. Estate Tax Consequences

The statutory scheme governing the estate tax consequences of the lapse of a *Crummey* withdrawal power is contained in IRC §2041(a)(2), which provides:

> The value of the gross estate shall include the value of all property… with respect to which the decedent has at any time exercised or released such a power of appointment by a disposition which is of such nature that if it were a transfer of property owned by the decedent, such property would be includible in the decedent's gross estate under sections 2035 to 2038, inclusive.

As discussed in §19.67, permitting a *Crummey* withdrawal power to lapse constitutes the release of a general power of appointment to the extent that the lapsed withdrawal power exceeds the 5 or 5 safe harbor amount. IRC §2041(b)(2). In addition, if a portion of the trust is included in the powerholder's estate under IRC §2041(a)(2), the powerholder becomes the transferor for generation-skipping transfer tax purposes. IRC §2652(a)(1).

In many if not most cases, the holder of a *Crummey* withdrawal power in an ILIT is also an income or remainder beneficiary of the trust. A release will accordingly be equivalent to a transfer subject to IRC §2036(a) because the powerholder will be viewed as having retained the use or enjoyment of the income and/or principal of the released property. If the released interest is includable in the powerholder's gross estate under IRC §2036(a), the value of the included interest is determined by multiplying the fair market value of the trust corpus at the applicable valuation date by a fraction, the numerator of which is the value of the property subject to the released power and the denominator of which is the fair market value of the entire trust corpus at the time of the release. Treas Reg §20.2041-3(d)(4).

If annual gifts are made to an ILIT to pay insurance premiums, each gift will generally give rise to a *Crummey* withdrawal power that will usually be allowed to lapse. If such lapses result in releases occurring in more than 1 calendar year, the percentage that each release bears to the fair market value of trust corpus at the time of such release must be determined separately and *the aggregate of such percentage interests* will be included in the powerholder's estate. Treas Reg §20.2041-3(d)(5). The effect of cumulative releases may be to include a substantial portion of the trust corpus in the powerholder's gross estate.

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§19.69 d. Income Tax Consequences

The income tax consequences to the powerholder arising from the lapse of a *Crummey* power are not clear. Under IRC §678(a)(2),

> A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which… such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, under the principles of [IRC §§671 to 677, inclusive] subject a grantor of a trust to treatment as the owner thereof.

Therefore, if IRC §678(a)(2) applies, the income, deductions, and credits attributable to the released portion of the trust will be included in the taxable income of the powerholder under the grantor trust rules of IRC §§671-679.

However, a crucial difference exists for the treatment of lapses under IRC §678 on the one hand and IRC §§2041 and 2514 on the other hand. Both IRC §§2041 and 2514 specifically equate lapses with releases, subject to the 5 or 5 safe harbor rule (see §19.67). But IRC §678(a)(2) refers only to powers that have been "partially released or otherwise modified." It does not equate lapses with releases or provide for the 5 or 5 safe harbor. This difference in the treatment of lapses for estate and gift tax purposes on the one hand, and income tax purposes on the other, has led some practitioners to question whether the phrase "partially released or otherwise modified" was intended to include all or any portion of the lapse of a *Crummey* power. However, in two letter rulings, the IRS has ruled that each year a trust beneficiary who had a retained interest in the trust failed to exercise a withdrawal power, the beneficiary would be deemed to have partially released the power under IRC §678(a)(2). In each case, the withdrawal powers were noncumulative and limited to the 5 or 5 amount of the trust corpus. IRS Letter Rulings 200104005, 200022035.

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J. Generation-Skipping Insurance Trust

§19.70 1. GST Tax and Exemption

Insurance trusts are frequently drafted to take advantage of the settlor's exemption from the generation-skipping transfer (GST) tax. In general, the GST tax is imposed on transfers to or for the benefit of beneficiaries who are "skip persons," *i.e.,* two or more generations younger than the donor, such as grandchildren. IRC §§2601, 2611-2613. The GST tax is imposed to prevent the avoidance of gift or estate tax on transfers of property at each generation level by skipping a level. An ILIT frequently involves generation-skipping transfers. A typical example of a generation-skipping ILIT is one that provides that the insurance proceeds are to be invested and the net income from them is to be paid to the insured's children for their lives. On the death of the last of the insured's children to die, the principal of the trust is either retained in further trust for the insured's grandchildren or distributed to them outright. If the trust has been drafted so that the children do not possess a general power of appointment over the trust property, estate tax will be avoided when the children pass away. However, a GST tax equal to the maximum federal estate tax rate at the time of the generation-skipping transfer will be incurred on distributions to the grandchildren unless the trust qualifies for an exemption from the GST tax. IRC §2641.

Each individual possesses an exemption from the GST tax. IRC §2631(a). The exemption was initially established at $1 million. Under IRC §2631(c), the exemption is indexed for inflation, with 1998 serving as the base year, for years 2011 and thereafter. For years 2004-2009, the exemption is equal to the IRC §2010(c) estate tax applicable exclusion amount. The GST tax does not apply to transfers in 2010. See chap 10 for further discussion of estate and GST tax repeal, and sunset provisions.

Note that the GST exemption is independent of the IRC §2505 gift tax applicable exclusion amount, which remains $1 million.

For further discussion of the GST tax, see chap 11.

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§19.71 2. Use of GST Exemption With ILIT

An ILIT can be an efficient means of leveraging the GST exemption. Leveraging is the process by which each dollar of exemption allocated to a transfer insulates some multiple of itself from the GST tax.

EXAMPLE: Assume that $100,000 is transferred to a GST trust that is exempted from the GST tax system by an allocation of the transferor's IRC §2631 GST exemption. If that $100,000 were invested in tax-exempt bonds and doubled in value in 10 years, it would produce a leverage factor of two. If that same amount were invested in a $1 million life insurance policy and the insured died in 10 years, the resulting proceeds would be equivalent to a leverage factor of ten.

If all transfers to an ILIT are exempted from the GST tax through use of the transferor's GST exemption, and there are no taxable releases due to *Crummey* withdrawal powers as discussed in §19.67, the trust will have an inclusion ratio of zero and be wholly exempt from the GST tax. For a discussion of the GST tax inclusion ratio, see chap 11. Because the trust itself would be exempt, proceeds of insurance attributable to policies owned by the trust would also be removed from the GST tax system. Through use of their combined gift tax applicable exclusion amounts and $2 million of GST exemption, a husband and wife may transfer up to $2 million (this amount leaves $2 million of their estate tax applicable exclusion amount and GST exemption unused) to an ILIT without incurring gift taxes or subjecting the trust to GST taxes. IRC §§2505(a), 2631(a). At the risk of stating the obvious, one can purchase substantial insurance with $2 million in premiums!

In order for an ILIT to function as a GST trust, three criteria must be met:

- GST exemption must be available to be allocated to the trust. See §19.70.
- The trust must be drafted to avoid creating general powers of appointment in the beneficiaries, which would subject the trust corpus to untimely estate taxation at their deaths and cause them to be the transferors for GST tax purposes. See §19.69. This includes limiting *Crummey* withdrawal powers to avoid taxable releases. See §19.73.
- The trust must be drafted to avoid creating an estate tax inclusion period (ETIP), which would prevent current allocation of GST exemption. See §19.77.

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§19.72 3. How to Avoid Taxable Releases

A generation-skipping insurance trust has two goals: insulating the insurance proceeds from estate and GST tax at the deaths of both the insured and the beneficiaries. If a *Crummey* withdrawal power is used to qualify gifts to an ILIT for the annual gift tax exclusion, the parties obviously contemplate that the beneficiary will allow the withdrawal right to lapse. After all, withdrawing the contribution from the trust defeats the purpose of making the gift in the first place, namely, to provide the trustee funds to pay the next insurance premium. On the other hand, allowing the withdrawal right to lapse without withdrawing the contribution may produce tax consequences that defeat the goal of the ILIT to insulate the insurance proceeds from estate taxation when the beneficiary dies. See §19.69.

The estate tax consequences of allowing a *Crummey* withdrawal power to lapse depends whether the lapsed amount exceeds the 5 or 5 amount. As the example in §19.73 shows, if the lapsed amount exceeds the 5 or 5 amount, the beneficiary will be treated as the owner of a portion of the trust, which portion will be subject to estate tax when the beneficiary dies. However, including a portion of a generation-skipping ILIT in the beneficiary's gross estate obviously defeats one of the goals of the trust.

Two strategies commonly used to avoid taxable releases are discussed in §§19.73-19.74.

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§19.73 a. Limit Maximum Withdrawal Amount to 5 or 5 Amount

First, the *Crummey* withdrawal power may be limited to the 5 or 5 safe harbor amount, with the donor's gift tax applicable exclusion amount being used to the extent that the transfer must exceed the 5 or 5 amount in any year. The 5 or 5 safe harbor is structured in terms of the maximum amount of a lapse that can occur from the viewpoint of the powerholder, not from the viewpoint of the donor. In other words, if both parents use a *Crummey* withdrawal power in order to transfer $12,000 each per child to an ILIT (or the same result is achieved by a split gift election under IRC §2513), the total amount that the child can let lapse during the calendar year without a taxable release occurring is still limited to one 5 or 5 amount for the total gifts, not per gift. IRC §2514(e). See Rev Rul 85-88, 1985-2 Cum Bull 201. If the withdrawal right is limited in this manner, the most at risk for each donor is the necessity to use a maximum of $9500 (½ of $24,000 minus $5000) of his or her applicable exclusion amount per donee in any year. Once the cash surrender value of the policy exceeds $100,000, the 5 percent of trust corpus limitation will become applicable because it will be greater than $5000). The full $12,000 gift tax annual exclusion for each parent is reached when the 5 percent amount is at least $24,000. This occurs when the cash surrender value reaches $480,000 (0.05 × $480,000 = $24,000).

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§19.74 b. Use of Hanging Power

Second, the *Crummey* withdrawal power can be structured as a hanging power. If the trust provides for a hanging power, the transferor can make use of his or her entire $12,000 gift tax annual exclusion per beneficiary, but the lapse is limited to the 5 or 5 safe harbor amount. The power to withdraw the excess amount remains in effect. The "hanging" power amounts lapse only in those years in which the powerholder did not have other lapsing powers fully utilizing his or her 5 or 5 safe harbor amount. When contributions are no longer being made to the trust, all hanging power amounts should eventually lapse. Otherwise, at the powerholder's death, any portion of the trust corpus subject to the hanging power will be included in the powerholder's gross estate under IRC §2041(a)(2). The powerholder will also become the transferor as to the portion included in his or her estate for GST purposes. Whether GST exemption needs to be allocated to that portion of the trust depends on the relationship of the beneficiaries to the original settlor and the powerholder. Of course, the settlor would have wasted any GST exemption that had been allocated to the portion of the trust included in the powerholder's gross estate. As discussed in §19.78, a hanging power must not be granted the transferor's spouse, because doing so would create an estate tax inclusion period (ETIP) and preclude the effective current allocation of GST exemption.

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4. Allocating GST Exemption to ILIT

§19.75 a. In General

Each individual (or his or her executor) may allocate the individual's GST exemption (see §19.71) at any time from the date of the transfer to the ILIT through the date for filing the individual's estate tax return, including any extensions actually granted. Allocations during the transferor's lifetime are made on the transferor's IRS Form 709 gift tax return. An allocation of GST exemption may be made by a formula, *e.g.,* the allocation may be expressed in terms of the amount necessary to produce an inclusion ratio of zero. An allocation of GST exemption once made is irrevocable. Treas Reg §26.2632-1(b)(4)(i). However, a subsequently filed but still timely Form 709 may amend any allocation made on a previously filed Form 709.

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§19.76 b. Deemed Allocations

If the transferor does not allocate GST exemption for a lifetime indirect skip to a GST trust on a timely filed IRS Form 709, the exemption will nevertheless be deemed to have been allocated to the trust, unless the trust meets certain exceptions (see IRC §2632(c)(3)(B)(i)-(vi)) or the transferor affirmatively elects to pay the GST tax on a timely filed Form 709. IRC §2632(c)(1), (c)(3)(A), (c)(3)(B)(i)-(vi), (c)(5). The amount of GST exemption that is deemed allocated is that amount necessary to reduce the inclusion ratio to zero. If the transfer exceeds the available exemption, the entire exemption will be deemed allocated. IRC §2632(c)(1). The allocation is effective as of the date of the transfer, and the value of the property transferred as determined for gift tax purposes also controls for purposes of determining the inclusion ratio. IRC §2642(b)(1)(A)-(B). As a result, it is only necessary to allocate to an ILIT that amount of GST exemption equal to the premium dollars being contributed to the ILIT to make the inclusion ratio equal to zero after the insured's death and the insurance proceeds are received.

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§19.77 c. Estate Tax Inclusion Period

If a transfer to a generation-skipping trust is subject to an estate tax inclusion period (ETIP), an allocation of GST exemption (including an automatic allocation) is effective no earlier than the termination of the ETIP. IRC §2642(f)(1). It is accordingly important to avoid the creation of an ETIP in an ILIT.

An ETIP is the period during which the value of the transferred property would be includable (other than by reason of IRC §2035) in the gross estate of the transferor if the transferor died. IRC §2642(f)(3). Any reference to the transferor includes the spouse of such transferor. IRC §2642(f)(4). However, property is not considered to be includable in the gross estate of the transferor's spouse if the spouse's *Crummey* withdrawal power is limited to the greater of $5000 or 5 percent of the trust corpus and such right lapses no later than 60 days after the transfer to the trust. Treas Reg §26.2632-1(c)(2)(ii)(B).

An ETIP may accordingly be avoided through proper drafting by doing the following:

- Limit a spouse's *Crummey* withdrawal right to the 5 or 5 safe harbor amount and lapse such right no later than 60 days after the transfer to the trust. Because the withdrawal right is limited to the 5 or 5 safe harbor, no taxable release will occur when the power lapses.
- Limit a spouse's discretionary powers as trustee through the use of an ascertainable standard.

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V. SPLIT-DOLLAR LIFE INSURANCE

§19.78 A. Introduction

Split-dollar life insurance is not a type of insurance contract but rather a means of splitting payment of the premium between the owner of the policy and a third party. There are numerous split-dollar arrangements. Variations exist in the manner of splitting the premium, the cash value, and the death benefit, as well as in the manner of documenting the arrangement. In addition, although most IRS rulings dealing with split-dollar insurance in the past involved traditional whole life products, any cash value product may be used, such as variable, universal, or second-to-die life insurance. However, IRS regulations have now substantially eliminated the tax benefits of these arrangements. See §19.79.

Traditionally, split-dollar plans were between employers and employees. The IRS definition of split-dollar insurance was found in Rev Rul 64-328, 1964-2 Cum Bull 11, which described the arrangement as an insurance contract in which an employer and employee joined in purchasing an insurance contract, in which there was a substantial investment element, on the life of the employee. This ruling discussed the two main methods for documenting the split-dollar arrangement—the "endorsement method" (the employer owns the policy) and the "collateral assignment method" (the employee or a third party owns the policy). Typically, the employer provided the funds to pay part of the annual premium to the extent of the increase in the cash surrender value each year, and the employee paid the balance of the annual premium. The employer was entitled to receive, out of the proceeds of the policy, an amount equal to the cash surrender value, or at least a sufficient part of it to equal the funds it has provided for premium payments. The employee had the right to name the beneficiary of the balance of any proceeds payable by reason of his or her death. See example in Rev Rul 64-328. "Reverse" split-dollar plans simply reversed the roles of the parties. The employer paid the term cost, while the employee paid the balance. At death, the employee's beneficiary received the cash value and the employer received the balance of the proceeds. "Private" or "family" split-dollar plans became increasingly common, especially as the result of some IRS letter rulings issued in 1996-1997. See IRS Letter Rulings 9745019, 9639053, 9636033. Private split-dollar plans were modeled after traditional employer/employee plans and were used to permit family members or trusts to provide funding for other family members or trusts without incurring gift or estate taxes. ILITs were frequently participants in split-dollar life insurance plans. See IRS Letter Ruling 9636033.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.79 B. IRS Treatment of Split-Dollar Insurance

§19.79 B. IRS Treatment of Split-Dollar Insurance

The IRS treatment of split-dollar insurance plans has changed several times through the years. The IRS first addressed split-dollar arrangements in Rev Rul 55-713, 1955-2 Cum Bull 23, which treated a split-dollar arrangement in an employment context as a nontaxable interest-free loan from the employer to the insured-employee. However, in 1964, the IRS issued Rev Rul 64-328, 1964-2 Cum Bull 11, which revoked Rev Rul 55-713 and rejected the loan characterization. This was the first of several rulings that conclude that the "economic benefit" conferred on an employee that is the value of the insurance protection in excess of the portions, if any, of premiums paid by the employee must be included in the employee's gross income each year. In Rev Rul 64-328, the IRS decided to treat premium payments as a form of economic benefit to the employee subject to income taxation, and established new rules that would apply to all split-dollar plans. The ruling stated that the value of the economic benefit may be determined by multiplying a factor called the P.S. 58 rate, set forth in a table contained in Rev Rul 55-747, 1955-2 Cum Bull 228, by the net death benefit payable to the employee's beneficiary. Revenue Ruling 66-110, 1966-1 Cum Bull 12, modified by Rev Rul 67-154, 1967-1 Cum Bull 11, amplified Rev Rul 64-328 by allowing the use of the insurer's "generally available" published term rates, if lower than the P.S. 58 rates. The concept of economic benefit was amplified again in Rev Rul 78-420, 1978-2 Cum Bull 67, and Rev Rul 79-50, 1979-1 Cum Bull 138.

In 2001, the IRS issued Notice 2001-10, 2001-1 Cum Bull 459, which revoked Rev Rul 55-547 and replaced the outdated P.S. 58 rates with new rates based on Table I of IRC §79(c) and Treas Reg §1.79-3(d)(2). The Notice refers to the new rates as the Table 2001 rates. The Table 2001 rates are significantly lower than the P.S. 58 rates at all ages.

However, Notice 2001-10 was short-lived. In anticipation of the issuance of regulations concerning the taxation of split-dollar life insurance plan participants, the IRS issued Notice 2002-8, 2002-1 Cum Bull 398, which revoked Notice 2001-10. Notice 2002-8 provided interim guidance regarding the tax treatment of parties entering into split-dollar life insurance plans and revised standards for valuing current life insurance protection.

Notice 2002-8 made modest changes in the rules for valuing the cost of current insurance protection that is included in the employee's income each year to the extent the value of that protection exceeds the employee's contribution to the premiums. More significantly, Notice 2002-8 raised issues about the future utility of split-dollar techniques by indicating that the employee would be subject to additional income tax consequences.

On September 17, 2003, the Service issued final regulations applicable to the taxation of split-dollar life insurance arrangements. TD 9092, 2003-2 Cum Bull 1055. As a result, the Revenue Rulings discussed above are now generally obsolete. See Rev Rul 2003-105, 2003-2 Cum Bull 696. Depending on the context of the transaction, the regulations can have an impact on income taxes, gift taxes, Federal Insurance Contributions Act (FICA) taxes, and Federal Unemployment Tax Act (FUTA) taxes. The regulations apply to any split-dollar life insurance arrangement entered into after September 17, 2003. Treas Reg §§1.61-22(j)(1)(i), 1.7872-15(n)(1). They also apply to earlier arrangements if there is a material modification of the arrangement. Treas Reg §§1.61-22(j)(2), 1.7872-15(n)(2).

PRACTICE TIP: It remains to be seen whether the typical estate planning practitioner will need to become familiar with the regulations. They only apply to arrangements created after September 17, 2003. Although insurance experts may yet identify situations in which new arrangements will be useful, those situations may be few and far between. See Brody, *What's New and What's Left in Sophisticated Life Insurance Techniques*, Estate Planning 2006, chap 5 (Cal CEB 2006).

The regulations apply to "split-dollar insurance arrangements," defined as arrangements between a policy owner and a nonowner in which either party pays some or all of the premiums, at least one of the parties is entitled to recover at least a portion of the premiums, and the recovery is to be made from (or secured by) the proceeds of the policy. Treas Reg §1.61-22(b)(1). For example, an employer and an employee might enter into an arrangement involving the purchase of insurance on the employee's life. The premiums would be paid by the employer. At death or other termination of the arrangement, the employer would be entitled to repayment of the premiums without interest to the

extent of the lesser of policy cash value or death benefits, with any remaining policy rights passing to the employee or an assignee or beneficiary selected by the employee. The transaction could be structured as an "endorsement" split-dollar arrangement in which the employer owns the policy, or as a "collateral assignment" split-dollar arrangement in which the employee owns the policy. Under the regulations, it is now more certain that the direct and indirect wealth transfers that result from split-dollar arrangements will be subject to tax.

The regulations create two mutually exclusive schemes for taxing split-dollar arrangements. The first scheme, detailed in Treas Reg §1.61-22 and referred to as the "economic benefit" regime, applies if an arrangement is entered into in connection with the performance of services and the employer or service recipient is the owner of the policy. The scheme also applies in private transactions involving a donor and donee if the donor is the owner of the policy. Conceptually, Treas Reg §1.61-22 treats the benefits received by the nonowner (or the nonowner's assignee or beneficiary) as compensation paid by the owner to the nonowner. The second scheme, detailed in Treas Reg §1.7872-15 and referred to as the "loan" regime, applies when the policy owner is the employee, service provider, or donee. This scheme generally treats disbursements by the nonowner as loans to the policy owner. This makes the transaction subject to the IRC §7872 below-market-rate loan rules if the arrangement does not provide for the payment of sufficient interest.

Under Treas Reg §1.61-22(d)(2), the nonowner is taxed on the value of economic benefits received during the taxable year, including the cost of current life insurance protection, the amount of any increase in the amount of policy cash value to which the nonowner has "current access," and the value of any other economic benefits. Under Treas Reg §1.61-22(d)(4), the nonowner has "current access" if the nonowner has a current *or future* right to the cash value increase and neither the policy owner nor the policy owner's creditors currently have access. From the nonowner's perspective, the scheme results in current income taxation of the inside build-up in the cash value of the policy. The Service takes the position that only the policy owner is entitled to avoid current taxation on the build-up.

On a transfer of the entire contract (or an undivided interest in the contract) to the nonowner, the excess of fair market value over consideration paid for the contract, less the amount of economic benefits previously taxed to the nonowner under Treas Reg §1.61-22(d)(2), will be taxed as compensation to the nonowner. Treas Reg §1.61-22(g)(1). The owner receives a corresponding deduction. Treas Reg §1.83-6(a)(5).

Generally, IRC §7872 provides, in connection with a below-market-rate loan, that the borrower receives a transfer from the lender of the difference between interest at a rate determined under the statute and the rate paid under the agreement. The borrower is then deemed to retransfer that amount back to the lender. The tax treatments of the transfer and retransfer depend on the context of the transaction. In the employer-employee context, the employer typically has a "wash" transaction, getting a business expense for the deemed transfer to the employee and recognizing interest income on the receipt of interest. The employee is treated as receiving compensation for services. Whether the employee can deduct the interest deemed paid to the employer depends on the normal rules for deducting interest, with no deduction being allowed for interest paid on loans for the acquisition of life insurance. IRC §264.

Because the parties to a split-dollar arrangement are fairly free to determine which party will be the named owner of the policy, the regulations basically take the position that the "owner" is the party shown as "owner" on the policy. If both parties are shown as owners, the first-named owner is the owner unless the policy is owned in fractional shares, in which case the policy is treated as two policies for purposes of the rules. Treas Reg §1.61-22(c)(1).

The grandfather rules of Notice 2002-8, providing various protections for existing arrangements that are not substantially modified after specified dates, are not affected by the regulations. Treas Reg §1.61-22(j).

Notice 2002-8 provides the following guidance for the valuation of current life insurance protection:

- For plans entered into before January 28, 2002, in which a contractual arrangement between an employer and employee provides that the P.S. 58 rates will be used to determine the value of current life insurance protection, the parties may continue to use the P.S. 58 rates to determine the value of current life insurance protection.
- For plans entered into before the effective date of the regulations and not materially modified after that date, the parties may use the table set forth at the end of Notice 2002-8 to determine the value of current life insurance protection. The table is called Table 2001, and was originally published in Notice 2001-10. However, in response to reports of abuses, the Service has given notice that neither the premium rates in Table 2001 nor the insurer's lower published rates may be relied on to value one party's current life insurance protection for the purpose of establishing the value of any policy benefits to which another party may be entitled. Notice 2002-59, 2002-2

Cum Bull 481.

- For plans entered into before the effective date of the regulations, to the extent provided in Rev Rul 66-110, the parties may continue to use the insurer's lower published premium rates, as further provided in Notice 2002-8, §III.3.

See Notice 2002-8, §IV, for further guidance on the treatment of split-dollar plans entered into before the effective date of the regulations.

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§19.80 C. The Split

Split-dollar tends to be confusing because of the numerous approaches to splitting the premium, the cash value of the policy, and the death benefit. The discussion that follows attempts to provide a useful road map of the various splits, explaining both the approach and when it was most commonly employed.

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§19.81 1. Splitting Premium

At least four common variations exist for splitting the premium payment:

- In the *classical split-dollar plan,* so-called because it is the variation discussed in Rev Rul 64-328, 1964-2 Cum Bull 11, the employer pays the annual premium to the extent of the increase in the cash surrender value each year, and the employee pays the balance of the annual premium.
- In the *contributory split-dollar plan,* the employer pays the full premium, less the amount of the economic benefit under the plan (see §19.78) and the employee pays the balance. The contributory plan is often used when an ILIT owns the policy. In such an arrangement, annual exclusion gifts using a *Crummey* withdrawal right can be made to the trust, which will be used to reimburse the employer when the policy is rolled out.
- The *bonus split-dollar contributory plan* is similar to the contributory plan but with the added factor that the employer pays a bonus to the employee of either the economic benefit or such larger amount as is needed to net the economic benefit that is paid by the employee (or contributed to the insurance trust) after the payment of income taxes.
- In the *employer pay-all split-dollar plan,* the employer pays the entire premium. Employer pay-all insurance was held to be subject to the split-dollar rules in *Arthur Genshaft* (1975) 64 TC 282 (taxpayers must include in gross income economic benefit conferred by family-owned corporation for payment of all premiums for insurance on taxpayers' lives).

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.82 2. Splitting Death Benefit

§19.82 2. Splitting Death Benefit

At least three common variations exist for splitting the death benefit:

- The employer is entitled to a return of the cash value and the beneficiary receives the balance.
- The employer is entitled to a return of the cash value up to the amount of the premiums actually paid, and the beneficiary receives the balance (the "equity" plan).
- The employer is entitled to receive the return of the greater of (a) the premiums paid or (b) the cash value, and the beneficiary receives the balance.

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§19.83 D. Documenting Split-Dollar Arrangement

A split-dollar plan requires appropriate documentation, both with the insurance company and between the contracting parties. The rights and obligations of the employer and employee are documented by a separate split-dollar agreement setting forth the amounts to be contributed by each party and the employer's rights to reimbursement on termination of the plan, whether by roll-out during the employee's lifetime or at the employee's death. The primary IRS split-dollar ruling, Rev Rul 64-328, 1964-2 Cum Bull 11, discussed two methods for documenting the split-dollar arrangement—the endorsement method and the collateral assignment method. In addition to these methods, at least two other techniques exist, the co-ownership approach and the unsecured loan approach, which are not discussed in the ruling.

- In the *endorsement method*, the employer owns the policy. The employer executes a policy endorsement filed with the insurance company that permits the employee/insured to name the beneficiary of that portion of the insurance proceeds remaining after the employer is reimbursed. The endorsement method is frequently used when the employer's interest in the policy is defined by reference to the cash value of the policy. It is used by public corporations that require an on-balance sheet asset and in situations in which state law or lenders impose restrictions on loans to officers or employees.
- In the *collateral assignment method,* the employee (or other owner, such as an ILIT) owns the policy. The employee executes a collateral assignment of the policy to the employer to secure the obligation to repay the employer. The collateral assignment is filed with the insurer. The collateral assignment method is frequently used when the employer's interest in the policy is defined by reference to the premiums paid. This method avoids a transfer of the policy if there is a policy roll-out. See §19.87.
- In the *co-ownership approach method,* actual ownership of the policy is split between the employer and the employee. Co-ownership can also be used in the private split-dollar context, in which the split is between the ILIT and a third party family member. (The author knows of at least one insurance company, Hartford, that has developed a proprietary co-ownership program.)
- In the *unsecured loan method,* the insurance policy is not used to secure the employee's obligation to repay the employer. Instead, the obligation to repay is the unsecured obligation of the insurance trust. Payment of the premium may be split in any of the traditional ways. This approach has been advocated as a means of avoiding inclusion of the policy proceeds in the insured's gross estate when the insured is a controlling shareholder. See §19.33.

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Source: Estate Planning/California Estate Planning/19 Use of Life Insurance in Estate Planning/§19.84 E. Income Tax Consequences of Split-Dollar Plans

§19.84 E. Income Tax Consequences of Split-Dollar Plans

The income tax treatment of existing split-dollar plans is now guided by Notice 2002-8, 2002-2 Cum Bull 398, as discussed in §19.79.

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§19.85 F. Gift Tax Consequences of Split-Dollar Plans

Existing split-dollar plans governed by Notice 2002-8, 2002-2 Cum Bull 398, may have the following gift tax consequences:

- If an employee owns the policy, there are no gift tax consequences arising from a split-dollar plan.
- If the employee owns an interest in a policy subject to an existing split-dollar plan and transfers that interest to a third person, including an insurance trust, the employee will be deemed to have made a taxable gift of the employee's interest in the policy, as that interest is determined under the split-dollar agreement.
- If the policy is owned by a third party (including an insurance trust) other than the employee, there will be gift tax consequences when premiums are paid in a split-dollar arrangement. The measure of the gift is the economic benefit to the insured, measured by the annual term cost, less the premium paid by the owner of the policy. The economic benefit is deemed to have been gifted by the employee to the third party owner of the policy. See, *e.g.,* Rev Rul 78-420, 1978-2 Cum Bull 67. The deemed gift of the economic benefit would presumably qualify for the gift tax annual exclusion if the policy is owned by an individual third party. If the policy is owned by an ILIT, (1) the *Crummey* demand clause would have to permit withdrawals on the occurrence of a deemed gift, and (2) the trust would have to be funded with sufficient other assets that the demand right would not be illusory. See the discussion of insurance trusts and *Crummey* demand rights in §19.59.

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§19.86 G. Estate Tax Consequences of Split-Dollar Plans

Existing split-dollar plans governed by Notice 2002-8, 2002-2 Cum Bull 398, may have the following estate tax consequences:

- If the insured-decedent owns the policy and is not a controlling shareholder, his or her gross estate will include the policy proceeds less the amount due the employer (the *at risk* portion).
- If the insured-decedent neither owns the policy nor is a controlling shareholder, no portion of the policy proceeds will be included in the employee's gross estate absent applicability of IRC §2035.
- If the insured-decedent is the sole or controlling shareholder, defined as a person possessing more than 50 percent of the total combined voting power of the corporation, the corporation's incidents of ownership will not be attributed to the decedent to the extent that the insurance proceeds are payable to the corporation. Treas Reg §20.2042-1(c)(6). However, the value of the stock included in the insured's estate increases because of the corporation's right to the policy proceeds.

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§19.87 H. Terminating Plan

Assuming that the insured does not die while the split-dollar plan is in effect, at some point it usually becomes necessary to terminate the plan. As a general rule, one should have determined the exit strategy from an existing split-dollar plan before entering into the plan in the first place. Exit strategy issues have now been made more complex by Notice 2002-8, 2002-2 Cum Bull 398, as discussed in §19.79.

Terminations generally become necessary in split-dollar plans because of the inverse relationship between the increasing economic benefit the employee must report as income each year and the declining death benefit. See the illustration in Rev Rul 64-328, 1964-2 Cum Bull 11. The classic split-dollar plan envisions the employer paying that portion of the premium attributable to the increase in cash value, with the employee paying the balance of the premium. Eventually, the yearly increase in the cash surrender value, which is paid by the employer, will exceed the total premium, and the employee will cease making payments. However, the employee must continue to report as income the economic benefit represented by the amount of the annual premium that he or she is relieved of but would otherwise pay for the death benefit payable to the employee's beneficiaries. And, as the cash surrender value increases, the death benefit payable to the beneficiaries decreases.

If a nonequity split-dollar plan is used, termination usually becomes necessary when the employee's cost (as calculated using Table 2001) becomes excessive. If an equity split-dollar plan is used and the current position of the IRS is sustained, termination will most likely be necessary at the cross-over point when the cash value exceeds the employer's contributions.

There are four primary exit strategies:

- A "roll-out" occurs if the employee repays the employer in a single payment. If the exit strategy contemplates using the cash value of the policy to repay the employer, the policy will probably lapse unless either (a) it was designed to accumulate substantial excess cash value, or (b) the insured has sufficient funds to replace the lost cash value.
- A "crawl-out" occurs if the employee repays the employer in a series of smaller payments.
- A "bonus" exit strategy involves either a taxable bonus to the employee in the year of roll-out sufficient to repay the employer or the transfer of the employer's interest in the policy to the employee without payment. Either approach to a bonus exit strategy results in taxable income for the employee.
- A "note repayment" strategy occurs if the employee "repays" the corporation using an unsecured note, payable at death. It is unclear to the author whether a note repayment exit strategy actually terminates the split-dollar plan or simply converts the existing split-dollar plan into some form of unsecured loan approach split-dollar plan (see §19.83). As a result, the author recommends caution in using this technique.

Two important issues in rolling out the policy to an ILIT are providing the trust with adequate cash to reimburse the employer, and avoiding the transfer-for-value rules.

- Cash can be provided to the ILIT through several techniques, including loans and gifts. If a contributory split-dollar plan is used and the Table 2001 cost is less than the insured's available annual exclusions, consideration should be given to making gifts to the trust in excess of the Table 2001 cost in order to create a cash reserve at roll-out.
- Care must be taken to avoid the transfer-for-value rule that would subject the insurance proceeds to income taxation at the insured's subsequent death. See §19.42. A frequently used means of avoiding the IRC §101(a)(2) transfer-for-value rule is to admit the ILIT to a partnership that includes the insured before the roll-out. See §19.45.

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VI. PLANNING WITH LIFE INSURANCE

A. Life Insurance and Charitable Giving

§19.88 1. Gifts of Life Insurance to Charity

Life insurance policies are commonly given to a charitable organization for one of two reasons: (1) the policy represents "excess" coverage, *i.e.,* coverage in excess of that desired by the insured; or (2) the insured wishes to "leverage" the amount the charity will obtain, much in the same way that life insurance may be transferred to a GST trust in order to leverage the insured's GST exemption (see §19.71). In addition, the donor receives a current charitable income tax deduction. A gift of an insurance policy is accomplished by naming the charitable organization as the irrevocable beneficiary of the policy and assigning all incidents of ownership in the policy to the charity.

The amount of the charitable deduction for income tax purposes is the lesser of (a) the donor's basis in the policy (premiums paid less dividends received) or (b) the fair market value of the policy. IRC §170(e)(1); Treas Reg §1.170A-4(a). In general, the deduction for a gift to a public charity is limited to 50 percent of adjusted gross income with a 5-year carry-forward. The deduction for a gift to a private foundation or "for the use of" (rather than "to") a charitable organization is limited to 30 percent. IRC §170(b)(1)(A)-(B), (b)(1)(G), (d)(1). If the donor subsequently pays insurance premiums on the gifted policy, such payments constitute additional charitable contributions. If the payments are made to the charitable organization, they would be subject to the 50-percent or 30-percent limitation. If the payments are made directly to the insurance company, they may be considered to be made "for the use of" the charity and be subject to a 30-percent limitation for both public charities and private foundations.

Under IRC §79(a), a participant in a group-term policy must include in income each year the cost of insurance protection in excess of $50,000 plus the amount paid by the employee. However, under IRC §79(b)(2), this income need not be reported to the extent the employee designates a charitable organization (as described in IRC §170(c)) as the sole beneficiary of the coverage in excess of $50,000.

It is important to keep in mind that IRC §170(f)(3) denies a charitable deduction for a nontrust transfer to charity of less than all the taxpayer's entire interest in the transferred property. See, *e.g.,* Rev Rul 76-1, 1976-1 Cum Bull 57. Although there are exceptions to this rule, gifts of a fractional interest in an insurance policy are not included in the exceptions. Thus no charitable deduction will be allowed if the donor transfers some, but not all, incidents of ownership in a policy. For example, the donor will not be allowed a deduction if he or she irrevocably designates a charity as the owner of the cash surrender value of the policy but retains the right to change the ultimate beneficiary.

For further discussion of gifts to charitable organizations, see chap 23.

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§19.89 2. Using ILIT as Wealth Replacement Trust

The income tax savings available through a charitable remainder trust (CRT) may be combined with an ILIT as a technique to provide estate tax-free wealth replacement. The donor creates a CRT with appreciated assets, and then makes a gift of all or part of the CRT payments to an ILIT to pay the premiums on a life insurance policy on the donor's life, with a death benefit at least equal to the value of the assets placed in the CRT. The proceeds of the policy will provide the "wealth replacement" upon the death of the donor. (For a discussion of CRTs, see chap 24.)

EXAMPLE: Assume a married couple has a combined net worth of $7,000,000, including real estate and securities valued at $4,000,000, and an interest in a business valued at $3,000,000 with a de minimis tax basis, and that their assets are owned as community property. They are preparing to retire and have received an offer to acquire their share of the business for its fair market value.

If they sell the business interest for $3,000,000 and the combined federal and state income tax is $600,000 ($1,500,000 × 0.20), $2,400,000 remains for investment to produce retirement income. If this is invested at 6 percent, the annual income will be $144,000, which will be subject to income tax. The couple will have a combined net estate for federal estate tax purposes of $6,400,000, and each spouse has a net worth of $3,200,000. Assume that the couple's estate plan uses mirror image marital deduction/credit shelter trusts with remainder to their children (see chap 17). At the first death, $2,000,000 will be placed in a credit shelter trust and the decedent's remaining $1,200,000 will be left to the survivor in a manner qualifying for the marital deduction. Assuming that the survivor's taxable estate is $4,400,000 ($3,200,000 + $1,200,000) and the estate tax is $1,080,000 ($4,400,000 × 0.45), the survivor's net estate will be $3,320,000 ($4,400,000 - $1,080,000) and the net amount passing to their children on the first death and the second death will be $5,320,000 ($2,000,000 + $3,320,000).

Now, assume that, instead of selling their business to a third party, the taxpayers contribute it to a CRT providing an 6-percent unitrust amount for their joint lives. The gain from any subsequent sale by the CRT of the business interest will be exempt from immediate taxation to the CRT. The CRT will provide an annual unitrust amount payout of $180,000, which will be subject to tax. Assume that their income tax savings and annual income will be sufficient to pay the premiums for a $3,000,000 second-to-die insurance policy on their joint lives owned by an ILIT—the wealth replacement trust. The couple will then have a combined net worth of $4,000,000. No estate taxes will be incurred on either death and the estates will pass tax free to the children. The insurance proceeds will also pass tax free to the children, and the net amount passing to children on the second death will be $7,000,000. This is $1,680,000 more than the net amount passing had a combination of a CRT and ILIT not been employed.

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§19.90 B. Life Insurance Partnership

In some circumstances, it may be desirable to create a partnership rather than an ILIT to own life insurance. Various disadvantages of an ILIT, *e.g.,* the arrangement is irrevocable and the insured cannot serve as trustee, can be avoided through the use of an insurance partnership. Insurance on the life of a partner owned by and payable to the partnership is not included in the insured partner's gross estate. See §19.33.

An intriguing aspect of an insurance partnership is the ability to make a contribution be a present interest qualifying for the annual gift tax exclusion without reliance on *Crummey* withdrawal powers. (This will be especially useful if Congress ever limits or eliminates the use of *Crummey* withdrawal powers.)

EXAMPLE: Assume that a married couple and their two children form a general partnership, and each partner is free to withdraw at any time. The parents own a 0.1-percent general partnership interest and the children own the remaining 99.9-percent general partnership interests. The partnership then acquires an insurance policy on the father's life that is payable to the partnership. Each year the insured contributes $24,000 to the partnership to be used to pay the insurance premiums. The contributions may be structured as gifts to the partners pro rata to their partnership interests, with the result that just under $12,000 will be gifted to each of the children. These gifts will qualify for the IRC §2503(b) present interest annual gift tax exclusion because each partner has the right to withdraw from the partnership, but no *Crummey* withdrawal power is necessary. At the father's death, the proceeds will not be included in his estate.

It is important to note, however, that use of an insurance partnership in lieu of an ILIT forgoes the ability to leverage the insured's GST exemption. See §19.71. GST exemption may be allocated to transfers of partnership units to skip persons in order to avoid incurring a GST tax. However, use of the exemption is limited to the immediate transfer of the partnership interests to the skip person and does not permit the interests to pass to more than one generation. For example, a gift of a partnership interest to a grandchild is a direct skip and will automatically utilize GST exemption unless the transferor affirmatively elects to pay the GST tax on a timely filed Form 709. See §19.76. However, the allocation of GST exemption merely permits the partnership interest to pass to the grandchild and cannot be used to shelter the partnership interest from estate and GST taxation at the grandchild's subsequent death. Had the GST exemption been allocated to an ILIT, it could have been effective to pass the interest tax-free to the grandchild's descendants on the death of the grandchild.

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Source: Estate Planning/California Estate Planning/20 Annuities/Chapter Outline

20

Annuities

Richard Burger

I. ANNUITIES IN GENERAL
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I. ANNUITIES IN GENERAL

§20.1 A. Definition of Annuity

An annuity is defined as "a right to receive fixed, periodic payments, either for life or for a term of years." Black's Law Dictionary (8th ed 2004). Although the estate planning lawyer will probably never be asked to determine whether a particular arrangement is an annuity because the contract will clearly be identified as such, he or she should know how an annuity works, how it is taxed, and how to integrate it into the client's estate plan.

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§20.2 B. Types of Commercial Annuities

Annuity contracts can be structured in a variety of ways, based on the following elements:

- **How premiums are paid**. The contract may provide for only one premium (a "single premium" annuity), or there may be an initial investment followed by subsequent payments, with the timing and amount left up to the owner (a "flexible premium" annuity).
- **When benefits are paid out**. Annuities may be either "immediate" (purchased with a single premium, with payments beginning within 1 year of purchase) or "deferred" (with payments beginning more than 1 year after purchase).
- **How premiums are invested**. The annuity may be "fixed," "variable," or "equity indexed."

With a *fixed* annuity, the contract's growth is based on the insurance company's investment returns. In addition, the company guarantees a modest minimum return—its "guaranteed rate" (historically 3 to 4 percent). The actual returns on a fixed annuity are almost always higher than the guaranteed rate. The return on a fixed annuity works much like the cash value of a traditional whole life insurance policy. The term "fixed" in this context is therefore somewhat misleading, because the ultimate value depends on the company's investment results over the life of the contract.

With a *variable* annuity, the contract owner, rather than the insurance company, assumes all investment responsibility and risk, and the value of the contract depends on the investment return achieved in a separate account, which is allocated among various mutual funds that the owner selects.

An *equity indexed* annuity is essentially a hybrid of a fixed and a variable annuity. The contract is credited with some of the upside of a rising stock market (based on the performance of a stock market index), but is protected from investment losses with a guaranteed minimum return.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.3 C. Parties to Annuity

§20.3 C. Parties to Annuity

There are typically five parties to a commercial annuity contract:

(1) The issuer: the insurance company;

(2) The owner: the person who purchases and controls the contract;

(3) The annuitant: the person whose life will be used in determining the payment of benefits;

(4) The payee: the recipient of the contract payments (usually the annuitant); and

(5) The beneficiary: the recipient of the contract's death benefit (if any).

NOTE: Most often, the owner and annuitant are the same person. When the owner and annuitant are different, however, unexpected results may occur when either dies. It is always helpful to review the terms of the specific annuity contract; when the annuitant and owner are different, it is critical to do so.

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II. DEFERRED ANNUITIES

§20.4 A. Characteristics of Deferred Annuities

Deferred annuities are far more common today than are immediate annuities. Regular payments from an immediate annuity begin within 1 year of its purchase; regular payments from a deferred annuity may not begin for many years, if ever. Although deferred annuities may offer a fixed return, most owners will choose a variable contract. Deferred annuities are usually purchased with flexible premiums. The owner makes investments whenever, and in whatever amount, desired, subject only to any minimum investment (*e.g.,* $100) that the insurance company might impose.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.5 B. Phases of Deferred Annuities

§20.5 B. Phases of Deferred Annuities

Deferred annuities have two distinct phases:

(1) The accumulation phase (also called the "deferral phase"); and

(2) The annuitization phase (also called the "distribution period," the "benefit period," or the "payout period").

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.6 1. Accumulation Phase

§20.6 1. Accumulation Phase

During the accumulation phase, the contract is allowed to grow. Both the amount invested and the investment performance will determine the contract's value. Earnings or investment gains are not taxed during this phase as long as the owner makes no withdrawals. Because there is no tax until withdrawals are made, deferred annuities are commonly called "tax-deferred annuities."

EXAMPLE: Albert, age 45, invests $10,000 in a flexible premium variable deferred annuity contract. Albert makes additional, irregular investments in the contract over the next 30 years. By the time Albert is 75, he has invested $150,000 in the contract, which is then worth $700,000. As long as he makes no withdrawals, Albert will not owe any income tax on the contract's earnings or increase in value.

Unlike IRAs or qualified retirement plans, the Internal Revenue Code does not impose any limits on contributions to annuities.

EXAMPLE: Albert may invest a large amount, such as $100,000, in the contract in 1 year.

Also, unlike IRAs or qualified retirement plans, there is no required beginning date when the annuitant must start taking distributions from a deferred annuity. (However, the issuer may require that regular withdrawals begin by a certain age, such as age 85 or 90. These withdrawal requirements are driven, in part, by state insurance law.)

EXAMPLE: Albert incurs no penalties, even though he has still made no withdrawals at age 75.

A penalty is imposed for early distributions. The penalty is assessed if the taxpayer is under 59½ when distributions are received. The penalty is 10 percent of the taxable amount. IRC §72(q)(1). The penalty does not apply to (IRC §72(q)(2)):

- Distributions made because of death or disability;
- Substantially equal periodic payments for the life or life expectancy of the taxpayer;
- Distributions from a qualified plan or IRA (which have their own early withdrawal penalties);
- Immediate annuity contracts; and
- Withdrawals allocable to investments in the annuity contract made before August 14, 1982.

These exceptions are similar, but not identical, to the exceptions to early withdrawal penalties for IRAs and qualified plans.

All distributions during the accumulation phase and before annuitization (see §20.7) are fully taxable, to the extent that earnings on the contract exceed the investment in the contract. See IRC §72(e)(2)(B). Additional distributions greater than this excess are a nontaxable return of capital. These nontaxable withdrawals will reduce the investment in the contract. IRC §72(c)(1)(B), (e)(2)(B), (e)(3)(B). This applies to contracts entered into after August 13, 1982, and earnings after August 13, 1982, allocable to contracts entered into before August 14, 1982. See IRC §72(e)(5)(B). This 1982 law reversed the previous rule, which allowed full recovery of basis before the earnings were taxed. See IRC §72(e)(5); Pub L 97-248, §265(a), 96 Stat 324. The previous rule continues to apply to contracts entered into before August 14, 1982, but amounts allocable to investments in the contract after August 13, 1982 are treated as from a contract entered into after that date. IRC §72(e)(5)(B).

EXAMPLE: When Albert is 55, he makes a $50,000 withdrawal from a contract entered into after August 13, 1982, to pay for his daughter's college education. At the time of the distribution, Albert's investment in the contract is $30,000 and the cash value of the contract is $100,000. The $50,000 distribution is fully taxable because it does not exceed the earnings in the contract. Furthermore, Albert will pay a penalty of $5000, because he is under 59½. If the distribution had been $75,000, $70,000 would have been taxable and $5000 would have been a nontaxable return of capital that would have reduced Albert's investment to $25,000.

A loan is also taxable as a distribution, because it is not considered an "amount received as an annuity." IRC §72(e)(4)(A)(i). A pledge of the annuity contract is treated as a loan. IRC §72(e)(4)(A)(ii).

Because most distributions prior to annuitization are likely to be taxable, and because there are penalties for early withdrawals, the owner will achieve the best results by allowing the investments to grow inside the annuity for many years.

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§20.7 2. Annuitization Phase

At some point, an owner who wants to withdraw funds may decide to "annuitize" the contract. This does not necessarily mean that the investment-based contract becomes a fixed annuity. Although most companies allow a fixed annuity as an option, annuitization simply means systematic withdrawals over a defined time frame, based either on a life (or lives), a period of years, or both.

If a fixed annuity is selected, the payments will be fixed. (A fixed annuity at annuitization—unlike a so-called fixed return during accumulation (see §20.2)—actually is fixed, and the payments will not vary.) If variable annuitization is selected, however, the amount received each year will likely vary, based on the contract's investment performance. These regular payments, even though variable, qualify as an "amount received as an annuity" under IRC §72(a) and are taxed accordingly. The first payment received on annuitization marks the annuity starting date. IRC §72(c)(4).

EXAMPLE: At age 80, Albert decides to annuitize the contract over his life expectancy. If Albert chooses fixed annuity payments, the company will pay him the same amount each year. If Albert opts for variable annuity payments, the payments to him will vary each year, based on the performance of the mutual funds he has selected.

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III. TAXATION OF ANNUITIES

§20.8 A. Estate Taxation of Annuities

The estate taxation of annuities is rather straightforward. When the owner dies, the value of the annuity contract is included in the owner's gross estate under various Internal Revenue Code sections, most commonly IRC §2033 or §2039. See *Estate of Sarah M. Davenport,* TC Memo 2006-215 (annuities payable under personal injury settlement agreement to estate of deceased 12-year-old as a result of her postsettlement death are included in her estate and valued under IRC §7520). If both the decedent and another person purchased the annuity, the decedent's proportionate share of the purchase is the portion of the annuity's value included in the decedent's gross estate. If the decedent was receiving payments for his or her lifetime and there is no refund or remaining benefit after death, the value in his or her estate is zero.

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B. Income Taxation of Annuities

§20.9 1. Gross Income and Recovery of Basis

Annuity payments, either over a fixed term of years or over life expectancy, are included in gross income and are thus subject to tax. IRC §§61(a)(9), 72(a). The only exception is for the recovery of basis (called "investment in the contract"; see §20.12). Basis is recovered systematically over the duration of the expected payments. However, basis can be recovered only when the taxpayer is receiving regular annuity payments, and not when the payments are irregular, such as loans or withdrawals.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.10 a. Recovery of Basis With Fixed Annuities: Exclusion Ratio

§20.10 a. Recovery of Basis With Fixed Annuities: Exclusion Ratio

With fixed annuities, basis is recovered by applying an "exclusion ratio" to the payments received. This allows the annuitant to recover the basis in the contract ratably as the payments are received. The exclusion ratio is the "investment in the contract" (see §20.12) divided by the "expected return" (see §20.11) under the contract.

EXAMPLE: Steve makes one payment of $10,000 for an annuity that will pay him $2500 each year for 10 years. Steve's investment in the contract is $10,000, the expected return is $25,000 ($2500 × 10 years), and an exclusion ratio of 40 percent will apply to each payment Steve receives.

Investment in the contract	$10,000
Expected return ($2500 × 10)	$25,000
Exclusion ratio ($10,000/$25,000)	40%

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.11 (1) 'Expected Return'

§20.11 (1) "Expected Return"

When the arrangement is a straight annuity for years (*e.g.,* fixed payments for 10 years), the "expected return" is simply the number of payments multiplied by the amount of each payment. However, when the annuity payments will be made for life, the actuarial tables in Treas Reg §1.72-9 are used. The annuitant's nearest birthday is used. (These tables may provide life expectancies that differ from the insurance company's projections and from the actuarial tables used for gift and estate tax calculations.)

EXAMPLE: In 1995, 5 months after her 68th birthday, Charlotte pays $160,000 to purchase an immediate annuity for her life. Under Treas Reg §1.72-9 Table V, Charlotte's life expectancy is 17.6 years. (Charlotte's nearest birthday was her 68th, so under the tables, she is 68 years old.) The insurance company agrees to pay her a fixed annuity of $1250 per month ($15,000 per year) for the rest of her life. The exclusion ratio is calculated as follows:

Investment in the contract	$160,000
Expected return ($15,000 × 17.6)	$264,000
Exclusion ratio ($160,000/$264,000)	60.6%

For each payment that Charlotte receives, 60.6 percent is tax-free, and the rest is taxable.

Once the investment in the contract has been recovered, all other amounts are fully taxable to the recipient. This is the rule for all contracts annuitized after January 1, 1986. IRC §72(b); Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, §1122(h)(2)(B), 100 Stat 2085). For pre-1987 annuities, the exclusion ratio continues to apply to all payments, even after the entire basis has been recovered. Thus, once Charlotte's investment in her contract is fully recovered, *i.e.*, if she lives longer than 17.6 years, all remaining payments would be fully taxable. (If the contract had a pre-1987 starting date, the 60.6-percent exclusion ratio would continue to apply to all subsequent payments.)

Annuity payments are either taxable ordinary income or non-taxable return of basis. There are no capital gain distributions from an annuity. Thus, even if an annuity's mutual fund investments have increased in value because of capital appreciation, the growth will be taxed as ordinary income when it is distributed.

NOTE: Many financial planners are skeptical about using annuities as wealth accumulation vehicles, and believe that investors often achieve better results by investing in (taxable) equity mutual funds. Although ordinary mutual fund investments are not tax-deferred, much of the income is taxed at capital gain rates. In addition, with ordinary mutual funds the investor does not incur the annual mortality expense that even no-load annuity contracts impose. A taxable mutual fund investment may provide higher after-tax returns than a tax-deferred annuity—particularly if results are compared before a number of years has passed.

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§20.12 (2) "Investment in the Contract"

Generally, the "investment in the contract" is the premiums paid, less the amount received tax-free from the contract. IRC §72(c)(1). However, the investment in the contract will not always equal the premiums paid. Many contracts contain a refund feature that guarantees that benefits received will be at least equal to the premiums paid, or a term certain feature, in which payments are guaranteed for the annuitant's life, but in no event for less than a specified number of years (*e.g.,* 10). In these situations, the investment in the contract will be less than the premiums paid. See IRC §72(c)(2). This adjustment is made using tables in Treas Reg §1.72-9. However, for pre-1987 contracts, the presence of a refund feature will not reduce the investment in the contract. IRC §72(c)(2); Treas Reg §1.72-7.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.13 b. Recovery of Basis From Variable Annuities

§20.13 b. Recovery of Basis From Variable Annuities

With fixed annuities, the investment in the contract and the expected return are easy to calculate. With variable annuities, however, the value of the investments, and thus the annuity payments, may vary substantially from year to year. With variable annuities, the tax-free portion of each payment is determined by dividing the total investment in the contract by the number of years that the annuity will likely be paid. Treas Reg §1.72-2(b)(3)(i).

EXAMPLE: Tom, age 80, and Sally, age 71, have annuitized a contract over their joint life expectancy. Under the Treas Reg §1.72-9 tables, they have a 17-year life expectancy, and their investment in the contract will be recovered over 17 years. If the investment in the contract is $150,000, this amount will be recovered equally over 17 years, or $8823 per year. Thus, if the first year's payment were $16,550, $8823 of this would be tax-free and the rest would be taxable.

Investment in the contract	$150,000
Joint life expectancy	17 years
Payment in first year	$16,550
Tax-free amount each year	$8,823
Taxable amount in first year	$7,727

If the payment were $18,500 in the second year, $8823 would be tax-free and $9677 (the remainder) would be taxable.

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§20.14 c. Death Before All Basis Has Been Recovered

If the annuitant dies before all of the investment in the contract (see §20.12) has been recovered, and the annuity payments cease at death, the unrecovered investment is a deduction on the owner's final income tax return. IRC §72(b)(3)(A).

If the contract has a refund feature (see §20.12), any difference between the total premium payments made and the total benefits received will be paid to the beneficiary or to the owner's estate. In this situation, the beneficiary or estate may claim the deduction for the unused investment in the contract. IRC §72(b)(3)(B). This allows the beneficiary or estate to use the otherwise lost basis.

NOTE: For purposes of the IRC §72(b)(3)(B) deduction, the investment in the contract is basically the premium dollars paid, less the tax-free dollars received during life, and is *not* adjusted to account for the refund feature. IRC §72(b)(4).

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§20.15 2. Natural Person Requirement

An annuity contract is taxed as an annuity contract only if it is held by a natural person. IRC §72(u)(1). This is a significant issue, because the tax-deferred accumulation of earnings is lost if the contract fails the §72(u)(1) test.

NOTE: The natural person requirement was added in 1986 to discourage employers from offering annuities as nonqualified deferred compensation for their key employees to avoid qualified plan nondiscrimination rules. See Joint Explanatory Statement of Comm of Conference of Tax Reform Act of 1986, 99th Cong, 2d Sess (1986), reprinted in US Code Cong & Ad News 4075, 4488.

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§20.16 a. Exception for Entity as Agent: Trusts as Owners

Although an annuity contract must be held by a "natural person" to be taxed as an annuity (see §20.15), if the contract is held by a trust or other entity as "an agent for a natural person," annuity treatment will not be lost. IRC §72(u).

The common revocable living trust should never present a §72(u) problem—at least while the grantor is alive. Even irrevocable grantor trusts often receive favorable rulings. See, *e.g.,* IRS Letter Rulings 200449011, 9316018. In general, the IRS has been liberal in its rulings on annuities that are owned by trusts, at least when the trust beneficiaries are all natural persons and no employment relationship is involved. See, *e.g.,* IRS Letter Rulings 9204010, 9204014. Other trusts, however, can create problems. See IRS Letter Ruling 9009047 (charitable remainder trust did not meet "agent" exception). In most situations, there is no advantage to having the annuity contract owned by a trust. Therefore, it is probably best not to name a trust as the owner, thus avoiding the potential tax problem altogether.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.17 b. Other Exceptions to Natural Person Rule

§20.17 b. Other Exceptions to Natural Person Rule

In addition to the exception provided for a trust or other entity that holds the contract as an agent for a natural person (see §20.16), IRC §72(u) provides other exceptions to the "natural person" requirement, including:

- Contracts acquired by the estate of a decedent because of the decedent's death (IRC §72(u)(3)(A));
- Contracts held by an IRA (IRC §72(u)(3)(B));
- Qualified funding assets under IRC §130(d) (structured settlements for personal injury lawsuits) (IRC §72(u)(3)(C)); and
- Immediate annuities (IRC §72(u)(3)(E)).

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§20.18 3. Death of Owner and "Forced Distributions" Under IRC §72(s)

There are limits on how long an annuity may be deferred. For all annuity contracts issued after January 18, 1985, IRC §72(s) "forces out" payments from the contract on the owner's death. As these required distributions are made, the previously untaxed income will be recognized. The statute requires annuity contracts to provide that (IRC §72(s)(1)(A)-(B)):

- If the holder of the contract dies on or after the annuity starting date and before the entire interest in the contract has been distributed, the remaining portion of the interest will be distributed at least as rapidly as under the method of distribution used as of the date of death; and
- If the holder of the contract dies before the annuity starting date, the entire interest in the contract will be distributed within 5 years after the holder's death.

As with IRAs and qualified plans, these are *minimum* distribution rules, and the distributions may always be more rapid than required under §72(s).

Section 72(s) makes a distinction between death before the annuity starting date and death after the annuity starting date. The annuity starting date (or "annuitization") is simply the beginning of regular annuity payments. IRC §72(c)(4). See §20.7.

NOTE: The statute refers to the "holder of the contract," who in most cases is the contract owner. However, if the contract is not owned by an individual, the "holder of the contract" is the primary annuitant. Any change in the primary annuitant (*i.e.,* death or replacement) is treated as a death of the "holder of the contract."

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.19 a. Exception For 'Designated Beneficiary'

§20.19 a. Exception For "Designated Beneficiary"

Notwithstanding the general rules concerning distributions on the death of an owner (see §20.18), IRC §72(s)(2)(A) provides that if the contract is payable to or for the benefit of a designated beneficiary, the distributions can be made over the beneficiary's life or life expectancy. A designated beneficiary must be an individual. IRC §72(s)(4).

To qualify for the exception, payments to the designated beneficiary must begin no later than 1 year after the death of the owner. IRC §72(s)(2)(C).

NOTE: Contrast the subtle distinctions between the rules for annuities and the rules for IRAs. For annuities, §72(s) refers to payments that begin within *1 year* after the owner's death. However, for IRAs, the regulations under §401(a)(9) require only that payments commence by *December 31* of the year following death. See Treas Reg §1.401(a)(9)-3, A-3(a). Because there are no regulations for annuities under §72(s), 1 year probably means within 365 days after death and not December 31 of the year following death. This same issue applies to distributions required under the 5-year rule (see §20.18): 5 years for annuities apparently means the fifth anniversary of the date of death, but for IRAs and qualified plans it means by December 31 of the fifth anniversary year after the date of death. Treas Reg §§1.401(a)(9), Q&A C-2, 1.401(a)(9)-3, Q&A 2.

Taxation of the beneficiary's payments is detailed in Treas Reg §1.72-11. The beneficiary will recover the decedent's remaining investment in the contract; the timing of this recovery depends on how the decedent was receiving payments as well as how the beneficiary receives them.

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§20.20 b. Exception When Surviving Spouse Is Beneficiary

There is an important exception to required distributions under IRC §72(s) (see §20.18) for surviving spouses. If the surviving spouse is the designated beneficiary, the spouse is treated as the "holder of the contract" (the owner), and thus distributions need not commence until the surviving spouse's death. IRC §72(s)(3).

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§20.21 c. No "Designated Beneficiary Trusts"

Under certain conditions, when a trust is named as the beneficiary, a beneficiary of the trust may qualify as a "designated beneficiary" of an IRA or qualified plan. See Treas Reg §1.401(a)(9)-4, A-5. But although the words "designated beneficiary" are identical in both IRC §72(s)(2)(A) (regulating annuities) and §401(a)(9) (regulating IRAs), the IRS has not issued regulations (or proposed regulations) that specify how the beneficiary of a trust may qualify as the designated beneficiary of an annuity. Furthermore, the IRS has not issued any rulings on this question. Although there is no apparent policy reason that the rules should be any different for annuities than they are for IRAs and qualified plans, until regulations or rulings are issued, there is no safe harbor for making a trust a designated beneficiary of an annuity. This means that if a trust is the beneficiary of an annuity contract, and the owner dies before annuitization, the full value of the contract generally must be distributed within 5 years after the owner's death. IRC §72(s)(1)(B). See §20.18. This is apparently true even if the sole beneficiary of the trust is the surviving spouse of the owner, to whom the requirement to distribute within 5 years would not apply. In IRS Letter Ruling 200323012, however, the IRS ruled that, although a revocable trust was the designated beneficiary of deferred annuities, the spouse will be treated as the beneficiary because the spouse was the trustee and had the power to allocate the annuities to a survivor's trust that gave her an unlimited power of withdrawal. Accordingly, the spouse will be treated as the holder of a new variable annuity contract in her name received in exchange for the annuity contracts allocated to the survivor's trust and withdrawn by the spouse. See §20.20.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.21A d. Restricted Beneficiary Designation

§20.21A d. Restricted Beneficiary Designation

Usually, an election is made by the designated beneficiary to receive payments over the beneficiary's life expectancy or to take a lump sum distribution, either immediately or within 5 years, but it is possible for the contract owner to specify the distribution option (*e.g.,* outright distribution, life expectancy option or annuitization for life or a period shorter than life expectancy, or a combination of periodic and outright distributions) by making a restricted beneficiary designation.

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§20.22 4. Constructive Receipt

Internal Revenue Code §72(h) adds a confusing twist to an already complex set of rules. It provides that a lump sum payment will not be constructively received by a beneficiary, provided the beneficiary elects to receive an annuity or installment payments within 60 days after the day when the lump sum first became payable. Otherwise, all the income will be recognized at once, rather than as the payments are received. Read literally, this rule requires any beneficiary who is entitled to receive a lump sum to notify the contract issuer within 60 days "after the day the lump sum first becomes payable" and elect to receive annuity or installment payments, in order to avoid constructive receipt of the lump sum.

PRACTICE TIP: Many insurance companies seem either to finesse this issue (for example, by providing that the lump sum is not automatically payable on death, but is payable only on submission of a claim form) or to ignore the issue altogether. Nevertheless, even a remote possibility of having all accrued income recognized at once suggests that it is good practice to notify the issuer, within 60 days after the owner's death, of the beneficiary's election to receive annuity or installment payments, rather than a lump sum.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.23 5. Surrender of Annuity Contract

§20.23 5. Surrender of Annuity Contract

If an annuity contract is surrendered, the amount received is taxable income, but only to the extent that it exceeds the remaining investment in the contract. IRC §72(e)(5)(A). Capital gain treatment is not available on surrender.

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§20.24 6. Gift of Annuity Contract

A gift of an annuity contract is treated as an immediate distribution and triggers income on the difference between the investment in the contract and the cash surrender value. The donor pays the income tax, and the donee's investment in the contract is the donor's investment, increased by the amount subject to tax. IRC §72(e)(4)(C)(i). (This rule applies to post-April 1987 policies, specifically with respect to any post-April 1987 investments. Pub L 99-514, §1826(b)(4), 100 Stat 2085). This means that the donor cannot shift the income to someone else during the donor's lifetime. Moreover, gifting a policy to charity during the donor's lifetime results in the same tax treatment, *i.e.*, the income in the contract must be recognized by the donor on transfer to the charity.

There is an exception to the rule for a transfer of an annuity contract between spouses, including a transfer pursuant to a divorce. IRC §72(e)(4)(C)(ii).

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§20.25 7. Basis, IRD, and IRC §691(c) Deduction

Annuities under IRC §72 do not get a new basis at death. IRC §1014(b)(9)(A). This rule, first announced in Rev Rul 79-335, 1979-2 Cum Bull 292, does not apply to annuity contracts purchased before October 21, 1979. See IRS Letter Ruling 200311030. However, the Service has attempted to deny the step-up in basis for the spouse's one-half community property interest in an annuity contract purchased before October 21, 1979, on the dubious theory that the former rule announced in Rev Rul 70-143, 1970-1 Cum Bull 167, was limited to the statement of facts involved. See IRS Letter Ruling 200345026. Surprisingly, there has been some confusion as to whether proceeds from an annuity contract that are received by a beneficiary after the owner's death constitute income in respect of a decedent (IRD). On IRD, see §12.4. However, in IRS Letter Ruling 200041018, the IRS clearly holds that the death benefit the beneficiaries receive is IRD (except for the deceased owner's investment in the contract, of course). Thus, the IRC §691(c) deduction for the federal estate tax allocable to the IRD item is available to the recipient.

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§20.26 8. Exchange of Contracts

A taxpayer may exchange an existing annuity contract for a new one without recognizing gain. IRC §1035. The transaction will not be treated as a complete surrender of the old contract, followed by the purchase of a new contract. In Rev Rul 2002-75, 2002-2 Cum Bull 812, for example, the IRS ruled that a transfer of the surrender value of an annuity contract issued by one company for the purpose of adding funds to an annuity contract issued by another company for the same annuitant was a tax-free exchange. See §19.49.

Before pursuing an exchange, however, it is important to review the various grandfathering provisions, because an exchange may cause the loss of some important grandfathered benefits (*e.g.,* no mandatory distributions on death for contracts issued before January 19, 1985). See H Rep 861, 98th Cong, 2d Sess (DEFRA 1984), reprinted in 1984-3 Cum Bull 1, 330, 1984 US Code Cong & Ad News 1445, 1764. Other grandfathered benefits (*e.g.,* withdrawals treated as basis first; see IRC §72(e)(5)) are retained after an IRC §1035 exchange. Rev Rul 85-159, 1985-2 Cum Bull 29.

Under Treas Reg §1.1035-1, there can be a tax-free exchange of annuity contracts under IRC §1035 in cases in which the same person or persons are the obligee or obligees under the contract. In *Dona Elizabeth Conway* (1998) 111 TC 350, acq 1999-2 Cum Bull xvi, the court allowed tax-free exchange treatment for a "partial exchange" in which part of the assets of an annuity contract was transferred directly to a second insurance company and invested in a second annuity. In Rev Rul 2003-76, 2003-2 Cum Bull 355, the IRS ruled that, in the event of a partial exchange of this kind, the basis in the original contract is allocated between the original and new contract on a proportionate basis, based on the value of the assets in each contract after the exchange. The revenue ruling notes, however, that the IRS is concerned that some taxpayers may enter into a partial exchange as a means of avoiding tax, and refers to Notice 2003-51, 2003-2 Cum Bull 361, issued the same day. Notice 2003-51 warns taxpayers that the IRS is considering promulgation of regulations that would prevent possible tax abuse.

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§20.27 IV. ANNUITIES IN QUALIFIED RETIREMENT PLANS AND IRAS

Most annuity contracts are "nonqualified" annuities, which means that the contracts do not meet the requirements of qualified retirement plans or IRAs. Although nonqualified annuities do not enjoy the benefits of qualified plans or IRAs, they are also not subject to the same restrictions (such as a required beginning date for distributions or limitations on contributions). Annuity contracts may be found within qualified plans and IRAs, however. Although the contracts themselves may look identical to nonqualified annuity contracts, the rules governing contributions and distributions are different from the rules governing nonqualified annuities. On pension and IRA distributions, see chap 21.

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§20.28 A. Section 403(b) Annuities

"Tax-sheltered annuities" are annuity contracts issued under IRC §403(b). These are retirement plans available only to employees of public educational institutions and IRC §501(c)(3) organizations, and are taxed much like other qualified plans. Because there are usually no after-tax contributions, there is no basis to recover, and all distributions will be fully taxable. With only a very few minor exceptions, §403(b) annuities are subject to the rules governing distributions from qualified plans and IRAs. See Treas Reg §1.403(b)-7(b).

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.29 B. IRAs (Individual Retirement Annuities)

§20.29 B. IRAs (Individual Retirement Annuities)

It is possible for an annuity contract to be held as an IRA (individual retirement annuity). The contract will look virtually identical to a nonqualified annuity contract. However, the minimum distribution requirements and penalties for IRAs apply, and override those portions of IRC §72 that govern nonqualified annuities (*e.g.,* IRC §72(h), (s)). See §§20.6-20.26.

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§20.29A C. Conversion of IRA to Roth IRA

Treasury regulations require valuing annuities at fair market value for the purpose of converting a traditional IRA to a Roth IRA. The regulations attempt to prevent perceived abuses in connection with annuities that are assets of traditional IRAs that are converted to Roth IRAs. Because the assets of traditional IRAs are subject to income tax in the year the assets are transferred to a Roth IRA, a low value based on cash surrender value results in a lower taxable income for the current year that is not recovered later, because distributions from Roth IRAs are not taxed. The regulations provide three valuation rules for annuity contracts (Treas Reg §1.408A-4, A-14(b)(1)):

- If the conversion occurs soon after the contract is sold and there have been no material changes in market conditions, the fair market value may be established by the premiums paid. Treas Reg §1.408A-4, A-14(b)(2)(i).
- If the conversion occurs after the contract has been in force for some time and no further premiums payments are to be made, the value may be established through the sale by the company of comparable contracts. Treas Reg §1.408A-4, A-14(b)(2)(i).
- If the conversion occurs after the contract has been in force for some time and further premium payments are to be made, the fair market value of the contract may be established through an approximation based on the interpolated terminal reserve at the date of the conversion plus the proportionate part of the gross premium last paid before the date of the conversion that covers the period extending beyond that date. Treas Reg §1.408A-4, A-14(b)(2)(ii).

An annuity contract that has not been annuitized may be valued under an alternative accumulation method, with certain modifications. Treas Reg §1.408A-4, A-14(b)(3).

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V. PRIVATE ANNUITIES

§20.30 A. The Appeal of Private Annuities

A private annuity can be a useful estate planning tool. The typical private annuity involves a sale among family members, in which the purchase payments are structured as an annuity. Because the value of an annuity is included in the decedent's gross estate only if payments continue beyond the annuitant's death, the payments on a private annuity are typically structured to terminate at death. This way, nothing is included in the annuitant's estate. Such an annuity, because it is not issued by a life insurance company, is called a "private annuity." An annuity need not be issued by a life insurance company to be taxed as an annuity.

WARNING: The IRS has issued proposed regulations providing that an exchange of appreciated property for an annuity contract will be treated as a realization of gain. REG-141901-05, 71 Fed Reg 61441 (Oct. 18, 2006); Prop Treas Reg §§1.72-6(e), 1.1001-1(j). The proposed regulations, effective for exchanges of property after October 18, 2006, would eliminate the favorable tax treatment of unsecured private annuities described in §20.32. The proposed regulations would not apply to charitable gift annuities described in §20.37.

Private annuities may be appropriate in some situations. A sale of an appreciated asset in exchange for a private annuity defers recognition of the capital gain over the term of the annuity. And, of course, a sale is an effective way to "freeze" asset values because any appreciation of the asset is removed from the seller's estate.

The private annuity often holds an instinctive appeal because it addresses two common (and competing) goals of the older generation: (1) reducing the size of the taxable estate; and (2) ensuring that clients will not "outlive" their assets. The private annuity that is structured to terminate annuity payments on death meets both of these needs, because the asset is not included in the estate, and the client cannot outlive the payments. Compare the treatment of a sale in exchange for a self-cancelling installment note, where gain deferred at death may be taxable to the estate under IRC §§453B(a) and 691(a)(2), (4)-(5). Rev Rul 86-72, 1986-1 Cum Bull 253; *Frane v Commssioner* (8th Cir 1993) 998 F2d 567. See §13.54.

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§20.31 B. Analyzing Private Annuities

Typically, the exchange of property for an annuity consists of both a sale and a gift. To properly analyze the transaction, these two elements must first be separated.

The value of the gift is the difference between the present value of the annuity and the fair market value of the property exchanged. The gift component is reported as a taxable gift, and the value of the gift is excluded from the income tax calculations.

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§20.32 1. Income Taxation of Unsecured Private Annuities

Income taxation of unsecured private annuity payments includes three separate elements: return of basis, capital gain, and annuity income. See Rev Rul 69-74, 1969-1 Cum Bull 43.

The return of basis is calculated exactly as the investment in the contract is calculated with a commercial annuity (see §20.12), except that basis is substituted for premiums paid.

The capital gain is the difference between the present value of the annuity and the seller's basis. The gain is recognized as the payments are received, using the Treas Reg §1.72-9 tables. See §20.11.

The rest of each payment is annuity (ordinary) income. Once basis is recovered and all gain is recognized, the entire payment is ordinary income.

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§20.33 2. Income Taxation of Secured Private Annuities

The income tax consequences are significantly different if the annuity is secured. For unsecured annuities, see §20.32. A sale in exchange for a secured private annuity is immediately taxable in full. *Estate of Lloyd G. Bell* (1973) 60 TC 469. Because of this, most private annuities are unsecured.

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§20.34 3. Interest Rates and Tables

The interest rate used to value private annuities is 120 percent of the federal midterm rate. IRC §7520(a). The gift and estate tax tables under §7520 (and not under IRC §72) are used to calculate life expectancy and thus to value the gift component of the transaction. Life expectancy under these tables is used unless the person is terminally ill. If there is at least a 50-percent probability that an individual will die within 1 year because of an incurable illness or other deteriorating physical condition, he or she is terminally ill, and the §7520 tables cannot be used. Treas Reg §25.7520-3(b)(3).

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§20.35 4. New Basis

A buyer of a private annuity receives a new basis equal to the present value of the annuity. If the annuitant outlives his or her life expectancy, and the buyer pays more than the expected amount, the buyer's basis increases as each "excess" payment is made.

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§20.36 5. When Private Annuities Are Most Effective

The estate tax advantages of a private annuity are greatest when the property is expected to appreciate substantially and when the annuitant's actual life expectancy is shorter than that provided under the IRC §7520 tables. This assumes that the annuitant's life expectancy is greater than 1 year. See §20.34.

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§20.37 VI. CHARITABLE GIFT ANNUITIES

Charitable gift annuities are offered by many well established charities. A gift annuity consists of two components combined into one transaction: (1) a charitable gift; and (2) the purchase of an annuity. The annuity payments received are taxed just as is a fixed commercial annuity: basis is recovered by applying an exclusion ratio to the payments received, and everything else is taxed as ordinary income. See §§20.10-20.12.

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Source: Estate Planning/California Estate Planning/20 Annuities/§20.38 VII. ANNUITIES AND MEDI-CAL

§20.38 VII. ANNUITIES AND MEDI-CAL

Many clients believe, incorrectly, that annuities will resolve all qualification and reimbursement issues for persons receiving nursing home benefits under the Medi-Cal program. An annuity contract in the accumulation phase, however, is considered an "available asset" no different from cash or securities. Only contracts that are annuitized with fixed payments may provide some protection. 22 Cal Code Regs §50489.5(g)(2)(A). On the accumulation and annuitization phases, see §§20.6-20.7. Even if the *contract* is not an available asset, however, the annuity *payments* may be considered income, and used to determine the Medi-Cal recipient's share of cost. 22 Cal Code Regs §50489.5(g)(1). If the Medi-Cal recipient's spouse is the payee, the payments will not be treated as income (under the so-called name-on-the-check rule). 42 USC §1396r-5(b); ACWD Letter 90-03 (Jan. 8, 1990); Draft 22 Cal Code Regs §50512.

The annuity will not be considered as an available asset only if the annuitization schedule is within the annuitant's life expectancy. 22 Cal Code Regs §50489.5(g)(2)(A). The life expectancy must be based on the tables used by the Department of Health Care Services (DHCS). 22 Cal Code Regs §50489.5(g)(2)(B). These tables may result in a payout period that differs from one based on a life insurance company's actuarial calculations. If the payout schedule exceeds the annuitant's life expectancy, the excess term is considered a transfer of property to the beneficiary and is subject to penalties for asset transfers. If the annuitization is based on either the individual's or his or her spouse's life expectancy, there is no transfer. 22 Cal Code Regs §50489.5(g)(2)(A); Medi-Cal Eligibility Procedures Manual Letters Nos. 179 (May 15, 1997), 192 (Dec. 18, 1997).

Perhaps most importantly, there is no advantage under present law to purchasing or annuitizing early in order to qualify for Medi-Cal. Because the proper annuitization of an existing contract is generally not considered a transfer of property, a contract properly annuitized just before applying for Medi-Cal is treated no differently from a contract that was properly annuitized 60 months before application. Further, the purchase of an annuity is generally treated as the disposal of an asset for less than fair market value unless the state is named as the remainder beneficiary for at least the total amount of medical assistance paid on behalf of the annuitant, although exceptions allow the community spouse or minor child of the annuitant to be named as the first beneficiary ahead of the state. 42 USC §1396p(c)(1)(F). However, an annuity that is irrevocable and nonassignable, actuarially sound, and provides for payments in equal amounts during the term of the annuity—with no deferral and no balloon payments—is not considered an asset of the annuitant and is therefore not subject to the transfer rules. 42 USC §1396p(c)(1)(G).

The DHCS is directed to satisfy reimbursement claims for Medi-Cal benefits "from the value of an annuity, annuity payments, or distributions receivable by any person or entity" upon the death of the Medi-Cal recipient. 22 Cal Code Regs §§50960.2, 50961(h). While the ultimate impact of these regulations is not yet known, they have the potential to significantly reduce the use of annuities in Medi-Cal planning. Because the rules relating to Medi-Cal qualification and recovery are continually changing, it is important to review the current law before advising a client with respect to an annuity contract. On Medi-Cal estate planning considerations, see chap 30. See also California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chaps 9-12 (Cal CEB 2003).

In summary, annuities have few benefits in Medi-Cal planning or generally in estate planning for elderly clients in poor health.

- The purchase of *deferred* annuities does not help to qualify for Medi-Cal program benefits because the contract is treated as an available resource until it is annuitized; these contracts often require payment of substantial early withdrawal penalties that limit the client's investment flexibility.
- The purchase of *immediate* annuities (or annuitization of existing annuity contracts) for the benefit of the community spouse may convert available resources into a stream of payments that are not treated as income to the Medi-Cal recipient, but this can be done when nursing home care is imminent.

The purchase of a fixed annuity results in a cessation of annuity payments at death, while the purchase of either a fixed or variable annuity with a substantial death benefit requires the payment of a larger premium to offset the cost of the benefit, which is often much less than the amount invested on a death occurring within a short time after the purchase. Accordingly, neither product is likely to be appropriate for an elderly client in poor health who may have less

than a normal life expectancy. In one reported case, an arbitration panel of the federal Financial Industry Regulatory Authority ordered an Ohio investment company to pay $110,000 in compensatory damages to the estate of an annuity owner after the company sold a $212,000 immediate fixed-rate annuity that paid $1500 per month to an 83-year-old woman who suffered from dementia, was partially blind from diabetes, and had recently moved into a nursing home. The annuity purchase required the owner to pay a $6000 surrender fee to cash out her existing annuities. The owner reportedly received one monthly payment of $1500 before she died, and her children received a death benefit of only $106,000. The authority had previously fined another investment company $225,000 for "making unsuitable sales of deferred variable annuities to 23 customers" when 21 of the 23 customers were over age 70. See Wartenberg, *Advice for Elderly: Beware Annuity Sharks*, Columbus Dispatch (Mar. 22, 2009).

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21

Employee Benefits and IRAs

CEB Staff

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I. OVERVIEW OF RETIREMENT BENEFITS

§21.1 A. Plan Benefits and Limitations

The Internal Revenue Code contains numerous provisions encouraging businesses and individuals to make arrangements for the support of working persons following their retirement. Common types of plans are discussed in §21.2. Depending on the specific arrangement, tax incentives may include an immediate income tax deduction for amounts contributed to a retirement fund, tax exemption of a retirement fund's investment income, deferral of the participant's income tax until distributions are actually received, and—in limited cases involving decedents separating from the service of the sponsoring employer before January 1, 1985—a grandfathered federal estate tax exemption under former IRC §2039. The benefits of tax deferral in retirement plans are illustrated in §21.3.

In the apparent view of Congress, the statutes providing these benefits are subject to a variety of forms of perceived abuse including: (1) creation of retirement plans that provide disproportionately high benefits to company owners and executives, with little benefit to lower-paid workers; and (2) creation of plans that provide benefits in excess of amounts needed for retirement. In each case, tax advantages are provided for wealthier persons without sufficiently promoting the social goal of retirement security.

Combined with pressures to generate tax revenue, the desire to assure the solvency of pension plans, and a variety of social concerns (*e.g.*, support of a retiree's spouse after the retiree's death), these issues have produced considerable legislation since the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461).

Today, all aspects of the operation of retirement plans and taxation of tax-favored retirement benefits are highly regulated. The "teeth" in the regulatory system are potential disallowance of expected tax benefits plus imposition of penalty taxes. The penalty taxes can range as high as the IRC §4974(a) 50-percent tax imposed on failures to make minimum required distributions. See §21.26.

Inasmuch as retirement benefits may comprise a substantial portion of a client's wealth, the high penalty tax exposure of these assets requires estate planners to actively and carefully include consideration of retirement benefits in their clients' plans. Contribution limitations are discussed in §§21.4-21.8. Retirement plan distribution issues are discussed in §§21.9-21.33. Issues involved in transferring retirement benefits are discussed in §21.34-21.38. A large IRA basic strategy is discussed in §§21.39-21.49. Beneficiary designation strategies for particular fact patterns are discussed in §§21.50-21.65.

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.2 B. Types of Plans

§21.2 B. Types of Plans

Retirement benefit estate planning problems and opportunities vary with the type of plan involved. The following are some of the more common types of plans.

- **Qualified plans.** "Qualified" is a general term. It is commonly used to refer to a pension, profit-sharing, or stock bonus plan satisfying the requirements for a qualified trust under IRC §401(a) or an annuity plan satisfying the requirements of IRC §404(a). The requirements regulate funding (the timing of the employer's contributions), coverage (nondiscrimination against lower-paid employees), vesting (requirements for making an employee's benefits nonforfeitable within a specified number of years of employment), and the form and timing of benefits. Qualification has the following desired tax results:
- The employer is entitled to an immediate income tax deduction for amounts contributed to the trust;
- The investment fund is exempt from income tax;
- Beneficiaries are not subject to income tax until benefits are received;
- Beneficiaries may be entitled to roll over a lump-sum distribution from the plan into an IRA;
- Beneficiaries may be entitled to favorable income tax treatment on the receipt of lump-sum distributions; and
- In some cases, benefits still may qualify for the estate tax exclusion of former IRC §2039 under grandfather provisions in §525(b) of the Deficit Reduction Act of 1984 (Pub L 98-369, 98 Stat 494).

NOTE: Care is required in referring to "qualified plans." For example, the definition of a "qualified retirement plan" for the purposes of the IRC §4974(a) excise tax on failure to make minimum required distributions includes IRAs and tax-exempt organization/public school annuity plans. IRC §4974(c). Further confusion is added by the fact that some plans maintained by government entities and tax-exempt organizations may share tax advantages and restrictions of plans qualified under IRC §401(a) or §404(a) even though they are not actually qualified under those statutes. See IRC §§403(b), 457.

- **Nonqualified plans.** Although this term could refer to almost any plan that does not satisfy the requirements of IRC §401(a), it is more typically used to refer to plans providing deferred compensation to high-salaried employees. The primary tax benefit is deferral of taxation to the employee until the year the compensation is received. The employer cannot deduct the compensation until the year that it is includable in the income of the employee. The term "nonqualified plan" may also refer to plans of government and tax-exempt organizations that are neither qualified under IRC §401(a) nor designed to meet the requirements of IRC §403(b) or §457. The desired tax benefit of these plans is taxation of retirement income when it is paid rather than when it is earned. "Nonqualified plans" must be designed carefully to avoid constructive receipt of income by employees before the income is actually paid.
- **Defined benefit plans.** A defined benefit plan is a qualified pension plan that does not have separate individual accounts for participants, but provides each participant with a defined retirement benefit usually determined by some percentage of salary. IRC §414(j). For employer contributions to defined benefit plans, the vesting period is generally 5 years. IRC §411(a)(2)(A). Defined benefit plans frequently do not permit lump-sum distributions as a retirement option. If the participant is married, the benefit must be payable in a form that provides an annuity for an employee's surviving spouse unless the spouse waives that option. IRC §401(a)(11). Many of these plans do not provide any other postdeath benefits.
- **Defined contribution plans.** A defined contribution plan is a qualified plan that maintains separate individual accounts for participants, with employer contributions allocated to each participant's account. For employer contributions to defined contribution plans, the vesting period is generally 3 years for plan years beginning after December 31, 2006. IRC §411(a)(2)(B). For previous plan years, the vesting period is 3 years for matching contributions and 5 years for nonelective employer contributions. The participant's retirement benefit is determined by the amount in his or her individual account, consisting of employer contributions and allocated earnings. IRC §414(i).
- **Money purchase pension plans.** A money purchase pension plan is a defined contribution plan in which the

amount of the employer's contribution is fixed, usually as a percentage of the employee's compensation.

- **Profit-sharing plans.** A profit-sharing plan is a defined contribution plan under which employer contributions are discretionary, but the contributions must be allocated among the plan participants according to a definite predetermined formula that may be based on the compensation of each participant. Profit-sharing plans are not subject to qualified annuity distribution requirements, including requirements for survival annuities to spouses of participants, and may provide a wide range of distribution options, commonly including the right to receive a lump-sum distribution.
- **Stock bonus plans.** A stock bonus plan is a profit-sharing plan in which benefits are distributable in securities of the employer company if the participant demands such distribution. IRC §§401(a)(23), 409(h).
- **ESOPs.** An employee stock ownership plan is a qualified defined contribution plan that invests primarily in employer securities.
- **Target benefit plans.** A target benefit plan is a defined contribution plan in which employer contributions are fixed and determined on the basis of the amount necessary to provide a target benefit at retirement.
- **Qualified annuity plans.** A qualified annuity plan is a qualified plan that purchases retirement annuities for employees instead of making contributions to a qualified trust. The general IRC §403(c) rule that the purchase of an annuity for an employee results in the value of the annuity being immediately included in the employee's income does not apply to a qualified annuity plan. Instead, the participant is taxed on the annuity as the annuity payments are made under IRC §72. IRC §403(a). In some cases, the employee may have the option of rolling over the value of the annuity contract into an IRA or another qualified plan.
- **IRC §403(b) tax-sheltered annuity/custodial account plans.** Public schools and tax-exempt organizations may purchase annuities for employees without the value of the annuities immediately being included in the income of the employee, provided the requirements of IRC §403(b) are met. The statute also permits establishment of plans that provide employees with individual custodial accounts that are usually funded by voluntary salary reductions. These "cash or deferred" plans are comparable to IRC §401(k) plans used by private employers. In many cases the employee may rollover an individual account into an IRA at retirement instead of receiving an annuity. The interest of the employee must be nonforfeitable.
- **HR 10 or Keogh plans.** A qualified pension plan established by owner-employees or "self-employed individuals" as defined in IRC §401(c).
- **CODA/§401(k) plans.** A qualified pension, profit-sharing, or stock bonus plan may include a cash or deferred arrangement (CODA) permitting participants to choose whether they wish compensation paid immediately to the participant in cash or alternatively paid to the participant's account in the plan. IRC §401(k). Under normal constructive receipt tax concepts, the participant's right to receive cash would cause the participant to be deemed to have received the cash and then transferred it to the plan. Under IRC §402(e)(3), however, the participant is not deemed to have received the money nor to have made the contribution.
- **Roth §401(k) plans.** Under IRC §402A, a qualified IRC §401(k) retirement plan may permit an employee who makes elective contributions to designate some or all of the contributions as Roth contributions. Nonelective and matching contributions cannot be designated as Roth contributions. Unlike conventional pre-tax elective contributions to a §401(k) plan, designated Roth contributions are includable in gross income. However, like Roth IRA contributions, a qualified distribution of designated Roth contributions is excludable from gross income. Thus, earnings on the designated Roth contributions will accumulate tax-free until withdrawal. Minimum distribution rules and existing limits on total plan contributions ($15,000 per year plus $5000 per year for employees age 50 and over) continue to apply, and eligible employees (those with adjusted gross income less than $95,000-110,000 for a single taxpayer and less than $150,000-160,000 for joint filers, plus cost-of-living adjustments beginning in 2007) may continue to make contributions to Roth IRAs. The IRS has issued proposed regulations providing guidance for employers choosing to implement a qualified Roth contribution program (QRCP). Under Prop Treas Reg §1.401(k)-1(f), designated Roth contributions are defined as elective contributions under a qualified cash or deferred arrangement that are: (1) designated irrevocably by the employee at the time of the cash or deferred election as designated Roth contributions; (2) treated by the employer as includable in the employee's income at the time the employee would have received the contribution amounts in cash if the employee had not made the election; and (3) maintained by the plan in a separate account. Notwithstanding the tax-free treatment of qualified distributions of designated Roth contributions, income allocable to corrective

distributions of excess contributions that are designated Roth contributions (although not the contribution amount) will be taxable to the same extent as income allocable to a corrective distribution of excess contributions that are pre-tax elective contributions. Prop Treas Reg §1.401(k)-2(b)(1)(ii).

- **Eligible deferred compensation plans (IRC §457).** This provision allows state and local governments and tax-exempt organizations to established deferred compensation plans, including cash or deferred arrangements. Failure to comply with the requirements of the statute causes deferred compensation to be taxed to the participants as soon as it is not subject to a substantial risk of forfeiture (which would be immediately in the case of a cash or deferred arrangement).
- **Individual retirement accounts/individual retirement annuities.** An IRA is a trust or custodial account for the exclusive benefit of an individual or the individual and his or her beneficiaries. IRC §408(a). IRAs may be established by the individual's contributions or by rollover of sums received from pension and profit-sharing plans.
- **Health savings accounts/medical savings accounts**. An HSA (IRC §223) or Archer MSA (IRC §220) is a trust or custodial account established by an individual or the individual's employer for the exclusive benefit of the individual or the individual and his or her family members. The accounts are available only to individuals who have no health coverage other than a high deductible health plan (HDHP) with a minimum annual deductible (*e.g.*, $2000 plus cost-of-living adjustments for family coverage for an individual with an HSA). However, individuals on Medicare may be eligible to enroll in a Medicare Advantage MSA under IRC §138. Individual contributions are generally deductible, whether or not the individual itemizes deductions, and employer contributions are not included in income, subject to annual contribution limits for the individual and employer. Earnings on the account are not taxed, and distributions to pay for qualified medical expenses are not taxed. Other distributions are taxed and nonqualified distributions before age 65 (except in the case of death or disability) are subject to a penalty of 10 percent for HSAs and 15 percent for Archer MSAs. Amounts remaining in the account at the end of the year are generally carried over to the next year. Amounts remaining on the death of the account holder are taxable to the designated beneficiary in the year of death unless the beneficiary is the holder's spouse, in which case the spouse becomes the holder of the account. Account funds in an Archer MSA also may be rolled over to an HSA. IRC §223(d)(1)(A). Further, a special provision allows a once-in-a-lifetime rollover from an IRA to an HSA. IRC §408(d)(9). However, IRC §223 does not apply for California tax purposes. Rev & T C §17215.4. Therefore, any amount deposited in an HSA, or rolled over from an Archer MSA or an IRA to an HSA, and earnings on the account are taxable to the holder. Conversely, withdrawals from the account are not taxable, because the money in the account has already been taxed.
- **Roth IRAs.** A Roth IRA is another form of individual retirement account for the exclusive benefit of the individual and his or her beneficiaries. IRC §408A(a). Like a regular IRA, a Roth IRA may be created by annual contributions (or by rollover from a regular IRA created by annual contributions), or by rollover of proceeds of a qualified plan previously rolled over to a regular IRA. There is no current tax deduction for a contribution to a Roth IRA, but qualified distributions from Roth IRAs are not subject to income tax. IRC §408A(d)(1). Generally, qualified distributions cannot be made for 5 years after the first contribution to the Roth IRA. IRC §408A(d)(2). Maximum contributions to Roth IRAs are not affected by the availability of other employee benefit plans. Contributions may be made after age 70½ and need not be withdrawn during the lifetime of the individual. IRC §408A(c)(4), (5). Treasury regulations require valuing annuities at fair market value under prescribed valuation rules for purposes of converting an IRA funded with annuities to a Roth IRA. Treas Reg §1.408A-4, A-14(b)(1). See §20.29A.
- **Simplified employee pension (SEP).** Under a simplified employee pension, employers make contributions to IRAs for their employees. IRC §408(k). From the employee's point of view, the advantage of an SEP over a self-funded IRA is that the contribution limitations are determined under qualified plan rules rather than being limited by the IRA contribution limit. A SEP is subject to nondiscrimination and other rules similar to those applicable to qualified plans. The employer is entitled to an immediate tax deduction for contributions.
- **Savings Incentive Match Plan for Employees (SIMPLE).** Under a SIMPLE plan, like a SEP, employers make contributions to IRAs for their employees. IRC §408(p). Unlike a SEP, a SIMPLE plan is exempt from most nondiscrimination and other rules applicable to qualified plans. The contribution limits for SIMPLE plans are greater than the IRA contribution limit but less than the contribution limits determined under qualified plan rules.

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§21.3 C. Benefits of Tax Deferral

The benefits of tax deferral in retirement plans can be illustrated by comparing the following hypothetical cases. In each case it is assumed that the combined federal and California tax rates will total a flat 35 percent of the funds subject to tax, that funds will be invested for 10 years, and that the pretax rate of investment return will be 10 percent per annum.

- **No tax deferral.** Client receives $1000 of income, pays tax of $350, and invests the remaining $650. Each year client pays income tax on the investment return with the result that the fund grows at a rate of 6.5 percent compounded annually. At the end of 10 years the client will have $1220 and owe no additional tax, leaving a net balance of $1220.
- **Tax deferral on investment income only.** This is the scenario for an IRA funded with nondeductible contributions. Client receives $1000 of income, pays tax of $350, and invests the remaining $650. Because no tax on investment income is paid, the fund grows at a rate of 10 percent, compounded annually. At the end of 10 years, the client has a gross balance of $1686. Tax at 35 percent on $1036 (the amount of the fund less the $650 original contribution) is $363, leaving a net balance of $1323.
- **Tax deferral on both contribution and investment income.** This is the scenario for a qualified profit-sharing account or IRA funded with deductible contributions. Client receives $1000 of income and invests the entire amount. The fund grows at a rate of 10 percent, compounded annually. At the end of 10 years, the client has a gross balance of $2594. Tax on the entire amount at 35 percent is $908, leaving a net balance of $1686.
- **Tax deferral on both grossed-up contribution and investment income.** This is the scenario for a Roth IRA. Client receives $1538 of income, pays tax of $538, and invests the remaining $1000. The fund grows at a rate of 10 percent, compounded annually. At the end of 10 years, the client has a gross balance of $2594. Tax is zero, leaving a net balance of $2594. The net balance is the same as a traditional IRA funded with deductible contributions of $1538 (the amount of the contribution plus the initial tax) and a gross balance of $3991.

These illustrations make it clear that the benefits of tax deferral can be dramatic. In effect, deferral is the equivalent of an interest-free loan of the unpaid tax. In the case of a Roth IRA, deferral is the equivalent of an interest-free loan of the unpaid tax on an amount equal to the amount of the contribution plus the amount of tax paid.

For obvious reasons, what is good for the taxpayer is not good for the federal budget. Accordingly, Congress has enacted the minimum distribution rules discussed in §21.27 to ensure that the tax benefits of deferred taxation do not last indefinitely. The IRC §4974 penalty assures compliance with those rules. Tax deferral under the minimum distribution rules and qualified plan annuities are compared in §21.33.

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§21.4 II. CONTRIBUTION LIMITATIONS

Because IRAs and other tax deferral benefits have a negative impact on public revenues, the relevant tax laws limit that maximum contributions to these plans. Most limitations involving employer funded plans are beyond the scope of this discussion. See IRC §415. The following limitations apply to some of the more popular plans that usually give the individual taxpayer discretion with respect to the annual contribution.

Excess contributions made by individuals to traditional IRAs, Roth IRAs, and IRC §403(b) plans are subject to a 6-percent excise tax imposed each year until the excess contribution is corrected. IRC §4973(a)(1), (3).

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.5 A. IRC §§401(k), 403(b), 457, and SEP Plans

§21.5 A. IRC §§401(k), 403(b), 457, and SEP Plans

Internal Revenue Code §402(g) imposes an aggregate limitation on elective deferrals of income in connection with IRC §401(k) plans, IRC §403(b) plans, and IRC 408(k)(6) simplified employee pension (SEP) plans. The limit is $15,000 (plus cost-of-living adjustments) per year. Individuals age 50 or older can make additional catch-up contributions of $5000 (plus cost-of-living adjustments) per year. IRC §414(v)(2)(B)(i). A separate inflation-adjusted $15,000 limit (with $5000 catch-up contributions) applies to IRC §457 deferred compensation plans of state and local governments and tax-exempt organizations. Thus, eligible employees can defer as much as $30,000 (or $40,000) per year.

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.6 B. SIMPLE Plans

§21.6 B. SIMPLE Plans

A separate contribution limit of $10,000 (plus cost-of-living adjustments) per year applies to IRC §408(p) simple retirement accounts. Individuals age 50 or older can make additional catch-up contributions of $2500 (plus cost-of-living adjustments) per year. IRC §414(v)(2)(B)(ii).

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§21.7 C. Traditional IRAs

For traditional IRAs, the contribution limit is generally the lesser of the individual's compensation or the deductible amount. IRC §§219(b)(1), 408(a)(1). The deductible amount is $5000 (plus cost-of-living adjustments) per year. IRC §219(b)(5)(A), (D). If a person has attained age 50, this amount is increased by $1000. IRC §219(b)(5)(B). The catch-up contribution limit is not indexed for inflation, unlike the IRC §401(k) plan limit. See §21.5. Additional IRA contributions are allowed for certain individuals affected by an employer's bankruptcy. IRC §219(b)(5)(C). A spouse with little or no income may be able to take into account the compensation of the other spouse in determining the compensation limitation. IRC §219(c).

Additional payments to an IRA may be allowed if the payments are considered "restorative" rather than contributions to the IRA under Rev Rul 2002-45, 2002-2 Cum Bull 116. In IRS Letter Ruling 200714030, for example, the IRS ruled that payments made to the taxpayer in settlement of claims that an investment adviser had misappropriated IRA assets could be deposited in the taxpayer's IRA because the payments were restorative.

The amount of a contribution that can be deducted for income tax purposes will generally be lower if the taxpayer is covered under any of a variety of other retirement arrangements, including qualified plans and government plans. Persons covered by such plans nevertheless may be entitled to full or partial deductions for their contributions if their adjusted gross income is below amounts specified in the statute ($60,000 for single persons, $100,000 for married persons filing jointly). IRC §219(g)(2)(A), (3)(B). However, if one of the spouses is not a plan participant, the allowable deduction for that spouse is not fully phased out until the couple's adjusted gross income exceeds $160,000. IRC §219(g)(7). These amounts are indexed for inflation. IRC §219(g)(8). Generally, a full IRA deduction is allowed if adjusted gross income is more than $10,000 below these amounts ($20,000 below the $100,000 amount for married persons filing jointly), with a prorated deduction being allowed for higher incomes that do not exceed the limit. IRC §219(g)(1)-(2).

Regardless of whether a deduction is allowed for the contribution, income accumulates in the IRA on a tax-deferred basis, being taxed later when distributions are made to the individual or the individual's beneficiary. Thus, contributions to a traditional IRA may be desirable if the individual is not eligible to make contributions to a Roth IRA. See §21.8.

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§21.8 D. Roth IRAs

Annual contributions to a Roth IRA are limited to the amount allowed for a traditional IRA, reduced by the amount of any contributions to a traditional IRA. IRC §408A(c)(2). See §21.7. The maximum contribution is phased out for married taxpayers filing jointly with incomes from $150,000 to $160,000 plus inflation adjustments ($167,000 to $177,000 in 2010), single taxpayers with incomes from $95,000 to $110,000 plus inflation adjustments ($105,000 to $120,000 in 2009), and married taxpayers filing separately with incomes from $0 to $10,000. IRC §408A(c)(3)(A), (C)(ii). However, these income limits are ineffective because there is no income limit for contributions to a traditional IRA and rollover contributions are unlimited. IRC §408A(c)(3)(B). See §21.17. Required minimum distributions are not eligible for rollover. IRC §§408(d)(3)(E), 408A(e). Annual contributions to a Roth IRA are not deductible for income tax purposes. IRC §408A(c)(1). Distributions can be rolled over directly from a retirement plan to a Roth IRA, instead of rolling over first to an IRA and then to a Roth IRA. See IRC §408A(e). For tax years beginning after December 31, 2009, the $100,000 limit and filing status requirement are eliminated. See IRC §408A(c).

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.8A E. HSAs and Archer MSAs

§21.8A E. HSAs and Archer MSAs

Annual contributions to a Heath Savings Account (HSA) or Archer Medical Savings Account (MSA) are limited to a specified amount. Only individuals with no health coverage other than a high deductible health plan (HDHP) with a minimum annual deductible are eligible for an HSA or an Archer MSA.

The annual contribution limit for an HSA is $4500 plus cost-of-living adjustments ($5950 in 2009) for family coverage or $2250 plus cost-of-living adjustments ($3000 in 2009) for individual coverage, plus $1000 for individuals age 55 or older. IRC §223(b). The annual deductible for an HSA cannot be less than $2000 plus cost-of-living adjustments ($2300 in 2009) for family coverage or $1000 plus cost-of-living adjustments ($1150 in 2009) for individual coverage and can be as much as $10,000 plus cost-of-living adjustments ($11,600 in 2009) for family coverage or $5000 plus cost-of-living adjustments ($5800 in 2009) for individual coverage. IRC §223(c).

WARNING: Health Savings Accounts (HSAs) are not recognized for California income tax purposes. Rev & T C §17215.4. Therefore, any amount contributed to an account and earnings on the account are taxable to the account holder. Conversely, withdrawals from the account are not taxable, because the money in the amount has already been taxed. California is one of six states (along with Alabama, Maine, New Jersey, Pennsylvania, and Wisconsin) that have not conformed to the federal legislation. For this reason, it is difficult to recommend the use of these accounts for California residents as compared with other health plan benefits or tax-deferred savings vehicles.

The annual contribution limit for an Archer MSA is the lesser of 75 percent (65 percent for an individual plan) of the annual deductible or total annual compensation from the employer that sponsors the plan. IRC §220(b). The annual deductible for an Archer MSA cannot be less than $3000 plus cost-of-living adjustments ($4000 in 2009) for family coverage or $1500 plus cost-of-living adjustments ($2000 in 2009) for individual coverage and can be as much as $4500 plus cost-of-living adjustments ($6050 in 2009) for family coverage or $2250 plus cost-of-living adjustments ($4000 in 2009) for individual coverage. IRC §220(c).

Earnings from these accounts are tax-free until distribution, and distributions to pay for qualified medical expenses are tax-free, at least for federal income tax purposes. Amounts remaining on the death of the account holder (or the later death of the spouse) are taxed to the beneficiary in the year of death. Thus, healthy high-income individuals may be able to achieve significant tax deferral by maintaining a health plan with the maximum annual deductible and making the maximum contributions. Tax deferral can be further increased by not taking distributions to pay for qualified medical expenses, provided that the account is used to pay for qualified medical expenses in later years. (Using after-tax dollars to pay for qualified medical expenses instead of taking account distributions is equivalent to making a non-deductible contribution to the account. Non-deductible contributions may be worthwhile if the individual has already maximized deductible contributions to qualified plans or traditional IRAs and Roth IRA contributions. See §21.3.) Note that individuals who are eligible for an employer-provided health flexible spending arrangement (FSA) or health reimbursement arrangement (HRA) generally cannot make contributions to an HSA or Archer MSA. For more details, see IRS Publication 969, Health Savings Accounts and Other Tax-Favored Health Plans.

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§21.9 III. RETIREMENT PLAN DISTRIBUTIONS

The bulk of estate planning for retirement benefits and IRAs involves planning for the distribution of benefits to the participant or the participant's named beneficiaries. Available distribution options are limited by the type of plan, the terms of the particular plan, statutory protections for spouses, the financial needs of the client, and a variety of penalty taxes that provide a scheme designed to control the timing and amounts of distributions. See §§21.10-21.32.

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A. Forms of Distributions

§21.10 1. Qualified Plan Retirement Distributions

The following are some of the most common distribution options available on retirement to participants in qualified retirement plans:

- **Annuity.** An annuity is a general form of benefit under any retirement plan that periodically pays a specified amount to the participant or his or her beneficiary over a specified term. The payments are usually made monthly. An annuity may be a single life annuity payable over the life of the employee, a joint and survivor annuity payable over the joint lives of the participant and a designated beneficiary, or an annuity for a term certain.
- **Qualified joint and survivor annuity (QJSA).** A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse that pays 50 to 100 percent of the periodic amount that was payable during the joint lives of the participant and spouse. IRC §417(b). With specified exceptions, all defined benefit plans and all defined contribution plans must offer this option to participants who are married at the time of retirement. IRC §401(a)(11). The more notable exceptions are profit-sharing plans, stock bonus plans, government plans, and church plans. If there is a rollover from a plan that requires a QJSA to one that does not, the QJSA requirement continues to apply to the portion of the funds attributable to the rollover. Treas Reg §1.401(a)-20, A-5. This is not the case when there is a rollover to an IRA. When a plan is required to provide a QJSA, that option is mandatory for participants who have been married more than 1 year at the time of retirement, unless the nonparticipant spouse formally waives the right to the option. IRC §417(a), (d).
- **Qualified preretirement survivor annuity (QPSA).** Plans required to provide a QJSA also must provide for a QPSA. A QPSA is a life annuity paid to the surviving spouse in lieu of a QJSA survivor annuity if the participant dies *before* retirement. IRC §§401(a)(11), 417(c).
- **Qualified optional survivor annuity (applicable to plan years beginning after December 31, 2007).** Plans required to provide a QJSA and a QPSA also must provide for a qualified optional survivor annuity that pays 75 percent of the periodic amount that was payable during the joint lives of the participant and spouse unless the QJSA and QPSA pay 75 percent or more of the joint annuity amount, in which case the qualified optional annuity must pay 50 percent of the joint periodic amount. IRC §417(a), (g).
- **Lump-sum distribution (applicable to employees who attained age 50 before January 1, 1986).** A lump-sum distribution is the distribution or payment, within 1 taxable year of the recipient, of the balance to the credit of an employee, which becomes payable to the recipient (former IRC §402(d)(4)):
- On account of the employee's death;
- After the employee attains age 59½; or
- On account of the employee's separation from the service of the employer (or on account of disability if self-employed).

If these and additional requirements are met, lump-sum distributions may be eligible for special grandfathered income tax treatment under §1122(h)(3), (5) of the Tax Reform Act of 1986 (Pub L 99-514, 100 Stat 2085), as amended by §1011A(b)(11), (13)-(15) of the Technical and Miscellaneous Revenue Act of 1988 (Pub L 100-647, 102 Stat 3342), as preserved following amendment of IRC §402(d) by §1401(c) of the Small Business Job Protection Act of 1996 (Pub L 104-188, 110 Stat 1755). See §21.23.

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§21.11 2. QDRO Distributions to Former Spouse

A qualified domestic relations order (QDRO) is a state court decree that "creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan… and relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant." IRC §414(p)(1). If the alternate payee is a spouse or former spouse, he or she is treated as the distributee of the assigned benefits, and those benefits are no longer treated as belonging to the participant for income and penalty tax purposes. If the alternate payee is not the spouse or former spouse, the participant remains the owner of the assigned benefits for purposes of these taxes. IRC §402(e)(1).

If an interest in an IRA is transferred incident to divorce, the account or annuity is thereafter treated as "maintained for the benefit" of the transferee spouse. Presumably, this causes the transferee to be deemed the holder of the account for all tax purposes during the lifetime of the transferee. IRC §408(d)(6). Apparently the interest of the transferee terminates on the transferee's death. The Ninth Circuit Court of Appeals has held that a dissolution of marriage decree could not accomplish a valid assignment of pension rights to be paid after the death of the nonparticipant spouse. *Branco v UCFW—Northern Cal. Employers Joint Pension Plan* (9th Cir 2002) 279 F3d 1154.

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§21.12 3. Rollovers to Traditional IRAs and Other Plans

Available planning alternatives are frequently dependent on whether a retirement plan or IRA distribution qualifies for a "rollover." An eligible rollover distribution is a transfer from a retirement plan or traditional IRA to an "eligible retirement plan" that does not result in the immediate recognition of income by the participant or the participant's surviving spouse. IRC §§402(c)(1), 403(a)(4), 403(b)(8), 408(d)(3). An eligible rollover distribution also may include a direct rollover from a retirement plan to an IRA. IRC §402(c)(11). The statute was enacted in response to the fact that many, if not most, retirement plans force nonspouse beneficiaries to take lump-sum distributions—thereby depriving such beneficiaries of the ability to defer income tax for the periods allowed by the minimum distribution rules.

PRACTICE TIP: The IRS issued interim guidance on direct rollovers to IRAs by nonspouse beneficiaries in Notice 2007-7, 2007-5 Int Rev Bull 395, but the guidance is unclear and planners should not assume without additional information that a nonspouse rollover will be available at death. In many cases, it will remain prudent to transfer the plan benefit to the IRA before death when that is possible and there are no creditor protection issues.

An "eligible retirement plan" includes all qualified pension and profit-sharing plans, IRC §403(b) annuities, IRC §457 plans, IRAs, and individual retirement annuities. IRC §402(c)(8)(B). Although it is permissible to accomplish a rollover by having the participant make a withdrawal from one plan followed by a deposit to another plan within 60 days, most rollovers are accomplished by direct transfer to avoid income tax withholding by the distributing plan. The Service may waive the 60-day limit under IRC §408(d)(3)(I). In determining whether to grant a waiver, the Service will consider all relevant facts and circumstances. Rev Proc 2003-16, 2003-1 Cum Bull 359. In IRS Letter Ruling 200332026, the Service waived the limit when the transferee investment company inadvertently put funds in a regular account. In Notice 2009-82, 2009-41 Int Rev Bull 491, the IRS extended the 60-day period to complete a rollover of "required" minimum distributions received at a time when minimum distributions were waived by IRC §408(a)(9)(H). In IRS Letter Ruling 200941037, however, the IRS declined to waive the 60-day limit when an agent acting under a durable power of attorney deposited an amount she had withdrawn from an IRA with the intention of making a rollover into three non-IRA accounts and then was prevented from correcting her mistake by hospitalization for a medical condition. If the transfer is not direct, the assets placed in the new IRA nevertheless must be the same assets as those withdrawn from the transferring plan. *Albert Lemishow* (1998) 110 TC 346.

Rolling over qualified plan benefits into a traditional IRA may provide extra flexibility in terms of the available options for later distribution to the participant or the participant's designated beneficiary. Furthermore, there are many occasions when it is unacceptable to a client to remain a participant in the plan of a former employer after separation from service. Distributions can also be made on the death of the participant directly to IRAs for beneficiaries other than the surviving spouse. The IRA must be funded by a direct transfer and the IRA must be maintained in the name of the deceased participant. IRC §402(c)(11). This avoids rapid distribution of the deceased participant's plan benefit as a consequence of a plan provision requiring such a distribution, and may allow the beneficiary greater flexibility if investment options are limited under the plan.

An "eligible rollover distribution" includes any distribution to an employee of all or any portion of the balance to the credit of the employee, except one of a series of substantially equal periodic payments over the life expectancy of the employee or designated beneficiary or over a specified period of 10 years or more or a required distribution under IRC §401(a)(9). IRC §402(c)(4)(A).

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§21.13 a. Creditor Rights Issues

Generally, an interest in a qualified plan cannot be reached by a participant's creditors, even in the case of bankruptcy. 11 USC §522(b)(3)(C); 29 USC §1056(d)(1); *Patterson v Shumate* (1992) 504 US 753, 119 L Ed 2d 519, 112 S Ct 2242; *Ehrenberg v Southern Cal. Permanente Med. Group (In re Moses)* (9th Cir 1999) 167 F3d 470. Funds in IRAs may be exempt in bankruptcy if they are "exempt from taxation" under IRC §408. Funds in an IRA are presumed to be exempt. 11 USC §522(b)(4)(A). However, that presumption can be rebutted by evidence that the IRA was improperly operated. *Plunk v Yaquinto (In re Plunk)* (5th Cir 2007) 481 F3d 302. Under IRC §408(e)(2), an IRA ceases to be an IRA on the first day of the calendar year in which the individual for whom the account was established engages in any transaction prohibited by IRC §4975. In *In re Willis* (Bankr SD Fla 2009) 104 AFTR2d 5669, the court held that a bankruptcy debtor's three IRAs were not exempt because the debtor borrowed funds from the first IRA, which resulted in the IRA assets ceasing to be exempt for both tax and bankruptcy purposes, and the first IRA was the source of the funds in the other two IRAs, with the consequence that the other two IRAs were also nonexempt.

An IRA is exempt from the bankruptcy estate to the extent of $1 million plus an unlimited amount attributable to rollover contributions from qualified plans. 11 USC §522(n). Given the difficulty of accumulating more than $1 million in a contributory IRA, it should be fairly easy in most cases to demonstrate that an IRA is fully exempt. Nevertheless, it may be prudent to keep rollover contributions in a separate account. California exempts IRAs from levy to the extent the funds are likely to be necessary for the support of the judgment debtor and dependents on retirement. CCP §704.115(e). See *In re McKown* (9th Cir 2000) 203 F3d 1188. However, nonqualified retirement plans are completely exempt under California law. CCP §704.115(b). See *McMullen v Haycock* (2007) 147 CA4th 753, 54 CR3d 660 (private retirement plan assets transferred to IRA continue to be completely exempt from levy by judgment creditors). But see *In re Mooney* (Bankr CD Cal 2000) 248 BR 391 (rollover IRA assets not completely exempt because not traceable to exempt fund under CCP §703.080). See discussion in §26.40. This exemption also applies in bankruptcy under 11 USC §522(b)(3)(A). See *Gill v Stern (In re Stern)* (9th Cir 2003) 345 F3d 1036, cert denied (2004) 541 US 936.

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§21.14 b. Marital Property Issues

When clients are married, they also must be advised that the rights of the parties to dispose of IRA interests on death may be quite different from their rights to dispose of qualified plan interests. It appears that if the nonparticipant spouse is the first to die, that spouse has no power to transfer a qualified plan community property interest to a third person. *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754; *Marriage of Shelstead* (1998) 66 CA4th 893, 78 CR2d 365. See §21.35. But if the plan interest is rolled over into an IRA before the death of the nonparticipant spouse, the nonparticipant spouse may be able to dispose of his or her community property interest by will. Similarly, a rollover may change the rights of the parties in the event of a later dissolution. The Ninth Circuit Court of Appeals has held that a dissolution of marriage decree cannot accomplish a valid assignment of qualified plan rights payable after the death of the nonparticipant spouse. *Branco v UCFW—Northern Cal. Employers Joint Pension Plan* (9th Cir 2002) 279 F3d 1154.

The impact of *Boggs* on *Estate of MacDonald* (1990) 51 C3d 262, 272 CR 153, which permitted testamentary disposition of a community property interest in rollover IRA accounts, is still uncertain. See also Prob C §§5010-5032. In addition, a nonparticipant spouse who consents to a rollover to an IRA effectively waives whatever rights that spouse may have to receive a qualified joint and survivor annuity (QJSA) if the participant dies. See §21.10. This may be a significant concern—particularly if the pension is primarily separate property of the participant spouse.

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§21.15 4. Rollovers Out of Traditional IRAs

An IRA can be rolled over to another IRA or to an "eligible retirement plan." Eligible retirement plans include qualified plans, IRC §403(b) annuities, and IRC §457 plans. IRC §§402(c)(8)(B), 408(d)(3). Generally, rollovers are allowed only between IRAs and eligible retirement plans for the benefit of the same participant/individual (with community property laws being ignored under IRC §408(g)). However, rollovers to IRAs for surviving spouses are permitted. IRC §401(a)(9); Treas Reg §1.408-8, A-5, A-7. The utility of such a rollover is that the laws affecting the timing of distributions will thereafter be applied based on the age and benefits of the surviving spouse, thus frequently extending the time during which income can be accumulated on a tax-deferred basis. See §21.43.

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5. Roth IRA Conversions

§21.16 a. Assessing Desirability

A traditional IRA may be converted to a Roth IRA if specified requirements are met. See §21.17. This is not a tax-free rollover. The withdrawals from the traditional IRA are treated as distributions that are included in the taxpayer's income in the current year. IRC §408A(d)(3). At first glance this immediate income recognition would seem undesirable, but there are other considerations.

In comparing the advantages and disadvantages of traditional IRAs and Roth IRAs, it is important to understand that the investment growth and tax results are conceptually the same. In one case tax is paid up front and in the other tax is paid at the end, but both IRAs will accumulate wealth at the same rate because in both cases there is no annual taxation of the investment growth. If a taxpayer starts with a pretax amount of $1000, invests it for *X* years in a traditional IRA until it doubles, and then pays a 35 percent tax on withdrawal, the taxpayer ends up with $1300. If on the other hand a taxpayer pays the 35-percent tax on $1000 up front, and invests the remaining $650 in a Roth IRA for the same *X* years until it doubles, the taxpayer ends up with the same $1300.

However, a Roth IRA investment is often better for several reasons.

- A Roth IRA makes it possible to have more money working for the taxpayer. Assume an income tax rate of 35 percent. If a taxpayer has $1000 in a traditional IRA, only 65 percent of the IRA really belongs to the taxpayer, so the amount that is growing for the benefit of the taxpayer is only $650. If, on the other hand, $1000 is growing in a Roth IRA, the growth on the entire amount benefits the taxpayer. Put another way, the reason the calculations above produced a $1300 net result was that the calculations effectively assumed that the owner of the Roth IRA used a portion of his $1000 to pay taxes and therefore put only $650 in the Roth IRA. The calculations did not consider the possibility of the taxpayer using other funds and putting a full $1000 in the Roth IRA. Therefore, in considering the benefits of a conversion from a traditional IRA to a Roth IRA, it is necessary to consider whether the taxpayer has the ability to pay the income taxes on the traditional IRA withdrawal from other assets. If that can be accomplished without other adverse tax results (*e.g.,* recognition of capital gain on assets liquidated to get the cash to pay the taxes), the taxpayer will end up with a larger fund growing tax free. This should improve the taxpayer's situation even after taking into consideration, as one should for a proper comparison, that there has been a corresponding reduction in the taxpayer's other assets to pay the tax.
- Roth IRA conversion avoids the predeath minimum distribution rules under IRC §401(a)(9). IRC §408A(c)(5). If the taxpayer does not need to make withdrawals from his or her IRA during his or her lifetime, the absence of minimum distribution requirements avoids reduction of the assets that are accumulating tax free.
- Roth IRA conversion removes the income taxes paid on the conversion from the taxpayer's estate for estate tax purposes. While IRC §691(c) provides an income tax deduction for estate taxes on a traditional IRA, this only partly compensates for the estate tax on the amount needed to pay the income tax. See §21.22.

A potential disadvantage to consider in assessing the desirability of a conversion from a traditional IRA to a Roth IRA has to do with tax rates. A current large withdrawal may result in a portion of the IRA being taxed in a higher tax bracket than would have been the case with later periodic distributions, unless the taxpayer and all potential beneficiaries are in the highest tax bracket. For a limited time, a Roth IRA conversion can be reversed if the taxpayer concludes that the conversion is undesirable. See §21.18.

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§21.17 b. Requirements for Conversion

A traditional IRA, including an IRA created by a rollover from a qualified plan, may be rolled over without penalty into a Roth IRA for the same participant. A Roth IRA is not an eligible retirement plan under IRC §402(c)(8)(B) for purposes of a direct rollover from a qualified plan, but the same result can be achieved by making a rollover contribution to a regular IRA and then making a rollover from the regular IRA to a Roth IRA. Rollover contributions were not allowed for taxpayers with an adjusted gross income in excess of $100,000 in taxable years beginning before January 1, 2010. IRC §408A(c)(3). A Roth IRA conversion can be reversed in 2010 if the gross income limit was exceeded in 2009. See §21.18. The rollover contribution does not reduce the annual limit on combined regular and Roth IRA contributions. IRC §408A(c)(6). Any amount that would be taxable on withdrawal from the traditional IRA is included in taxable income in the year of the rollover (or in 2011 and 2012 in the case of a rollover contribution in 2010). IRC §408A(d)(3). The amount of any distribution from a qualified plan or regular IRA that is a required minimum distribution in the year of the rollover is not eligible for rollover to a Roth IRA. IRC §§408(d)(3)(E), 408A(e). Treasury regulations require valuing annuities at fair market value under prescribed valuation rules for purposes of converting a traditional IRA to a Roth IRA. Treas Reg §1.408A-4.

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§21.18 c. Correcting a Failed Conversion

A Roth IRA conversion can be reversed by making a trustee-to-trustee transfer of the conversion contribution and earnings on the contribution to a traditional IRA before the due date, including extensions, for filing an income tax return for the year of the conversion. IRC §408A(d)(6)(A), (d)(7); Treas Reg §1.408A-5, A-9. Accordingly, a conversion may be reversible for as long as 21 months (from January 1 to October 15 of the following year). This procedure may be used if the taxpayer concludes that the conversion is undesirable (see §21.16), or the taxpayer became ineligible for the conversion (see §21.17). Some practitioners believe that segregated Roth IRAs can be established for each grouping of assets within the converted IRA, which can then be reversed or remain unchanged based on investment performance. Treas Reg §1.408A-5, A-2(c)(4). See Keebler & Bigge, *To Convert or Not to Convert, That is the Question*, J Retirement Planning 51, 57 (May-June 2007).

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§21.19 6. Other IRA Withdrawals

In most cases a participant in an IRA maintained at a financial institution can withdraw amounts on deposit at any time, assuming the participant is willing to suffer whatever tax consequences may result. The named beneficiary will have the same withdrawal powers following the participant's death. These rights are often poorly stated or not mentioned in the actual IRA agreement, which typically will paraphrase distribution options that satisfy minimum distribution rules without consideration of the possibility of faster withdrawals. This lack of clarity regarding withdrawal rights has little practical consequence except when the beneficiary is a QTIP trust. See §21.45. The tax consequences of IRA distributions are discussed in §§21.20-21.25.

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B. Taxation of Distributions

§21.20 1. General Rule of Annuity Taxation

As a general rule, distributions from qualified plans, IRC §403(b) plans, and IRAs are taxed as annuities under IRC §72. "Distributions" include loans of more than $50,000 to the participant and assignments and pledges of participant interests except as provided in IRC §72(p). If the participant made contributions without being entitled to a deduction for the contribution, as would be the case for most IRA contributions made by a person who is a participant in a qualified plan, such contributions are treated as investments in an annuity contract and the payee is permitted to recover the investment on a prorata basis, resulting in an exclusion from income of a portion of each distribution received. A 10-percent penalty applies to early distributions. IRC §72(t). See §21.25. On taxation of annuities, see §§20.9-20.14.

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§21.21 2. Taxation of Roth IRA Distributions

Qualified distributions from Roth IRAs are excluded from taxable income. IRC §408A(d)(1). Qualified distributions do not include early distributions to which a penalty applies (see §21.25) or distributions within 5 years of the first day of the year of the participant's first Roth IRA contribution. IRC §408A(d)(2). The first Roth IRA contribution may be either a regular contribution or a conversion contribution. Treas Reg §1.408A-6, A-2. Distributions that are not qualified distributions are included in taxable income to the extent that the total amount of Roth IRA distributions exceeds the amount of contributions. Treas Reg §1.408A-6, A-4.

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§21.22 3. Income in Respect of a Decedent (IRD)

Benefits received by beneficiaries generally constitute income in respect of a decedent (IRD) under IRC §691. This does not apply to the prorata recovery of the decedent's investment in the contract (the beneficiary recovers the decedent's nondeductible contributions without tax on a prorata basis), nor to life insurance benefits excluded from income under IRC §101(a). Income in respect of a decedent is taxed to the beneficiary when received, with taxation being accelerated if the right to receive the income is transferred by the beneficiary or the decedent's estate.

Generally, counsel should take care to make sure that benefits are not used to fund a pecuniary gift, because funding the gift may be a transfer accelerating the recognition of income. See §21.44. This applies to formula pecuniary gifts under marital deduction estate plans.

When IRD is taxed to the beneficiary, the beneficiary is entitled to a federal income tax deduction under IRC §691(c) for the federal estate tax attributable to the IRD. This only partially compensates the beneficiary for the dual burden of estate taxes and income taxes.

The Franchise Tax Board takes the position that the deduction for federal estate taxes cannot be claimed for California income tax purposes. The instructions for completing the California personal income tax return expressly provide for making an adjustment to federal itemized deductions that eliminates the deduction for California purposes. This apparently is based on an interpretation of Rev & T C §17024.5(b)(14). The benefit of the federal deduction is further reduced by the fact that the deduction must be utilized over a period of years—particularly in a case in which the beneficiary is attempting to withdraw as little as possible from the IRA.

No estate tax is attributable to IRD if the IRD item passed to the spouse and the estate received an IRC §2056 estate tax marital deduction for the transfer. See §17.72.

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4. Grandfathered Special Rules for Lump-Sum Distributions

§21.23 a. Overview of Tax Calculation

For employees who attained age 50 before January 1, 1986, former IRC §402(d)(1)(A) (as amended and applied by §1122(h)(3), (5) of the Tax Reform Act of 1986 (TRA 1986) (Pub L 99-514, 100 Stat 2085), in turn amended by §1011A(b)(11), (13)-(15) of the Technical and Miscellaneous Revenue Act of 1988 (Pub L 100-647, 102 Stat 3342) and §1401(c)(2) of the Small Business Job Protection Act of 1996 (Pub L 104-188, 110 Stat 1755)) imposes a special tax on lump-sum distributions from qualified plans (not including IRAs), which may apply in lieu of the regular income tax if the employee so elects. A distribution may be an eligible lump-sum distribution if there is a distribution or payment within 1 taxable year of the recipient of the balance to the credit of an employee from a retirement plan that is qualified under IRC §401(a) (pertaining to private plans) or §403(a) (pertaining to certain plans maintained by many public schools and tax-exempt organizations). Some distributions from IRC §457 public entity plans also may qualify. Distributions from IRAs do not qualify.

If the client may be eligible, the easiest way to determine whether the election may be useful is simply to struggle through IRS Form 4972 and its instructions. These are included in Package X. Additional practical information is contained in IRS Publication 575, Pension and Annuity Income. California taxation closely parallels federal law and is computed using Form 540, Schedule G-1.

The following is a brief overview of the calculation. In any case, the taxpayer may be able to exclude part of the distribution from tax to take into account any contributions to the plan made from funds that were previously taxed.

- **Ten-year averaging.** If the distribution is less than $70,000, the distributed amount is reduced by the "minimum distribution allowance." The allowance is the lesser of (1) $10,000 or (2) 50 percent of the lump-sum distribution reduced by 20 percent of the amount by which the lump-sum distribution exceeds $20,000. (The maximum amount of the allowance is $10,000 on a distribution of $20,000.) Reducing the $10,000 by one-fifth of the distribution in excess of $20,000 results in reducing the allowance to zero if the distributed amount is $70,000 or more. The remaining distribution is divided by 10. Then the 1986 tax rates for single taxpayers are applied, and the result is multiplied by 10. TRA 1986 §1122(h)(5). Because the upper income tax brackets were relatively high in 1986, 10-year averaging may produce a poor result for a very large lump-sum distribution, but can produce excellent results for smaller distributions.
- **Special taxation of the pre-1974 taxable amount.** The taxpayer may have an additional option regarding taxation of the "pre-1974 amount." This amount is calculated by making a simple proration, multiplying the total distribution by a fraction having the pre-1974 years of service as the numerator and the total years of service as the denominator. The taxpayer may elect to pay a flat 20-percent tax on the pre-1974 amount. TRA 1986 §1122(h)(3).

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§21.24 b. Comparison With IRA Rollover Alternative

Although the special tax on lump-sum distributions can provide a substantial tax savings, electing to pay the tax may be a poor choice compared to the alternative of making a rollover into an IRA so as to continue to enjoy the benefits of tax deferral. For an illustration of the significance of these benefits, see §21.3. If a client is healthy and is not likely to need to make rapid withdrawals from a rollover IRA, the rollover option often will be preferable. An alternative is to make a rollover into an IRA and then a rollover from the IRA into a Roth IRA. This alternative maximizes tax deferral, provided that another source of funds is available to pay the income tax on the Roth IRA contribution. See §21.16. If an employee has died, the beneficiary will not have the option of doing a rollover to an IRA unless the beneficiary is the spouse. IRC §402(c)(9). Many plans also do not provide the option of leaving assets in the plan for the benefit of a beneficiary who is not a spouse.

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§21.25 5. Early Distribution Penalty

Because plans and IRAs are intended to provide retirement benefits and not simply provide another means of short-term investment, a penalty is imposed if the participant withdraws funds before age 59½ unless a specific exception applies. IRC §72(t)(1). The penalty, in the form of an addition to tax, is 10 percent of the amount of the distribution that is includable in the employee's income for the year; thus, there is no tax if there is a rollover to another plan or IRA. The addition to tax is not imposed if distribution is made on account of an employee's death, disability, separation from service after age 55, or to reimburse medical expenses, or is made to a qualified reservist called to active duty, or is part of a series of substantially equal periodic payments based on beneficiary life expectancy, made at least annually and meeting specified requirements. IRC §72(t)(2), (4). The last exception can be important in the case of a client who wishes to retire early.

The IRS provides three methods (minimum distribution method, fixed amortization method, and fixed annuitization method) for determining whether payments to individuals constitute a series of substantially equal periodic payments. Rev Rul 2002-62, 2002-2 Cum Bull 710; Notice 89-25, 1989-1 Cum Bull 662. If there is a modification in the amount of the withdrawals before age 59½ or the expiration of a 5-year period, the 10-percent penalty is imposed. IRC §72(t)(2)(A)(iv). For these purposes, Rev Rul 2002-62 provides that a modification includes any nontaxable transfer of a portion of the account balance to another retirement plan. Accordingly, a 10-percent penalty may be imposed on amounts previously distributed if a nontaxable trustee-to-trustee transfer is made before the end of the 5-year period. IRS Letter Ruling 200925044. See also IRS Letter Ruling 200929021 (mistakenly misdirected transfer from retirement plan to IRA in last calendar year of 5-year period did not cause modification). However, Rev Rul 2002-62 clarifies that the penalty is not imposed when the failure to make the required payments for the required period is the result of a complete depletion of assets. Revenue Ruling 2002-62 also allows an employee to slow down distributions from an IRA that has lost value by switching to the minimum distribution method from another method.

Some annuities are exempt if the payments begin after separation from service. Payments to alternate payees under qualified domestic relations orders are also exempt. Withdrawals from IRAs may also be exempt if the proceeds are used for certain qualified higher education expenses or for the purchase of a home by a qualified first-time home buyer. IRC §72(t)(2)(E), (F), (t)(7), (t)(8). The proceeds can be recontributed in cases of first-time homebuyers who made a withdrawal for purposes of buying a home but did not complete the purchase because of Hurricane Katrina. Pub L 109-73, §102, 119 Stat 2016. There is no hardship exception under IRC §72(t). *Andrew P. Gallagher,* TC Memo 2001-34.

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C. Minimum Distribution Requirements

§21.26 1. Failure to Distribute Penalty

Internal Revenue Code §4974 imposes a 50-percent tax on failures to make minimum required distributions from qualified plans, IRC §403(b) plans for educational and nonprofit organizations, IRC §457 plans for public entities, and IRAs. There are no minimum required distributions from Roth IRAs during the lifetime of the individual. IRC §408A(c)(5). The penalty statute is a conspicuous reminder of the significant tax benefits that result from deferral of tax on retirement funds. See §21.3.

The minimum distribution requirements are discussed in §§21.27-21.32.

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§21.27 2. Minimum Distributions: Basic Statutory Requirements

The most significant rules concerning minimum distributions are codified in IRC §401(a)(9). Although IRC §401(a)(9) is a qualified retirement plan statute, its distribution rules are generally incorporated by reference in IRA statutes and statutes pertaining to public entity plans. IRC §§403, 408, 457. The IRC §401(a)(9) rules are backed up by IRC §4974, which imposes a 50-percent tax on failures to make minimum distributions. The rules are important to estate planners because wealthier clients would like to maximize the period of tax deferral and do not need distributions in order to pay their bills.

The two most significant rules in IRC §401(a)(9) address distributions concerning "employees" (a term that includes IRA owners) who survive the required beginning date (RBD) and those who do not. Assuming the employee survives the RBD and does not withdraw all benefits before the RBD (IRC §401(a)(9)(A)(i)), the benefits must be distributed "over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary)." IRC §401(a)(9)(A)(ii). If the employee dies after the RBD, postdeath distributions must be made at least as rapidly as before death. IRC §401(a)(9)(B)(i).

If the employee dies before the RBD, the benefits must be distributed within 5 years unless the employee had a "designated beneficiary," in which case the benefit may be distributed over the life of the designated beneficiary, provided distributions begin within 1 year. IRC §401(a)(9)(B)(ii)-(iii). If the designated beneficiary is the spouse, the beginning of distributions can be deferred until the employee would have attained age 70½. IRC §401(a)(9)(B)(iv). (This rule is irrelevant if the benefit is rolled over into an IRA belonging to the spouse.) These requirements are elaborated and somewhat liberalized in regulations. See §21.28.

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§21.28 3. Implementation in Regulations

The rather general statutory minimum distribution requirements discussed in §21.27 are elaborated by extremely lengthy regulations under IRC §401(a)(9) and related provisions that provide detailed and complex rules concerning the timing and amounts of minimum distributions. Treas Reg §§1.401(a)(9)-1—1.401(a)(9)-9. However, the regulations provide that government plans may comply with the required minimum distribution rules by using a reasonable and good faith interpretation of the statute. IRC §§403(b)(10), 457(d)(2); Treas Reg §§1.401(a)(9)-1, A-2(d), 1.403(b)-6(e)(8).

As discussed in §§21.29-21.32, the rules vary depending on, among other things:

- Whether payments are made during the life of the employee or after the employee's death;
- Whether death occurs before retirement;
- Whether there is a "designated beneficiary;" and
- Whether the "designated beneficiary" is the spouse.

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.29 a. Distributions During the Employee's Lifetime

§21.29 a. Distributions During the Employee's Lifetime

The predeath minimum distribution rules apply to all qualified plans and IRAs other than Roth IRAs. Reg §1.401(a)(9)-1, A-1. There are no predeath minimum distribution requirements for Roth IRAs. IRC §408A(c)(5). Generally, employees must receive distributions for each calendar year beginning with the year the employee attains the age 70½. Treas Reg §1.401(a)(9)-2, A-1. The predeath distribution rules also determine the distribution that must be made for the calendar year of death. See Treas Reg §1.401(a)(9)-2, A-5. In the case of a qualified plan, but not an IRA, the first year for which there must be a required distribution will be postponed until the year the employee retires if that year is later and the employee is not a 5-percent owner of the employer under IRC §416. IRC §401(a)(9)(C); Treas Reg §1.401(a)(9)-2, A-2.

In the case of the first calendar year for which a distribution is required, the actual distribution may be delayed until April 1 of the following year, which is the employee's required beginning date (RBD). There is no comparable grace period for later-year distributions, with the consequence that an employee taking advantage of the grace period will receive two minimum distributions in the year of the RBD. Treas Reg §1.401(a)(9)-5, A-1(c).

The amount of each distribution is a fraction of the value of the plan benefits at the end of the preceding calendar year. Treas Reg §1.401(a)(9)-5, A-1(a), A-3. The numerator of the fraction is one. Normally the denominator is determined under Treas Reg §1.401(a)(9)-5, A-4(a), using the Uniform Lifetime Table in Treas Reg §1.401(a)(9)-9, A-2. The table represents the joint life expectancy of the participant and a deemed designated beneficiary 10 years younger than the participant as of the participant's birthday in the distribution calendar year. The table is reprinted below in Table 1.

There is an exception to the general rule that Table 1 is used to determine the denominator. If the employee has a "designated beneficiary" (see §21.30) and that sole beneficiary is a spouse more than 10 years younger than the employee for the entire calendar year, the denominator is the joint life expectancy of the employee and the employee's spouse based on the employee's and spouse's birthdays in the distribution calendar year. Treas Reg §1.401(a)(9)-5, A-4(b). This joint life expectancy will produce a larger divisor (a smaller minimum distribution) than Table 1 and will be determined using the Joint and Last Survivor Table in Treas Reg §1.401(a)(9)-9, A-3. In IRS Letter Ruling 200250037, the Service ruled that an IRA owner who married his designated beneficiary was entitled to a smaller minimum distribution. The effect of using joint life expectancy for a participant age 75 is illustrated below in Table 2.

Table 1. Joint life expectancy table for the participant and a deemed designated beneficiary 10 years younger than the participant. The denominator of the minimum distribution fraction is determined using the attained age of the participant in the distribution calendar year.

Table 1

Attained Age	Denominator	Attained Age	Denominator
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9

79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
82	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

Table 2. Effect of using the joint life expectancy of the participant and spouse for participant age 75. The denominator of the minimum distribution fraction with and without the spouse is determined using the age of the spouse.

Table 2

Age of Spouse	Denominator Without Spouse	Denominator With Spouse
56	22.9	29.6
57	22.9	28.8
58	22.9	28.0
59	22.9	27.2
60	22.9	26.5
61	22.9	25.7
62	22.9	25.0
63	22.9	24.3
64	22.9	23.6
65	22.9	22.9

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§21.30 b. Postdeath Minimum Distributions—Designated Beneficiary Concept

The statutory provisions concerning minimum distributions quoted in §21.27 sometimes permit minimum distributions to be calculated in a manner that takes into account the life expectancy of a "designated beneficiary." In connection with predeath distributions, the existence and identity of a "designated beneficiary" is irrelevant except in the case when the designated beneficiary is a spouse more than 10 years younger than the employee, in which case the life expectancy of the spouse is used to reduce minimum distributions. See §21.29. Designated beneficiary issues are much more important when calculating postdeath minimum distributions. See §§21.31-21.32. Detailed rules for determining the existence and identity of the designated beneficiary are provided by Treas Reg §1.401(a)(9)-4.

In some cases determination of the existence and identity of a designated beneficiary is relatively simple, for example in the case of a single named beneficiary on a beneficiary designation form who survives the employee and is still living on the date the designated beneficiary is determined. In other cases, the determination becomes more complex. Important concepts include the following:

- Only living persons have life expectancies, with the consequence that there usually is no designated beneficiary if the named beneficiaries are not living persons.
- A trust cannot be a designated beneficiary, but the eldest beneficiary of the trust will be treated as the designated beneficiary if certain requirements are met. See §21.44. There is no comparable look-through rule for estates.
- If there are multiple individual beneficiaries, the eldest is the designated beneficiary. An exception to this rule may occur if the shares of the benefit for each individual is a separate account. Treas Reg §1.401(a)(9)-8, A-2.

With respect to postdeath distributions, the designated beneficiary is determined as of September 30 of the year following the year of death. Treas Reg §1.401(a)(9)-4, A-4(a). This does not necessarily mean that the designated beneficiary is the person receiving distributions at that time. For example, the death of a beneficiary between the decedent's death and September 30 of the following year does not result in a change of the designated beneficiary. Treas Reg §1.401(a)(9)-4, A-4(c). The regulations clarify that the designated beneficiary will change after death if the original beneficiary makes a disclaimer that is a qualified disclaimer under IRC §2518. The designated beneficiary may also change if there are multiple beneficiaries and the shares of some of them are fully distributed by the determination date. Treas Reg §1.401(a)(9)-4, A-4(a). The only relevant predeath determination of the designated beneficiary arises when the employee wants to claim the lower minimum distributions allowed in the case of an employee who has a spouse who is more than 10 years younger than the employee. Generally, the spouse must be the designated beneficiary for the entire year. The requirement is treated as being met if the spouse remains the beneficiary until death or divorce during the calendar year. Treas Reg §1.409(a)(9)-5, A-4(b).

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Source: Estate Planning/California Estate Planning/21 Employee Benefits and IRAs/§21.31 c. Postdeath Distributions: Employee Survives Required Beginning Date (RBD)

§21.31 c. Postdeath Distributions: Employee Survives Required Beginning Date (RBD)

If the employee survives the required beginning date (RBD), which is usually April 1 of the year following the year in which the employee attains age 70½, postdeath distributions for years after the year of the employee's death (the minimum distribution for the year of death is determined under the rules applicable during the employee's lifetime) depend on whether the employee has a designated beneficiary and whether that designated beneficiary is the spouse. Treas Reg §1.401(a)(9)-5, A-5(a).

- **No designated beneficiary.** If there is no designated beneficiary, distributions generally must be made over the hypothetical life expectancy of the employee, using the age the employee attained (or would have attained) in the calendar year of death. The life expectancy will be determined using the Single Life Table in Treas Reg §1.401(a)(9)-9, A-1. The table is reprinted below in Table 3. This is a "fixed" life expectancy, meaning that the divisor is reduced by one each subsequent year. For example, if the employee dies at age 80, the life expectancy at death is 10.2. The first year that the divisor is computed under the postdeath rule is the year following death. The divisor will be 9.2. Because the life expectancy is "fixed," the divisor is not the life expectancy shown in the table for a person age 81. In subsequent years, the divisor will be 8.2, 7.2, and so on. Treas Reg §1.401(a)(9)-5, A-5(a)(2), A-5(c)(3).
- **Designated beneficiary other than spouse.** If there is a designated beneficiary, but that beneficiary is not the spouse, the initial divisor for the year following the year of death is the life expectancy of the beneficiary based on the beneficiary's age that year. This also is a fixed life expectancy. Treas Reg §1.401(a)(9)-5, A-5(a)(1), A-5(c)(1).
- **Spouse as designated beneficiary.** When the spouse is the designated beneficiary, the postdeath minimum distribution rule will be irrelevant if the spouse rolls the benefit over to the survivor's own IRA or treats the IRA as belonging to the survivor. See §21.43. In other cases, the distribution rule is essentially the same as for other beneficiaries, except that the spouse's life expectancy is redetermined each year that the spouse survives by returning to the life expectancy table and plugging in the spouse's newly attained age. Once the spouse dies, a fixed life expectancy is established using the spouse's age in the year of the spouse's death and subtracting one each subsequent year. Treas Reg §1.401(a)(9)-5, A-5(a)(1), A-5(c)(2).

Table 3. Single life expectancy table for the participant or designated beneficiary. The denominator of the minimum distribution fraction is determined using the attained age of the participant or designated beneficiary in the applicable calendar year.

Table 3			
Attained Age	**Denominator**	**Attained Age**	**Denominator**
0	82.4	56	28.7
1	81.6	57	27.9
2	80.6	58	27.0
3	79.7	59	26.1
4	78.7	60	25.2
5	77.7	61	24.4
6	76.7	62	23.5
7	75.8	63	22.7
8	74.8	64	21.8
9	73.8	65	21.0

10	72.8	66	20.2
11	71.8	67	19.4
12	70.8	68	18.6
13	69.9	69	17.8
14	68.9	70	17.0
15	67.9	71	16.3
16	66.9	72	15.5
17	66.0	73	14.8
18	65.0	74	14.1
19	64.0	75	13.4
20	63.0	76	12.7
21	62.1	77	12.1
22	61.1	78	11.4
23	60.1	79	10.8
24	59.1	80	10.2
25	58.2	81	9.7
26	57.2	82	9.1
27	56.2	83	8.6
28	55.3	84	8.1
29	54.3	85	7.6
30	53.3	86	7.1
31	52.4	87	6.7
32	51.4	88	6.3
33	50.4	89	5.9
34	49.4	90	5.5
35	48.5	91	5.2
36	47.5	92	4.9
37	46.5	93	4.6
38	45.6	94	4.3
39	44.6	95	4.1
40	43.6	96	3.8
41	42.7	97	3.6
42	41.7	98	3.4
43	40.7	99	3.1
44	39.8	100	2.9
45	38.8	101	2.7

46	37.9	102	2.5
47	37.0	103	2.3
48	36.0	104	2.1
49	35.1	105	1.9
50	34.2	106	1.7
51	33.3	107	1.5
52	32.3	108	1.4
53	31.4	109	1.2
54	30.5	110	1.1
55	29.6	111 and older	1.0

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§21.32 d. Postdeath Distributions: Employee Fails to Survive Required Beginning Date (RBD)

The postdeath distribution rules are modestly different from the rules described in §21.31 if the employee fails to survive the required beginning date (RBD). As required by statute, the benefit must be distributed within 5 years if there is no designated beneficiary. Treas Reg §1.401(a)(9)-3, A-1. This is also the rule if there is a designated beneficiary but there is a failure to make the first required distribution to the beneficiary in the year following the year of death. Treas Reg §1.401(a)(9)-3, A-3(a). A spouse can defer distributions until the employee would have attained age 70½. Treas Reg §1.401(a)(9)-3, A-3(b). There is a fresh start if the spouse also dies before the employee would have attained that age (meaning the contingent beneficiaries start receiving distributions calculated as if the spouse had been the employee). Treas Reg §1.401(a)(9)-3, A-5. In other respects, distributions are calculated the same as if the employee survived the RBD. Again, the spouse rules are irrelevant in the event of a spousal rollover. See §21.43.

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§21.33 D. Minimum Distributions Versus Annuities

In general, an annuity calculated under Temp Treas Reg §1.401(a)(9)-6T results in less tax deferral than minimum withdrawals under the rules described in §§21.27-21.32. The reason for this is that an annuity makes significantly higher early distributions, thus resulting in a smaller investment fund growing at faster tax-deferred rates. Of course, this comparison is made in something of a vacuum, assuming a hypothetical opportunity to elect or purchase an annuity paying an amount calculated on the same rate of investment return that we are predicting for future investments for a choice of a rollover IRA. Real world alternatives require greater scrutiny.

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IV. TRANSFERRING RETIREMENT BENEFITS

§21.34 A. Spousal Protection Limitations

Under provisions of the Retirement Equity Act of 1984 (REAct) (Pub L 98-397, 98 Stat 1426), most qualified plans must provide that benefits will be payable in the form of a qualified joint and survivor annuity (QJSA) unless the nonparticipant spouse waives the right to such an annuity. Similarly, the plan must provide for payment of a qualified preretirement survivor annuity (QPSA) in the event of the participant's death before retirement. IRC §401(a)(11). Plans that are not required to provide these distributions are listed in IRC §412(h) and include profit-sharing plans and stock bonus plans. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse that is 50 to 100 percent of the amount of the annuity payable during the joint lives of the participant and spouse. IRC §417(b). A QPSA, generally, is an annuity of an amount equal to or greater than that which would have been payable as the survivor portion of a QJSA if the participant had retired rather than died. IRC §417(c).

NOTE: For plan years beginning after December 31, 2007, plans required to provide a QJSA also must provide a qualified optional survivor annuity that pays 75 percent of the periodic amount that was payable during the joint lives of the participant and spouse unless the QJSA pays 75 percent or more of the joint annuity amount, in which case the qualified optional annuity must pay 50 percent of the joint periodic amount. IRC §417(g). For example, a plan that provides a QJSA that pays 50 percent must provide an optional survivor annuity that pays 75 percent, while a plan that provides a QJSA that pays 75 percent must provide an optional survivor annuity that pays 50 percent.

The right to a QJSA or QPSA can be waived. IRC §417(a)(1). The waiver must be in a writing signed by the nonparticipant spouse that is notarized or witnessed and that acknowledges the effect of the waiver. The waiver can be revoked during the 90-day period ending on the annuity starting date. The waiver of a QJSA also must designate a beneficiary or form of benefit that cannot be changed without spousal consent unless the spouse's waiver expressly permits changes without further consent. IRC §417(a)(2); Treas Reg §1.401(a)-20, A-31(b).

Rights to QJSAs and QPSAs are sometimes waived in prenuptial or similar agreements by providing that a spouse is obligated to execute and deliver the documents required by the statute.

If a participant dies and the survivor receives a QJSA or QPSA, the transfer qualifies for the marital deduction. IRC §2056(b)(7)(C)(ii). The plan benefit is qualified terminable interest property, and the value of any benefits remaining at the survivor's death will be included in the survivor's estate.

The requirements for providing QJSAs and QPSAs have the effect of requiring the consent of the nonparticipant spouse to receive a lump-sum distribution. This may create conflict of interest issues for the attorney advising a married couple, because the nonparticipant spouse will give up significant rights if the lump-sum distribution is made. This is true even if the assets are rolled over into an IRA, because there are no comparable spousal protection provisions for IRAs. However, if the plan interest is community property, the nonparticipant spouse may actually gain rights. See §21.35.

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§21.35 B. Community Property Issues

Under California law, plan benefits earned during marriage are community property. The United States Supreme Court has ruled, however, that ERISA preempts California law and precludes the testamentary transfer of pension benefits by a nonparticipant spouse who dies before the participant spouse. See *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754. The apparent result is that any community property interests of the nonparticipant spouse pass to the participant spouse as a matter of law if the nonparticipant dies first. Based on *Boggs*, the California Court of Appeal has held that ERISA's preemption and antialienation provisions do not allow a court to make a domestic relations order providing the nonparticipant spouse the right to name a successor in interest (other than a designated beneficiary or alternate payee under the terms of the plan) to receive her share of undistributed pension benefits on her death. *Marriage of Shelstead* (1998) 66 CA4th 893, 78 CR2d 365. The Ninth Circuit Court of Appeals further held that a dissolution decree could not accomplish a valid assignment of pension rights following the death of the nonparticipant spouse. *Branco v UCFW—Northern Cal. Employers Joint Pension Plan* (9th Cir 2002) 279 F3d 1154.

It is not clear whether the *Boggs* rule applies to IRAs and other retirement arrangements that are not subject to the antialienation provisions of ERISA. See 29 USC §1056(d). As a practical matter, the majority of nonparticipant spouses do not intentionally try to transfer to third parties their community property interests in pensions and IRAs held in the name of their spouse. The more difficult issues can be avoided by ensuring that the nonparticipant's will cannot be construed as devising the interests to someone other than the spouse, as might occur if some share of the residue passes to someone other than the spouse. Some practitioners routinely add provisions to wills that expressly devise such interests to the surviving spouse to avoid inadvertent disposition of these interests to other persons under the will's residuary clause.

In the case of IRAs, community property issues also arise when the participant dies first and the participant has named a beneficiary other than the spouse. Such situations are addressed by California's Nonprobate Transfers of Community Property Law (Prob C §§5010-5032) with the typical result that a surviving spouse who did not consent to the beneficiary designation will be able to recover that spouse's half community property interest. This assumes however, that *Boggs* does not apply to IRAs.

In *Emard v Hughes Aircraft Co.* (9th Cir 1998) 153 F3d 949, the court held that ERISA did not preempt community property claims to the decedent's group-term life insurance policies still naming decedent's first husband as beneficiary. In *Egelhoff v Egelhoff* (2001) 532 US 141, 149 L Ed 2d 264, 121 S Ct 1322, however, the U.S. Supreme Court held that the ex-spouse of a decedent was entitled to collect the benefits of a life insurance policy and pension plan governed by ERISA when the decedent failed to change the beneficiary designations following divorce. The decision also appears to preclude community property claims by a surviving spouse when the employee names a third party as beneficiary. In *Metropolitan Life Ins. Co. v Buechler* (9th Cir Aug. 10, 2001, No. 00-35374) 2001 US App Lexis 21390 (unpublished opinion), the Ninth Circuit held that, to the extent that *Emard* held that ERISA does not preempt state laws that require an employee welfare plan to pay life insurance proceeds to someone other than the named beneficiary, *Emard* did not survive *Egelhoff*. See also *Carmona v Carmona* (9th Cir 2008) 544 F3d 988, in which the court held that a former spouse's interest in surviving spouse benefits vested on the participant's retirement and preempted a state court order directing pension plans to change beneficiaries to the current spouse and creating a resulting trust.

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C. Estate and Gift Tax

§21.36 1. Inclusion and Exclusions

Unless shielded by grandfather clauses, retirement benefits are now fully subject to estate, gift, and generation-skipping transfer taxes in most cases. The former IRC §2039 unlimited estate tax exclusion for qualified plan interests was limited to $100,000 by §245 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (Pub L 97-248, 96 Stat 324) and repealed entirely by §525 of the Deficit Reduction Act of 1984 (Pub L 98-369, 98 Stat 494). Both changes, however, were made subject to grandfather clauses that were subsequently clarified by §1852(e)(3) of the Tax Reform Act of 1986 (Pub L 99-514, 100 Stat 2085). As long as the individual does not change the *form* of benefit before death (beneficiary changes are permitted):

- The unlimited exclusion remains available for the estate of an individual who separated from service before January 1, 1983; and
- The $100,000 exclusion remains available for the estate of an individual who separated from service before January 1, 1985.

If a grandfather clause applies, eligibility for the exclusion requires satisfying other requirements of prior law. Most notably, the benefits cannot be payable to the decedent's estate and the beneficiary cannot elect lump-sum tax treatment.

An exception to the general rule of estate tax inclusion under IRC §2031 may arise in cases in which an employee does not contribute to a plan and has no ability to name the beneficiary. Some employers have plans that pay death benefits to specified relatives if a decedent dies while still employed. The Tax Court has ruled that such benefits are not subject to estate or gift tax and the IRS has acquiesced. See *Estate of Anthony F. DiMarco* (1986) 87 TC 653, acq in result 1990-2 Cum Bull 1; Rev Rul 92-68, 1992-2 Cum Bull 257. A gift generally results when a participant *irrevocably* selects a benefit that provides benefits to another person (typically by selecting a joint and survivor annuity retirement option). IRC §2511; Treas Reg §25.2511-1(h)(10).

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§21.37 2. Marital Deduction Issues

Outright transfers of pension interests to surviving spouses generally qualify for the marital deduction, as do qualified survivor annuities. IRC §§2056(b)(7)(C), 2523(f)(6). The issues related to naming a QTIP trust as beneficiary of an IRA are discussed in §21.45.

Marital deduction problems may arise if the surviving spouse is not a citizen of the United States, in which case no marital deduction is allowable unless the property is transferred to a qualified domestic trust (QDOT). IRC §§2056(d), 2056A. This poses problems because there is no method for transferring a retirement plan interest to a QDOT. In recognition of this dilemma, the IRS will treat pensions as transferred to a QDOT if the spouse agrees to transfer the corpus portion of each payment to a QDOT as the payment is received. Alternatively, the spouse must agree to treat each receipt of corpus as a withdrawal of corpus from a QDOT—a treatment that may trigger a delayed QDOT estate tax under IRC §2056A(b). Treas Reg §20.2056A-4(c).

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§21.38 3. Charitable Deduction

In many cases a charity or charitable remainder trust is an appropriate beneficiary for a retirement plan benefit. This is particularly true when the combination of income and estate taxes that will be imposed will consume the bulk of the benefit. A transfer to charity qualifies for a full estate tax deduction under IRC §2055, and the charity is not required to pay income tax on a fund that is otherwise fully taxable. IRC §170. For more extensive discussion in the context of IRAs, see §21.48.

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§21.39 V. LARGE IRA BASIC STRATEGY

One of the most difficult challenges involves planning for an estate that will include either a large IRA (see §21.40) or a retirement plan benefit that can be transferred to an IRA to provide distribution options not available under a retirement plan. Large IRAs are relatively common, especially when a highly compensated person has rolled over a retirement plan benefit into an IRA and enjoyed good investment results. Analysis of planning for large IRAs is also useful for illustrating the problems that arise when planning for other types of retirement benefits.

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§21.40 A. The Large IRA Problem

Total estate and income taxes owed with respect to a large IRA can amount to more than 70 percent of the gross value of the IRA. For example, if the estate tax rate is 45 percent and the beneficiary has a 35 percent federal income tax rate and a 9.3 percent California income tax rate, then the combined taxes on an IRA of $100,000 will be $70,295, calculated as follows:

- The estate tax will be $45,000;
- The California income tax will be $9300; and
- The federal income tax will be 35 percent of $45,700 ($100,000 reduced by a $45,000 IRC §691(c) deduction for the estate tax attributable to income in respect of a decedent (IRD), and further reduced by a $9300 IRC §164 deduction for the California income tax), which is $15,995 (.35 × $45,700).

Although heavy taxation of a large IRA in a large estate is unavoidable short of naming a charity as the beneficiary (see §21.48), such unfortunate results can be mitigated through a careful selection of options pertaining to distributions to any surviving spouse and next-generation beneficiaries. See §§21.41-21.47.

Another alternative is to convert the IRA to a Roth IRA during the lifetime of the owner, provided that other funds are available to pay the income tax on the conversion contribution. The proceeds of the Roth IRA will be excluded from taxable income on distribution to the estate or beneficiaries, and the funds used to pay the income tax are thereby removed from the estate tax base without the loss of tax deferral. See §21.49.

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§21.41 B. Importance of Naming Designated Beneficiary

During the lifetime of the owner, required minimum distributions are generally determined by the owner's age in the distribution calendar year, based on the joint life expectancy of the owner and a hypothetical designated beneficiary 10 years younger than the owner. An exception to this rule applies if the designated beneficiary is a spouse who is more than 10 years younger than the owner, in which case the joint life expectancy of the owner and spouse may be used in determining required minimum distributions under IRC §401(a)(9) and Treas Reg §1.401(a)(9)-5. See §21.29. The obvious advantage of using the joint life expectancy when possible is that it reduces the rate of forced withdrawal during the owner's lifetime.

If the owner survives until the RBD, postdeath distributions will be based on the life expectancy of the owner in the year of death if there is no designated beneficiary. In IRS Letter Ruling 200742026, the IRS refused to honor a state court order reforming an IRA beneficiary designation to name the deceased participant's sole heir as the beneficiary of the IRA. Because the IRA was payable to the decedent's estate and an estate cannot be a designated beneficiary, the IRS ruled that minimum distributions must be based solely on the decedent's life expectancy at the time of death.

If the owner fails to survive to that date, and the IRA does not pass to a surviving spouse who can effect a rollover, the general rule is that the IRA must be distributed within 5 years if there is no designated beneficiary. In IRS Letter Ruling 200327059, the Service ruled that a spouse's disclaimer caused IRAs to have no designated beneficiary, because the disclaimed interests passed under the owner's will. An estate cannot be a designated beneficiary even though the residuary devisees under the will would have been designated beneficiaries if they had been named as alternate takers under the IRA beneficiary designation. As a result, the IRAs must be distributed within 5 years of the owner's death. In IRS Letter Ruling 200646025, the IRS ruled that "separate account" treatment was not available for "sub-IRAs" (one for each residuary devisee) of an IRA payable to an estate. Because an estate cannot be a designated beneficiary and the decedent had attained his RBD, each sub-IRA must calculate minimum distributions based on the decedent's actuarial life expectancy at death. Thus, it is important to name a designated beneficiary (see §21.42) and alternate takers even though the designated beneficiary generally does not affect lifetime distributions. See §§21.30-21.31.

Note that the minimum distribution requirements do not apply to a Roth IRA during the lifetime of the owner. IRC §408A(c)(5). The rest of the above discussion largely applies after the death of the owner. If there is no designated beneficiary, the Roth IRA must be distributed within 5 years. If the spouse is the designated beneficiary, the Roth IRA may be rolled over to a Roth IRA for the spouse, apparently with the result that the minimum distribution requirements do not apply during the lifetime of the spouse. Treas Reg §1.408A-6, A-14.

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§21.42 C. Beneficiary Designation Options

Counsel must take considerable care when designating primary and contingent beneficiaries for IRAs. It is now common to see private letter rulings involving attempts to rescue problems caused by ill-advised designations. The possibilities discussed in §§21.43-21.47 deserve particular comment.

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§21.43 1. The Spouse

In the case of married persons in good health, the most commonly named beneficiary is the spouse. This designation eliminates, or at least postpones, a variety of problems if the spouse survives. On the owner's death, the spouse will be able to treat the IRA as his or her own, or—with the same effect—will be able to roll over the IRA into an IRA in his or her own name. Treas Reg §1.408-8, A-5, A-7. In either case, the spouse can name designated beneficiaries, and the minimum distribution rules will be applied using the current life expectancy of the spouse and then the life expectancies of his or her beneficiaries, typically providing an extended period of tax deferral. If the spouse is under age 70½, these rules result in a suspension of required distributions until that age. See §§21.31-21.32.

The minimum distribution rules do not apply to a Roth IRA during the lifetime of the owner. IRC §408A(c)(5). Thus, if the spouse is the designated beneficiary, and the spouse rolls over the Roth IRA into a Roth IRA of his or her own, distribution can be postponed until after the death of the spouse. Treas Reg §1.408A-6, A-14. After the death of the spouse, distribution can be made over the life expectancy of the spouse's designated beneficiary, further extending the period of tax deferral.

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§21.44 2. The Revocable Trust

Naming a revocable trust as the beneficiary of an IRA can be risky. Several problems must be addressed:

- **Designated beneficiary problem.** As noted in §21.41, it is generally important that the IRA have a designated beneficiary. Otherwise, if the owner does not survive until the RBD, the IRA must be distributed within 5 years after the owner's death. Furthermore, if the owner does survive until the RBD, minimum distributions after the owner's death will be calculated using the hypothetical life expectancy of the IRA owner in the year of death reduced by 1 year for each year thereafter. Unfortunately, a trust has no life expectancy, and the regulations state that a trust cannot be a designated beneficiary. Treas Reg §1.401(a)(9)-4, A-5(a). Nevertheless, the beneficiaries of a trust will be recognized as "designated beneficiaries" if, during any period during which required minimum distributions are being determined by treating the beneficiaries of the trust as designated beneficiaries of the employee, the following requirements are met (Treas Reg §1.401(a)(9)-4, A-5(b)):
- The trust is a valid trust under state law, or would be but for the fact that there is no corpus.
- The trust is irrevocable, or will, by its terms, become irrevocable on the death of the employee.
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's benefit are identifiable from the trust instrument within the meaning of Treas Reg §1.401(a)(9)-4, A-1 (generally permitting identification by name or relationship). However, the IRS has ruled that a successor beneficiary under a trust was not a designated beneficiary of a surviving spouse trust beneficiary who died before age 70½. IRS Letter Ruling 200644022. Accordingly, the IRA must be distributed within 5 years of the surviving spouse's death. See §21.32. The ruling has the troubling implication that an IRA that names a QTIP trust as beneficiary will not have a designated beneficiary when the spouse dies. At least in the usual case, the spouse will have no ability to designate her own successor beneficiary. If the participant had wanted to permit the spouse to name a successor beneficiary, the participant would have named the spouse—rather than the trust—as primary beneficiary. See §21.43.
- The documentation described in Treas Reg §1.401(a)(9)-4, A-6 (a copy of the trust instrument and a list of all of the beneficiaries of the trust) has been provided to the plan administrator by October 31 of the year following the year of death.
- **Oldest beneficiary problem**. If a trust has multiple beneficiaries, the age of the oldest beneficiary is generally used to calculate minimum distributions. Treas Reg §1.401(a)(9)-5, A-7(a). While the IRA can be divided into separate accounts if the trust is to be distributed to multiple beneficiaries in equal shares (Treas Reg §1.401(a)(9)-8, A-2(a)(2)), the division will not be recognized for purposes of calculating minimum distributions. Treas Reg §1.401(a)(9)-4, A-5(c). Therefore, it is usually desirable to designate subtrusts as beneficiaries of separate accounts, rather than name the revocable trust as a whole. See IRS Letter Ruling 200634068 (minimum distributions to revocable trust designated as IRA beneficiary must be calculated using life expectancy of eldest beneficiary even though trust divides into separate trusts for child and grandchildren). Further, all potential beneficiaries of a trust are generally considered designated beneficiaries of the IRA, including contingent beneficiaries. Treas Reg §1.401(a)(9)-5, A-7(b). This presents a problem because an estate cannot be a designated beneficiary. Treas Reg §1.401(a)(9)-4, A-3. Therefore, if the trust has only one individual beneficiary and the beneficiary dies, the IRA will cease to have a designated beneficiary. In that event, the entire IRA must be distributed within 5 years after the employee's death. IRC §401(a)(9)(B)(ii). However, if the trust is a "conduit trust" (*i.e.,* the trust instrument provides that all amounts distributed from the IRA are paid directly to the primary beneficiary) successor beneficiaries who may receive benefits as a result of the death of the primary beneficiary will be disregarded. Treas Reg §1.401(a)(9)-5, A-7(c). (The phrase "conduit trust" is professional jargon that does not appear in the regulations, but it has been used by the IRS in private letter rulings.) To avoid the remote possibility that the IRA will cease to have a designated beneficiary if all the beneficiaries die, the trust may provide that the IRA is distributed outright to the last successor beneficiary. The IRS has ruled that a trust may be a considered a conduit trust even though trust expenses can be withheld from distributions. IRS Letter Ruling 200537044. If the trust is not a conduit trust, it is an accumulation trust—meaning that some of the

minimum distributions will be accumulated in the trust—and the IRS takes the position that all contingent remainder beneficiaries of the trust down to the beneficiary who would get the property today if all prior beneficiaries are deceased must be considered in determining the oldest beneficiary. Treas Reg §1.401(a)(9)-5, A-7(c)(3), Example 1; IRS Letter Rulings 200610026, 200438044.

- **Spousal rollover problem.** The advantages of naming the spouse as the IRA beneficiary—particularly the benefit of enabling the spouse to treat the IRA as his or her own—are noted in §21.43. Usually these benefits are lost if a revocable trust is the IRA beneficiary, although the IRS has liberally treated some dispositions to trusts as being dispositions to the spouse, provided the spouse is able to withdraw the IRA benefits from the trust without the aid of an exercise of discretion by a fiduciary other than the spouse. See IRS Letter Rulings 200705032, 200704033. The withdrawal must actually be made. This is strictly postmortem rescue work.
- **The pecuniary gift problem.** The transfer of an IRA to a marital deduction plan revocable trust may result in immediate recognition of the IRA income by the trust. This is most likely to occur when the trust provides for a gift of a formula-determined pecuniary amount to either a marital deduction trust or a credit shelter trust. If the IRA is used to satisfy the original trust's obligation to pay a pecuniary amount (which may be necessary, depending on the size of the pecuniary gift and the availability of other assets), the arguable result will be immediate recognition of the IRA income. *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217. See, *e.g.*, IRS Legal Memorandum 200644020, discussed in §21.48 (pecuniary charitable gifts). The courts have not ruled on this question in connection with an IRA, but few clients will want to finance a test case. This problem does not arise with a Roth IRA because there is no recognition of income from a qualified distribution of a Roth IRA. IRC §408A(d)(1). If a marital deduction trust or a credit shelter trust is intended to be the IRA beneficiary (see §21.45), this result should be achieved by naming the specific trust as beneficiary or by including in the trust instrument a specific provision that allocates the IRA to one trust or the other *before* the amount of the pecuniary gift is calculated or satisfied.

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§21.45 3. The Marital Deduction Trust

Provided the requirements for treating the beneficiaries of a trust as designated beneficiaries are satisfied as discussed in §21.44, the IRA beneficiary can be a marital deduction trust. Because of the necessity to forego the benefits of a disposition to the spouse, intentional dispositions of this type are relatively rare.

- **Marital trusts other than QTIP trusts.** There is generally no reason to leave IRA benefits to a typical survivor's trust or other trust giving the survivor an unlimited power of withdrawal. To do so produces no benefit, because the spouse will be forced to withdraw the IRA balance from the trust to effect a rollover. Concerns about the survivor's possible incompetence in the future can be addressed with a durable power of attorney that authorizes the attorney-in-fact to receive IRA distributions and transfer them to the trust. See chap 30. It seems unlikely that it would ever be appropriate to name some other form of general power of appointment trust as an IRA beneficiary.
- **QTIP trusts.** The primary advantage of a QTIP trust is that the transferor can control the disposition of the remainder. Occasionally there will be cases in which this is a client's paramount concern, even to the point of foregoing the significant advantages of an outright disposition to the spouse. A QTIP trust also may be desirable to make use of the deceased spouse's GST tax exemption, by permitting a reverse QTIP election under IRC §2652(a)(3). See chap 11. A transfer to a QTIP is not the equivalent of a transfer to the spouse for purposes of the rules allowing a rollover to a surviving spouse. Treas Reg §1.408-8, A-5(a). There has been considerable debate about the requirements for a valid IRA-funded QTIP trust, but it seems clear based on IRC §2056(b)(7) and Treas Reg §20.2056(b)-7 that the IRA agreement should contain express language giving the QTIP trustee an absolute right to withdraw all IRA income. The QTIP trust instrument similarly must contain express language giving the spouse the absolute right to compel the QTIP trustee to make such a demand at any time and to further compel that trustee to deliver the income to the spouse. See Rev Rul 2000-2, 2000-1 Cum Bull 305.

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§21.46 4. Credit Shelter (Bypass) Trusts

Provided the requirements for treating the beneficiaries of a trust as designated beneficiaries are satisfied as discussed in §21.44, the IRA beneficiary can be a credit shelter trust. In many cases, however, an IRA is not a good choice for funding a typical credit shelter bypass trust. The benefits of naming the spouse as the beneficiary are lost. In addition, if the unrecognized income tax liability of the IRA is taken into account, the true initial value of a bypass trust funded with a $2 million IRA is substantially less than $2 million. Future income tax deferral might eventually compensate for this liability, but this is unlikely because the eldest beneficiary of the trust is treated as the designated beneficiary and the eldest beneficiary of a bypass trust is usually the spouse. This will result in fairly rapid depletion of the IRA unless the spouse is relatively young. While the IRA can be divided among separate trusts for different beneficiaries, the IRS has ruled that distributions must be made over the lifetime of the eldest beneficiary unless the IRA beneficiary designation identifies each trust and the trusts come into existence not later than the date of the settlor's death. See IRS Letter Ruling 200317041. Notwithstanding these factors, it is sometimes necessary to name the bypass trust as beneficiary because there are no other suitable assets available for funding it. These problems do not arise with a Roth IRA because there is no unrecognized tax liability of a Roth IRA. IRC §408A(d)(1).

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§21.47 5. Multiple Beneficiaries

In many cases the likely beneficiary designation choices will be limited to issue. When issue (or persons other than a spouse) are the beneficiaries, it is important to take advantage of the possibility that the beneficiaries can prolong the benefits of tax deferral after the owner's death for a period equal to their life expectancies (actually, their life expectancies at the end of the year following the year of the owner's death, reduced by 1 year for each year thereafter). The tax burden on the IRA will be bad enough without also losing the primary tax benefit. In this connection:

- If a single IRA has multiple beneficiaries and the interests of those beneficiaries are not divided into separate accounts, minimum distributions are based on the life expectancy of the eldest beneficiary of the IRA on September 30 of the year following the year of death. Treas Reg §1.401(a)(9)-5, A-7(a).
- If a trust is the beneficiary, and the rules for having the beneficiaries of the trust recognized as beneficiaries of the IRA have been satisfied, minimum distributions are based on the age of the eldest beneficiary of the trust. Treas Reg §1.401(a)(9)-4, A-5(a).
- It is permissible to split IRAs and name different beneficiaries for each IRA. Such a split apparently will be recognized for minimum distribution purposes if it is accomplished by September 30 of the year following the year of death. Treas Reg §1.401(a)(9)-8, A-2.

It is important to make sure each IRA beneficiary is truly a "designated beneficiary" under Treas Reg §1.401(a)(9)-4, A-1. In addition, it is important for estate plans to address the need for a separate source of funds for paying death taxes on IRAs. The benefits of income tax deferral are lost if the beneficiary is forced to make otherwise unnecessary IRA withdrawals to pay the taxes. Also, an IRA should be split into separate IRAs if one of the beneficiaries is significantly older than the others.

The generation-skipping transfer (GST) tax also must be taken into account with respect to distributions to grandchildren or other skip persons. It is rarely desirable to allow an IRA to pass to a skip person unless there is sufficient GST tax exemption to give the transfer a zero inclusion ratio. Assuming that the estate tax is paid from other estate assets, the GST tax exemption necessary to fully exempt the transfer will be the full value of the IRA assets without consideration of the potential income tax liability. This problem does not arise with a Roth IRA because it has no potential income tax liability. Consistent with regular GST tax planning concepts, any share of an IRA passing to a skip person should be split off into a separate IRA before allocation of the GST tax exemption. See chap 11.

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§21.48 6. Charity and Charitable Remainder Trusts

Because a traditional IRA and its beneficiaries may be subject to extraordinary tax liabilities, clients with large traditional IRAs should strongly consider the possibility of making a transfer to charity. Indeed, if the client wishes to make a gift to charity in any event, it is usually important to make the IRA the source of the gift rather than using property that is not subject to the same potential income tax liabilities. Otherwise the gift to charity will not simultaneously reduce the potential income tax liabilities. In IRS Letter Rulings 200633009, 200520004, and 200452004, the IRS favorably ruled that the assignment of IRAs and deferred annuity contracts to a charitable organization in satisfaction of its share of the decedent's residuary estate would not cause the estate or any beneficiary of the estate to have any taxable income.

If a charity is to receive only a share of an IRA, the share should be defined as a fraction rather than a dollar amount so that the IRS cannot argue that there is a recognition of IRA income as a result of funding a pecuniary gift. See §21.44. In IRS Legal Memorandum 200644020, the IRS ruled that funding pecuniary charitable gifts with shares of a decedent's IRA resulted in the distributing trust recognizing income under IRC §691(a)(2). See §13.54. The ruling further noted that no income tax deduction could be claimed by the trust because the terms of the trust did not provide for paying the charitable gifts from gross income as required by IRC §643(c). See §13.11A.

The IRA should be divided into separate shares or accounts by September 30 of the year following death so that the interest of the charity does not result in the IRA not having a designated beneficiary. Treas Reg §1.401(a)(9)-4, A-3. Alternatively, the interest of the charity can be distributed by that date.

NOTE: Direct IRA distributions to charity by persons age 70½ and older are excluded from gross income. The maximum exclusion for each year is $100,000. IRC §408(d)(8). The exclusion can be very important for any taxpayer who wishes to make charitable contributions but cannot effectively fully deduct contributions—including taxpayers who do not itemize, have already exceeded or will exceed the IRC §170 charitable deduction limitations (see chap 23), or are subject to the IRC §68 provisions that reduce allowable itemized deductions by 2 percent of income in excess of $166,800 ($83,400 for a married taxpayer filing separately) in 2009.

In some cases it may be desirable to name a charitable remainder trust (CRT) as the traditional IRA beneficiary. This will occur when the client wants to provide an income for life to a noncharitable beneficiary and also wants the charity to receive the remainder. Generally, naming a CRT as the beneficiary will result in less wealth passing to the noncharitable beneficiary than would be the case if the participant designated made the noncharitable beneficiary the designated beneficiary. This is not a situation in which the tax benefits of the CRT are likely to outweigh the cost of the charitable gift.

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§21.49 D. Converting IRA to Roth IRA Before Death

If, because of distribution rules or other circumstances, the IRA assets will be withdrawn within a short time after death, resulting in a loss of any compensating tax deferral benefits, it may be appropriate to convert the IRA to a Roth IRA and pay the income tax on the conversion contribution. IRC §408A(d)(3). See §21.16. The primary advantage of this approach is that it simplifies planning the estate. There is also a tax benefit because the income tax is fully removed from the tax base for the remaining estate tax. In contrast, estate taxes are not fully removed from the income tax base when benefits are held until death. California does not allow an income tax deduction for estate taxes paid to the United States, with the result that the California income tax can become significant when viewed as a percentage of the amount remaining after the payment of federal estate tax. See §21.22.

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§21.50 VI. PARTICULAR FACT PATTERNS

The following sections recommend specific beneficiary designation strategies, in particular fact patterns involving plan participants (and IRA owners) with spouses. The recommendations vary depending on the assumed wishes of the client, beginning with the most common case of naming the spouse when the client wants the spouse to benefit from the plan without restriction. The discussion in these sections is based on the more detailed discussion in Cluster & Tippett, *Designating Retirement Plan Beneficiaries Designations*, Estate Planning 2007, chap 6 (Cal CEB 2007).

CAUTION: In some cases, the nonparticipant spouse may want to name a beneficiary other than the participant in a will or revocable trust with respect to his or her community property interest in the retirement plan, in the event the nonparticipant spouse dies before the participant. If the plan is a qualified plan, the attorney should strongly advise the nonparticipant spouse not to do so. Courts have held that the nonparticipant spouse does not have the ability to transfer an interest in a qualified plan, and any attempt to do so will only place a cloud on the participant's rights under the plan and invite litigation. See §21.35.

For nonqualified plans, an agreement that confirms the nonparticipant spouse's community property interest in the plan may be advisable, although there is no guarantee that the IRA custodian will distribute any portion of the plan to anyone other than the participant or the participant's named beneficiaries, again placing a cloud on title to the plan. Moreover, even if the nonparticipant spouse is able to successfully pass his community property interest in the plan to beneficiaries other than the participant, estate tax may be due on the transfer. The attorney should discourage the nonparticipant spouse from naming anyone other than the participant as the beneficiary of his community property interest in the retirement plan or IRA.

For qualified plans, the nonparticipant spouse must consent to the naming of any plan beneficiary other than himself, even if the plan beneficiary is a trust for his benefit. See §21.34. The estate planning attorney should consult with the plan administrator to determine if designation of a non-spouse is permitted and, if it is, what procedural requirements must be satisfied to make the spouse's consent effective. If the spouse is amenable, a general consent may be preferable so that the participant has the flexibility to modify the plan beneficiaries in the future without obtaining another consent. The spouse may need to be represented by independent counsel.

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§21.51 A. Client Wants Surviving Spouse to Benefit from Plan Without Restriction

The attorney's job is relatively easy if the client wants her surviving spouse to be the beneficiary of the retirement plan and is willing to allow the surviving spouse to have complete control over the plan, including the ability to withdraw all of the plan assets during his lifetime and to select his own beneficiary to receive the assets remaining in the plan at his subsequent death. In that case, the participant's spouse is named as the primary beneficiary of the retirement plan.

CAUTION: Naming the revocable trust as beneficiary on the assumption that the trustee can then allocate the retirement plan to the surviving spouse may prevent the surviving spouse from rolling over the retirement plan, because the plan may be considered to have passed to the surviving spouse from the trust and not from the participant. See §21.44.

After the participant's death, the surviving spouse would have the option of rolling over the plan.

- *Rollover*. If the surviving spouse elects to roll over the plan, (i) minimum required distributions under the plan do not have to start until the spouse turns age 70½ ; (ii) the Uniform Life Table (rather than the Single Life Table) is used to calculate his life expectancy, resulting in a longer pay-out period and greater deferral of income; and (iii) the spouse can name his own designated beneficiary to receive the plan after his death. The designated beneficiary can then use his or her own life expectancy (rather than the surviving spouse's life expectancy) in determining the minimum required distributions for his or her lifetime.
- *No Rollover Before RBD*. If the surviving spouse elects *not* to roll over the plan, and the participant dies *before* the required beginning date, distributions under the plan must commence by the later of December 31 of the year after the year in which the participant died or December 31 of the year in which the participant would have turned age 70½. Minimum required distributions are calculated on the basis of the surviving spouse's life expectancy.
- *No Rollover After RBD*. If the surviving spouse elects *not* to roll over the plan, and the participant dies *after* the required beginning date, distributions under the plan must commence by December 31 of the year after the year in which the participant died. Minimum required distributions will be calculated on the basis of the surviving spouse's life expectancy or the participant's life expectancy as of the date of her death, whichever is longer.

If the client wants other beneficiaries to receive a portion of the plan, see discussion in §21.55. Other primary beneficiaries can be named along with the surviving spouse, and it may be advisable to direct that separate accounts be created for the surviving spouse and each other primary beneficiary.

PRACTICE TIP: If the participant wants the surviving spouse to be the beneficiary of the retirement plan, but there are insufficient non-retirement plan assets to fully fund the credit shelter trust (see §21.61), it may be prudent to name the surviving spouse as the primary beneficiary and to name the credit shelter trust as the contingent beneficiary, thereby permitting the surviving spouse to disclaim a portion of the plan to fund the credit shelter trust, if this is deemed advisable after the participant's death.

Careful consideration should also be given to the selection of contingent beneficiaries, who will receive the retirement plan if the non-participant spouse predeceases the participant spouse. Failure to name a contingent beneficiary will cause the plan to pass to the default beneficiary under the plan if the primary beneficiary predeceases the participant spouse. The default beneficiary is often the participant's estate, which can result in the plan being subject to probate and also in forfeiture of designated beneficiary status. See §21.41.

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§21.52 B. Client Wants Surviving Spouse to Benefit but Does Not Want Surviving Spouse to Control Plan

When the client wants the surviving spouse to receive retirement plan distributions but does not want him to be able to accelerate plan distributions or designate his own beneficiary to receive any assets remaining in the plan at his death, a trust must be named as the beneficiary of the plan. On naming a subtrust of the participant's revocable trust as beneficiary of the plan, see §21.53. For additional considerations in naming the selected trust, see §21.54.

NOTE: Naming a trust as beneficiary of the retirement plan prevents the participant from using the joint life expectancy table during her own lifetime, an attractive feature that would be available if the participant's spouse is more than 10 years younger than the participant and were named as the plan beneficiary. This may be a significant disadvantage. See §21.29.

For the reasons discussed below, a trust for the benefit of the participant's surviving spouse should be named as beneficiary of a retirement plan only if the client is insistent that the surviving spouse not control the plan distributions. In that case, a QTIP marital trust may be the least unpleasant alternative.

If the participant expresses an interest in charitable gifts at death, the estate planning attorney should consider the use of a QTIP marital trust that qualifies as a charitable remainder trust. See §21.65.

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§21.53 1. Naming Subtrust as Beneficiary of Plan

As noted in §21.44, it is generally desirable to identify which trust or "subtrust" under the couple's revocable trust will be the beneficiary of the retirement plan. In a classic estate plan that provides only for the surviving spouse and the couple's children, the surviving spouse will be the oldest beneficiary anyway, and naming the revocable trust rather than a specific subtrust might not, in itself, create any additional problems. But the attorney should be careful if there are any beneficiaries of the revocable trust who are older than the surviving spouse. In a typical estate plan, the trusts that would be the candidates to serve as beneficiary of the retirement plan would be the credit shelter trust, a QTIP marital trust or a non-QTIP marital trust.

- *Credit Shelter Trust*. Allocating items of IRD (income in respect of a decedent) such as retirement plans to a credit shelter trust is generally not tax efficient because the participant's estate tax exemption is effectively wasted paying income tax on the distributions from the plan. See §21.46.
- *Non-QTIP Marital Trust*. One problem with naming a non-QTIP marital trust as the beneficiary of a retirement plan is that most clients simply do not want a non-QTIP marital trust. They would rather defer payment of estate tax until the death of the surviving spouse. If a non-QTIP marital trust is named as the beneficiary of the IRA, estate tax will be due on the IRA assets at the death of the participant.
- *QTIP Marital Trust*. To qualify for the unlimited marital deduction, a QTIP trust must distribute all trust income to the surviving spouse annually. A QTIP trust that holds a retirement plan must distribute not only all trust income, but also all income generated by the retirement plan. This means that each year the trustee of the trust must withdraw the greater of the plan's minimum required distributions and the plan income, which diminishes the benefits of tax deferral if the plan income exceeds the minimum required distributions. See §21.45.

If the credit shelter trust is named as the beneficiary of the retirement plan, it must of course be a qualifying trust to defer plan distributions over a period longer than the participant's life expectancy (measured as of the date of her death). This means that the trust must be either a "conduit trust," which passes all plan distributions through to the surviving spouse and would thereby unnecessarily augment the survivor's estate, or an "accumulation trust" with all of its attendant complexities. See Oldest Beneficiary Problem in §21.44.

If an item of IRD, such as a retirement plan, is used to satisfy a gift of a pecuniary amount, then the realization of income attributable to that item is accelerated. Thus, if a marital trust is named as the beneficiary of the retirement plan, it should not be a pecuniary marital trust, and if a credit shelter trust is named as beneficiary, it should not be a pecuniary credit shelter trust. See Pecuniary Gift Problem in §21.44.

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§21.54 2. Additional Considerations in Naming Subtrust as Beneficiary of Plan

Whichever type of subtrust is chosen as the beneficiary of the retirement plan, a separate trust (*e.g.*, the "Retirement Plan QTIP Marital Trust") should be created to hold the retirement plan, unless the regular QTIP marital trust would qualify as a conduit trust anyway. See §21.53. If a separate trust is created, the trust instrument should provide that no estate taxes, administrative expenses, or debts of the participant may be paid from it. The trust instrument should also specify from which QTIP trust discretionary distributions of principal should be made first.

PRACTICE TIP: To maximize income tax deferral, care should be taken that: (1) all beneficiaries of the trust are individuals (*i.e.*, no charities); (2) the ages of all beneficiaries of the trust are identifiable (*e.g.*, no power of appointment may be exercised in favor of an unidentified "spouse" of a descendant); and (3) the surviving spouse is the oldest beneficiary of the trust. For IRAs, consideration should be given to using a trusteed IRA to simplify the process and keep costs down.

The specific subtrust should be identified as the plan beneficiary in the plan itself as well as in the revocable trust. The trust should specify what portion of each plan distribution will constitute trust income in a manner that complies with QTIP requirements. If the nonparticipant spouse is not a U.S. citizen, the trust must be a Qualified Domestic Trust (QDOT) to obtain the unlimited marital deduction for estate tax purposes. See §§17.74-17.78.

Consideration should be given as to whether the surviving spouse should serve as trustee of the trust. If he does serve as trustee, he might be in a position to arrange for distribution of the entire plan to the trust. If the surviving spouse, as trustee, has the authority to distribute principal to himself, as beneficiary, the participant's desire to restrict the surviving spouse's access to the plan assets might be thwarted. Similarly, even if the plan assets are not distributed to the surviving spouse, if the surviving spouse has a power of appointment over the trust, the participant's dispositive desires might still be thwarted.

Careful consideration should also be given to the selection of contingent beneficiaries, who will receive the retirement plan if the nonparticipant spouse predeceases the participant, in which case no marital or credit shelter trust will be created at the participant's death. Failure to name a contingent beneficiary will cause the retirement plan to pass to the default beneficiary under the plan if the subtrust that is named as the primary beneficiary is not created. The default beneficiary is often the participant's estate, which can result in the plan being subject to probate and also in forfeiture of designated beneficiary status. See §21.41.

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§21.55 C. Client Wants Non-Spouse Beneficiary to Benefit from Plan Without Restriction

As noted in §21.51, the attorney's job is relatively easy if the client is willing to allow a non-spouse beneficiary to have complete control over the plan, including the ability to withdraw all of the plan assets and to select his or her own beneficiary to receive the assets remaining in the plan at his or her subsequent death. In that case, the individual selected by the client would be named as the primary beneficiary of the retirement plan. However, the participant's spouse must consent to the beneficiary designation in the case of a qualified plan.

Minimum distributions will be determined as follows:

- If the participant dies *before* her required beginning date, distributions under the plan must commence by December 31 of the year after the year in which the participant died. Minimum required distributions are calculated on the basis of the designated beneficiary's life expectancy. Alternatively, the designated beneficiary may elect the 5-year rule if the plan permits.
- If the participant dies *after* her required beginning date, distributions under the plan must commence by December 31 of the year after the year in which the participant died. Minimum required distributions are calculated on the basis of the designated beneficiary's life expectancy or the participant's life expectancy as of the date of her death, whichever is longer.

If the individual is a minor, consider naming a custodian under the California Uniform Transfers to Minors Act (CUTMA) as the plan beneficiary. See §8.26.

The estate planning attorney should make sure the estate tax allocation clause in the revocable trust is consistent with the retirement plan beneficiary designation and the client's wishes in that regard. Bear in mind that requiring that estate tax be paid from the plan assets will trigger early recognition of income, thereby undermining tax deferral opportunities.

PRACTICE TIP: If a qualified plan requires a lump sum distribution upon the death of the participant, a designated beneficiary may roll over the qualified plan into an inherited IRA and take distributions over the longer of the beneficiary's life expectancy and the participant's life expectancy (measured as of the date of her death). See §21.12. In this case, the participant may want to create a "dry IRA" during her lifetime and name the same beneficiary for both the qualified plan and the IRA.

Careful consideration should be given to the selection of contingent beneficiaries, who will receive the retirement plan if the primary beneficiary predeceases the participant. Failure to name a contingent beneficiary will cause the plan to pass to the default beneficiary under the plan if the primary beneficiary predeceases the participant. The default beneficiary is often the participant's estate, which can result in the plan being subject to probate and also in forfeiture of designated beneficiary status. See §21.41.

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§21.56 D. Client Wants Non-Spouse Beneficiary to Benefit but Does Not Want Beneficiary to Control Plan

When the client wants an individual to receive retirement plan distributions but does not want that individual to be able to accelerate plan distributions or designate his or her own beneficiary to receive any assets remaining in the plan at his or her death, a trust must be named as the beneficiary of the plan. However, the participant's spouse must consent to the beneficiary designation in the case of a qualified plan. On naming a trust as beneficiary of the plan, see §21.57. For additional considerations in naming a trust, see §21.58.

Minimum distributions will be determined as follows:

- If the participant dies *before* her required beginning date, distributions under the plan must commence by December 31 of the year after the year in which the participant died. Minimum required distributions are calculated on the basis of the oldest trust beneficiary's life expectancy. Alternatively, the trustee of the trust may elect to take payments under the 5-year rule, if the plan permits. If the trust is not a qualifying trust, payments must be made under the 5-year rule. See Designated Beneficiary Problem in §21.44.
- If the participant dies *after* her required beginning date, distributions under the plan must commence by December 31 of the year after the year in which the participant died. Minimum required distributions are calculated on the basis of the oldest trust beneficiary's life expectancy or the participant's life expectancy as of the date of her death, whichever is longer. If the trust is not a qualifying trust, payments are based on the participant's life expectancy (measured as of the date of her death). See Oldest Beneficiary Problem in §21.44.

If the individual is a minor and the portion of the retirement plan passing to him or her is not large, consider naming a custodian under the California Uniform Transfers to Minors Act (CUTMA) as the plan beneficiary. See §8.26.

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§21.57 1. Naming Trust as Beneficiary of Plan

The specific trust or subtrust that will hold the retirement plan should be identified as the plan beneficiary both in the plan beneficiary designation and in the revocable trust. In most cases, efforts should be made to qualify the trust only if the retirement plan represents a significant portion of the family's assets. This means that the trust must be either a "conduit trust," which tends to subvert the reason a trust is being named as the plan beneficiary in the first place (*i.e.*, the participant's desire that the trust beneficiary not receive all of the plan distributions during his or her lifetime), or an "accumulation trust" with all of its attendant complexities. If the trust is to be a qualifying trust, a separate trust should be created to hold the retirement plan unless another qualifying trust will otherwise exist. The separate trust should provide that no estate taxes, administrative expenses or debts of the participant may be paid from it.

The estate planning attorney should make sure the estate tax allocation clause in the revocable trust is consistent with the retirement plan beneficiary designation and the client's wishes in that regard. Bear in mind that requiring that estate tax be paid from the plan assets will trigger early recognition of income, thereby undermining tax deferral opportunities.

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§21.58 2. Additional Considerations in Naming Trust as Beneficiary of Plan

The trust should not be funded with a pecuniary amount. If an item of IRD, such as a retirement plan, is used to satisfy a gift of a pecuniary amount, then the realization of income attributable to that item is accelerated. To maximize income tax deferral, care should be taken that (1) all beneficiaries of the trust are individuals (*i.e.,* no charities); (2) the ages of all beneficiaries of the trust are identifiable (*e.g.,* no power of appointment may be exercised in favor of an unidentified "spouse" of a descendant); and (3) the primary trust beneficiary is the oldest trust beneficiary. The trust should specify what portion of each plan distribution will constitute trust income or should give the trustee the discretion to make that determination. For IRAs, consideration should be given to using a Trusteed IRA to simplify the process and keep costs down.

Consideration should be given as to whether the trust beneficiary should serve as trustee of the trust. If the trust beneficiary does serve as trustee, he or she might be in a position to arrange for distribution of the entire plan to the trust. If the trust beneficiary, as trustee, has the authority to distribute principal to himself or herself, the Participant's desire to restrict the trust beneficiary's access to the retirement plan assets might thereby be thwarted. Similarly, even if the plan assets are not distributed to the trust beneficiary, if the trust beneficiary has a power of appointment over the trust, the participant's dispositive desires might still be thwarted.

Careful consideration should be given to selection of the remainder beneficiaries who will receive the plan distributions after the income beneficiary dies. If the income beneficiary predeceases the participant, the participant may prefer not to have the trust created at all, in which case careful consideration should also be given to the selection of contingent plan beneficiaries. Failure to name a contingent beneficiary will cause the plan to pass to the default beneficiary under the plan if the trust that is named as the primary beneficiary is not created. The default beneficiary is often the participant's estate, which can result in the plan being subject to probate and also in forfeiture of designated beneficiary status. See §21.41.

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§21.59 E. Client Wants Multiple Beneficiaries to Benefit from Plan Without Restriction

Naming multiple beneficiaries of a retirement plan or IRA does not generally maximize income tax deferral. But fortunately the solution is relatively easy. The problem with naming multiple beneficiaries of the plan is that, if all of the plan beneficiaries are individuals, the pay-out period and the minimum required distributions will be determined by looking at the life expectancy of the oldest plan beneficiary, which means that younger beneficiaries may have to take distributions more quickly than if the payout period were based on their own life expectancies. See §21.30. If not all of the beneficiaries are individuals, the plan has no "designated beneficiary" and minimum required distributions are made based on the participant's life expectancy (measured as of the date of the participant's death) or, if the participant died before her required beginning date, all payments must be made under the 5-year rule. In either case, the beneficiaries fail to realize the full benefits of income tax deferral. See §21.41.

One way to avoid these results is to divide the plan into separate accounts such that minimum required distributions for each designated beneficiary are based upon the longer of his or her own life expectancy and the participant's life expectancy (or, if the participant died before the required beginning date, only on the designated beneficiary's life expectancy). If separate accounts are not created during the participant's lifetime, the separate accounts must be established by December 31 of the year after the year in which the participant died. Accordingly, the attorney should advise the client to name the multiple beneficiaries selected by the client and direct that separate accounts be created for each beneficiary. (The beneficiaries need not be specifically named. For example: "The issue of Mary Jones by right of representation.") While "separate account direction" in the plan itself is not necessary to create the separate accounts, it may facilitate the process after the participant's death.

PRACTICE TIP: If the plan is not divided into separate accounts, it may nonetheless be possible to maximize income tax deferral by arranging to have certain beneficiaries disclaim their interests or by making distributions to certain beneficiaries no later than September 30 of the year after the year in which the participant died. See §21.47.

If a qualified plan requires a lump sum distribution upon the death of the participant, a designated beneficiary may roll over the qualified plan into an inherited IRA and take distributions over the longer of the beneficiary's life expectancy and the participant's life expectancy (measured as of the date of her death). In this case, the participant may want to create "dry IRAs" during her lifetime and name the same beneficiaries for both the qualified plan and the IRAs.

The estate planning attorney should make sure the estate tax allocation clause in the revocable trust is consistent with the retirement plan beneficiary designation and the client's wishes in that regard. Bear in mind that requiring that estate tax be paid from the plan assets will trigger early recognition of income, thereby undermining tax deferral opportunities. When multiple beneficiaries are named, the beneficiary designation should be drafted to provide for the possibility that one or more of the beneficiaries will predecease the participant, and consideration should also be given to the selection of contingent beneficiaries.

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§21.60 F. Client Wants Multiple Beneficiaries to Benefit but Does Not Want Them to Control Plan

This fact pattern is essentially a hybrid of fact patterns discussed above. Trusts must be created for the intended beneficiaries of the retirement plan (see §21.56) and a separate account should be created for each beneficiary's trust (see §21.59).

Each separate share trust will have its own account for which the minimum required distributions are based upon the life expectancy of the oldest trust beneficiary. To get "separate account" treatment, the separate accounts must be established by December 31 of the year after the year in which the participant died.

- To satisfy the participant's desire that the beneficiaries' access to the plan be restricted, consideration should be given as to whether the beneficiary should serve as trustee of the trust. Similarly, even if the plan assets are not distributed to the beneficiary, if the beneficiary has a power of appointment over the trust, the participant's dispositive desires might still be thwarted.
- The trust must be a qualifying trust to defer plan distributions over a period longer than the participant's life expectancy. This means that the trust must be either a "conduit trust," which tends to subvert the reason a trust is being named as the plan beneficiary in the first place, or an "accumulation trust" with all of its attendant complexities. If income tax deferral is not an objective, the trust need not be a qualifying trust.

The specific separate share trusts should be identified as the retirement plan beneficiaries in the plan beneficiary designation as well as in the participant's revocable trust. In most cases, efforts should be made to qualify the separate share trusts only if the retirement plan represents a significant portion of the family's assets.

PRACTICE TIP: Even outside the retirement plan context, separate share trusts are administratively easier to work with than pot trusts. When a retirement plan is to be held in trust for multiple beneficiaries, therefore, it only makes sense to create a separate share trust for each beneficiary so that the separate account rule can be utilized.

None of the trusts should be funded with a pecuniary amount. If an item of IRD, such as a retirement plan, is used to satisfy a gift of a pecuniary amount, then the realization of income attributable to that item is accelerated. To maximize income tax deferral, care should be taken that (1) all beneficiaries of the trusts are individuals (*e.g.,* no charities); (2) the ages of all beneficiaries of the trusts are identifiable (*e.g.,* no power of appointment may be exercised in favor of an unidentified "spouse" of a descendant); and (3) the primary beneficiary of each trust is the oldest beneficiary of that trust.

The trusts should specify what portion of each plan distribution will constitute trust income or should give the trustee the discretion to make that determination. The estate planning attorney should make sure the estate tax allocation clause in the participant's revocable trust is consistent with the retirement plan beneficiary designation and the client's wishes in that regard. Bear in mind that requiring that estate tax be paid from the plan assets will trigger early recognition of income, thereby undermining tax deferral opportunities.

If a qualified plan requires a lump sum distribution upon the death of the participant, a qualifying trust may roll over the qualified plan into an inherited IRA and take distributions over the longer of the oldest trust beneficiary's life expectancy and the participant's life expectancy (measured as of the date of her death). See §21.12. In that case, the participant may want to create a "dry IRA" during her lifetime and name the trusts as beneficiaries of both the qualified plan and the IRA.

When multiple trusts are named as beneficiaries, the beneficiary designation should be drafted to provide for the possibility that one or more of the primary trust beneficiaries will predecease the participant, in which case the trust(s) for those beneficiaries might not need to be created at all. Consideration should then be given to the selection of contingent beneficiaries.

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§21.61 G. Plan Must Go Into Client's Revocable Trust

In some cases, the client needs to have, or will insist on having, her revocable trust named as the beneficiary of the retirement plan, with the plan being distributed under the trust's residuary clause. For example, the client might be unsure of the value of her estate and might be concerned that leaving the retirement plan to particular beneficiaries will result in an allocation of assets among the estate beneficiaries different from what she desires. Or the revocable trust might be named as beneficiary of the plan with the plan being allocated as the trustee determines is most appropriate, as may occur when the participant's share of the couple's non-retirement plan assets is insufficient to fully fund the credit shelter trust.

As discussed in §21.53, at least two unfortunate results may occur if a revocable trust is named as the beneficiary of a retirement plan. First, if the participant's debts, expenses of administration, and estate taxes are payable from the revocable trust, the IRS may take the position that the participant's estate is the beneficiary of the retirement plan, thereby precluding the trust from enjoying "designated beneficiary" status. Second, even if the trust does have designated beneficiary status, all beneficiaries of the revocable trust will be counted in determining the oldest beneficiary for purposes of setting the minimum required distributions, thereby potentially forfeiting maximum income tax deferral.

CAUTION 1: Naming the revocable trust as beneficiary on the assumption that the trustee can then allocate the retirement plan to the surviving spouse may prevent the surviving spouse from rolling over the retirement plan because the plan may be considered to have passed to the surviving spouse from the trust and not from the participant.

CAUTION 2: Naming the participant's revocable trust as the retirement plan beneficiary, which might make sense in some circumstances, is not the same thing as naming the participant's estate, which will almost never make sense. Naming the estate as the beneficiary will not only cause the retirement plan to go through probate. It will also automatically preclude the ultimate beneficiaries of the plan from being designated beneficiaries, thereby potentially forfeiting maximum income tax deferral.

Accordingly, the attorney should advise the client to name the revocable trust as the beneficiary of the retirement plan only if necessary. To preserve "designated beneficiary" status, the attorney should consider creating a separate revocable trust to hold the retirement plan from which no estate taxes, administrative expenses or debts of the participant may be paid. In most cases, efforts should be made to preserve designated beneficiary status only if the retirement plan represents a significant portion of the family's assets.

- If an item of IRD, such as a retirement plan, is used to satisfy a gift of a pecuniary amount, the realization of income attributable to that item is accelerated. Therefore, the trust that is to receive the retirement plan must not be funded with a pecuniary amount.
- If the reason the revocable trust is named as the plan beneficiary is that it cannot be determined at the planning stage whether the plan should be allocated to the credit shelter trust or the marital trust, the division of assets between the credit shelter trust and the marital trust should be made on a fractional share basis rather than on a pecuniary/residuary basis.

If the retirement plan falls to the residue of the revocable trust and the residue passes to several persons, separate accounts should be established post-mortem for those beneficiaries. See §21.55. If the retirement plan falls to the residue of the revocable trust and the residue passes to a pot trust, the terms of the pot trust should be drafted to ensure that the trust is a qualifying trust if income tax deferral is important to the client.

PRACTICE TIP: If a qualified plan requires a lump sum distribution upon the death of the participant, a qualifying trust may roll over the qualified plan into an inherited IRA and take distributions over the longer of the oldest trust beneficiary's life expectancy and the participant's life expectancy (measured as of the date of her death). See §21.12. In that case, the participant may want to create a "dry IRA" during her lifetime, make sure that her

revocable trust is a qualifying trust, and name the revocable trust the trusts as beneficiary of both the qualified plan and the IRA.

For qualified plans, the nonparticipant spouse must consent to the naming of any retirement plan beneficiary other than the spouse. The estate planning attorney should consult with the plan administrator to determine if designation of a non-spouse is permitted and, if it is, what procedural requirements must be satisfied to make the spouse's consent effective. See §21.50.

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§21.62 H. Client Wants Charity to Benefit from Plan

Because retirement plan assets usually generate IRD, the aggregate income and estate tax liability for retirement plan assets may be greater than 70 percent. As a result, it has long been axiomatic among many estate planning attorneys that retirement plan assets are ideal to satisfy bequests to charities because retirement plan assets may be distributed to charities after the participant's death free of both income and estate tax liability. Accordingly, if the client expresses an interest in making a gift to a charity, the estate planning attorney should consider whether the gift may be most effectively made, in whole or in part, from the client's retirement plan assets. See §21.48.

The most direct and efficient way to leave retirement plan assets to charity at the participant's death is for the participant to designate the charity as the sole primary beneficiary of her retirement plan. See §21.63. If the client wishes to designate multiple retirement plan beneficiaries including a charity, consider dividing the retirement plan into separate accounts during the client's lifetime, if permitted. However, in certain situations the participant may need to designate a trust as beneficiary of the plan and name the charity as a beneficiary of the trust. See §21.64.

PRACTICE TIP: Charitable gifts of retirement plan assets to charitable lead trusts or pooled income funds should be avoided because neither form of charitable entity is exempt from income tax upon receipt of retirement plan assets. In all cases, the estate planning attorney must keep in mind that the rules regarding the administration of charities are subject to frequent revision which may impact the client's selection of the type of charity to benefit.

If the client wants to provide for an income stream for an individual and would also like to make a gift to charity, consider designating a charitable remainder trust as the retirement plan beneficiary. See §21.65. The retirement plan assets will pass to the CRT free of income taxes, and the client will receive an estate tax deduction for the value of the portion of the plan passing to the charity.

For purposes of making charitable gifts of retirement plan assets not all types of charities are treated equally. Generally, charitable gifts of retirement plan assets may be safely made to public charities, private foundations, charitable remainder trusts, gift annuities and donor-advised funds. Where the recipient charity may not be established during the participant's lifetime or the participant wishes to leave the selection of charities to be made after her death, the participant should consider designating a donor-advised fund as the plan beneficiary after reviewing any recent changes to the law regarding the administration of donor-advised funds.

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§21.63 1. Naming Charity as Beneficiary of Plan

In any scenario that involves designating a charity as a retirement plan beneficiary along with individual beneficiaries, the situation is complicated by the fact that the charity is not a designated beneficiary. Because the charity is not a designated beneficiary, the charity's interest in the retirement plan must be segregated from the interests of the individual beneficiaries to maximize income tax deferral for the individual beneficiaries.

If the participant designates a charity as a fractional share beneficiary of the retirement plan along with one or more individual beneficiaries, the participant should divide the retirement plan to create a separate account for the charitable beneficiary during her lifetime or the estate planning attorney must arrange for either (i) distribution of the charity's share of the retirement plan assets by September 30 of the year after the year in which the participant died, or (ii) division of the retirement plan into separate accounts by December 31 of the year after the year in which the participant died.

If the participant wants a charity to receive a pecuniary interest in her retirement plan, and individual beneficiaries to receive the balance, she may establish a separate account for the charity during her lifetime, assuming the plan administrator allows it.

Alternatively, the participant may designate a charity to receive a pecuniary gift of the retirement plan assets, with the remainder to be distributed to individual beneficiaries. The estate planning attorney should ensure that the participant makes it clear on the beneficiary designation form whether the charity will share in post-death fluctuations in the plan's value. If the charity is named to receive a pecuniary gift of the plan assets, the charity's share must (i) be allocated to a separate account by December 31 of the year after the year in which the participant died (if the charity shares in post-death gain or loss), or (ii) be paid out by September 30 of the year after the year in which the participant died (in either event).

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§21.64 2. Naming Trust as Beneficiary of Plan and Naming Charity as Beneficiary of Trust

If the participant wishes to allocate some or all of her retirement plan assets to a charity, it is almost always preferable to designate the charity as a direct beneficiary of the retirement plan. See §21.63. However, in certain situations, the attorney may determine that the only way to accommodate the participant's wishes is to designate the trust as the plan beneficiary and the charity as a beneficiary of the trust, *e.g.*, the participant wishes to leave her retirement plan assets to be distributed along with other trust assets under a formula which includes both individual and charitable beneficiaries and will not be calculated until after the participant's death, or the participant wishes to a designate a charity as a residuary beneficiary of her trust estate and the residue may include retirement plan assets.

In the case where the charity is named along with individuals as beneficiaries of the trust, the charity qualifies for distribution at the participant's death, the trust is named as the retirement plan beneficiary, and retirement plan assets will be used to fund the gift to the charity, distribution of the retirement plan assets to the charity must be made by September 30 of the year following the year of the participant's death to allow the individual beneficiaries to maximize income tax deferral on their portion of the retirement plan.

In the case where the charity will be designated as a remainder beneficiary of the participant's trust, and the trust will be named as the plan beneficiary, and the trust will not qualify as a charitable remainder trust (see §21.65), the estate planning attorney must provide for the segregation of retirement plan assets in the trust document. The participant must decide whether the trust will:

- Provide that all retirement plan benefits will be payable directly to the trusts that benefit only individuals, thus preserving the maximum income tax deferral for individual beneficiaries, or
- Provide that all gifts to charities be funded first with retirement plan assets, so that the retirement plan assets pass free of income and estate taxes.

In some cases, either result may be facilitated by planning for the creation of separate trusts to receive retirement plan assets and non-retirement plan assets. If the estate planning attorney is uncertain that the amount of retirement plan assets available at the time of distribution will warrant the administrative cost of establishing separate trusts, the trust may be drafted to provide for the establishment of separate trusts only if retirement plan assets are in excess of a designated minimum value.

PRACTICE TIP: Where the gift to the charity under the trust is a pecuniary gift, and that gift may be funded with retirement plan assets, the estate planning attorney should provide in the trust document that the gift to the charity must be funded, to the extent possible, with retirement plan assets in order to avoid income tax realization.

If a trust is designated as the retirement plan beneficiary and a charity is a beneficiary of the trust, along with one or more individuals, to receive distributions upon the client's death, the trustee should be given the authority in the trust to provide for the designation of the charity as the retirement plan beneficiary. The retirement plan interest should be assigned directly to the charity to prevent income tax from being realized at the trust level.

The estate planning attorney should make sure the estate tax allocation clause in the participant's revocable trust is consistent with the retirement plan beneficiary designation and the client's wishes in that regard. Bear in mind that requiring that estate tax be paid from the plan assets will trigger early recognition of income, thereby undermining tax deferral opportunities. This may create an especially complicated situation where a charity is named as the residuary beneficiary in the revocable trust.

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§21.65 3. Naming Charitable Remainder Trust as Beneficiary of Plan

If the participant expresses interest in establishing a charitable remainder trust (CRT), designating the CRT as the retirement plan beneficiary may be an attractive option because the CRT pays no income tax upon receipt of the retirement plan assets. See chap 24. Thus, the CRT's individual beneficiary will receive life income from the CRT generated by the full value of the transferred retirement plan assets. In addition, certain investment strategies will permit the individual beneficiary to take advantage of the four-tier CRT accounting structure to push through ordinary income in the early years of the CRT and allow for later distributions to the individual beneficiary to be taxed at capital gains rates, so that the CRT's individual beneficiary may achieve a more tax efficient net result than if the retirement plan assets had been distributed to the individual beneficiary directly. See Finestone, *Charitable Remainder Trusts at 37*, Estate Planning 2007, chap 9 (Cal CEB 2007).

If the participant names the nonparticipant spouse as the sole individual beneficiary, the CRT may qualify as a QTIP marital trust, allowing all retirement assets allocated to the CRT to pass free of estate and income taxes and enabling the participant to direct the disposition of any retirement plan benefits remaining at the surviving spouse's death to one or more charities of her choosing. See §17.36.

CRTs may also be appropriate where the participant wishes to provide a life income stream for multiple beneficiaries (because cashing out the retirement plan assets to the CRT without paying income tax eliminates the problem of coordinating the minimum required distribution among several beneficiaries) or where the retirement plan offers only a lump sum distribution (because the annual payout from the CRT approximates the long-term payout of a deferred retirement plan).

However, there are disadvantages to using retirement plan assets to fund a CRT. In cases where someone other than the surviving spouse is named as the CRT's income beneficiary, the estate tax deduction to the participant's estate will be reduced by the actuarial value of the income beneficiary's interest in the CRT. Moreover, under prevailing guidance from the IRS, the IRC §691(c) income tax deduction for any estate tax attributable to the retirement plan assets may be lost when retirement plan assets are transferred to a CRT. See Treas Reg §1.691(c)-1(a)(2); Rev Rul 67-242, 1967-2 Cum Bull 227; *Thomas M. Chastain* (1972) 59 TC 461, acq in part and nonacq in part 1978-1 Cum Bull 1, 3; Ferguson, Freeland & Ascher, Federal Income Taxation of Estates, Trusts, and Beneficiaries §3.07[B][3] (3d ed 1999). In some cases, a bequest of retirement plan assets to a CRT to benefit a young child or multiple beneficiaries may be prevented by the requirement that at least 10 percent of the value transferred to the CRT must represent the charity's remainder interest.

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21A

IRC §529 College Savings Accounts

Genevieve M. Moore

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I. PAYING FOR HIGHER EDUCATION

§21A.1 A. Costs of Education

The cost of higher education is significant, and growing. Tuition and fees currently average $26,273 per year for private universities and $7,020 for in-state public universities (average figures for 2009-2010), and exceed $35,000 per year at some institutions. See http://www.collegeboard.com. These figures are rising annually, often significantly in excess of the rate of inflation. These figures also do not take into account the cost of room and board and other living expenses.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.2 B. Available Payment Options

§21A.2 B. Available Payment Options

For years, families have employed different methods to save for and pay for these higher education costs. These methods include:

- Making outright payments of tuition without gift tax or generation-skipping transfer (GST) tax effect under IRC §§2503(e), 2611(b);
- Using various tax credits and deductions for qualified higher education expenses, *e.g.,* the Hope Scholarship Credit and Lifetime Learning Credit (IRC §25A), the deduction for higher education expenses under IRC §222, and the student loan interest deduction under IRC §221 (see Hamill & White, *The Interaction of Broad-Based State Scholarship Programs and Federal Education Credits*, 109 Tax Notes 515 (Oct. 24, 2005));
- Using penalty-free withdrawals from a regular IRA for education under IRC 72(t)(2)(E); and
- Establishing savings vehicles such as custodianship accounts and *Crummey* trusts. See chap 8.

Families have also been able to establish and utilize education savings accounts under IRC §530 and qualified tuition programs under IRC §529. A detailed comparison of all of the education planning options is beyond the scope of this chapter. Instead, this chapter will focus on one type of qualified tuition program, the §529 College Savings Account. The chapter will then address other factors contributors may wish to consider when contemplating an investment in a College Savings Account.

This chapter will then describe the primary differences between §529 College Savings Accounts and Coverdell Education Savings Accounts (Coverdell ESAs), formerly known as Education IRAs, under IRC §530.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.3 C. Benefits of College Savings Accounts

§21A.3 C. Benefits of College Savings Accounts

The costs of higher education can be overwhelming, and starting a savings plan early can be advantageous. The tax-deferred (and potentially tax-exempt) features of College Savings Accounts can compound the benefits of these savings plans. These flexible accounts offer significant savings potential and are a valuable addition to the array of educational planning options. The short history of College Savings Accounts has borne this out. Since 2001, account balances nationwide have climbed from about $7 billion to about $120 billion (as of December 31, 2007). Since the tax exemption on qualified withdrawals was made permanent, growth has continued at a strong pace. According to some commentators, College Savings Accounts have emerged as the best investment choice for college savings, and the question is not whether to use College Savings Accounts, but which state's plan to use.

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II. SELECTING COLLEGE SAVINGS ACCOUNTS

§21A.4 A. Two Types of Qualified Tuition Programs

Internal Revenue Code §529 authorizes states or their agencies or instrumentalities, or authorized eligible educational institutions under certain conditions, to establish and maintain two different types of qualified tuition programs: Prepaid Tuition Plan programs and College Savings Account programs.

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§21A.5 1. Prepaid Tuition Plans

Prepaid Tuition Plans permit a contributor to purchase credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses. IRC §529(b)(1)(A)(i). In a Prepaid Tuition Plan the contributor locks in tuition at today's rate. This avoids the risk that earnings on the funds invested will not grow fast enough to match tuition increases between the investment date and the beneficiary's college entrance date. Historically, Prepaid Tuition Plans have not been very flexible and have often limited the beneficiary's college choices. Some programs impose a penalty if the student uses the credits for a private or out-of-state college, reducing the return on the investment. Another limitation on Prepaid Tuition Plans is that many are only open to state residents. Recently, there have been further pressures on Prepaid Tuition Plans, many of which have had to deal with double-digit tuition increases in a period of shrinking investment returns. Many plans have begun charging a premium in addition to current tuition costs; others have begun restricting investments to younger beneficiaries (*e.g.*, under age 13) or suspended enrollment entirely. Because private institutions are now permitted to offer Prepaid Tuition Plans, this may ultimately result in more user-friendly plans and more options in this area. For example, the nonprofit Tuition Plan Consortium now offers a Prepaid Tuition Plan it calls the Independent 529 Plan on behalf of at least 300 independent colleges and universities across the country. Further information is available at http://www.independent529plan.org.

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§21A.6 2. College Savings Accounts

In a College Savings Account program, a contributor funds an account for purposes of meeting the qualified higher education expenses incurred by a designated beneficiary in the future. IRC §529(b)(1)(A)(ii). Distributions made for qualified educational expenses are tax-exempt. Traditionally, these accounts have been favored over Prepaid Tuition Plans because of their potential to produce a higher rate of return than the annual increase in college costs. Also, these accounts generally allow distributions for the costs of colleges located in any state, not just the state administering the program. While many states offer both Prepaid Tuition Plan programs and College Savings Account programs, California currently offers only a College Savings Account program, known as the Golden State ScholarShare Savings Trust. See §21A.8.

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§21A.7 B. Wide Variety Among College Savings Account Programs

All 50 states and the District of Columbia have established College Savings Account programs, although a few states have consolidated their programs with neighboring states. A state contracts with one or more institutional investment managers to manage its College Savings Account program. California now uses Fidelity Investments after several years of using the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF).

A state may operate more than one College Savings Account program, and many do. In states with multiple College Savings Account programs, different investment managers may operate the different programs. Most state programs offer more than one portfolio. Portfolios typically invest in one or more mutual funds. States may offer direct-sold plans and broker-sold plans. Investment choices vary widely, plan by plan and state by state. Unlike Prepaid Tuition Plans, College Savings Accounts are open to a state's residents and nonresidents equally, although some states that offer multiple College Savings Account programs may have one plan that is open only to residents. Because College Savings Accounts are significantly more flexible than Prepaid Tuition Plan programs, some states have converted their Prepaid Tuition Plan programs to College Savings Account programs.

Each state that offers College Savings Accounts creates and maintains its own program within the federal parameters. Each state is required to set the terms and conditions of its own program. IRC §529(b)(1). Therefore, each state chooses who may contribute, who may be a designated beneficiary, when and what benefits the program provides, the maximum amount a person may contribute, and what penalties apply. These features, varying state by state, have prompted an explosion of "forum shopping" among individuals interested in establishing College Savings Accounts and seeking the most attractive College Savings Account program to meet their needs and interests. In response to this, states are continually enhancing their College Savings Account programs to make them more attractive to investors nationwide. However, accounts established in the individual's state of residence often have significant state tax advantages. See §21A.32.

For state-by-state comparisons of College Savings Account programs, see the websites at http://www.collegesavings.org and http://www.savingforcollege.com. Meaningful comparison is difficult because of the wealth of investment options and limited historical performance data. However, because there are so many state programs with differing rules, and because the rules are changing frequently, these websites contain more current state-specific information than is found in this chapter. Investors also may wish to consult their tax advisors for advice before choosing a College Savings Account program. See IRS Publication 970, Tax Benefits for Education, for general information with respect to College Savings Accounts, Coverdell ESAs, and available credits and deductions, particularly once an investor's College Savings Account is operational.

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§21A.8 C. General Operation of College Savings Accounts

An individual contributes after-tax dollars to a state-sponsored College Savings Account program to establish an individual College Savings Account for a designated beneficiary. Depending on the state program chosen and the contributor's preference, contributions may be made through a broker or financial advisor, or directly to the College Savings Account program, and may be made in person, by mail, or in some cases online. The contributor is typically the account owner, and retains significant controls over the account, including the ability to control distributions, to change the beneficiary, and to reacquire the assets in the account. Contributions are not deductible for federal income tax purposes but are treated as completed gifts to the beneficiary that qualify for the gift tax and generation-skipping transfer (GST) tax annual exclusion. IRC §529(c)(2). With one exception (see §21A.36), the value of the contributions is removed from the contributor's gross estate for estate tax purposes. IRC §529(c)(4). See §§21A.33-21A.40.

NOTE: The performance of any College Savings Account depends on how the contributions are invested within the program. There is no guarantee that a College Savings Account will cover all of a beneficiary's qualified expenses. If the program does poorly, there may not be enough in a beneficiary's account to cover education costs.

Earnings within the College Savings Account grow tax-free until distribution. IRC §529(c)(1). If distributions are made for the beneficiary's qualified higher education expenses, then the distributed earnings are exempt from federal income tax. IRC §529(c)(3)(B). Distributions for nonqualified expenses are subject to income tax on the earnings portion at the distributee's tax rate and a 10-percent penalty. IRC §§529(c)(3)(A), (c)(6), 530(d)(4). See §§21A.24-21A.32. Note that the distributee, if a student, may be in a lower tax bracket than the account owner, reducing the potential tax in this situation. If the designated beneficiary does not use all of the funds in the account, the funds may be transferred to a new beneficiary or new account, or even possibly distributed to charity.

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§21A.9 D. California's College Savings Account Program

California offers its College Savings Account program through the Golden State ScholarShare Savings Trust. See Ed C §§69980-69990 and related tax provisions in Rev & T C §§17140-17140.3. The ScholarShare Program is open to residents and nonresidents of California. Until 2006, California used the Teachers Insurance and Annuity Association College Retirement Equities Fund (TIAA-CREF) as the asset manager for the ScholarShare accounts, but California Fidelity Investments now manages California's 529 Plan.

The ScholarShare Program allows contributors to choose one or more various index funds and actively managed funds, ranging from an annual cost of 0.5 percent per year for the index funds to 0.87 to 1.09 percent per year for the actively managed funds. California now also offers a broker-sold plan.

Comprehensive information about the ScholarShare Program is available at http://www.scholarshare.com, together with account agreements, performance results, and reporting information.

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III. REQUIREMENTS AND MECHANICS

§21A.10 A. Account Owner

Federal law requires an account owner for each College Savings Account. This person (who may or may not be the original contributor) controls the College Savings Account. He or she selects which state's College Savings Account program to invest in, chooses among the investment options, selects the designated beneficiary, decides when distributions are made, and has the power to change the beneficiary and to reacquire the account assets. See IRC §529(c)(3)(C). Federal law does not require that the account owner be an individual. Section 529(b)(1)(A) refers to the account owner only as a "person," and Prop Treas Reg §1.529-1(c) provides that "person" has the same meaning as under IRC §7701(a)(1). Section 7701(a)(1) defines "person" to include "an individual, a trust, estate, partnership, association, company or corporation." The term also includes a guardian, executor, administrator, conservator, or any person acting in a fiduciary capacity. Treas Reg §301.7701-6(a). Therefore, any of these individuals or entities could be an account owner, if permitted by state law and the governing account agreement. There may be practical difficulties with a trustee, other fiduciary, or corporation acting as account owner, however, and it is unclear how contributions would be treated from a gift tax perspective.

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§21A.11 1. Custodial Accounts

Custodial accounts under the Uniform Gift to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA) may be used to fund College Savings Accounts if state law and the account agreement permit this. Many states do not permit this, because the controls retained by an account owner under IRC §529 are incompatible with the fact that the custodial assets are irrevocably vested in the minor beneficiary under state law. California's College Savings Account program permits custodians to establish College Savings Accounts using custodial funds, but only for California custodial accounts under Prob C §§3900-3925. This requires a separate account agreement and rules. Those rules generally provide that title to the College Savings Account assets vest in the designated beneficiary at the age of majority, and that the account owner/custodian has no ability to change the designated beneficiary. There should be no gift tax ramifications on contributing custodial funds to a College Savings Account, because the gift was complete when the custodial account was created. See §21A.14, discussing requirement of cash contributions to a College Savings Account.

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§21A.12 2. Trust Ownership

Trusts may be account owners if state law and the account agreement permit this, and a majority of states do. The trust beneficiary would be the designated beneficiary of the College Savings Account; the trust itself cannot be a designated beneficiary. See §21A.13. The trustee would need specific powers under the trust agreement or state law to invest in the College Savings Account, and adhere to the Prudent Investor Rule (see Prob C §§16045-16054), the trust's standards for distributions, and trust accounting rules in managing the College Savings Account. California's College Savings Account program permits trust ownership, and has a separate account agreement for this arrangement.

Trust ownership may provide advantages in the area of additional spendthrift protection, a specified succession of account owners (*i.e.*, successor trustees), and the imposition of fiduciary duties on account owners. The trust could also be structured as a grantor trust, allowing any tax and penalties on a nonqualified distribution to be borne by the grantor as an additional tax-free gift.

One disadvantage of trust ownership is that contributors wishing to fund a College Savings Account through a trust arrangement do not have the ability to use the IRC §529(c)(2)(B) front-loading feature described in §21A.36 for gift tax purposes (allowing an amount equal to 5 years' worth of annual exclusions to be contributed in 1 year), and the trust would have to be a *Crummey* trust or an IRC §2503(c) trust for transfers to it to qualify for the gift tax annual exclusion at all. See chap 8. Also, to the extent a trust owner of a College Savings Account made nonqualifying distributions (*i.e.,* distributions for something other than qualified higher education expenses), those distributions would be subject to income tax at trust tax rates unless the distribution carries out DNI to the beneficiary or the trust is a grantor trust. IRC §529(c)(3)(A).

PRACTICE TIP: Faced with the need to make nonqualifying distributions (*e.g.,* because the trust terms require a distribution) the account owner should consider changing ownership as to some or all of the accounts to the beneficiary, thereby avoiding the tax and penalty.

Another potential disadvantage to trust ownership is the grantor's inability to reacquire the assets, if needed.

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§21A.13 B. Designated Beneficiary

Federal law requires that a College Savings Account have a designated beneficiary, and that the designated beneficiary be an individual. IRC §529(e)(1); Prop Treas Reg §1.529-1(c). The beneficiary need not be related to the account owner. The account owner may designate himself or herself as beneficiary. Under federal law, contributions are permitted for any age beneficiary, allowing contributions to be made even while the beneficiary is attending college or graduate school, and there is no requirement that an account be terminated when the beneficiary reaches a specified age. Therefore, College Savings Accounts can last as long as there is a living beneficiary, unless state law imposes age restrictions on contributions, and several states do. The designated beneficiary does not need to be notified of the existence of the College Savings Account, unless state law or the account agreement require this.

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§21A.14 C. Cash Contributions Only

Federal law requires that all contributions to College Savings Accounts must be in cash. IRC §529(b)(2); Prop Treas Reg §1.529-2(d). One reason for this requirement is to prevent individuals from using College Savings Accounts as vehicles to avoid capital gains tax on appreciated assets. There is no ability for a contributor to give other property, *e.g.,* stock, minority interests in closely held businesses, or tangible property. This reduces the ability to leverage gifts through discounting. See chap 18. This also means that any custodial assets, trust assets, or other investment assets must be sold, and the appropriate income and capital gains taxes paid, before they can be contributed to a College Savings Account. For individuals not wishing (or not able) to sell such assets, College Savings Accounts may not be a viable education planning option.

States impose their own requirements on how contributions may be made. Most allow contributions may be made by check, money order, or credit card. Contributions generally may be made by mail, online, or through a broker, depending on the specific state program. California's College Savings Account program allows contributions to be made by check, automatic deposit, electronic transfer, or payroll deduction. Each state sets its minimum contribution amount, which ranges from $15 to $1000. Some retailers and credit card companies offer programs that rebate some percent of purchases to a purchaser's College Savings Account.

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§21A.15 D. Contribution Limits

To prevent abuse, federal law requires states to establish procedures preventing contributions beyond the amount that is necessary to pay the beneficiary's qualified higher education expenses. IRC §529(b)(6); Prop Treas Reg §1.529-2(i)(1). A College Savings Account program satisfies the requirement if it will bar any additional contributions to a College Savings Account as soon as the account reaches the amount necessary to pay tuition, fees, and room and board expenses of a designated beneficiary for 5 years of undergraduate enrollment at the highest cost institution in the state. Prop Treas Reg §1.529-2(i)(2). This is determined by actuarial calculations based on the beneficiary's age.

NOTE: All accounts for a particular beneficiary within a state are aggregated in determining when the maximum contribution limit has been reached. To date, there is no federal requirement that all College Savings Accounts nationwide for a particular beneficiary be aggregated for purposes of applying a contribution limit.

Most states have established their own maximum contribution amounts, which currently range from roughly $225,000 to $350,000, with many states standing at about $300,000. Within this maximum contribution amount, many states impose *annual* contribution limits. The maximum overall contribution amounts are subject to adjustment, typically upward, as states position themselves to attract investors. Some states have received private letter rulings for their College Savings Account programs that calculate their maximum contribution limit based on 7 years of education, which is designed to take into account graduate school expenses.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.16 E. No Investment Direction

§21A.16 E. No Investment Direction

Federal law prohibits a contributor from retaining direct or indirect control over the account investments. IRC §529(b)(4); Prop Treas Reg §1.529-2(g). The contributor merely selects among the investment options available in the state program when making the initial and subsequent contributions. Some states offer more investment options than others. Most state programs offer age-based portfolios that automatically shift investments from stock funds to less risky investments as the beneficiary nears college age. Once the College Savings Account is established, subsequent changes to the account investments are limited to once per calendar year or on a change of beneficiary. Notice 2001-55, 2 Cum Bull 299.

WARNING: The authorization to permit investment changes once per year was added by the IRS to address investor concerns about loss of control of investments. Some states' College Savings Account programs have not yet incorporated this feature, so changing investments in these states' programs may not yet be possible. Prospective investors should confirm that this feature is available in a state's College Savings Account program, if the feature is desired.

Aside from these choices, an account owner may exercise no other investment direction, directly or indirectly, for the life of the College Savings Account. For some individuals, the relinquishment of investment control is viewed as a major drawback to College Savings Accounts. Custodianships and trusts offer significantly more investment control and flexibility.

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§21A.17 F. Qualified Higher Education Expenses

To be fully exempt from income tax, distributions from College Savings Accounts must be used to meet the beneficiary's qualified higher education expenses at an eligible institution of higher education. IRC §529(e)(3); Prop Treas Reg §1.529-1(c). "Qualified higher education expenses" are limited to the following:

- Tuition, fees, and the costs of books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution;
- Costs of room and board, provided that the student is carrying at least half of the course load required for full-time enrollment; and
- Expenses for special-needs services for special-needs beneficiaries incurred in connection with attendance or enrollment at an eligible educational institution.

The allowable room and board cost is geared to the institution's invoice amount for this item (whether the student lives on campus or in off-campus housing), and the parents of students living at home may be reimbursed up to $1500 per academic year. Accepted methods of distribution for qualified higher education expenses are discussed in §21A.21.

PRACTICE TIP: Although IRC §529 contemplates use of College Savings Account funds for graduate and undergraduate expenses, some programs restrict the use of funds to undergraduate education, so this is another variable that prospective investors should evaluate.

"Eligible educational institutions" are those described in §481 of the Higher Education Act of 1965 (20 USC §1088), as in those in effect on August 5, 1997, provided they are also eligible to participate in Department of Education student aid programs. Such institutions generally include accredited postsecondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level degree, or other recognized postsecondary credential. Certain proprietary institutions and postsecondary vocational institutions are also eligible. Many foreign educational institutions are recognized as eligible educational institutions. The current list of eligible educational institutions can be found on the Department of Education website at http://www.ope.ed.gov/accreditation.

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§21A.18 G. Nonqualified Distributions

If withdrawals from a College Savings Account are not applied towards qualified higher education expenses (see §21A.17), the earnings portion of the withdrawal will be taxed as ordinary income to the distributee. IRC §529(c)(3)(A); Prop Treas Reg §1.529-3(b). The distributee in this situation may be the designated beneficiary, the account owner, or (if permitted by state law or plan rules) a third party chosen by the account owner. The earnings portion of the nonqualified distribution also will be subject to a 10-percent federal penalty that must be paid by the distributee. IRC §§529(c)(6), 530(d)(4)(A). However, the penalty will not be assessed if the beneficiary of the 529 Plan is disabled. IRC §530(d)(4)(B)(ii). Taxable income is not reduced by the amount of the penalty.

NOTE: Some states have additional penalties that would apply to a nonqualified distribution, because the penalty was required to be imposed at the state level before IRC §529 was amended to include the federal penalty. However, many states with individual penalties have repealed or reduced them to remain competitive. Recent budget proposals would have imposed penalties on nonqualified distributions to the original contributor. The proposals also called for an excise tax on cumulative nonqualified distributions to someone other than the initial designated beneficiary. These proposals were designed to prevent the use of College Savings Accounts as retirement or other (non-education) savings vehicles.

The penalty is intended to deter the use of College Savings Account funds for noneducational purposes. The penalty (but not the tax) is waived if the nonqualified distribution occurs because of the death or disability of the designated beneficiary. IRC §530(d)(4)(B)(i)-(ii). Distributions made subsequent to the designated beneficiary's receipt of a scholarship also qualify for a waiver of the federal penalty, as long as the distributions do not exceed the amount of the scholarship. IRC §530(d)(4)(B)(iii).

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§21A.19 H. Changing Beneficiary

An account owner may change the designated beneficiary to any other member of the previously designated beneficiary's family at any time without any income tax consequences and without any penalty, provided that state law and the account agreement permit this. IRC §529(c)(3)(C)(ii). "Member of the family" includes the following relatives of the designated beneficiary (IRC §529(e)(2)):

- Son or daughter, or a descendant of either;
- Stepson or stepdaughter;
- Brother, sister, stepbrother, or stepsister;
- Father or mother, or an ancestor of either;
- Stepfather or stepmother;
- Son or daughter of a brother or sister;
- Brother or sister of the father or mother;
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- Spouse of the designated beneficiary or spouse of any individual described above; and
- First cousin of the designated beneficiary.

The provision including first cousins as "members of the family" should make College Savings Accounts even more attractive to grandparents who might appreciate the ability to change beneficiaries as needed among their grandchildren who are cousins (but not siblings) of one another. For purposes of determining who is a member of the family, a legally adopted child of an individual is treated as the child of such individual by blood, and the terms "brother" and "sister" include a brother or sister by the half-blood. Prop Treas Reg §1.529-1(c).

WARNING: The definition of "member of the family" does not include grandnieces or grandnephews, a descendant of a stepchild, or a spouse's niece or nephew. A transfer to someone who is not a member of the family of the original beneficiary is treated as a nonqualifying distribution, and therefore subject to tax and penalty.

This broad definition of "member of the family" offers a great deal of flexibility. For example, if the College Savings Account is initially funded for a beneficiary who decides not to go to college, or who drops out, or who completes college (or graduate school) without exhausting all of the College Savings Account, the account owner can change the beneficiary to another individual who can use the funds for qualified higher education expenses. The account holder may even select a new beneficiary of a younger generation, keeping an account invested free of income tax for another generation. This may, however, have transfer tax consequences, discussed in §§21A.33-21A.40.

This feature also allows the transfer of College Savings Account funds to another person, including the account owner, who may need the funds for noneducational expenses such as support or medical needs—keeping in mind, of course, that this type of change would generate income tax on the earnings portion of the account, as well as a 10-percent penalty on the earnings, when a distribution is made. See §21A.18. The IRS has issued an advance notice of proposed rulemaking suggesting that the IRS was developing new regulations that would impose tax on an account owner whenever funds in the account were distributed to him or her, unless the account owner could prove that he or she contributed the funds to the account. There was much criticism of this and other features of the advance notice, and the future of the proposed regulations is unclear. See §21A.23A.

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§21A.20 I. Rollover to Another College Savings Account Program

It is possible to roll over funds from one state's College Savings Account program to another state's College Savings Account program for the same designated beneficiary. This feature was intended to address contributors' concerns about a loss of investment control. The new College Savings Account must be funded within 60 days of the rollover from the old College Savings Account, or it is treated as a nonqualified distribution. IRC §529(c)(3)(C)(i). Only one of these rollovers may occur per 12-month period per College Savings Account. IRC §529(c)(3)(C)(iii). A rollover to another state's College Savings Account program can still be made at any time without adverse income tax consequences if there is a change of beneficiary. See §21A.19.

PRACTICE TIP: A rollover to another state's program may provide a useful planning device for changing account investments more than once in a year, if the account owner is comfortable changing state plans *and* changing beneficiaries.

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§21A.21 J. Methods of Distribution

For a distribution to be fully exempt from income tax, it must be made to meet the qualified higher education expenses of the designated beneficiary. See §21A.17. This result is generally accomplished in one of the following ways provided in Prop Treas Reg §1.529-2(e)(4)(ii)(A):

- Making a direct distribution to the eligible education institution;
- Writing a check payable to both the designated beneficiary and the eligible educational institution;
- Reimbursing the designated beneficiary for qualified higher education expenses, as long as sufficient documentation and receipts for payments are available; or
- Making a distribution directly to the designated beneficiary, who certifies in writing that the distribution will be expended for qualified higher education expenses within a "reasonable time" after the distribution.

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§21A.22 K. Reporting Requirements

It is unclear what requirements the Service will impose for substantiating that withdrawals from a College Savings Account were used for qualified higher education expenses. All receipts should be retained.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.23 L. No Pledging of Interest

§21A.23 L. No Pledging of Interest

No interest in a College Savings Account may be pledged as collateral or used as security for any loan. IRC §529(b)(5); Prop Treas Reg §1.529-2(h).

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§21A.23A M. Advance Notice of Proposed Rulemaking

In Announcement 2008-17, 2008-9 Int Rev Bull 512, the IRS gave advance notice of proposed rulemaking (REG-127127-05) to address perceived abuses involving 529 Plans. The notice is in the form of a lengthy narrative that outlines ways in which 529 Plans can be used for unintended purposes and indicates the general nature of proposed regulations that will be issued in the future to prevent the use of strategies perceived as abusive. The future proposed regulations will also clarify tax treatment in various situations.

WARNING: The discussion of tax considerations in this chapter is based on the current regulations and should be viewed with caution in light of the advance notice. See §§21.24-21.40.

The contemplated regulations will be issued under the authority granted by IRC 529(f): "Notwithstanding any other provision of this section, the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section and to prevent abuse of such purposes, including regulations under chapters 11, 12, and 13 of this title."

The advance notice indicates that any new rules will generally apply prospectively, but the "anti-abuse rule" discussed below may be applied retroactively in accordance with IRC §7805(b)(3).

The anti-abuse rule. The advance notice describes two situations in which the present law creates opportunities for abuse. The first situation involves the possibility that a taxpayer could make gifts to 529 Plans for ten individuals, claim ten annual gift tax exclusions, and later change the beneficiary designations for all plans so that a single individual is the beneficiary of all ten. See §21A.35. The second situation involves essentially the same facts and result, but instead of changing beneficiaries, the original "account owner" (not a statutory term) transfers account ownership to a second party who then withdraws the plan assets. The notice states:

> The IRS and the Treasury Department anticipate that the anti-abuse rule will generally follow the steps in the overall transaction by focusing on the actual source of the funds for the contribution, the person who actually contributes the cash to the section 529 account, and the person who ultimately receives any distribution from the account. If it is determined that the transaction, in whole or in part, is inconsistent with the intent of section 529 and the regulations, taxpayers will not be able to rely on the favorable tax treatment provided in section 529. The anti-abuse rule will include examples such as those set forth above that provide clear guidance to taxpayers about the types of transactions considered abusive.

Rules relating to the tax treatment of contributions to and participants in section 529 accounts. The advance notice addresses four particular tax problems. The first of these involves IRC §529(c)(5)(B), which provides that the gift and generation-skipping transfer (GST) taxes apply to a transfer by reason of a change in the designated beneficiary unless the new beneficiary is a member of the same family and the same (or higher) generation as the former beneficiary. Unfortunately, the statute does not indicate who is liable for the tax. In 1998, the IRS issued proposed regulations that generally took the view that the former beneficiary would be treated as making a transfer to the new beneficiary. See §21A.38.

That approach will now be rejected because the beneficiary has no control over the account. The advance notice indicates that the IRS is now considering a rule in which a taxable change of beneficiary will be treated as a complete distribution to the account owner followed by the creation of a new 529 account for the new beneficiary. As a consequence, the deemed distribution will be included in the account owner's income under the IRC §72 rules applicable to annuities, and an "additional tax" on distributions not used for qualified higher education expenses will be imposed in the amount of 10 percent of the taxable portion of the distribution. IRC §529(c)(6), incorporating by reference the IRC §530(d)(4) additional tax provision applicable to Coverdell Education Savings Accounts. See §21A.26. The account owner will then be treated as donor of the deemed "new" plan for gift tax purposes.

Providing no answers but asking for suggestions, the advance notice raises general concerns about the tax consequences of withdrawals by the account owner and changes in the account owner—particularly in the context of the situation described above in which gift tax exclusions are claimed for multiple 529 plans and withdrawals are made by an account owner other than the original donor. Similarly, the advance notice then seeks input on transfer tax

questions involved when trusts or other entities fund 529 plans.

Concluding this portion of the advance notice, the IRS discusses transfers to 529 plans that name the transferor as beneficiary—including transfers from uniform transfers to minor custodianships for the benefit of the minor. Generally, the IRS appears inclined to permit such transfers, but believes that there should be a deemed withdrawal and creation of a new 529 plan if there is a subsequent change of beneficiary. Special rules would apply in the event of the death of the original transferor/beneficiary.

Consistent with the proposed gift tax treatment of a change of beneficiary, the advance notice indicates that the proposed rules will provide that the value of an account generally will not be included in the gross estate of a deceased beneficiary under IRC §529(c)(4)(B). The value of the account will be included in the beneficiary's gross estate only if the account owner distributes the account to the beneficiary's estate within 6 months after the beneficiary's death. There will be a deemed withdrawal by the account owner if no successor beneficiary is named in the account contract or program and the account owner does not name a new beneficiary by the due date for filing the deceased beneficiary's estate tax return.

Rules governing the function and operation of qualified tuition plans and section 529 accounts. The advance notice addresses rules for making an IRC §529(c)(2)(B) election to have gifts to 529 plans treated as made ratably over 5 calendar years for gift tax purposes (with IRC §529(c)(4)(C) providing for estate tax inclusion of portions of the gifted amount in cases where the donor fails to survive the 5-year period). The election is to be made on a timely filed (including extensions) gift tax return. See §21A.36.

The advance notice indicates that the proposed rules will allow taxpayers to claim losses on 529 accounts as miscellaneous itemized deductions. Currently, such deductions are approved by Publication 970, Tax Benefits for Education, in the year in which no amounts remain in the account. Neither Publication 970 nor the advance notice indicates the identity of the taxpayer entitled to claim the deduction.

Finally, the advance notice observes that IRC §529 is silent on the question of whether the qualified higher education expenses must be paid in the same year as the account withdrawal in order to exclude the withdrawal from income. The IRS proposes allowing the exclusion from income for withdrawals used to pay higher education expenses, provided the expenses are paid in the same tax year or by March 31 of the following tax year.

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IV. TAX CONSIDERATIONS

A. Federal Income Tax Treatment

§21A.24 1. Contributions

For federal income tax purposes, contributions to a College Savings Account are not deductible by the account owner and do not result in taxable income to the designated beneficiary. However, some states have different rules on this. See §21A.30.

WARNING: The discussion of tax considerations in this chapter is based on the current regulations and should be viewed with caution in light of the advance notice of proposed regulations discussed in §21A.23A.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.25 2. Earnings Within the Account

§21A.25 2. Earnings Within the Account

Earnings within the College Savings Account before distribution are exempt from federal income tax, so that the earnings on contributions grow tax-free until they are withdrawn. IRC §529(c)(1).

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§21A.26 3. Distributions

Generally, all distributions for the same designated beneficiary during a taxable year must be treated as one distribution. IRC §529(c)(3)(D). Distributions from a College Savings Account are reported on Form 1099-Q and are excluded from the distributee's gross income if used for qualified higher education expenses. IRC §529(c)(3)(B). Distributions for nonqualified expenses are included in gross income and subject to income tax on the earnings portion of the distribution. The tax is payable by the distributee at the distributee's tax rates. IRC §529(c)(3)(A). Distributions for nonqualified expenses are also subject to a 10-percent penalty on the earnings portion of the distribution, as described in §21A.18.

The proposed regulations explain how the earnings portion of a nonqualified distribution is calculated, and follow the annuity rules of IRC §72. Basically the amount of the distribution is multiplied by an earnings ratio that equals the earnings allocable to the account on the last day of the calendar year, divided by the account balance on the last day of the calendar year. The earnings allocable to the account and the account balance on the last day of the year include all distributions made during the year. The proposed regulations provide examples to assist with these calculations. Prop Treas Reg §1.529-3(b).

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§21A.27 4. Change of Beneficiary/Rollover

Changing the beneficiary to a "member of the family" of the original designated beneficiary is not deemed to be a taxable distribution for income tax purposes. See §21A.19. For transfer tax implications, see §§21A.33-21A.40. Similarly, a rollover of College Savings Account assets to another College Savings Account for the same beneficiary will not be a taxable distribution, provided that a rollover occurs no more than once every 12 months. See §21A.20. In both situations, the new account must be funded within 60 days after the distribution from the old College Savings Account. There may, however, be state-imposed fees or penalties for these types of changes.

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§21A.28 5. No Income Limitations

There are no income limitations that apply with respect to contributors. Even individuals with a high adjusted gross income may contribute to College Savings Accounts, unlike Coverdell ESAs discussed in §§21A.47-21A.56. This makes College Savings Accounts an attractive educational savings vehicle and one of the few available for higher-income families.

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§21A.29 6. Support Test for Dependent

Parents of a College Savings Account beneficiary should be aware that use of College Savings Account assets may prevent a parent from claiming the beneficiary as a dependent for income tax purposes, because the beneficiary/child may flunk the support test in IRC §152(a). That test requires that a parent claiming a child as a dependent provide at least half of the child's support in the taxable year.

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§21A.30 B. State Income Tax Treatment

States that impose a state income tax treat contributions to, and distributions from, College Savings Accounts in a variety of ways. All of these state-specific factors must be weighed if a contributor is interested in finding the most attractive state in which to invest. Some of these are described in §§21A.31-21A.32, but anyone shopping among various states' plans to establish a College Savings Account is encouraged to compare specific state income tax features in more detail. See, *e.g.,* Rev & T C §§17140, 17140.3.

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§21A.31 1. Contributions

Depending on the law of the particular state, a resident may obtain a state income tax deduction for contributions to a College Savings Account, although usually this is limited to contributions to the particular state's own College Savings Accounts. About half of the states offer this deduction to their residents, although in some cases the deduction is capped at a certain amount. California does not provide a tax deduction for contributions. Deductions may not be available for funds rolled over from another state's College Savings Account program. In some states this deduction is recaptured if the College Savings Account funds are moved to another state's College Savings Account program. Other states will tax the plan earnings upon any rollover to another state's plan. Some states offer tax credits to state residents who establish College Savings Accounts in that state. Other states offer matching grants (often only to low- or moderate-income taxpayers). At least one state offers out-of-state residents who invest in its plan the ability to qualify for in-state tuition rates if the funds remain invested for a certain period of time.

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§21A.32 2. Distributions

In determining the state income taxation of a qualified distribution, the law of the beneficiary's state of residence controls. Some states would allow all the earnings portion of such distributions—from any state's College Savings Account program—to be exempt from state income tax. See, *e.g.,* Rev & T C §17140.3 (incorporating IRC §529). Other states exempt only those distributions from that state's particular College Savings Account program. Some states do not offer a state income tax exemption for the earnings portion of qualified distributions at all, and those distributions are subject to state income tax at the beneficiary's rates.

Nonqualified distributions are subject to state income tax in states with an income tax. States also may impose their own penalties on nonqualified distributions. Some of these penalties are holdovers from the period when penalties on nonqualified distributions were required to be imposed at the state level. Most such states may be acting to remove this penalty. See §21A.18.

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C. Estate Tax Treatment

§21A.33 1. Contributor

Contributions to a College Savings Account are considered completed gifts for federal gift and estate tax purposes and are excluded from the account owner's gross estate, notwithstanding the owner's retained control under traditional estate tax principles. IRC §529(c)-(4)(A). The one exception to this general rule is if the contributor dies within 5 years after establishing the College Savings Account and had elected to "front-load" the College Savings Account with more than 1 year's worth of annual exclusions. See §21A.36. In this situation the pro rata value of the remaining annual exclusion amounts is required to be included in the contributor's gross estate. IRC §529(c)(4)(C). Otherwise, no portion of the College Savings Account earnings are includible in the contributor's estate, but the estate also does not take into account any losses within the College Savings Account before the contributor's death. Federal budget proposals have been floated that would change these rules by making gifts to College Savings Accounts incomplete until (1) the contributor relinquishes his or her right to reacquire the account assets, or (2) a distribution is made to the beneficiary. These proposals have made little headway as of this writing.

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§21A.34 2. Beneficiary

If the designated beneficiary dies during the existence of a College Savings Account for his or her benefit, the value of the College Savings Account assets may be included in the gross estate of the designated beneficiary. Under IRC §529(c)(4)(A), "[n]o amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program." However, that provision "does not apply to amounts distributed on account of the death of a beneficiary." IRC §529(c)(4)(B).

The proposed regulations state that "[t]he gross estate of a designated beneficiary of a [College Savings Account] includes the value of any interest in the [College Savings Account]." Prop Treas Reg §1.529-5(d)(3). The proposed regulations do not define the extent of a designated beneficiary's "interest" in the College Savings Account. One view is that the beneficiary's "interest" should include only that portion of the College Savings Account that would otherwise be included in the beneficiary's estate under traditional estate tax rules, *e.g.,* if he or she had any control over the account. Another (and more widely accepted) view is that the entire value of the account assets is includible in the estate of the deceased beneficiary.

The advance notice of proposed rulemaking discussed in §21A.23A contained proposed rules for determining whether a College Savings Account should be included in the beneficiary's estate, primarily on the basis of what actions are taken in the 6 months following the beneficiary's death. Given the uncertain status of the proposed regulations, there remains little guidance on this point.

Because control of the account remains with the account owner, who would likely roll the account assets over to another, living beneficiary, the estate of the deceased beneficiary may not have assets available to pay the estate tax that may be due. The beneficiary (or his or her executor) may not even know about the existence of the account, if distributions have not commenced. These concerns are offset to some degree by the maximum contribution limits on College Savings Accounts, by the increasing IRC §2010(c) estate tax applicable exclusion amount, and by the actuarial likelihood that most beneficiaries, because they are young, will outlive their College Savings Accounts.

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D. Gift Tax Treatment

§21A.35 1. Contributor

Contributions to a College Savings Account qualify as completed gifts of a present interest. IRC §529(c)(2)(A)(i). Contributions to a College Savings Account do not qualify for the unlimited IRC §2503(e) exclusion for qualified transfers to educational institutions. IRC §529(c)(2)(A)(ii).

The donor is the contributor (rather than the account owner, if they are different persons), and the donee is the designated beneficiary. Therefore the gifts qualify for the IRC §2503(b) gift tax annual exclusion of $13,000 per donee in 2009. This is true even though the contributor retains significant control over the College Savings Account, including the right to decide when and by whom the funds are received, and the right to reacquire the funds at any time (subject to penalty). See §21A.19. This is a significant deviation from traditional gift tax principles. Federal budget proposals have been floated that would change these rules by making gifts to College Savings Accounts incomplete until (1) the contributor relinquishes his or her right to reacquire the account assets, or (2) a distribution is made to the beneficiary.

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§21A.36 a. Front Loading

A special provision applicable only to College Savings Accounts allows a contributor to fund an account with an amount equal to 5 years' worth of IRC §2503(b) gift tax annual exclusions, and elect to treat the contribution as if it were being made pro rata over 5 consecutive years. IRC §529(c)(2)(B). The election effectively permits a contributor to "front load" a College Savings Account with $65,000 in 2009, free of any gift tax. The election will, however, reduce or eliminate the contributor's ability to make tax-free gifts to the beneficiary in the succeeding 4 years. Individual state contribution limits may impact this.

A gift of less than the maximum $65,000 is still charged ratably over 5 years; in other words, the length of the spread period is not optional.

PRACTICE TIP: If a contributor wishes to establish an account in a year in which he or she has no available annual exclusion remaining for use with respect to a particular beneficiary, the contributor might consider funding the plan —naming the contributor as the beneficiary—and then change beneficiaries in a later year, triggering a gift at that time. The risks and benefits of doing this (including the risk of transfer tax law changes with respect to College Savings Accounts, should be carefully evaluated.

The election is made on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, Schedule A, Item B, and a written explanation is required. The explanation must include the total amount contributed per beneficiary, the amount for which the election is being made, and the names of the designated beneficiaries. It appears that gift tax returns are required for the subsequent 4 years, reporting and explaining one-fifth of the initial gift in each of the years.

NOTE: If the initial gift exceeds five times the annual exclusion amount, it is not clear when the excess should be reported: either as a taxable gift in the first year (as supported by the language of Prop Treas Reg §1.529-5(b)(2)) or ratably over the 5-year period (as supported by the language of IRC §529(e)(2)(B)). In either case, no gift tax would be due until the contributor's IRC §2505 lifetime applicable credit amount had been used.

If the contributor elects to treat a gift as having been made ratably over 5 years for gift tax annual exclusion purposes and dies before the 5-year period ends, the portion of the gift allocable to the remaining years is included in the contributor's gross estate, as discussed in §21A.33.

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§21A.37 b. Gift-Splitting

Gift-splitting of contributions to a College Savings Account is also permitted under IRC §2513. Thus, a married donor can contribute up to ten times the IRC §2503(b) gift tax annual exclusion amount ($130,000 in 2009) per beneficiary in a single year and avoid gift tax under IRC §529(c)(2)(B), assuming the donor's spouse agrees to this election and both spouses report the election on their respective gift tax returns as discussed in §21A.36. Practical and reporting difficulties can arise, however, if the spouses divorce during the 5-year period following the contribution.

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§21A.38 2. Beneficiary

If the designated beneficiary of a College Savings Account is changed, the original beneficiary will be treated as having made a taxable gift to the new beneficiary if the new beneficiary is assigned to a lower generation than the original beneficiary for generation-skipping transfer (GST) tax purposes as defined in IRC §2651. Prop Treas Reg §1.529-5(b)(3)(ii). This is the case even if the original beneficiary had nothing to do with the change. The original beneficiary is required to file a gift tax return if the "gift" exceeds the IRC §2503(b) gift tax annual exclusion amount. The original beneficiary may take advantage of the front-loading feature and elect to treat the "gift" as made ratably over a 5-year period. See §21A.36. The "gift" also may be subject to generation-skipping transfer (GST) tax. See §21A.40.

It is easy to envision a situation in which the designated beneficiary is changed and the original beneficiary never even knew of the existence of the College Savings Account for his or her benefit, but now would be required to file a gift tax return. The Service is expected to address this issue, possibly with notice-and-acceptance forms to be signed by or on behalf of designated beneficiaries, when a College Savings Account is created and whenever a beneficiary change or rollover occurs. The advance notice of proposed rulemaking discussed in §21A.23A suggested that this problem could be addressed by assigning the tax liability to the account owner, but it is unclear whether the proposed regulations (whenever they are issued) will be consistent on this point.

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E. Generation-Skipping Transfer (GST) Tax Treatment

§21A.39 1. Contributor

Contributions made to a College Savings Account that qualify for the IRC §2503(b) gift tax annual exclusion are treated as meeting the requirements of IRC §2642(c). Therefore, such a gift will have an inclusion ratio of zero for purposes of the generation-skipping transfer (GST) tax, if it is a "direct skip," as defined in IRC §2612(c) that qualifies for the annual exclusion. Prop Treas Reg §1.529-5(b)(1). No allocation of GST tax exemption is required. Combined with the 5-year election under IRC §529(c)(2)(B) (see §21A.36), this provision makes substantial gifts to grandchildren possible within 1 year, even when the contributor's IRC §2631 GST tax exemption has previously been allocated.

If the contribution exceeds the annual exclusion amount for a given year, the excess amount will be subject to GST tax to the extent that it is made for a designated beneficiary who is a "skip person" as defined in IRC §2613 (*e.g.,* grandchild, grandniece, grandnephew). If there will be a direct skip, an allocation of GST tax exemption should be made.

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§21A.40 2. Beneficiary

If there is a change of beneficiary, and the new beneficiary is assigned to a generation two or more generations below the original beneficiary, this is deemed to be a generation-skipping transfer by the original beneficiary. The resulting "gift" by the original beneficiary would be subject to generation-skipping transfer (GST) tax imposed on the original beneficiary. If the parent of the new beneficiary is not living, the predeceased parent exception to the GST tax should apply. The application of GST tax to the original beneficiary raises the same notice issues and reporting requirements as the application of gift tax discussed in §21A.38.

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V. OTHER CONSIDERATIONS

§21A.41 A. Fees and Costs

Anyone interested in shopping among various states' College Savings Account programs should pay particular attention to the fees and costs of each program. Quite often, there is an annual fee that is imposed based on the asset value, which can range from one-third of 1 percent to more than 3 percent. There can also be investment fund fees, broker fees, transaction fees, application fees, and other costs. In addition, some College Savings Account programs have sales load fees of 6 percent or more, and may assess additional fees whenever there is a change in beneficiary or a rollover. Each state's College Savings Account program has a different fee/cost structure, subject to change.

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§21A.42 B. Impact on Financial Aid

It is worth considering whether establishing a College Savings Account will affect the financial aid application of the designated beneficiary. A detailed discussion of the rules governing financial aid is beyond the scope of this chapter. However, the following overview may be helpful as a starting point. In general, College Savings Account assets are treated as assets of the account owner for purposes of determining financial aid. If the student is the account owner, about 35 percent of the account assets are likely to be viewed as accessible by the student, reducing a potential financial aid award. If a parent is the account owner, then typically a much lesser amount (often about 5-6 percent of the assets' value) is deemed to be accessible to the student. If a grandparent (or more remote relative) is the account owner, then typically nothing is deemed accessible by the student or even required to be reported on a financial aid application.

NOTE: The impact on financial aid is most likely to be an important consideration for plans established by the student's grandparents. Many students with parents who are wealthy enough to fully fund a plan and benefit from its tax advantages may be ineligible for financial aid in any event.

Distributions from a College Savings Account to a beneficiary generally will be considered income to the beneficiary for the subsequent year's financial aid calculation. This suggests that if College Savings Account assets may not cover all higher education expenses, they should be used later and not earlier in the beneficiary's higher education, to allow access to other funds (*e.g.*, scholarships, loan) in the early years.

The rules in this area are rapidly changing, partly in response to the growing use of College Savings Accounts. The U.S. Department of Education has advised that assets in a tuition savings account not owned by the parent will not be considered in the student's need analysis except to the extent that the student receives proceeds from the account. Presently, the Department of Education considers prepaid tuition benefits as a resource that reduces a student's financial need dollar for dollar. Federal guidelines in determining financial aid eligibility differ from many institutions' own guidelines for awarding private aid dollars. Some educational institutions have also indicated that they will consider the balances of College Savings Accounts when determining eligibility for financial aid.

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§21A.43 C. Creditor Issues

It seems clear that College Savings Account assets should not be reachable by the creditors of a designated beneficiary under state law and federal bankruptcy law, as long as the designated beneficiary is not the account owner. See chap 26. Some states are also considering or have enacted legislation to bar creditors of account owners from attaching College Savings Account assets. Contributions to College Savings Accounts made more than 720 days before a contributor files for bankruptcy are exempt from the debtor's estate, and contributions made at least 365 days before filing are exempt up to the amount of $5475 ($5000 plus 3-year inflation adjustments, to be adjusted again effective April 1, 2010), provided that the designated beneficiary is a child, stepchild, grandchild, or step grandchild of the contributor. 11 USC §541(b)(6). At least 27 states (not including California) have enacted statutes that protect accounts from creditor claims more generally, including claims brought outside bankruptcy proceedings, but only a few states (Alaska, Arkansas, Colorado, Florida, Kansas, Kentucky, Maine, North Dakota, Pennsylvania, South Dakota, Virginia, West Virginia) appear to provide complete protection for account owners. See Rosen, State Creditor Protections for 529 Plans: A SEED Working Paper (Apr. 2007) available at http://www.cfed.org. The protections offered to the account owner can be an important factor in choosing among particular states' College Savings Account programs and in deciding who the account owner will be. Some commentators have suggested that College Savings Accounts can be a simple and tax-effective way for individuals who are concerned about professional liability to protect and save for a child's or grandchild's education. See Horwood & Wolven, *New Choices in Education Funding—Do You Know Your ABC's? (Qualified Tuition Programs)*, 18 Tax Mgmt Est, Gift & Tr J 59 (2002).

It has not yet been determined whether and to what degree Medi-Cal and other state-run financial assistance programs will consider assets in College Savings Accounts as available assets in determining eligibility. See chap 30.

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§21A.44 D. Succession of Ownership Issues

Because the account owner holds such significant controls over College Savings Account assets, an individual's College Savings Accounts should be considered at every estate planning juncture. For example, if an account owner dies and his or her estate planning documents are silent as to who succeeds to ownership of the College Savings Account, control might devolve to a contingent account owner (if permitted by the state and if designated by the original account owner), or to the beneficiary, or to the probate estate of the account owner. The personal representative may have a fiduciary duty to withdraw the College Savings Account assets, *i.e.,* to maximize the value of the estate, to satisfy the terms of the estate plan, or to provide for liquidity or solvency. These types of problems might be avoided by taking the following steps:

- Designating a successor owner in the account agreement, if state law allows this; and
- Including specific provisions on the succession of ownership and the use of the College Savings Account assets in the account owner's estate planning documents. These provisions might include the following:
- The trustee or personal representative has no fiduciary duty to withdraw the account assets; and
- The trustee or personal representative cannot change the beneficiary or can change the beneficiary to persons in a specified class of individuals (excluding the fiduciary).

Estate planners also should consider expanding their power of attorney forms to grant an agent the right to act for the account owner with respect to a College Savings Account in the event of the account owner's incapacity. This is particularly true if state law requires the account owner's approval before the beneficiary can access College Savings Account funds. The grant might specify the agent's powers or provide that consent of another person is required for a specific act, *e.g.,* if the agent wishes to change the designated beneficiary. To avoid general power of appointment issues, the drafter may wish to restrict the agent's ability to exercise the powers of the account owner for his or her own benefit. See chap 9.

PRACTICE TIP: From a general planning perspective, it may be useful to grant fiduciaries under wills and trusts instruments the power to invest in College Savings Accounts.

With respect to lifetime transfers of account ownership, this may or may not be permitted under state law. Some state plans do not permit any such transfers. Others permit transfers but may impose restrictions on who may act as transferee. California's plan is among the latter.

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§21A.45 E. Community Property Issues

Most if not all state plans allow only one account owner per College Savings Account. If community property funds are used to establish the College Savings Account, the non-owner spouse could have a community property interest in funds contributed to the College Savings Account. This should be addressed to the extent possible in the couple's estate planning documents.

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.46 F. Checklist

§21A.46 F. Checklist

Because College Savings Accounts are governed by federal and state law, an investor must look closely at the proposed regulations under IRC §529 and even more closely at various state laws and account requirements, which vary widely and may be more restrictive than IRC §529 requires. The contributor may wish to consult a Certified College Planning Specialist, a designation granted by the National Institute of Certified College Planners (NICCP) (see http://www.niccp.com). At a minimum, if a contributor wishes to compare various plans, the contributor should evaluate the following factors. In each case it will be necessary to evaluate these and other factors, keeping in mind the contributor's particular investment sophistication, risk tolerance, and comfort with administrative details:

- Fees and costs of administration (enrollment fees, maintenance fees, transaction costs, broker's compensation).
- Investments. What are the available options? How are investments managed? How have they performed? Are they secure?
- Contribution limits and funding flexibility.
- Flexibility of rules governing distributions.
- Are changes in beneficiary permitted?
- State incentives (*e.g.,* tax benefits) for contributions, distributions, or rollovers.
- Penalties or other disincentives on withdrawal, rollover, change of beneficiary, or investment changes.
- Restrictions on withdrawal, rollover, change in beneficiary, or investment changes.
- Age restrictions on beneficiary when funds are contributed.
- Age restrictions on beneficiary that would require account termination at specified age.
- State residency requirements for the contributor or the beneficiary.
- Are graduate school expenses included within qualified expenses?
- Is any beneficiary control allowed or required?
- Are creditor protections available, if desired?
- How is reporting handled?

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VI. COVERDELL EDUCATION SAVINGS ACCOUNTS

§21A.47 A. Introduction to Coverdell ESAs

For individuals interested in establishing tax-advantaged education savings vehicles, it may be worth considering IRC §530 Coverdell Education Savings Accounts (Coverdell ESAs). Coverdell ESAs allow annual contributions of $2000 per beneficiary. The $2000 annual cap per beneficiary takes into account contributions from others for the same beneficiary. IRC §530(b)(1)(A). For example, investing $2000 per year for a beneficiary starting at birth, assuming a 6 percent compound annual rate of return, would result in about $62,000 being available when the beneficiary reaches age 18. Of course, investment and administrative fees may reduce the overall return to some degree.

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§21A.48 B. Differences Between Coverdell ESAs and College Savings Accounts

A Coverdell ESA is similar to a College Savings Account in many ways, *e.g.,* in the requirement of cash contributions, in the tax treatment of contributions and distributions, in penalties for nonqualified distributions, in the transfer tax treatment of contributions, rollovers, and transfers, in the mechanics of distribution, and in the rules governing change of beneficiaries. Those similarities will not be discussed here. Rather, the primary differences between Coverdell ESAs and College Savings Accounts are described for purposes of comparison.

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§21A.49 1. Investment Options

One significant feature of a Coverdell ESA is that the contributor retains complete control over the investments. Funds are invested by the contributor through an approved financial sponsor (*e.g.,* a bank or mutual fund) in any investments offered by the sponsor. Investments can be changed as often as the account owner wishes, with no penalty and minimal administrative burdens.

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§21A.50 2. Qualified Education Expenses

The definition of "qualified education expenses" is much broader for Coverdell ESAs than for College Savings Accounts. Unlike distributions from College Savings Accounts (see §21A.17), distributions from Coverdell ESAs can be used for elementary and secondary school expenses, as well as for higher education expenses. IRC §530(b)(2)(A). Qualified education expenses for elementary and secondary school extend beyond tuition, books, and fees to a wide range of education-related expenses such as tutoring, uniforms, transportation, extended care, and certain software and computer equipment. IRC §530(b)(3).

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Source: Estate Planning/California Estate Planning/21A IRC §529 College Savings Accounts/§21A.51 3. No Reacquisition by Contributor

§21A.51 3. No Reacquisition by Contributor

Funds in a Coverdell ESA generally cannot be reacquired by the contributor. They must be distributed to the designated beneficiary or the beneficiary must be changed to another beneficiary who is not the contributor. See IRC §530(b)(1), (d)(5), (d)(6).

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§21A.52 4. Income Limitations

Coverdell ESAs may only be utilized by individuals whose modified adjusted gross income does not exceed certain amounts. The maximum amount that can be contributed per year is phased out for taxpayers with modified adjusted gross income ranging from $95,000 to $110,000 (for single taxpayers) and from $190,000 to $220,000 (for married individuals filing jointly). IRC §530(c). Coverdell ESAs therefore are not available to higher-income taxpayers.

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§21A.53 5. Age Limitations

Coverdell ESAs do not permit contributions after the beneficiary reaches age 18. IRC §530(b)(1)(A). Also, all account assets must be distributed by the time the beneficiary reaches age 30. IRC §530(b)(1)(E). This translates to less years of tax-free growth, and reduces the availability of Coverdell ESAs for graduate school expenses or for older students. These age limitations do not apply to a designated beneficiary with special needs.

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§21A.54 6. Financial Aid

Coverdell ESAs are more likely than College Savings Accounts to be considered the student's asset for purposes of financial aid qualification. See §21A.42.

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§21A.55 C. Coordination With College Savings Accounts

A contributor may make contributions to Coverdell ESAs and College Savings Accounts in the same year with no penalty. IRC §4973(e). If distributions are made from both types of accounts for the same beneficiary in the same year, the beneficiary is required to allocate qualified higher education expenses among the distributions in order to determine the amount excludible from the beneficiary's federal income tax. IRC §529(c)(3)(B)(vi).

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§21A.56 D. Transfer Tax Treatment of Coverdell ESAs

Because a contributor is limited to contributions of $2000 per beneficiary per year to Coverdell ESAs, no gift will exceed the contributor's gift tax or generation-skipping transfer (GST) tax annual exclusion. A contributor would simply need to coordinate such gifts with his or her other gifts to or for the benefit of the beneficiary, to ensure that the total gifts did not exceed the annual exclusion limit. See IRC §§2503(c), 2642(c)(3). Other estate, gift, and GST tax features are similar to the College Savings Account, including the transfer tax implications of a change in beneficiary. See §§21A.33-21A.40. One difference is that if there is a change in beneficiary, the new beneficiary generally must be a member of the family who is under age 30 to avoid a taxable distribution. See §21A.53.

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§21A.57 E. Comparison With Roth IRAs

While Coverdell ESAs are an excellent education savings vehicle, they are inferior to a Roth IRA funded by the contributor as a vehicle for long-term wealth accumulation by a beneficiary with earnings. Roth IRAs have identical tax-deferral advantages, a higher annual cap on contributions, no minimum distributions during the lifetime of the beneficiary, and no restrictions on the eventual use of the funds after the beneficiary reaches age 59½. See chap 21.

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22

Executive Compensation and Stock Options

Robert J. Lowe

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§22.1 I. INTRODUCTION

This chapter describes the tax consequences of various forms of compensation, with particular emphasis on the basic types of equity compensation. The chapter does not cover qualified retirement plans. For a discussion of pension and IRA distributions, see chap 21.

Throughout the chapter, individuals providing services to the company are referred to as employees; however, some service providers are independent contractors. When the distinction is significant, it is pointed out. In addition, the equity interests provided are referred to in this chapter generally as stock, though in some instances LLC or partnership interests may be involved. Again, when the distinction is important it is noted. On using LLC or partnership interests as compensation, see §§22.30-22.33.

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II. OVERVIEW

§22.2 A. Types of Compensation

The types of compensation an employer may offer include every conceivable form of payment and benefit. Compensation can range from cash to stock, from parking to health care, from qualified pension plans to nonqualified stock options. This chapter focuses on forms of compensation that provide the employee with a stake in the future of the company. The forms of such compensation include:

- Direct equity interests in the company, usually with vesting over time and restricted transfer rights, such as restricted stock (see §§22.8-22.11) and employee stock purchase plans (see §§22.27-22.29);
- Options to acquire equity in the company, usually becoming exercisable over time, such as nonqualified stock options (NQSOs) (see §§22.16-22.21) and incentive stock options (ISOs) (see §§22.22-22.26);
- Equity interests in limited liability companies and partnerships (see §§22.30-22.33); and
- Synthetic forms of option interests, such as stock appreciation rights (SARs) or phantom stock (see §§22.34-22.35).

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§22.3 B. Tax Consequences to Employee of Receiving Various Forms of Compensation

The tax consequences to the employee vary depending on the type of compensation. With cash, the employee has income when he or she receives the compensation. See IRC §61(a). When the compensation is property, the employee generally has income on receipt of the property unless it is subject to a substantial risk of forfeiture. See IRC §83. (Property that is subject to a substantial risk of forfeiture is referred to as "restricted" property.) Thus, an employee recognizes income on the value of shares of unrestricted stock at the time received. With restricted stock, the employee ordinarily is subject to tax on the value of the shares at the time the risk of forfeiture lapses (*i.e.,* when the shares become vested). Treas Reg §1.83-3(b). However, the employee may elect to treat restricted property as income on the date of grant. See §§22.12-22.15.

With a stock option, the employee generally does not recognize income on the grant of the option unless it is actively traded on an established market. Thus, an employee is not subject to tax on the receipt of nonqualified stock options (NQSOs) or incentive stock options (ISOs), or on the grant of stock appreciation rights (SARs) or phantom stock. For an NQSO, the employee will have ordinary income when the option is exercised. See Treas Reg §1.83-7(a). If the option is an ISO, however, the employee does not have income at the time of exercise (unless the alternative minimum tax applies; see §22.25), and, further, if the employee holds the stock received on exercise for the requisite period, the employee will not recognize any ordinary income from the exercise of the option—only capital gain on the sale of the underlying shares of stock. IRC §421(a)(1); see IRC §1222.

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§22.4 C. Tax Consequences to Employer of Compensating Employees

The tax consequences to the company vary depending on the type of compensation. In general, the company may deduct the amount of cash compensation or the value of noncash compensation at the same time the employee recognizes ordinary income with respect to the compensation. IRC §162(a)(1). Thus, for example, when an employee exercises NQSOs or becomes vested in restricted stock, the employee recognizes taxable compensation income (Treas Reg §1.83-7(a)), and the company is entitled to a corresponding deduction (IRC §§83(h), 162). The employee also recognizes taxable income, and the company receives a deduction, when the employee exercises SARs or receives payment for phantom stock. IRC §§404(a)(5), 451(a).

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§22.5 D. Employer's Withholding and Reporting Requirements

An employer's withholding and reporting requirements vary depending on whether the individual providing the services is an employee or an independent contractor. If the service provider is an independent contractor, the company must simply report the compensation paid on a Form 1099 for the year the worker is required to take the compensation into income. IRC §6041; Treas Reg §1.6041-1(a)(2). If the service provider is an employee, the company must (1) report the compensation on the employee's Form W-2 for the year the employee must take the compensation into income, and (2) withhold on the amount of compensation even if the compensation is in the form of an equity interest. IRC §6051; Treas Reg §31.6051-1(a)(1)(i).

For equity compensation, the company withholds either on the shares of stock delivered or from other cash compensation payable to the employee, or the employee pays the withholding tax to the employer.

In addition to state and federal income tax withholding, the company must withhold the employee's portion of FICA (Social Security and Medicare) taxes and include the compensation as wages for the company's payment of federal unemployment tax (FUTA). IRC §§3101-3102, 3301. See Advising California Employers and Employees, chap 19 (Cal CEB 2005).

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§22.6 E. Employee Versus Independent Contractor

Unfortunately, there is no simple method for determining who is an employee and who is an independent contractor, notwithstanding the critical importance of the answer in many circumstances. Generally, under common-law principles, the relationship of employer and employee exists when the company has the right to control and direct the worker, not only in the result to be accomplished, but also in the details and means by which that result is to be accomplished. Treas Reg §31.3401(c)-1(a)-(b). It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient that the company has the right to do so. The IRS has set forth factors to take into account in determining whether the service provider is an employee (see Rev Rul 87-41, 1987-1 Cum Bull 296), but no single factor is determinative.

NOTE: Sometimes both the service provider and the company would like to treat the service provider as an independent contractor to eliminate withholding obligations, among other reasons. However, the company can suffer significant adverse tax consequences for mischaracterizing its service providers. In addition, a company may be liable for retroactive employee benefits not furnished to service providers that the company has erroneously treated as independent contractors.

In addition to these adverse consequences, a company that mischaracterizes an employee as an independent contractor can be responsible for the employee's tax if the employee fails to pay it. See Treas Reg §§31.3401(c)-1(e), 31.3403-1.

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§22.7 III. EQUITY-BASED COMPENSATION

A corporation can offer all types of equity participation packages, including restricted stock, NQSOs, ISOs, employee stock purchase plans, SARs, and phantom stock. An LLC or partnership can offer restricted partnership interests, but the tax treatment of options for an LLC interest is not entirely clear. An LLC cannot issue ISOs. See §§22.30-22.33.

A company usually offers equity-based incentives to key employees and, occasionally, outside independent contractors whose future services are considered crucial to developing and maintaining the company's business. Directors and advisory board members are also typically granted equity-based incentives. Only employees are eligible to receive ISOs or employee stock purchase plan awards. IRC §§422(a)(2), 423(b)(1).

Typically, restricted stock, NQSOs, ISOs, SARs, phantom stock, or phantom stock options, or some combination of these, are offered. After start-up (or, more commonly, after an initial public offering (IPO)), stock purchase plan awards may also be offered to employees.

A company usually establishes a written plan under which it grants equity-based awards. The plan describes the kind or kinds of incentives, who is entitled to them, the amount, if any, that the employee has to pay to receive them, how income tax withholding obligations will be satisfied, the restrictions that will be imposed, and other pertinent information. The terms of the plan usually limit the types and amount of equity incentives that the company can grant under the plan. In some instances, the plan must be approved by the stockholders of the company.

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§22.8 A. Restricted Stock

Restricted stock plans are deferred compensation arrangements under which employers transfer stock to employees as compensation for services. The stock is "restricted" because the employee's right to it is subject to his or her completion of a period of employment or achievement of certain performance goals. When the employee has remained with the company for the specified period or accomplished the specified goals, the restrictions lapse, and the stock becomes vested. The stock is forfeited or may be repurchased by the employer (at the employee's original cost) if the vesting events do not occur. See IRC §83.

The restrictions on stock given to employees vary widely. However, for tax purposes, restricted stock is stock that is both nontransferable and subject to a substantial risk of forfeiture. IRC §83(a). It is nontransferable (even though it may be sold, assigned, or pledged) as long as the transferee is required to return the stock or its value if the forfeiture event materializes. IRC §83(c)(1)-(2); Treas Reg §1.83-3(d). The stock is subject to a substantial risk of forfeiture if the employee is obligated to return it to the company under certain circumstances that may reasonably occur, and the price the company would pay for the stock on the happening of the event is less than fair market value at the time of forfeiture. Treas Reg §1.83-3(c)(1).

NOTE: The stock is subject to a substantial risk of forfeiture and is restricted stock until the conditions for vesting are met if (1) the company can repurchase the stock at a price equal to the value of the stock when it is given to the employee unless the employee remains in the company's service for a specified period of time (a so-called "earn out" restriction), or (2) the stock becomes nonforfeitable (*i.e.*, vests) only if the company reaches specified earnings levels. See Treas Reg §1.83-3(c)(1)-(2), (4) (listing other examples of "substantial risk of forfeiture").

To protect the company, other restrictions that limit the transfer of the shares to third parties typically are imposed. The company may have repurchase and call rights or rights of first refusal; the stock may be subject to so-called "lock-up" rights (*i.e*., no sale for a period of time after an IPO) or "drag-along" rights. Drag-along rights allow certain stockholders, if they decide to sell their shares, to require the employee to sell his or her shares at the same time at the same price per share. The employee, on the other hand, may have "tag-along" rights (rights to sell his or her shares at the same time and price with any significant stockholders—such as founders—who decide to sell their shares). These other restrictions will not cause the stock to be subject to a substantial risk of forfeiture for tax purposes and are taken into account in determining value only if they will never lapse. See §22.9. If the plan permits, a holder of restricted stock can transfer the stock to a living trust to avoid probate if the holder dies while holding the stock.

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§22.9 1. Restrictions That Never Lapse

Stock may be subject to certain restrictions that never lapse (called "nonlapse restrictions"). See IRC §83(d); Treas Reg §1.83-5(a). A nonlapse restriction is a permanent limitation on the transferability of the stock that includes both of these conditions (Treas Reg §1.83-3(h)):

- It requires the transferee to sell or offer to sell it at a price determined under a formula; and
- It will continue to apply to and be enforced against the transferee or any subsequent holder.

Nonlapse restrictions may reduce the value of the stock, but do not prevent the stock from having to be taken into income at the time the stock is issued. However, the restrictions can be removed under limited circumstances without causing the employee to recognize additional income at that time. See Treas Reg §1.83-5(b).

NOTE: An employee receives stock that can never be transferred and, if the employee's employment terminates, the company can buy the stock back for its book value. However, these restrictions will be removed if the company engages in an IPO. Because these are nonlapse restrictions, the employee will have income when he or she receives the stock, based on the book value of the stock, but generally will not have income if the restriction is removed because of an IPO. The company will not get a deduction when the restrictions lapse.

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§22.10 2. Tax Consequences to Employee of Receiving Restricted Stock

The receipt of restricted stock by the employee is not taxable at the time of receipt, unless the employee makes a §83(b) election. See §§22.12-22.15. The employee must include the value of the stock, less any amount paid for it, in ordinary income when the risk of forfeiture lapses and the stock vests. IRC §83(a); Treas Reg §1.83-1(a)(1).

EXAMPLE: A founder pays one cent per share for 100,000 shares of stock when issued, but the company may repurchase the stock for one cent per share if the founder leaves the company within 3 years. In 3 years, when the stock ceases to be subject to the resale restriction, the stock is worth $10 per share. The founder will have no income when the stock is received, but will have $999,000 of income when the stock vests.

NOTE: The result in the above example can be avoided if the employee makes a §83(b) election.

The employee is treated as receiving the stock when the restriction lapses, so the holding period begins at that time. IRC §83(f); Treas Reg §1.83-4(a). A subsequent sale within 1 year of vesting will generate short-term capital gain or loss. A sale after 1 year will generate long-term capital gain or loss. See IRC §1222(2)-(4).

NOTE: Assume that an employee receives 100,000 shares of company stock worth one cent per share, subject to forfeiture if the employee leaves the company within 3 years. Assume that the stock is worth $10 per share at the end of the 3-year period. The employee will have no income on the receipt of the shares, but will have $1 million of ordinary income on vesting, even if no liquidity event (*e.g.*, redemption of the shares) has occurred. If the employee sells the stock within a year of vesting, any gain in excess of the $10 per share, which was taken into income, will be short-term capital gain. If the employee sells the stock after 1 year of vesting, any gain in excess of the $10 per share, which was taken into income, will be long-term capital gain.

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§22.11 3. Tax Consequences to Employer of Granting Restricted Stock

Generally, the company gets a deduction in the year the employee includes the value of restricted stock in income. IRC §83(h). The amount of the deduction equals the amount of ordinary income the employee recognizes. IRC §83(h); Treas Reg §1.83-6(a). To get the deduction, the company must timely comply with applicable reporting and withholding requirements. Treas Reg §1.83-6(a)(2).

PRACTICE TIP: Timely compliance with the reporting requirements is a safe harbor for the deduction. Treas Reg §1.83-6(a)(2). If the company fails to comply with the requirements, the IRS will not allow the company to take the deduction unless the employee actually includes the value of the stock in income. Treas Reg §1.83-6(a)(1).

The company may usually satisfy its withholding obligations by holding back the required amount from other cash compensation payable to the employee. Alternatively, the company can require the employee to make a cash payment to the company equal to the amount of the company's withholding obligation. The terms of the employment agreement, restricted stock plan, or award agreement should clearly indicate that the company has the authority to satisfy its withholding obligations using either method.

NOTE: If the company simply pays the withholding amount from its own funds, the payment will represent additional income to the employee. Therefore, if the company desires to satisfy the employee's entire tax obligation from its own funds, the company will have to "gross up" the withholding amount by the taxes due on the withholding taxes paid by the company for the employee.

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Source: Estate Planning/California Estate Planning/22 Executive Compensation and Stock Options/§22.12 B. Section 83(b) Election

§22.12 B. Section 83(b) Election

Instead of waiting until vesting, the employee can elect to accelerate the taxable event to the time he or she receives the restricted stock. This election is simply referred to as an "83(b) election." See IRC §83(b).

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§22.13 1. Tax Consequences of Making Election

If the employee makes an 83(b) election, the employee includes the value of the nonvested stock, less any amount paid for the stock, in income (as compensation) as of the transfer date. All future appreciation on the stock is eligible for capital gain treatment. Treas Reg §1.83-2(a). The value taken into income is determined without regard to any restriction, other than a restriction that will never lapse. See §22.9. The employee's holding period for capital gain and loss purposes begins when he or she receives the stock (whereas if he or she does not make an 83(b) election, the capital gain holding period will not begin until the vesting date). Treas Reg §1.83-4(a).

NOTE: The employee receives 100,000 shares worth one cent per share subject to forfeiture if the employee leaves within 3 years. The employee makes an 83(b) election when he or she receives the stock. The stock is worth $10 per share after 3 years. The employee has income of $1000 in the year the stock is received. The value is determined without regard to the risk of forfeiture. The employee will not have any income when the restriction lapses. After the restriction lapses, the employee can sell the stock and will pay tax at long-term capital gain rates on the excess of the amount realized over one cent per share.

PRACTICE TIP: The determination of value for a private company's stock is not an exact science. After the initial formation stage (when founders usually receive their stock), the value of the stock is usually very uncertain. In its attempt to provide the benefits of an 83(b) election to key employees, the company may be tempted to take aggressive positions on value. If there is no appraisal of the stock by a qualified appraiser, the best defense to an IRS challenge is some contemporaneous record of how the company arrived at its valuation, to show its reasonableness.

NOTE: In determining value, any recent prior or subsequent events (*e.g.*, a pending IPO or prior round of financing) must be taken into account. However, if the employee receives shares of common stock, those shares may have a lower value than recently issued shares of preferred stock that are convertible into the same number of shares of common stock, due to the preference rights of the preferred stock.

The company gets a deduction in the same amount as the compensation included in the employee's income. It has reporting and withholding obligations at that time.

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§22.14 2. Strategies for 83(b) Election

An 83(b) election should be considered whenever the value of a share of restricted stock is nominal or the employee pays full value (or nearly full value) for the stock; *i.e.*, the election is available and should generally be made if there is little or no spread between the amount paid for the stock and its fair market value.

NOTE: An 83(b) election by the company's founders for restricted stock awarded at or near the time of formation results in the receipt of stock at virtually no tax cost because of the nominal value of the company at that time.

There is, however, a potentially significant downside to both the employee and the company of making the 83(b) election. If the stock is forfeited, the employee will have paid tax, at ordinary income tax rates, on the excess of the value of the stock over the amount, if any, that he or she paid for the stock at the time of transfer. However, on the forfeiture, the employee's basis in the stock will not include income recognized in connection with the 83(b) election. The employee will be entitled to a capital loss only if, and to the extent that, the price that he or she actually paid for the stock exceeds the repurchase price (if any) to be paid by the company in connection with the forfeiture. Once the stock vests, any loss on a subsequent sale of the stock will be a capital loss in the amount of the excess of the amount paid for the stock plus the amount included in income, minus the amount (if any) realized on the sale.

EXAMPLE: Assume that an employee pays $1000 for 1000 shares of restricted stock worth $5000 and makes an 83(b) election. The employee will pay tax on $4000 of compensation income. If the stock is subsequently forfeited and the employee receives nothing, he will get only a $1000 capital loss. If he sells the stock for $2000 after it vests, he will be allowed a $3000 capital loss.

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§22.15 3. Procedure for Making Election

The employee must make the election in writing no later than 30 days after receipt of the stock. Treas Reg §1.83-2(b). The employee must file the election with the IRS office where the employee files his or her return for the year in which the stock is received and send a copy to the company at the same time. Treas Reg §1.83-2(c). (The employee must also file another copy with the IRS with his or her tax return for that year.) Once made, the election is generally irrevocable. Information that must be contained in the election includes the employee's name, address, and taxpayer identification number, a description of the property, the transfer date, the nature of the restrictions, the value of the property at the time of transfer, the amount paid, and confirmation that the employee has provided a copy of the election to the company. Treas Reg §1.83-2(e).

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§22.16 C. Nonqualified Stock Options (NQSOs)

An option is a contractual right to acquire stock from the company for a fixed price within some fixed period of time. A nonqualified option (also called an NQSO or "nonstatutory" stock option) is an option to acquire stock of the company awarded to an employee or independent contractor in connection with the performance of future services. See IRC §83(a). It is called "nonqualified" to distinguish it from an "incentive" stock option. See §§22.22-22.26. NQSOs usually are granted to employees at no cost and offer upside potential to the employee if the value of the company's stock goes up.

NQSOs generally are subject to vesting schedules that determine when the option can first be exercised. An NQSO sometimes provides that certain events result in an acceleration of vesting. For example, vesting may accelerate on a change in control of the company or an IPO. The presence of accelerated vesting provisions alone has no tax consequences. Exercise of a NQSO remains the taxable event, unless the stock received is restricted stock. See §§22.8-22.11.

If the option exercise price is nominal or deeply discounted compared to the stock's value, the IRS may try to tax the grant of an option as an actual stock transfer at the time the option becomes exercisable. Instead of tax deferral, immediate taxation would result (assuming that the option is exercisable for unrestricted stock).

NQSOs will be treated as deferred compensation for purposes of IRC §409A if the option price is less than the fair market value of the stock at the time of grant. Treas Reg §1.409A-1(b)(5)(i)(A). Since an NQSO is unlikely to satisfy the requirements of IRC §409A, it is very important that the option price is not less than the fair market value of the stock. Otherwise the taxable income arising under the option could be subject to a 20 percent penalty tax under IRC §409A. It will often be difficult to determine fair market value of stock in a corporation that is not publicly traded. The IRS has issued regulations stating that the valuation will be presumed to be reasonable if it is based on (1) an independent appraisal by a qualified appraiser no more than 12 months before the option grant date; (2) a formula, provided the same formula is used for other transfers of stock to the issuer or 10-percent shareholder requiring valuation of the stock; or (3) a written report that takes into account factors normally applied in an appraisal in the case of a "start-up" that has been in business 10 years or less. Treas Reg §1.409A-1(b)(5)(iv)(B)(*2*).

If an employee leaves or is terminated before exercising the options, the option plan or agreement determines the employee's rights. The employee may be given some reasonable period of time after termination to exercise vested options (typically 90 days; 1 year for a death or disability). However, if termination is for cause, vested options are usually immediately terminated. In either event, nonvested options usually terminate if the employee leaves. The IRS has ruled that the transfer of a NQSO to a family member without consideration will be treated as a completed gift on the later of the date of transfer or the date of vesting. Rev Rul 98-21, 1998-1 Cum Bull 975. Thus, the transfer of a NQSO will have gift tax consequences based on the option spread when the gift is completed.

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§22.17 1. Tax Consequences of Receiving and Exercising NQSOs

The grant of a NQSO is usually not a taxable event. An NQSO is taxable on grant only if the option itself has a readily ascertainable fair market value. IRC §83(a). The option has a readily ascertainable fair market value if it is actively traded on an established market (Treas Reg §1.83-7(b)(1)), or, if not traded, passes the following four tests (Treas Reg §1.83-7(b)(2)):

- The option is transferable by the optionee;
- The option is exercisable immediately in full by the optionee;
- Neither the option nor the property underlying it is subject to any restriction that has a significant effect on the option's value; and
- The fair market value of the option privilege is ascertainable, *i.e.*, measurable with reasonable accuracy.

If, as is usually the case, the option has no readily ascertainable fair market value, the taxable event occurs when the option is exercised, unless the stock received on exercise is itself restricted stock (see §§22.8-22.11), and no 83(b) election is made (see §§22.12-22.15).

In *U.S. v Tuff* (9th Cir 2006) 469 F3d 1249, the court held that an employee exercised an NQSO by purchasing shares from the employer with money borrowed from a third party, using the shares as collateral. Under IRC §83, an employee is taxed on exercising the option and receiving shares if two conditions are met: (1) the shares must be transferred to the employee, and (2) the shares must be substantially vested in the employee. Under the regulations, a transfer occurs when the employee acquires a beneficial ownership interest in the shares (Treas Reg §1.83-3(a)(1)), and shares are substantially vested when they are either transferable or not subject to a substantial risk of forfeiture (Treas Reg §1.83-3(b)). The court found that the shares were transferred to and substantially vested in the employee when he exercised the option, because he enjoyed all the incidents of stock ownership, including pledging the shares as collateral to secure the loan.

Assuming that the stock received is not restricted stock, the employee recognizes compensation income (taxable at ordinary income rates) on exercise of an NQSO, based on the spread between the stock's fair market value on the exercise date and the option exercise price. The employee's basis in the stock is the sum of the amount of the exercise price and the amount of taxable income he or she recognizes on exercise. Treas Reg §1.83-7(a). The taxable event may be further delayed if the stock received is restricted stock.

PRACTICE TIP: If the stock received is restricted stock, the employee should consider making an 83(b) election at the time of the option exercise so that future appreciation is not compensation income.

NOTE: The employee's holding period for the stock does not begin until the option is exercised. IRC §83(f). Therefore, a sale of the stock within 1 year after exercise of the option will be short-term capital gain (taxed like ordinary income). See IRC §1222.

EXAMPLE: Assume that an employee exercises nonqualified options for 1000 shares at an exercise price of $1 per share when the stock is worth $10 per share and sells the stock within a year of exercise at $12 per share. On exercise, the employee has ordinary income of $9000 and a basis in the stock of $10,000 ($10 per share). A sale of the stock within a year of exercise of the option at a sales price of $12,000 results in a short-term capital gain of $2000.

NOTE: An employee is taxed on the exercise of an option even if he or she cannot sell the stock because there is no market for the stock. However, the subsequent sale of the stock generates a capital gain or loss. See IRC §1222.

The company will receive a deduction at the time of exercise in an amount equal to the excess of the value of the shares over the option exercise price. The company is not subject to tax on the amount that it receives from an optionee as payment of the exercise price of the option. See IRC §83(h).

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§22.18 2. Employer's Reporting and Withholding Obligations

On exercise of a NQSO, the company must withhold employment taxes (unless the stock is restricted stock and no 83(b) election is made) and report to the IRS. Rev Rul 67-257, 1967-2 Cum Bull 359. (If the stock is restricted stock and no 83(b) election is made, the obligation arises when the restrictions lapse.)

NQSO plans typically permit the company to satisfy its withholding obligations in any of several methods, *e.g.*, the company may reduce the number of shares it delivers on the employee's exercise of the option; the employee may make a cash payment to the company; or the company may hold back the required amount from other cash compensation payable to the employee. (Obviously, reducing the number of shares delivered on exercise does not generate any cash to the company, which must then satisfy the withholding obligation with its own cash or by selling the stock.)

NOTE: If the company simply pays the withholding amount for the employee, the company's payment of the withholding amount is additional income to the employee.

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Source: Estate Planning/California Estate Planning/22 Executive Compensation and Stock Options/§22.19 3. Using Previously Owned Company Shares to Pay Exercise Price

§22.19 3. Using Previously Owned Company Shares to Pay Exercise Price

Use of previously owned company shares to exercise a NQSO defers built-in gain on the old shares. A corresponding number of new shares will have the same tax basis and holding period as the previously owned shares. Rev Rul 80-244, 1980-2 Cum Bull 234. The value of the remaining new shares will be taxed as compensation income.

EXAMPLE: Assume that an employee exercises a NQSO for 1000 shares with an exercise price of $10 per share when the share value is $40. The aggregate spread on the option is $30,000 ($30 × 1000). Assume also that the employee pays the $10,000 exercise price by exchanging 250 previously acquired shares with a basis of $5 per share. On exercise, 250 new shares will have a basis of $5 per share. The employee has compensation income on 750 shares of $30,000 (750 × $40 per share). Those 750 shares will have a basis of $40 per share.

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§22.20 4. Tax Consequences of Paying Exercise Price by Reducing Number of Shares to Be Received on Exercise

A NQSO feature that permits a reduction of the number of shares to be received on exercise to pay the option exercise price is referred to as a nonqualified option with a stock appreciation right (SAR) feature. Although this feature permits an exercise without any cash investment, it may severely reduce the number of shares to be received on exercise.

EXAMPLE: Assume that an option for 1000 shares with an exercise price of $10 per share is exercised in full when the share value is $40. The aggregate spread on the option is $30,000 ($30 × 1000) and the employee will recognize that amount as ordinary compensation income. Because it will take 250 shares to cover the exercise price (250 shares × $40), the employee will receive only 750 shares on exercise. (If shares are also used to satisfy the 28-percent federal withholding obligation (210 shares for $8400), the employee will receive only 540 shares.)

If the company reprices, extends, or cancels his or her NQSOs and grants new options with more favorable terms, this may be treated as the grant of a new option under IRC §409A. Treas Reg §1.409A-1(b)(5)(v). Thus, the option price must equal at least the fair market value of the stock at that time.

Just as with restricted stock, the company may wish to impose other restrictions on the option shares, at least before an IPO, that limit transfers to third parties. These restrictions may include company repurchase and call rights, company rights of first refusal, so-called "lock-up" rights (no sale for a period of time after an IPO), and so-called "drag-along" rights (if the majority owners sell their shares, a required sale by the employee to the same party at the same price per share). Those changes generally would not be treated as the grant of a new option.

NOTE: If the NQSO stock itself is subject to a substantial risk of forfeiture (*i.e.*, is restricted stock), the taxable event will be deferred beyond the exercise date, unless an 83(b) election is made. (On restricted stock, see §§22.8-22.11. On 83(b) elections, see §§22.12-22.15.) If the restrictions do not constitute a substantial risk of forfeiture, they will not prevent taxation on exercise, although, if they never lapse, they may affect value.

Generally, gain on the sale of stock held for more than 12 months from the date of receipt is eligible for long-term capital gain treatment. See IRC §1222.

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§22.21 5. Advantages and Disadvantages of Granting NQSOs Compared With Restricted Stock

The advantages of NQSOs for the employee are no cost and no tax on the granting of the option. The disadvantages are the significant tax cost to the employee on exercise if the value of the company increases significantly and the risk of violating IRC §409A if the stock was not valued correctly.

The advantage of restricted stock for the employee is the ability to make an 83(b) election when the stock value is nominal, thereby deferring tax on any subsequent appreciation of the stock after the grant date until the employee sells the stock. A disadvantage arises if the value of the stock is significant or if the employee makes an 83(b) election and the value of the stock subsequently decreases. The company's tax deduction may also be smaller if an 83(b) election is made and the stock appreciates.

EXAMPLE: Assume that the company grants Employee A a nonqualified stock option for 1000 shares at an exercise price of $1, which is the value of a share of stock on the grant date. Employee A exercises the option when the shares are worth $20. Assume that the company grants to Employee B 1000 shares of restricted stock on the same date for a purchase price of ten cents per share, with respect to which Employee B makes an 83(b) election. Employee A has no tax cost on grant, but has taxable income (and the company has a deduction) of $19,000 on exercise, with a federal tax of $6650 (assuming the maximum 35-percent federal rate). Employee B has income of $900 on grant because of the 83(b) election and recognizes no income for tax purposes when the stock vests. The company has a deduction of $900 at the time that it awards the restricted stock to Employee B, instead of $19,900 at the time the restricted stock vests if no 83(b) election had been made—a federal tax cost of $6650 (assuming a 35-percent federal tax rate) for the company. If the employee had not made an 83(b) election, he or she would have been taxed on the spread at the time of vesting ($6650 assuming a 35-percent rate), whereas by having made the 83(b) election, he or she could sell the stock on vesting and be taxed at capital gains rates ($2850 assuming a 15-percent capital gains rate), for a tax savings of $3800.

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§22.22 D. Incentive Stock Options (ISOs)

An ISO is an option granted to an individual for any reason connected with his or her employment, if granted by the employer corporation (or its parent or a subsidiary), to purchase stock of the corporation. IRC §422(b). It is similar to a NQSO, except that, if certain requirements are met (see §22.23), the employee never has to report ordinary compensation income. Instead, there is no income tax until the employee sells the stock received on exercise of the ISO, and the entire "spread" between the option exercise price and the selling price of the stock is capital gain. See IRC §§421(a)(1), 422(a)(1). However, see discussion of the application of the alternative minimum tax on exercise of the ISO in §22.25.

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§22.23 1. Qualifying as ISO

To qualify as an ISO, the option must meet the following requirements:

Option plan. An ISO must be issued under a written plan. The plan must state the aggregate number of option shares and the employees who are to receive the options, either by name or by class (*e.g.*, "eligible employees"). Stockholders must approve the plan within 12 months before or after adoption of the plan. IRC §422(b)(1).

NOTE: Any class of shares of the employer company or any corporation within the parent-subsidiary group may be used. The parent-subsidiary group must consist of corporations within an unbroken chain of 50-percent ownership (by vote) as of the grant date. Although any class of shares may be used, using a special class of shares can create valuation issues.

Employees. ISOs can be granted only to employees and, generally, the employment relationship must be continuous up until 3 months before exercise. IRC §422(a)(2). If termination is because of disability, the 3-month period is extended to 1 year. IRC §422(c)(6). If the employee dies, there is no statutory or regulatory time frame within which the option must be exercised. Treas Reg §1.421-2(c). A person who acquires the option because of the employee's death (*e.g.*, the executor or administrator of the estate) may exercise the option within the time period established under the terms of the option plan, typically 1 year.

Option term. The options must be granted within 10 years of the earlier of the adoption date or stockholder approval date. IRC §422(b)(2). The option must have an exercise period of no more than 10 years after the option is granted. For 10-percent shareholders, the exercise period is limited to 5 years. IRC §422(b)(3), (c)(5).

NOTE: For purposes of the 10-percent-ownership rule, direct and indirect ownership (such as through entities), as well as constructive ownership (such as through family members), is taken into account.

Option exercise price. The ISO must have an exercise price equal to or greater than the fair market value of the stock as of the grant date. IRC §422(b)(4).

NOTE: Fair market value can be determined using any reasonable method, including estate valuation methods. IRC §422(c)(1). ISOs are not subject to IRC §409A and therefore are not subject to the presumption in favor of certain valuation methods set forth in the proposed regulations issued under IRC §409A discussed above in connection with NQSOs. See §22.16.

Nontransferability. The option must be nontransferable during the employee's lifetime, but it may be transferred to the employee's beneficiaries (including the employee's estate) on the employee's death. IRC §422(b)(5).

Only corporations (either a C corporation or an S corporation) can adopt an ISO plan; an LLC or partnership cannot. See IRC §422(a). The company is free to select any employee or class of employees as eligible employees for ISO grants.

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§22.24 2. Limit on Value of Shares

The fair market value of ISO shares (determined as of the date the ISO was granted) that may be purchased for the first time in a calendar year by a particular individual may not exceed $100,000. IRC §422(d). If an option that is intended to be an ISO becomes exercisable in a year for shares with a value in excess of $100,000, the portion of the option covering the excess shares is treated as an NQSO. IRC §422(d).

EXAMPLE 1: Assume that a company grants an employee an ISO to purchase 40,000 shares that have a fair market value of $10 on grant of the ISO, that the ISO has a 4-year vesting schedule at 25 percent per year, and that the fair market value of a share at the time of exercise of the ISO is $50. The entire option qualifies as an ISO because only $100,000 in share value becomes exercisable in each year (10,000 shares × $10 per year). However, if, for example, as a result of a change of control in year 2, vesting of the remaining portion of the option was accelerated, only the portion of the option covering 20,000 shares would be an ISO (the 10,000 shares vesting in each of years 1 and 2) and the portion of the option covering the remaining 20,000 shares would be a nonqualified option.

EXAMPLE 2: Assume the same facts and 50-percent vesting in year 2 and 50 percent in year 4. The portion of the option vesting in each year is treated as an ISO for 10,000 shares and as a nonqualified option for the other 10,000 shares.

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§22.25 3. Tax Consequences of ISO

Just as with an NQSO, the employee does not recognize any compensation income on the grant of an ISO and the company gets no deduction.

Assuming that all of the statutory requirements are satisfied, unlike a NQSO, the employee does not have any income for regular federal income tax purposes on exercise. IRC §421(a)(1). However, the exercise can have alternative minimum tax consequences, which in some instances can be substantial.

NOTE: The alternative minimum tax (AMT) is a secondary tax system for individual taxpayers that requires the individual to pay additional tax when the regular income tax system would produce a lower result. The AMT is computed the same as the regular income tax except that many of the regular deductions are adjusted or not allowed. The AMT rate is 26 percent for taxable income up to $175,000 in excess of the exemption amount and 28 percent for taxable income more than $175,000 over that amount, with an adjustment for any net capital gains. IRC §55(b)(1)(A)(i). The exemption amount is $45,000 ($70,950 for tax years beginning in 2009) for married taxpayers filing jointly and surviving spouses, $33,750 ($46,700 for tax years beginning in 2009) for single taxpayers, and $22,500 ($35,425 for tax years beginning in 2009) for married taxpayers filing separately. IRC §55(d)(1). It is widely expected that the exemption amounts will be extended to future years.

For AMT purposes, the value of the shares on the date of exercise of the ISO over their option price (the "spread") is included in calculating an employee's alternative minimum taxable income. IRC §56(b)(3). The result may be that the employee may be required to pay the AMT on exercise even though no regular income tax is due.

EXAMPLE: Assume that an employee exercises an ISO for 10,000 shares with an exercise price of $10 and a share value of $50 on exercise. The $400,000 spread is not income for regular income tax purposes but is for AMT purposes. Whether the AMT will have to be paid will depend on the amounts and types of income that the employee receives from other sources.

NOTE: The imposition of the AMT on the spread does not increase the employee's basis in his or her shares for ordinary income tax purposes (although basis is increased for AMT purposes), so that the subsequent sale of stock will generate gain equal to the excess of the sales price over the exercise price. This gain is potentially taxed twice, once under the AMT system and once as capital gain. However, a credit for a prior year's AMT is generally available to reduce a current year's regular tax liability, to the extent that such regular tax liability (after taking all other credits into account) exceeds the "tentative" (*i.e.,* hypothetical) AMT liability for the current year. See IRC §53(a). The computations are complex, but, if the credit is available, it could eliminate all or a portion of the double tax. Any AMT credit not used in a taxable year may be carried forward (but not back) indefinitely to future years. A special provision allows individuals to take advantage of a refundable credit with respect to certain long-term unused AMT credits before January 1, 2013. The annual credit amount is the greater of (i) the lesser of $5000 or the amount of the unused AMT credit, or (ii) 20 percent of the amount of the long-term unused AMT credit. The refundable credit was later accelerated to permit taxpayers to deduct 50 percent of the remaining unused credit amount each year for 2 years in 2008 and 2009.

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§22.26 4. Holding Period Requirement

To qualify for long-term capital gains treatment on disposition of ISO stock, the employee must hold the stock for at least 2 years after the option was granted and at least 1 year after exercise of the option before he or she may sell the stock. IRC §422(a)(1). The holding periods do not apply to options exercised by the employee's estate or by a person acquiring the option by bequest or inheritance. IRC §421(c)(1)(A).

A sale of the option stock before the holding period requirements are satisfied is referred to as a "disqualifying disposition." See IRC §421(b). A disqualifying disposition results in ordinary income to the employee (and a deduction for the company) in the year of disposition equal to the spread between the exercise price and the value of the shares on the exercise date. IRC §421(b). This amount is added to the employee's tax basis in the stock for purposes of determining gain or loss on a sale of the stock. If, however, the sales price of the stock is less than its fair market value at the time of exercise, the compensation income is limited to the gain. IRC §422(c)(2).

EXAMPLE 1: Assume the grant of an ISO for 1000 shares at an exercise price of $5 per share; the option is exercised when the share value is $15 and the stock is sold in less than a year for $20 per share. On the sale, the employee has compensation income of $10,000 (($15 minus $5) × 1000), resulting in a basis in the shares of $15,000 ($5000 exercise price plus $10,000 income recognized), and short-term capital gain on the sale of $5000.

EXAMPLE 2: Same facts as above but sales price is $12 per share. The employee has compensation income of only $7000 (($12 minus $5) × 1000).

NOTE: If the disqualifying disposition occurs in the same taxable year as the exercise, there is no AMT effect because the same amount is included in income for regular income tax purposes. If the sale is in the subsequent year, there is an AMT effect in the year of exercise and a regular income tax effect in the year of sale, subject to a possible credit. See §22.25.

An ISO can be exercised using previously owned company stock if the plan permits it. IRC §422(c)(4)(A). The exercise of an ISO with previously acquired company stock results in a deferral of any built-in gain on the previously owned shares. The new shares, equal in number to the old shares, will have a carryover basis. The remaining shares will have a zero basis.

NOTE: If the old shares were received on exercise of ISOs and the holding period requirements were not satisfied, the use of those shares to exercise the ISO will be a disqualifying disposition.

The modification of an ISO, including the extension of its term, a change in its strike (exercise) price, or its renewal, is treated as the issuance of a new option for tax purposes. To qualify as an ISO, the new option must be repriced at the fair market value of the stock at the new grant date and meet all of the other requirements for an ISO under IRC §422, including the $100,000 limitation, at the time of the new grant. IRC §424(h)(1).

NOTE: A change in number of shares subject to, or in the exercise price of, the ISO to reflect a corporate transaction (such as a stock split, merger, or reorganization) is generally not a modification as long as the employee is not given any greater benefits than before the change and the relative value of the option price to the fair market value of the shares subject to the option stays the same. See IRC §424(h)(3).

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Source: Estate Planning/California Estate Planning/22 Executive Compensation and Stock Options/§22.27 E. Employee Stock Purchase Plans

§22.27 E. Employee Stock Purchase Plans

An employee stock purchase plan (also called an ESPP or employee stock option plan) is a plan designed to enable employees to purchase company stock, usually through payroll deduction and usually at a discount. Employee stock purchase plans typically are adopted for an established company, often after the initial public offering.

NOTE: ESPPs should not be confused with employee stock ownership plans (ESOPs). Although both result in the employees owning company stock, an ESOP involves distribution of the stock to employees as an employee benefit under IRC §409, while an ESPP allows employees to purchase company stock under IRC §423.

With an ISO, the exercise price and number of shares subject to the option are generally fixed at grant. See §22.23. By contrast, the number of shares an employee purchases under an employee stock purchase plan generally equals the employee's contributions to the plan for the offering period divided by the option price for that offering period. Employee stock purchase plans usually operate based on successive 6- or 12-month offering periods.

Unlike an ISO, in which the option exercise price must be 100 percent of fair market value at grant, the option price in an employee stock purchase plan can be as low as 85 percent of fair market value, at the start or end of the applicable offering period. IRC §423(b)(6)(A).

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Source: Estate Planning/California Estate Planning/22 Executive Compensation and Stock Options/§22.28 1. Qualifying as Employee Stock Purchase Plan

§22.28 1. Qualifying as Employee Stock Purchase Plan

To qualify as an employee stock purchase plan, a plan must meet the following requirements (IRC §423(b)):

- The plan must be offered to all employees, other than those owning more than 5 percent of company stock;

NOTE: Employees with less than 2 years' service, employees working no more than 20 hours a week or 5 months a year, and highly compensated employees may be excluded from participation.

- The plan must be approved by the stockholders within 12 months after the plan is adopted;
- All participants must have the same rights and privileges;
- The option exercise period cannot be more than 5 years from the date of grant;
- Options must be exercisable only by the employee during his or her lifetime and within 3 months of termination of employment (IRC §423(a)(2)) (although options are transferable by will or the laws of intestacy (IRC §423(b)(9)), and the plan may permit the employee to designate a person to exercise the option after the employee's death (see Treas Reg §1.423-2(j)); and
- The right to purchase shares under the plan must not accrue at a rate greater than $25,000 per employee, based on share value on the grant date, for each calendar year the options are outstanding.

EXAMPLE: Assume an award on January 1, 2010, of options to purchase 1000 shares at 85 percent of the $100 per share stock value on the date of grant. Only 250 shares may be purchased in calendar year 2010 and an additional 250 shares in each of years 2011, 2012, and 2013, or all 1000 shares may be purchased in 2013.

NOTE: In determining the $25,000 limit, NQSOs and ISOs are not taken into account. Treas Reg §1.423-2(i)(3).

The failure to include a common-law employee under the terms of an employee stock purchase plan is technically occasion for disqualification of the plan. See Treas Reg §1.421-1(h) (determination of whether optionee is employee to be made under IRC §3401(c) and related regulations). Common-law employees are distinct from independent contractors. See §22.6. Under common-law principles, the relationship of employer and employee exists when the company has the right to control and direct the worker not only in the result to be accomplished, but also in the details and means by which that result is to be accomplished. Treas Reg §31.3401(c)-1(a)-(b).

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§22.29 2. Tax Consequences of Employee Stock Purchase Plan

As with an ISO, as long as all of the employee stock purchase plan requirements are met (see §22.28), the employee will not recognize any income on exercise of the option, even if the options were issued at a strike (exercise) price less than fair market value at the grant date. See IRC §§421(a), 423(a). The employee's basis in the stock is the option exercise price. IRC §421(c)(3).

NOTE: There are no AMT consequences of a discounted strike price.

The holding period requirements for favorable tax treatment are the same as for ISOs (see §22.26): the longer of 2 years from grant or 1 year from exercise. IRC §423(a)(1). If the holding period requirements have been met, the sale will result in compensation income to the employee equal to the lower of (1) the gain on the sale, or (2) the spread between the stock value on the grant date and exercise price. IRC §423(c); Treas Reg §1.423-2(k).

EXAMPLE: Assume an employee is granted an option for 100 shares at an $85 exercise price when the shares are worth $100. The employee realizes no income on the exercise of the option. However, a sale of the 100 shares 3 years after exercise for $150 will result in compensation income of $1500 (100 × $15 spread at grant). The $1500 is added to the $8500 cost basis, resulting in a $5000 capital gain ($15,000 sales price minus $10,000 basis).

If the holding period requirements are not met, the sale is a disqualifying disposition, resulting in compensation income equal to the lesser of (1) the difference between the value of the shares on the exercise date and the exercise price, or (2) the gain on the sale. Any additional gain on the sale is capital gain. See IRC §421(b).

If the employee dies while owning stock acquired under an ESPP at an option price that was less than 100 percent of its fair market value when granted, compensation must be reported on the employee's final return equal to the lesser of (1) the amount by which the purchase price exceeded the fair market value when the option was granted, or (2) the amount by which the purchase price exceeded the fair market value at death. Treas Reg §1.423-2(k)(1). The basis of the stock in the employee's estate is the fair market value of the stock at death (or the alternate valuation date). Treas Reg §1.423-2(k)(2).

Generally, the company gets no deduction on the exercise of the option or sale of the option stock, even if the employee has compensation income because of a discounted exercise price. IRC §421(a)(2). However, as in an ISO, if there is a disqualifying disposition of the stock, the company gets a deduction for the amount that the employee must report as ordinary compensation income. IRC §421(b).

As in an ISO, the modification of an option granted under an employee stock purchase plan is treated as the grant of a new option under the plan. IRC §424(h).

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§22.30 IV. EQUITY IN LIMITED LIABILITY COMPANIES AND PARTNERSHIPS

With the exception of ISOs and qualified stock purchase plans, an LLC or partnership can issue most of the equity interests that a corporation can issue as a form of compensation. See Corp C §17301. However, the proper tax treatment of these equity interests to the recipient and the LLC or partnership is not always clear.

Equity interests in an LLC or partnership can consist of a capital interest or a profits interest. A capital interest is generally viewed as an interest that entitles the owner to receive a share of proceeds of the sale of LLC partnership assets, if the LLC or partnership were to sell all of its property, pay all of its debts, and liquidate on the date of receipt of the interest. Thus, a capital interest gives the holder a right to a share of the value of LLC or partnership assets on the date the interest is received. In contrast, a profits interest entitles the holder to capital appreciation and profits arising only after the interest is received.

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§22.31 A. Tax Consequences of Receiving Capital Interest in LLC or Partnership for Services

An employee who receives a capital interest in the LLC or partnership for services has compensation income equal to the value of the interest received. IRC §61; Treas Reg §1.721-1(b)(1). However, just as with restricted stock (see §22.8) if the receipt of the interest is subject to a substantial risk of forfeiture and the interest is nontransferable, the taxable event is delayed until the restriction lapses (IRC §83(a)), unless an 83(b) election (see §§22.12-22.15) is made.

If a capital interest received for services is subject to a substantial risk of forfeiture and no 83(b) election is made, the employee will likely not be treated as a partner for tax purposes until the restriction lapses. Instead, the LLC or partnership would be treated as not having issued the interest until vesting. Treas Reg §1.83-1(a)(1). If the employee makes an 83(b) election, on the other hand, he or she should be taxed immediately on receipt of the capital interest, rather than when it vests. By making an 83(b) election, the employee will be treated as a partner for tax purposes, even though the interest has not vested. See Rev Rul 83-22, 1983-1 Cum Bull 17.

The LLC or partnership should be entitled to a deduction for the value of the capital interest that the employee reports in income at vesting or on making the 83(b) election (assuming that services were not attributable to a capital asset). See IRC §83(h).

WARNING: The LLC or partnership might have to recognize gain, based on an assumed sale of a portion of its assets. The tax consequences to an LLC or partnership on the issuance of a capital interest to an employee are somewhat unsettled. Usually, when property is transferred for services, the employer is treated as having sold the property and paid for the services with cash, the deemed sale being a taxable event. There is no explicit tax law provision that protects the LLC or partnership from taxation on the transfer of a capital interest in exchange for services, as there is in IRC §118(a) for the issuance of stock by a corporation in exchange for services. Accordingly, there is a risk that the LLC or partnership would be treated as having sold an undivided interest in all of its properties for cash and paid the cash to the employee, who would then contribute the cash to the LLC or partnership for the capital interest. The resulting gain or loss from the deemed sale would be taxable to the other members or partners of the LLC or partnership, but would then be offset in part by the deduction generated by the payment of compensation to the employee. See IRC §707(a)(2)(B). See also Forming and Operating California Limited Liability Companies §4.20 (2d ed Cal CEB 2007).

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§22.32 B. Tax Consequences of Receiving Profits Interest in LLC or Partnership for Services

The tax consequences from the grant of a profits interest in exchange for services is subject to some uncertainty. However, the IRS has supplied a safe harbor. The employee does not have income on the receipt of a profits interest, provided that (Rev Proc 93-27, 1993-2 Cum Bull 343, clarified by Rev Proc 2001-43, 2001-2 Cum Bull 131):

- The profits interest is received as, or in anticipation of becoming, a member or partner;
- The receipt of a profits interest is not related to a substantially certain and predictable stream of income; and
- The interest is not sold within 2 years of receipt.

Receipt of the profits interest is not taxable if these requirements are satisfied, even if the interest is fully vested.

NOTE: If the safe harbor is not met, there remains some uncertainty about whether the employee is subject to tax on the receipt of the interest.

The tax consequences may be different if the profits interest is not vested. If the profits interest is not vested, the employee will not be treated as the owner of the interest until vesting (in the absence of an 83(b) election). Therefore, the employee cannot be allocated profits (or losses) of the LLC or partnership until the interest vests. At the time of vesting, the employee will be entitled to appreciation on the profits interest property during the period between receipt and vesting, thereby potentially converting the profits interest into a capital interest and thus taxable at the time of vesting.

Assuming that the IRS agrees that the 83(b) election can be made, it would solve the problem. However, it is not entirely clear that the IRS treats a profits interest as the kind of "property" with respect to which an 83(b) election can be made. Even if it does, there seems to be an inherent inconsistency between the election, which causes the profits interest to be taxed currently, and the IRS safe harbor, which provides that the receipt of a vested profits interest is not taxable.

NOTE: A further issue is whether the capital accounts can be adjusted on the grant of the profits interest to allocate all of the built-in appreciation (or depreciation) to the existing partners. Failure to make the allocation could convert the profits interest into a capital interest. It is not clear that the adjustment is allowed under the current technical rules.

The IRS has issued proposed regulations that would treat all partnership interests, whether capital interests or profits interests, as property for purposes of IRC §83. See Prop Treas Reg §1.83-3(e). The proposed regulations provide for a "safe harbor" election by the partnership that would permit compensatory partnership interests to be valued on the basis of liquidation value. Prop Treas Reg §1.83-3(*l*). Therefore, if a safe harbor election were in effect, the receipt of a profits interest would not result in income to the recipient, since it has no liquidation value. In addition, the recipient of an unvested partnership interest would not be treated as a partner for tax purposes until the partnership interest vests, unless an 83(b) election is made. The proposed regulations would be effective with respect to issuances of compensatory partnership interests that occur on or after the publication of final regulations.

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§22.33 C. Options on Profits Interests and Capital Interests

Although an LLC or partnership cannot issue ISOs, it can issue nonqualified options to acquire either a capital interest or a profits interest. The grant of an option for either a capital interest or a profits interest is not a taxable transaction to either the service provider or the LLC or partnership. See Treas Reg §1.83-7(a). On the exercise of an option to acquire a capital interest, the employee will have taxable income and the LLC or partnership will get a deduction (assuming that the services are not attributable to a capital asset). The LLC or partnership will have to face the issue of gain on the deemed sale of assets. See §22.31. Assuming that the safe harbor rules are met, the exercise of an option to acquire a profits interest would not be a taxable event for either the service provider or the LLC or partnership. An option on a profits interest is itself somewhat strange, because a profits interest is in effect a right to receive capital appreciation and profits from the date the interest is received.

NOTE: One issue facing the parties on the exercise of an option to acquire a profits interest is whether the employee gets credit for the appreciation in value between the date of grant and the date of exercise. If he or she does, it may convert the profits interest into a capital interest, creating tax on the date of exercise.

The law on how to treat a partner that is also an employee is not clear. Generally, a partner that receives payments for services may be treated as receiving a "guaranteed payment," which is treated as a partnership distribution under IRC §707(c). However, an employer that receives a small partnership interest as additional compensation may be treated as an employee. The difference is important. An employee's salary is subject to withholding and employment tax payments by the partnership, while distributions to a partner are not. The partner must make quarterly estimated tax payments and pay his or her own employment taxes.

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V. SYNTHETIC EQUITY INCENTIVES

§22.34 A. Stock Appreciation Rights (SARs)

An SAR is a contractual right that a company grants to an employee to receive the appreciation in value of a share of company stock from the time of grant to the date the employee exercises the SAR. The company may pay the amount of the appreciation in value in cash or stock.

The employee is not taxed at the time of grant, nor is he or she taxed on the appreciation until he or she exercises the SAR. At that time, the employee has ordinary compensation income on the amount of cash or value of the stock received. See IRC §451(a). See also Rev Rul 82-121, 1982-1 Cum Bull 79; Rev Rul 80-300, 1980-2 Cum Bull 165. The company generally must treat the amount paid as deductible compensation in the same taxable year that the employee includes the amount in income. IRC §404(a)(5).

Payments (whether in the form of cash or stock) on the employee's exercise of SARs constitute wages subject to all withholding and reporting requirements imposed on compensation. When payment is made in stock, the issues are the same as for exercise of NQSOs. See §§22.16-22.21.

SARs are subject to the deferred compensation provisions of IRC §409A. Under that section, deferred compensation can be distributed only at specified times that must be elected when the compensation is initially deferred. Thereafter, the recipient's ability to change the date previously elected is substantially restricted. As a result, it is difficult to use SARs. Under the regulations, however, the issuance of stock appreciation rights will not result in deferred compensation for purposes of IRC §409A if (1) the compensation payable per share of stock subject to the right cannot be greater than the difference between the fair market value of the stock on the date of exercise and the fair market value on the date of grant, (2) the exercise price can never be less than the fair market value of the stock on the date of grant, and (3) the right does not include any feature for deferral of compensation beyond the date of exercise. Treas Reg §1.409A-1(b)(5)(i)(B).

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§22.35 B. Phantom Stock

Phantom stock is essentially unfunded deferred compensation that is based on the company's stock performance. It takes the form of a contractual arrangement in which an account is set up on the company's books for the benefit of the employee. The account is credited with a specified number of hypothetical company shares and with any dividends payable on a corresponding number of actual shares. (Adjustments also are made for corporate transactions such as stock splits.)

Some phantom stock plans are designed so that the employee can elect to cash out after a period of time and receive any appreciation in value in cash. Other phantom stock plans are designed so that the entire value of the hypothetical shares and accrued dividends credited to an employee's account are paid out at certain specified times. Payment can be made in cash or shares, and in lump sums or installments over time. If payments can be deferred to termination of employment, a phantom stock plan may be subject to the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461), in which case participation must be limited to a select group of management or highly compensated employees. See 29 USC §§1002(1)-(3), 1101(a)(1).

PRACTICE TIP: Phantom stock is attractive when a company does not want to issue true equity or, in the case of a partnership or LLC, wishes to minimize tax or other legal uncertainties.

The employee is generally not taxed until payment is made. *Martin v Commissioner* (1991) 96 TC 814, 830. See Rev Rul 80-300, 1980-2 Cum Bull 165 (even though employee's rights under phantom stock plan had vested and employee could withdraw benefits at any time, employee was not taxable on phantom stock until employee actually exercised rights and received benefit). The company receives a deduction in the taxable year in which the employee has compensation income. IRC §404(a)(5). The company has the same obligation to withhold as in the case of any cash or stock payment.

NOTE: For the employee to avoid taxation before payment on the bargain element, the company's obligation must remain an unfunded and unsecured promise to pay.

Phantom stock is subject to the deferred compensation provisions of IRC §409A. Under that section, deferred compensation can be distributed only at specified times that must be elected when the compensation is initially deferred. Thereafter, the recipient's ability to change the date previously elected is substantially restricted.

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§22.36 VI. GOLDEN PARACHUTES

Golden parachutes are arrangements for payments to key employees in the event of mergers, reorganizations, or takeovers. The arrangements are usually made in the form of separate severance agreements or as part of an employment contract. See IRC §280G(b)(2). Generally, the golden parachute tax rules deny tax deductions and impose excise taxes on receipt of payments made on the change in control of a corporation.

A parachute payment is generally compensation paid to a "disqualified person" (a stockholder, an officer, or a highly compensated individual) that is equal to or more than three times a base amount and that is contingent on a change in control of the company. IRC §280G(c). The base amount is generally the employee's average annual W-2 compensation for the 5 calendar years preceding the year in which the change in control occurs. IRC §280G(b)(2), (d)(2).

NOTE: If three times the base amount is not reached, there are no parachute payments.

The parachute rules do not apply to payments made by an S corporation (see IRC §280G(b)(5)(A)(i)), *i.e.*, a corporation having one class of shares and no more than 75 stockholders who are individuals and that has elected to be treated as an S corporation (IRC §1361(b)).

If the company's stock is not traded on an established market immediately before the change in control, there is no parachute payment if the stockholders who own or owned (immediately before the change in control) more than 75 percent of the voting power, acting with knowledge of all material facts, approve the payment. IRC §280G(b)(5)(A)(ii).

The company is denied a deduction for, and the employee is subject to, a 20-percent excise tax on the receipt of, an "excess parachute payment." An excess parachute payment is an amount equal to the aggregate amount of all parachute payments in excess of one times the base amount. See IRC §§280G(b), 4999.

If vesting of options or restricted stock is accelerated on a change in control, their value is taken into account under the golden parachute rules.

NOTE: Nonqualified options have to be valued under special rules for this purpose even though they are not traded on an established market.

NOTE: If an 83(b) election (see §§22.12-22.15) was previously made for the restricted stock, any compensation element would be taken into account as part of the base amount. However, the value of the accelerated vesting would be counted as a payment contingent on a change in control.

Generally, if it is substantially certain that the options or restricted stock would have vested even without a change in control (*e.g.,* services would have continued to be performed), the value taken into account is the lesser of (1) the value of the payment, and (2) the value of the acceleration feature (*i.e.,* the time value of money and the value of not having to perform the services, the "lapse factor"). Treas Reg §1.280G-1, Q & A-24(c)(2). The time-value-of-money factor is the difference between the value of the payment as accelerated and the present value of the payment if made at the future regular vesting time. The lapse value factor cannot be less than 1 percent of the accelerated payment multiplied by the number of months of acceleration. Treas Reg §1.280G-1, Q & A-24(c)(4).

Special rules deny tax deductions and impose excise taxes on receipt of severance payments to "covered executives" by employers participating in the troubled assets relief program (TARP) federal financial bailout package. IRC §280G(e).

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Charitable Giving

Michael Burnstein

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I. OVERVIEW OF CHARITABLE TRANSFER PLANNING

§23.1 A. Scope of Chapter

Estate plans often include transfers to charitable organizations during the client's lifetime, at death, or both. Federal and California tax laws bestow tax benefits for qualifying transfers, subject to many limitations. See §23.2. For example, lifetime gifts may qualify for a deduction for income tax purposes or gift tax purposes. Transfers at death may qualify for a deduction for estate tax purposes. The rules relating to charitable contribution deductions differ depending on the context. The rules relating to income tax deductions (see §§23.3-23.60A), estate tax deductions (see §§23.61-23.82), and gift tax deductions (see §23.83) for charitable contributions are similar but by no means identical.

This chapter outlines the tax considerations relevant to charitable giving. It discusses the types of recipient organizations for which contributions will qualify for a charitable deduction, the amount of the allowable deduction, an individual's annual limits on charitable deductions, and substantiation requirements for contributed property. The chapter also introduces split-interest charitable gifts. See §§23.84-23.102. Finally, the chapter briefly discusses vehicles for deferred giving. See §§23.103-23.108.

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§23.2 B. Governing Statutes

There are three principal Internal Revenue Code sections relevant to charitable giving. The income tax charitable contribution deduction is governed by IRC §170. The estate tax charitable contribution deduction is governed by IRC §2055. The gift tax charitable contribution deduction is governed by IRC §2522.

California's Revenue and Taxation Code generally tracks the income tax provisions of the Internal Revenue Code and thus will not be covered in this chapter. See Rev & T C §§17024.5, 17201. California currently does not have an estate or gift tax. As a result, it does not have an estate tax or gift tax charitable deduction.

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II. INCOME TAX CHARITABLE CONTRIBUTION DEDUCTION

§23.3 A. Allowable Income Tax Deduction

Internal Revenue Code §170(a)(1) allows an income tax deduction for charitable contributions made to qualified recipients within the donor's taxable year. The deduction is allowed only to taxpayers who itemize their income tax deductions. Taxpayers who claim the standard deduction are not entitled to claim income tax deductions for charitable contributions. See IRC §63(b).

The income tax charitable contribution deduction is subject to many limitations. The principal considerations in determining whether and to what extent an income tax charitable contribution deduction is allowable in respect of a particular tax year are the following:

- Whether the donee is a qualified recipient described in IRC §170(c) (see §§23.4-23.9);
- Whether the contribution was made in a way that will support a deduction (see §§23.10-23.21);
- Whether the contribution was made during the tax year in question or in a subsequent tax year (see §23.22);
- Whether IRC §170(e) applies to reduce the amount otherwise deductible (see §§23.23-23.36);
- Whether any general limitations apply, including limitations based on the donor's contribution base (adjusted gross income) under IRC §170(b) (see §§23.37-23.45); and
- Whether the contribution is sufficiently substantiated (see §§23.46-23.58).

This chapter will address each of these considerations in detail. It will also outline some additional considerations and scenarios. See §§23.59-23.60A.

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§23.4 B. Qualified Recipients: IRC §170(c)

Internal Revenue Code §170(a)(1) allows an income tax deduction for a "charitable contribution" as defined in IRC §170(c). The term "charitable contribution" is defined to mean a contribution or gift to or for the use of a donee listed in that section. In essence, the provision lists the qualified charitable recipients contributions to which can be made that may give rise to an income tax deduction. On the relationship of IRC §170(c) and IRC §501(c)(3), see §23.5.

Section 170(c) lists the following types of organizations, among others:

- The United States, an individual state, the District of Columbia, or a possession of the United States, so long as the contribution or gift is made for exclusively public purposes. IRC §170(c)(1).

PRACTICE TIP: When making a contribution to an entity listed in IRC §170(c)(1), any instrument effectuating such contribution or gift should explicitly limit the use of the contribution to exclusively public purposes.

- Corporations, trusts, community chests, and foundations organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals. IRC §170(c)(2).
- Certain war veterans organizations (IRC §170(c)(3)), certain domestic fraternal societies, orders, and associations operating under the lodge system (IRC §170(c)(4)), and certain cemetery companies (IRC §170(c)(5)).

Section 170(c) is a little misleading unless it is read together with IRC §508. Section 508 provides that contributions to organizations described in IRC §170(c)(2) will not be deductible unless the organization notifies the Secretary of the Treasury that it is applying for recognition as a tax-exempt organization described in IRC §501(c)(3). IRC §508(a), (d)(2)(B). The notification method is IRS Form 1023 (Application for Recognition of Exemption), and if the Secretary approves, a favorable determination letter is issued to the organization making the application.

The Internal Revenue Service maintains a list of organizations that have notified the Secretary of the Treasury and have been approved as described in IRC §170(c). That list is known as IRS Publication 78 (Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986) and is available online at http://www.irs.gov/charities/index.html. The list, together with all updates, should always be consulted before making a contribution. If a donee is listed in IRS Publication 78 and has not been publicly removed before the contribution in question, the donor is generally entitled to treat the recipient as an organization described in Section 170(c). Tips on using the list, as well as organizations that are qualified to receive deductible contributions but not generally listed in the publication, are set forth on the IRS website. For example, churches are often not listed, because they are not required to apply for approval because contributions to churches are generally deductible under an exception applicable to churches. IRC §508(c)(1)(A).

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§23.5 1. Relationship of Section 170(c) and Section 501(c)(3)

Section 170 governs the deductibility of charitable contributions for income tax purposes, while IRC §501(c) lists organizations that are exempt from federal income taxation. Thus, IRC §170(c) addresses the tax treatment of the donor, while IRC §501(c)(3) addresses the tax treatment of the donee. Nevertheless, the two sections are closely related. Section 501 is often made relevant in the context of Section 170 by cross-reference and by overlap. Accordingly, some discussion of Section 501 may be helpful.

Section 501(c) sets forth a list of organizations that are tax-exempt. Section 501(c)(3) describes "charitable" organizations, while all others in the list are tax-exempt but not charitable. Section 501(c)(3) organizations may be thought of as special or favored tax-exempt organizations.

Section 170(c) lists organizations that are qualified to receive deductible contributions. Section 170(c)(2)(B) describes charitable organizations using similar but not identical language. As a result, IRC §501(c)(3) organizations and IRC §170(c)(2)(B) organizations are often thought of as synonymous, and for the most part they are. However, there are some important differences between the two types of organizations. For example, a foreign charitable organization can qualify for tax-exempt status under §501(c)(3) but cannot qualify as an organization described in §170(c)(2).

For simplicity, this chapter will often describe organizations qualified to receive deductible contributions as "170(c) organizations." Section 170(c) includes not only charitable organizations, but also governmental and other entities. At times, it will be necessary to refer specifically to those organizations described in §170(c)(2) and §501(c)(3). Where reference to such organizations is necessary, the reference will assume that the organization has been formally recognized by the IRS as described in both sections, and they will be referred to as "charitable organizations." On categories of charitable organizations, see §§23.6-23.9.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.6 2. Categories of Charitable Organizations

§23.6 2. Categories of Charitable Organizations

Charitable organizations are divided into subcategories. The distinction is relevant to the organization and to the donor. From the donor's perspective, IRC §170 sometimes discriminates against charitable organizations in one category as compared to another. IRS Publication 78 not only lists the organizations that are described in IRC §170(c)(2), but also sets forth the organization's subcategory using codes. Because these categories are sometimes relevant under IRC §170, a brief description of the categories will be helpful:

- Private foundations (see §23.7);
- Public charities (see §23.8); and
- Private operating foundations (see §23.9).

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§23.7 a. Private Foundations

Private foundations are the least favored charitable organizations and represent the default category. An organization that meets the requirements of IRC §501(c)(3) will be classified as a private foundation unless it meets an exception to private foundation status under IRC §509(a). A contribution made to a private foundation will sometimes give rise to a charitable contribution deduction lower than the deduction that would be available for a contribution to other types of entities under IRC §170(b). See §23.41.

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§23.8 b. Public Charities

Public charities are the most favored charitable organizations, and the organization must qualify for that status. An organization that meets the requirements of IRC §501(c)(3) and also an exception to private foundation status under IRC §509(a) will be classified as a so-called "public charity." A contribution to a public charity generally gives rise to the most favorable income tax charitable contribution deduction available. IRC §170(b)(1)(A)(vi). See §23.39.

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§23.9 c. Private Operating Foundations

Private operating foundations are hybrid charitable organizations that are sometimes favored like public charities and sometimes disfavored like private foundations. An organization that meets the requirements of IRC §501(c)(3) but cannot meet any of the categories listed in IRC §509(a) will be classified as a private foundation by default, as noted in §23.7. However, if the organization can satisfy the requirements of IRC §4942(j)(3), it will be treated as a private operating foundation. IRC §170(b)(1)(A)(vii), (1)(E). Contributions to a private operating foundation will usually give rise to a charitable contribution deduction equal to that available for a contribution to a public charity under IRC §170(b). See §23.39.

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§23.10 C. Situations in Which Deduction Reduced or Eliminated

Even when money or property is transferred to a 170(c) organization, the income tax charitable contribution deduction under IRC §170(c) may be limited or disallowed entirely because of the circumstances of the transfer, including quid pro quo contributions (see §§23.11-23.14), gifts made directly to foreign charities (see §23.15), contributions subject to conditions (see §23.16), contributions of partial interests in property (see §23.17), contributions of services (see §23.18), earmarked contributions (see §23.19), contributions of vehicles (see §23.20), and certain contributions to donor-advised funds (see §23.21).

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§23.11 1. Quid Pro Quo Contributions

When a contribution is made to a 170(c) organization in exchange for goods or services, the value of the goods or services generally offsets the value of the contribution for tax purposes. These are known loosely as "quid pro quo" (something for something) contributions.

Generally, if a donor transfers property and receives something in return, the donor's charitable income tax deduction is limited to the amount by which the value of the property transferred to the charity exceeds the value of the items received in return. Treas Reg §1.170A-1(h)(2); Rev Rul 67-246, 1967-2 Cum Bull 104; *U.S. v American Bar Endowment* (1986) 477 US 105, 116, 91 L Ed 2d 89, 101, 106 S Ct 2426.

NOTE: A contribution that is made at about the same time that value is received by the donor is not necessarily a quid pro quo contribution. For example, where admission to a museum is free to the general public but those entering the museum are encouraged but not required to contribute $30, individuals paying $30 on entry need not reduce their charitable deduction by the value of the admission. The payment in that circumstance is independent of the value received in return.

This generalization is subject to qualification, however. For example, under a de minimis rule, the full charitable gift is deductible if either of the following is true (see Treas Reg §1.170A-13(f)(8)(i); Rev Proc 90-12, 1990-1 Cum Bull 471; Rev Proc 2009-50, 2008-45 Int Rev Bull 617 (amounts in 2010 as adjusted for inflation)):

- The fair market value of all benefits received by the donor is no more than 2 percent of the value of the gift or $96, whichever is less; or
- The donor's payment is $48 or more and the only benefits received are token items (*e.g.,* coffee mug, T-shirt) as provided in IRC §513(h)(2) bearing the charity's name or logo and having a total cost of no more than $9.60.

Common quid pro quo situations include purchases of raffle tickets (see §23.12), auction items (see §23.13), and charity event tickets (see §23.14).

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§23.12 a. Raffle Tickets

Generally, the fair market value of a raffle ticket is assumed to be equal to the purchase price. As a result, the "contribution" is really not a contribution at all. Rather, it is a purchase, and no income tax charitable contribution deduction is allowable. Rev Rul 67-246, 1967-2 Cum Bull 104.

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§23.13 b. Auction Items

When an item is purchased at a charity auction sponsored by a charitable organization, the fair market value of the auction item and the amount paid for the item are assumed to be equal. In essence, the auction process sets the value of the item. However, there is an exception to this rule when the donor is made aware of the value of the item in advance of his or her successful bid and yet he or she bids in excess of the value. When this occurs, the regulations permit an income tax charitable contribution deduction in excess of the value of the item. Treas Reg §1.170A-1(h)(5), Example 2.

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§23.14 c. Charity Event Tickets

When a charity event ticket is "purchased" for a price that is in excess of the fair market value of the event (*i.e.,* the value of the food, music, etc.), the amount of the payment may be deductible to the extent it exceeds the fair market value of the event. See IRS Publication 526, Charitable Contributions, p 4.

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§23.15 2. Gifts Made Directly to Foreign Charities

Charitable organizations located outside of the United States and its possessions generally cannot qualify as 170(c) organizations, because IRC §170(c)(2) refers specifically to entities organized in the United States or a possession of the United States. As a result, a contribution made directly to a charitable organization organized in a foreign country will not be deductible under IRC §170. This is true even if the foreign entity has been recognized as a tax-exempt organization under IRC §501(c)(3), and it represents one of the most significant differences between §501(c)(3) and §170(c). There are very limited treaty-based exceptions to this rule for charities located in Canada, Mexico, and Israel.

The IRS recognizes, however, that a gift made to a U.S. charity may be used outside of the United States and its possessions. Contributions made to a domestic charity may be deductible even if the domestic charity conducts its charitable activities exclusively in one or more foreign countries. See *Bilingual Montessori Sch.* (1980) 75 TC 480. In addition, the IRS has recognized that so-called "U.S. Friends" organizations—those that raise funds in the United States obviously intended for foreign charities—may receive tax-deductible contributions, provided they are properly operated. See Rev Rul 66-79, 1966-1 Cum Bull 148; Rev Rul 63-252, 1963-1 Cum Bull 101.

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§23.16 3. Contributions Subject to Conditions

A charitable contribution deduction may be disallowed when the transfer will be made only on the occurrence of a future event. Similarly, a deduction may be disallowed when a contribution will later fail if an event occurs in the future. Whether or not the contribution is deductible depends on the nature of the condition. The deduction will be allowed only if the possibility that the event in question will occur is "so remote as to be negligible." Treas Reg §1.170A-1(e). The regulation gives the following example:

EXAMPLE: A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, then A is entitled to a deduction under IRC §170 for the charitable contribution.

Contributions made subject to conditions precedent or subsequent are risky and should be avoided whenever possible.

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§23.17 4. Partial Interests

A contribution to a 170(c) organization may be nondeductible because it is a partial interest in property. IRC §170(f)(3); Treas Reg §1.170A-7. Examples of nondeductible partial interests include:

- Contribution of the use of property. For example, donating 1 week of rent-free use of the donor's vacation home to a charity for its charity auction.
- Contribution of some intellectual property rights while retaining other rights in the same property. Rev Rul 2003-28, 2003-1 Cum Bull 594.

Partial interests (split-interest charitable gifts) are discussed in greater detail in §23.84.

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§23.18 5. Contributions of Services

Contributions of an individual's efforts are not deductible under IRC §170(c). However, if an individual incurs unreimbursed expenses on behalf of a 170(c) organization, the amounts may be deductible. Treas Reg §1.170A-1(g).

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§23.19 6. Earmarked Contributions

A contribution made to a 170(c) organization may not be deductible under IRC §170(c) because the organization is not the true end recipient. A donor will sometimes attempt to disguise a nondeductible contribution by giving it to a 170(c) organization with directions to use the funds to benefit a donee other than a 170(c) organization. This is known as "earmarking" a contribution. See *S.E. Thomason* (1943) 2 TC 441 (gift to Illinois Children's Home and Aid Society was gift for particular individual); Rev Rul 62-113, 1962-2 Cum Bull 10 (gift to missionary fund was not deductible, because it was intended to benefit donor's son); Rev Rul 61-66, 1961-1 Cum Bull 19 (gift to university earmarked to research project of a particular professor was not deductible, because university had no discretion over use of the funds). But see IRS Letter Ruling 200250029 (contribution to charity that supports composition and performance of musical works was not impermissibly earmarked for the composer and therefore qualifies for a charitable deduction).

EXAMPLE: X contributes $5000 to a private university, a 170(c) organization, on condition that the funds be used to defray the cost of his child's tuition at the private university. The contribution will be nondeductible. The contribution has been earmarked for the benefit an individual—X's child. Consequently, the contribution will be treated as a gift to X's child and the contribution to the private university is not deductible.

PRACTICE TIP: The line between an earmarked contribution and one that is not earmarked can be quite blurry. When a contribution is made subject to an enforceable agreement that the donee will use the funds for the benefit of a noncharitable donee, the contribution is definitely earmarked and nondeductible. On the other hand, when the donor makes the contribution and then afterward requests that the charity consider a particular donee that fits the charity's exempt purposes, and if the charity decides to honor the request, the contribution was not earmarked and should be deductible.

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§23.20 7. Contributions of Qualified Vehicles

Section 170(f)(12) governs the contribution of a "qualified vehicle" having a claimed value for deduction purposes in excess of $500. The term "qualified vehicle" means a motor vehicle manufactured primarily for use on public streets, roads, and highways; planes; and boats. IRC §170(f)(12)(E). The term does not include inventory items under IRC §1221(a)(1).

NOTE: The definition of qualified vehicle seems not to include off-road vehicles, like all-terrain vehicles and dirt bikes.

Section 170(f)(12) provides that no deduction is allowable for the contribution unless the donor obtains a contemporaneous written acknowledgment meeting specific requirements from the charitable donee. IRC §170(f)(12)(A)(i). The term "contemporaneous" means that the acknowledgment is received within 30 days of the contribution or, in the case of a sale of the vehicle, within 30 days of the sale. IRC §170(f)(12)(C). The acknowledgment must contain very specific information. The IRS has prescribed IRS Form 1098-C for use by charitable organizations in reporting the information required. The information that must be included differs depending on whether the vehicle has been sold by the donee. IRC §170(f)(12)(B).

When the donee sells the qualified vehicle, the donor's income tax deduction is generally limited to the amount of the sale proceeds the donee receives from the sale. IRC §170(f)(12)(A)(ii). The limitation on the donor's income tax deduction does not apply in two situations:

- The charity makes significant intervening use of the vehicle or makes a material improvement of the property. IRC §170(f)(12)(A)(ii).
- The donee transfers the vehicle for less than fair market value in a way that furthers the donee's charitable purposes. See IRS Publication 4303, Donor's Guide to Vehicle Donations, p 4.

EXAMPLE: X contributes a car with a fair market value of $1000 and a tax basis of $5000 to a 170(c) organization. X claims an income tax charitable contribution deduction of $1000. The charity sells the car to a needy person for $200, and the sale of the car for well below fair market value furthers the charity's exempt purposes. The reduction rule will not apply, and X is entitled to deduct the full $1000 under IRC §170(c).

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§23.21 8. Contributions to Donor-Advised Funds

Donor-advised funds are separate funds maintained by public charities whereby the donor is permitted to recommend charitable donees to the organization maintaining the fund. They have become quite popular in recent years because they tend to operate much like a private foundation, but enhanced charitable contribution deductions are allowed under IRC §170(c) because contributions are treated as a contribution to the charity maintaining the fund. See §23.107.

A contribution to a donor-advised fund is not deductible unless the donor obtains a contemporaneous written acknowledgment from the organization administering the fund advising the donor that such organization has exclusive legal control over the assets contributed. IRC §170(f)(18). This provision should not pose a problem for contributions to most well-known charities administering such funds.

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§23.21A 9. Contributions of Clothing or Household Items

No income tax deduction is allowable for contributions of "clothing or household items" unless such items are in "good used condition or better." IRC §170(f)(16)(A). This rule does not apply to a single item when an income tax deduction of less than $500 is claimed and the taxpayer includes a qualified appraisal for the item with his or her income tax return. IRC §170(f)(16)(C). The term "household item" includes furniture, furnishings, electronics, appliances, linens, and other similar items. IRC §170(f)(16)(D)(i). The term does not include food, paintings, antiques, and other objects of art, jewelry and gems, and collections. IRC §170(f)(16)(D)(ii). See also Prop Treas Reg §1.170A-18.

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§23.22 D. Determining Tax Year When Contribution Is Deductible

Internal Revenue Code §170(a)(1) provides that a charitable contribution deduction is available for a charitable contribution that is made during the donor's tax year. (Section 170(a)(2) permits corporations to treat charitable contributions paid after the end of the tax year as deductible in respect of the tax year.) The regulations provide that a contribution is made for tax purposes when delivery is effected. Treas Reg §1.170A-1(b).

The following are some examples of when contributions are deemed to have been made for tax purposes:

- Contribution made by check is deductible in the year it is unconditionally delivered or mailed, so long as the check is honored by the bank in due course.
- Contribution made by credit card is deductible in the year the charge is incurred irrespective of when the credit card bill is paid.
- Contribution made by transferring a properly endorsed stock certificate is deductible in the year it is unconditionally delivered or mailed to the donee or the donee's agent.
- Contribution made by transferring a stock certificate to the donor's bank or broker, or to the issuing corporation, for transfer into the name of the donee, is deductible in the year the certificate is delivered only if the stock is transferred on the books of the corporation before the end of the year.
- Contribution made by a donor's promissory note is deductible only if the note is paid before year's end.
- Contribution made by a donor's pledge is deductible only if the pledge is paid before year's end. The pledge itself is not deductible.
- Contribution made by transferring real estate is deductible in the year the deed is unconditionally delivered. Recording the deed before year's end is recommended but appears to be unnecessary.

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§23.23 E. Reduction From Fair Market Value: IRC §170(e)

Section 170(a) generally permits a charitable contribution deduction equal to the fair market value of the property contributed. However, IRC §170(e) will often require a reduction from fair market value. When it applies, §170(e) reduces the amount deductible by the amount of potential gain or income recognition that would result were the asset sold at its fair market value. The rules differ depending on whether the asset has ordinary income or short-term capital gain potential on the one hand (see §23.24), or long-term capital gain potential on the other hand (see §23.25). Generally (though not always), these reduction rules will reduce the amount deductible from fair market value to basis. Special rules apply to contributions of inventory (see §23.34), research property (see §23.35), and computer technology (see §23.36).

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§23.24 1. Reduction for Ordinary Income and Short-Term Capital Gain Property

Section 170(e)(1)(A) provides that the amount of a charitable contribution otherwise deductible shall be reduced by the ordinary income potential and short-term capital gain potential in the property. That section says this in a convoluted but effective way—the reduction is the amount of gain that would not be long-term capital gain if the asset were sold at its fair market value instead of contributed. In making this determination, IRC §1221(b)(3) is disregarded.

NOTE: Section 1221(b)(3) overrides the long-standing rule that musicians who sell their own compositions may not treat the income as capital gain. As a result, a musician who sells his or her own musical composition may realize long-term capital gain. But because §1221(b)(3) is disregarded under §170(e)(1)(A), a musician who contributes his or her music to charity is treated as contributing an ordinary income asset.

Unlike the reduction rule applicable to long-term gain (see §23.25), the reduction under §170(e)(1)(A) applies regardless of the type of 170(c) organization (public charity or private foundation) receiving the contribution.

EXAMPLE: X donates to a public charity 500 shares of stock held for 6 months. The stock has an aggregate fair market value of $6000 and an aggregate tax basis of $2000. Because the stock has been held only 6 months, the gain potential in the stock is short-term capital gain. If the stock were sold at its fair market value, X would realize $4000 of short-term capital gain. Section 170(e)(1)(A) then reduces the deductible amount by $4000 (from $6000 to $2000). The charitable contribution deduction is limited to $2000.

The following are examples of property with ordinary income potential:

- Property held primarily for sale to customers in the donor's ordinary course of trade or business;
- Depreciable personal property subject to recapture under IRC §1245;
- Artistic and literary works created by the donor;
- Capital assets with a holding period that does not qualify for long-term capital gain treatment (*i.e.,* less than 12 months); and
- Preferred stock created in certain types of recapitalizations or received as dividends on common stock (so-called "section 306" stock) under IRC §306(c). On how to compute the deduction for contributions of section 306 stock, see Rev Rul 76-396, 1976-2 Cum Bull 55.

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§23.25 2. Reduction for Long-Term Capital Gain Property

When it applies, IRC §170(e)(1)(B) requires that the amount of a charitable contribution otherwise deductible shall be reduced by the long-term capital gain potential in the property. Property used in a trade or business, as defined in IRC §1231(b), is treated as a capital asset for purposes of §170(e)(1)(B), except to the extent the property is subject to depreciation recapture. See flush language at the end of IRC §170(e)(1).

Common examples of long-term capital gain property are securities or real property held for investment, and artistic works held by a donor other than the creator or a dealer, so long as they were owned for longer than 1 year.

Unlike the reduction rule applicable to ordinary income and short-term gain (see §23.24), §170(e)(1)(B) requires reduction of the deductible amount by the long-term capital gain potential only if the contribution falls into one of the following categories: tangible personal property (see §§23.26-23.28), contributions to private foundations (see §§23.29-23.31), certain intellectual property (see §23.32), and contributions of taxidermy (see §23.33).

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§23.26 a. Contribution of Tangible Personal Property

Section 170(e)(1)(B) will sometimes require that the amount of a contribution of tangible personal property otherwise deductible must be reduced by the long-term capital gain potential. There are two situations that may potentially trigger this reduction rule: unrelated use of the property by the donee (see §23.27) and sale of the property by the donee (see §23.28).

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§23.27 (1) Unrelated Use

The reduction rule of IRC §170(e)(1)(B) applies when the contributed property is used by the donee in a way that is unrelated to the purpose or function constituting the basis of the donee's exemption under IRC §501(c)(3). See IRC §170(e)(1)(B)(i)(I).

EXAMPLE: X purchased a valuable painting 10 years ago. The value of the painting is $500,000 and X's basis in the painting is $150,000. If the painting is contributed to a museum that will display the painting as part of its collection, the reduction rule will not apply. The display of the painting furthers the museum's charitable purposes. As a result, the deductible amount is $500,000. However, if the painting is contributed to a hospital that sells the painting in a fundraising event, the amount deductible would be reduced by the long-term capital gain potential ($500,000 - $350,000 = $150,000). The amount deductible would be limited to $150,000.

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§23.28 (2) Sale by Donee

The reduction rule of IRC §170(e)(1)(B) also may apply when the contributed property is sold within a short time by the donee. Tangible personal property contributions must be reduced by the long-term capital gain potential if the asset is sold, exchanged, or otherwise disposed of before the end of the year in which the contribution is made. IRC §170(e)(1)(B)(i)(II).

In addition, IRC §170(e)(7) reduces the fair market value charitable contribution deduction by the amount of long-term capital gain potential if the asset is disposed of by the donee after the end of the contribution year but before the third anniversary of the contribution. It accomplishes the reduction by requiring the donor to include in his or her income in the year of the sale the difference between the fair market value of the asset and its basis at the time of contribution.

Neither of the above rules apply in two circumstances. First, the rules do not apply if the contribution, together with all other contributions of similar items of tangible personal property, does not exceed $5000. IRC §170(e)(7)(C) (cross-referencing IRC §6050L(a)(2)(A)). Second, the rules do not apply if the donee makes a prescribed certification described in IRC §170(e)(7)(D). The certification must be in writing and signed under penalty of perjury. In addition, it must either:

- Certify that the use of the property by the donee was substantial and related to the purpose or function constituting the basis for the donee's exemption under IRC §501(c)(3) and describe how the property was used and how it furthered the donee's exempt purpose or function; or
- State the intended use of the property by the donee at the time of the contribution and certify that such intended use has become impossible or infeasible to implement.

EXAMPLE: If in the previous example (see §23.27) the contribution had been made to the museum, and it had sold the painting after the end of the contribution tax year but before the third anniversary of the contribution, X would be required to include $350,000 in X's income for the year of the disposition, unless the museum made a certification. The certification might provide that the museum was forced by budgetary concerns to close the facility where X's art and other pieces were displayed.

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§23.29 b. Contribution to Private Foundation

Section 170(e)(1)(B)(ii) provides that contributions made to private foundations as defined in IRC §509(a) (see §23.7) must be reduced by the amount of long-term capital gain potential. The reduction rule applies regardless of the type of property contributed and regardless of the use by the donee. However, there are exceptions to this rule for contributions to certain special private foundations (see §23.30) and contributions of qualified appreciated stock (see §23.31).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.30 (1) Exception for Contribution to §170(b)(1)(F) Foundations

§23.30 (1) Exception for Contribution to §170(b)(1)(F) Foundations

The reduction rule of IRC §170(e)(1)(B)(ii) does not apply if the contribution is made to certain special private foundations listed in IRC §170(b)(1)(F). That section lists three types of special private foundations.

- Private operating foundations (described in §23.9).
- Distributing foundations. A "distributing foundation" is a foundation that distributes within a short time all contributions made to it in addition to its other required distributions.
- Private foundations operating a pooled common fund.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.31 (2) Exception for Contribution of Qualified Appreciated Stock

§23.31 (2) Exception for Contribution of Qualified Appreciated Stock

Section 170(e)(5) provides that the reduction rule of IRC §170(e)(1)(B)(ii) does not apply to contributions of "qualified appreciated stock." Qualified appreciated stock is defined as:

- Stock in a corporation;
- Stock for which market quotations are readily available on an established securities market;
- Stock that has long-term capital gain potential ("capital gain property" as defined in IRC §170(b)(1)(C)(iv)); and
- Stock regarding which the donor and related parties have not contributed more than 10 percent of the outstanding stock by value.

PRACTICE TIP: The IRS has ruled that limitations on transfer arising under the securities laws may disqualify stock from treatment as qualified appreciated stock. The rationale is that the value of the restricted stock is different from the value of stock not so restricted and, as a result, market quotations are not readily available. See, *e.g.,* IRS Letter Ruling 9247018.

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§23.32 c. Contribution of Certain Intellectual Property

Section 170(e)(1)(B)(iii) provides that contributions of certain intellectual property must be reduced by the amount of long-term capital gain potential. Contributions of intellectual property, including any patent, copyright (other than a copyright described in IRC §1221(a)(3) or §1231(b)(1)(C)), trademark, trade name, know-how, software (other than software described in IRC §197(e)(3)(A)(i)), or similar property, are subject to the rule.

Section 170(m) softens the impact of the reduction somewhat by providing the possibility of additional future income tax deductions with respect to the contributed property. In essence, if the donor notifies the donee that the donor intends to claim additional contributions in future years, the donor will be entitled to additional income tax charitable contribution deductions each year for income earned by the intellectual property. The amount of income deductible in each future year after the second year is limited by a sliding percentage scale, decreasing from 90 percent in the third year to 20 percent in the tenth year. IRC §170(m)(7). Further, no additional deductions are allowed after the tenth year. IRC §170(m)(5).

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§23.33 d. Contribution of Taxidermy Property

Section 170(e)(1)(B)(iv) provides that contributions of certain taxidermy property must be reduced by the amount of long-term capital gain potential. Specifically, contributions of any taxidermy property by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting are subject to the reduction rule. In addition, only the cost of preparing, stuffing, or mounting is included in the basis of the property. IRC §170(f)(15).

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§23.34 3. Special Inventory Reduction Rule: IRC §170(e)(3)

The general rules of IRC §170(e)(1) do not apply to certain contributions of inventory. Instead, IRC §170(e)(3) prescribes a more favorable reduction rule when certain requirements are met. The enhanced limitation is generally available only to contributions made by C corporations to charitable donees other than nonoperating foundations. However, special rules apply to certain contributions of food inventory and book inventory. IRC §170(e)(3)(C)-(D).

While a number of other requirements apply, the principal requirement is that the property must be used by the donee solely for the care of the ill, the needy, or infants. IRC §170(e)(3)(A).

When the enhanced limitation applies, it permits the donor to deduct the lesser of (1) the donor's basis in the inventory plus half of the unrealized appreciation, or (2) an amount equal to twice the property's basis. IRC §170(e)(3)(B). The reduction computation also applies to certain contributions of research property (see §23.35) and computer technology (see §23.36).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.35 a. Application to Research Property: IRC §170(e)(4)

§23.35 a. Application to Research Property: IRC §170(e)(4)

The inventory reduction computation described in §23.34 also applies to contributions of certain scientific equipment or apparatus made to colleges and universities for research purposes. The limitation applies only to contributions made by corporations other than S corporations, personal holding companies, and personal service organizations. Many other requirements apply. See IRC §170(e)(4).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.36 b. Application to Computer Technology: IRC §170(e)(6)

§23.36 b. Application to Computer Technology: IRC §170(e)(6)

The inventory reduction computation described in §23.34 also applies to certain contributions of computer technology and equipment made to certain educational organizations and specifically including public libraries. Many other requirements apply. See IRC §170(e)(6).

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§23.37 F. Limitations Based on Contribution Base

Internal Revenue Code §170(b) limits the aggregate income tax charitable contribution deductions otherwise allowable in a given tax year. The limitations are expressed as percentages of an individual's "contribution base." The contribution base is the individual's adjusted gross income for the taxable year computed without regard to any net operating loss carryback. IRC §170(b)(1)(G). Generally, contributions to organizations listed in IRC §170(b)(1)(A) are limited to 50 percent or 30 percent of the donor's contribution base (see §23.38), and contributions to organizations not listed in IRC §170(b)(1)(A) are limited to 30 percent or 20 percent of the donor's contribution base (see §23.41). On the interaction of these percentage limitations, see §23.43. On carryover of excess contributions, see §23.44.

The limitations based on the donor's contribution base apply after the reductions required by IRC §170(e) (see §§23.23-23.36) and the quid pro quo rules (see §§23.10-23.21).

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§23.38 1. Contributions to Organizations Listed in IRC §170(b)(1)(A)

Contributions made to organizations listed in IRC §170(b)(1)(A) are deductible subject to a limitation based on 50 percent of the donor's contribution base (see §23.39) or 30 percent of the donor's contribution base (see §23.40).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.39 a. Contributions Subject to 50-Percent Limitation

§23.39 a. Contributions Subject to 50-Percent Limitation

Section 170(b)(1)(A) establishes a limitation based on 50 percent of an individual's contribution base. The 50-percent limitation applies only to contributions made "to" organizations listed in IRC §170(b)(1)(A).

NOTE: Section 170(c) defines a charitable contribution as a contribution or gift made "to or for the use of" an organization listed therein. Section 170(b)(1)(A) treats contributions or gifts made "to" listed entities differently from contributions or gifts made "for the use of" listed entities. For example, a contribution of a remainder interest, *e.g.,* in a charitable remainder trust (see §23.85), is generally considered a contribution "to" the donee for this purpose. Treas Reg §1.170A-8(a)(2).

The 50-percent limitation applies to contributions made to organizations described in §170(b)(1)(A), unless §170(b)(1)(C) trumps it. When §170(b)(1)(C) trumps §170(b)(1)(A), the result is a limitation based on 30 percent of an individual's contribution base. See §23.40.

The list of organizations in IRC §170(b)(1)(A) includes governmental entities, public charities, and private operating foundations, among others. Section 170(b)(1)(A) is the list of favored IRC §170(c) organizations. The list does not include most private foundations.

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§23.40 b. Contributions Subject to 30-Percent Limitation

The 30-percent limitation for contributions otherwise subject to the 50-percent limitation applies in two principal situations. The first is when a contribution is made "for the use of" an organization described in IRC §170(b)(1)(A). See IRC §170(b)(1)(B) (applicable to any charitable contribution other than a contribution to which §170(b)(1)(A) applies). For example, a deductible contribution of an income interest is generally considered a contribution for the use of the donee. Treas Reg §1.170A-8(a)(2). The second is when the asset contributed has a fair market value in excess of basis and the contribution is not reduced to basis under IRC §170(e). IRC §170(b)(1)(C).

Section 170(b)(1)(C) by its terms applies only to contributions of "capital gain property." Capital gain property is defined in §170(b)(1)(C)(iv) to mean only long-term capital gain property. Further, the section applies only to capital gain property to which §170(e)(1)(A) does not apply. As a result, §170(b)(1)(C) will trump §170(b)(1)(A) with respect to contributions "to" organizations listed in the latter section only if the asset has long-term capital gain potential and the reduction rules of §170(e)(1)(B) do not apply. See §23.25.

Section 170(b)(1)(C)(iii) allows a donor to treat all contributions in a given tax year as subject to the reduction in §170(e)(1)(B). To the extent the reduction is so applied (and would not otherwise be applicable), §170(b)(1)(C) will not trump §170(b)(1)(A), and the contribution will enjoy a limitation based on 50 percent of the donor's contribution base. See §23.39.

PRACTICE TIP: The election under IRC §170(b)(1)(C)(iii) may be beneficial when the difference between the asset's fair market value and its basis is not significant but the difference between a 50-percent limitation and a 30-percent limitation is very significant (because the donor's contribution base is very high). The election may be especially significant when the donor is not expected to live long enough to deduct contributions carried forward to future years. See §23.44.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.41 2. Contributions to Organizations Not Listed in §170(b)(1)(A)

§23.41 2. Contributions to Organizations Not Listed in §170(b)(1)(A)

Contributions to organizations other than those listed in IRC §170(b)(1)(A) (including private foundations other than private operating foundations) are deductible subject to a limitation based on 30 percent or 20 percent of the donor's contribution base. Section 170(b)(1)(B) provides that contributions to such organizations are limited to 30 percent of the donor's contribution base unless IRC §170(b)(1)(D) trumps it.

Section 170(b)(1)(D) trumps §170(b)(1)(B) and the 20-percent limitation applies when the contributed asset has long-term capital gain potential and the reduction rules of IRC §170(e)(1)(B) do not apply. See §23.25.

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§23.42 3. Special Rule for Conservation Easements

Qualified conservation contributions (described in §§23.93-23.102) are deductible subject to a limitation based on 50 percent—rather than the usual 30 percent—of the donor's contribution base (100 percent for contributions by a qualified farmer or rancher of certain property used in agriculture or livestock production) with a 15-year carryover period rather than the usual 5 years. IRC §170(b)(1)(E). This provision applies through December 31, 2009, unless extended by further legislation. IRC §170(b)(1)(E)(vi).

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§23.43 4. Interaction of Percentage Limitations

If a donor in one taxable year makes several contributions of various types of property, *e.g.,* capital gain property, and other assets "to" and "for the use of" both public charities and private foundations, the total deductible amount depends on how the percentage limitation rules apply and the manner in which they interact. For example, contributions "for the use of" public charities—which are limited to 30 percent of the donor's contribution base—are further limited to 50 percent of the excess of the donor's contribution base over the amount contributed "to" public charities. See IRC §170(b)(1)(B). An analysis of these interaction rules, which are very complex, is beyond the scope of this chapter. They can best be understood by studying the examples in Treas Reg §1.170A-8(f).

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§23.44 5. Carryover of Excess Contributions

Generally, for federal income tax purposes, an individual donor may carry over contributions in excess of the limitation amount for 5 succeeding taxable years. The carryover rules are, strangely, scattered throughout IRC §170. Provisions for carryover of excess contributions appear in §§170(b)(1)(B), 170(b)(1)(C)(ii), 170(b)(1)(D)(ii), and 170(d)(1)(A). Carryovers are treated as paid in a succeeding taxable year only after the contributions actually made in the succeeding year are taken into account. More detailed rules and examples concerning carryovers are set forth in Treas Reg §1.170A-10. Illustrations of the 30-percent carryover rules in §170(b)(1)(C) and (D) are also contained in Treas Reg §§1.170A-4(d) and 1.170A-8(f).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.45 G. General Limitations on Itemized Deductions: IRC §68

§23.45 G. General Limitations on Itemized Deductions: IRC §68

In addition to the general and specific limitations that apply to charitable contribution deductions (see §§23.37-23.44), another limitation applies to itemized deductions including charitable contribution deductions under IRC §68.

Section 68 provides that all itemized deductions are subject to reduction in accordance with the following formula based on adjusted gross income (AGI). The reduction is equal to the lesser of:

- 3 percent of the excess of AGI over the applicable amount; or
- 80 percent of all itemized deductions.

The "applicable amount" is indexed for inflation. For 2009, the amount is $166,800, or $83,400 for married taxpayers filing separately. Rev Proc 2008-66, 2008-45 Cum Bull 1107.

The Section 68 limitation is being phased out. In 2008-2009, the reduction is reduced to one-third of the formula result. It is scheduled to be eliminated altogether in 2010. IRC §68(f).

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§23.46 H. Substantiation Requirements

Section 170(a) allows income tax deductions for charitable contributions, but only to the extent "verified" under regulations prescribed by the Secretary of the Treasury. This means that the taxpayer has the burden of proving that he or she made a charitable contribution and providing the relevant details of that contribution. Relevant details include (for example) the identity of the donee, the amount of the contribution, the type of property contributed, and whether anything valuable was received in return from the donee. The extent of the substantiation required depends on the amount of the contribution, ranging from contributions of less than $250 to contributions of more than $500,000. See §§23.47-23.56. Special rules apply to contributions of nonpublicly traded stock (see §23.57) and contributions of art (see §23.58).

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§23.47 1. Contributions of Less Than $250

The IRS requires only minimal substantiation for contributions of less than $250. For a contribution in money, the only requirement is that the donor have a canceled check, a receipt from the donee showing the date and amount of the contribution, or another reliable writing. Treas Reg §1.170A-13(a)(1). For a contribution other than in money, the donor must obtain a receipt from the donee showing the donee, the date, and the location and a description of the property contributed. Treas Reg §1.170A-13(b)(1). An exception applies when obtaining a receipt is impractical (*e.g.,* depositing property at a charity's night drop). See Prop Treas Reg §§1.170A-16, 1.170A-18.

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§23.48 2. Contributions of $250 or More

Deductions for contributions of $250 or more will be disallowed unless the donor obtains a contemporaneous written acknowledgment. IRC §170(f)(8). Section 170(f)(8) does not apply to contributions of qualified vehicles over $500. IRC §170(f)(12). See §23.20.

The acknowledgment must meet the following requirements (Treas Reg §1.170A-13(f)(2)):

- The writing must be "contemporaneous" (*i.e.,* obtained before filing an income tax return or before the tax return due date, including extensions, whichever comes first).
- It must contain the amount of cash and a description of property other than cash contributed.
- It must contain a description of the goods and services given by the donee in exchange.
- It must contain a description and good faith estimate of the value of the benefits given by charity.
- If the charity provides intangible religious benefits, it must contain a statement to that effect.

Where the contribution is made by payroll deduction, the donee is required to obtain a record on his or her W-2 or pay stub and a statement from the donee that it did not provide any goods or services in exchange for the contribution. Treas Reg §1.170A-13(f)(11)(i). Each payroll deduction is treated as a separate contribution for purposes of the $250 threshold. See Prop Treas Reg §1.170A-16.

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§23.49 3. Contributions of More Than $500

No deduction is allowed for contributions of property in excess of $500 unless additional information is provided beyond the contemporaneous written acknowledgment described in §23.48. The taxpayer is required to include with his or her tax return a description of the property contributed "and such other information as the Secretary [of the Treasury] may require." IRC §170(f)(11)(B). See also Treas Reg §1.170A-13(b)(3). The Secretary requires IRS Form 8283, Noncash Charitable Contributions, for this purpose.

Section 170(f)(11) does not apply to contributions of cash, intellectual property to which IRC §170(e)(1)(B)(iii) applies, inventory, or publicly traded securities, and certain vehicle donations. IRC §170(f)(11)(A)(ii)(I). See Prop Treas Reg §1.170A-16.

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§23.50 4. Contributions of More Than $5000

Contributions of property in excess of $5000 must be substantiated by a qualified appraisal. IRC §170(f)(11)(C). The donor must obtain a qualified appraisal (see §23.51) prepared by a qualified appraiser (see §§23.52-23.54) and file an appraisal summary with the donor's tax return (see §23.55). Treas Reg §1.170A-13(c)(2). Section 170(f)(11)(C) does not apply to contributions of cash, intellectual property to which IRC §170(e)(1)(B)(iii) applies, inventory, or publicly traded securities, and certain vehicle donations. IRC §170(f)(11)(A)(ii)(I).

These requirements—which must be met to claim a charitable contribution income tax deduction—are in addition to the substantiation requirements that apply to contributions of cash or property of $250 or more described in §23.48. The donor must also retain records that contain the information required by Treas Reg §1.170A-13(b)(2)(ii).

In applying the $5000 contribution threshold, all similar items contributed in the same year are aggregated, regardless of whether the property is contributed to the same donee. Treas Reg §1.170A-13(c)(1)(i). Items of property are similar if they are within the same generic category or type, such as stamp collections, paintings, or jewelry. Treas Reg §1.170A-13(c)(7)(iii).

EXAMPLE: X claims an income tax charitable contribution deduction of $2000 for books donated to College A, $2500 for books donated to College B, and $900 for books donated to College C. Because the books are all similar items of property, their fair market values must be aggregated. Added together, their total value is $5400, an amount in excess of the $5000 threshold. Thus, the donor must comply with the appraisal requirements for contributions in excess of $5000.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.51 a. Qualified Appraisal

§23.51 a. Qualified Appraisal

The donor must obtain a qualified appraisal. IRC §170(f)(11)(C); Treas Reg §1.170A-13(c)(2). The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) modified the definition of "qualified appraisal." To be respected as a qualified appraisal, the document must include the information specified in Treas Reg §1.170A-13(c)(3)(ii) and must be conducted by a qualified appraiser (see §23.52) in accordance with generally accepted appraisal standards and applicable Treasury regulations. See IRC §170(f)(11)(E).

NOTE: Notice 2006-96, 2006-2 Cum Bull 902, provides interim guidance on the definition of "qualified appraisal." The notice provides that, until new Treasury regulations are issued, an appraisal will be treated as a qualified appraisal if the appraisal complies with all of the requirements of Treas Reg §1.170A-13(c), except to the extent that the regulation is inconsistent with IRC §170(f)(11)(E)(i). See Prop Treas Reg §1.170A-17.

The regulations currently in effect provide that a "qualified appraisal" is a document that (Treas Reg §1.170A-13(c)(3)(i)):

- Relates to an appraisal that is made no earlier than 60 days before the date of contribution of the appraised property and no later than the due date (including extensions) of the return on which the deduction is first claimed or, if the deduction is first claimed on an amended return, the date when the amended return is filed;
- Is prepared, signed, and dated by a "qualified appraiser" (see §23.52); and
- Does not involve an appraisal fee that is based on a percentage of the appraised value of the property (except for an appraisal fee paid to a nonprofit association that is generally recognized as regulating appraisers, as long as the association does not pay any compensation to the appraiser for the appraisal and the fee is not based on the amount of the deduction allowed by the IRS).

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§23.52 b. Qualified Appraiser

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) modified the definition of "qualified appraiser." As amended, IRC §170(f)(11)(E)(ii) provides that a qualified appraiser is a person who has earned an appraisal designation from a recognized professional appraiser organization or otherwise meets minimum requirements set forth in Treasury regulations, regularly performs appraisals for compensation, and meets other requirements prescribed in Treasury regulations or other guidance.

NOTE: Notice 2006-96, 2006-2 Cum Bull 902, provides interim guidance on the meaning of the term "qualified appraiser" until new Treasury regulations are issued. The notice sets forth guidelines for the requisite professional appraisal designation, education and experience, and other requirements. The notice provides that the requirements of Treas Reg §1.170A-13(c) continue to apply except to the extent that the regulation is inconsistent with IRC §170(f)(11)(E)(ii). See Prop Treas Reg §1.170A-17.

The Treasury regulations currently require the qualified appraiser to make certain declarations on the appraisal summary. See §23.53. Certain persons, however, may not serve as a qualified appraiser. See §23.54.

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§23.53 (1) Required Declarations

The qualified appraiser must declare on the appraisal summary (see §23.55) that he or she (Treas Reg §1.170A-13(c)(5)(i)):

- Holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;
- Is qualified to make appraisals of the type of property being valued because of his or her qualifications as described in the appraisal;
- Does not fall within any category of excluded persons as described below; and
- Understands that an intentionally false or fraudulent overstatement of the value of the property can subject him or her to a civil penalty for aiding and abetting an understatement of tax liability and that he or she may have other appraisals disregarded under federal law.

In addition, for returns filed after February 16, 2007, the declaration also must include a statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund may subject the appraiser to a civil penalty under IRC §6695. See Notice 2006-96, 2006-46 Int Rev Bull 902.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.54 (2) Disqualified Persons

§23.54 (2) Disqualified Persons

Persons who may not serve as a qualified appraiser include the following (Treas Reg §1.170A-13(c)(5)(iv)):

- The taxpayer claiming the deduction;
- A party to the transaction in which the donor acquired the property, unless it is donated within 2 months after its acquisition and its appraised value does not exceed its acquisition price;
- The donee;
- Any person regularly employed by any person listed in the first three categories;
- Any person related or married to any person listed in the first three categories; or
- An appraiser who is regularly used by any person described in the first three categories and who does not perform a majority of his or her appraisals for other persons.

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§23.55 c. Appraisal Summary

The donor must include an "appraisal summary" with the tax return for the year in which the contribution of property is made and the deduction is claimed. Treas Reg §1.170A-13(c)(2).

An appraisal summary is a summary of a qualified appraisal made on IRS Form 8283, Noncash Charitable Contributions, signed and dated by the donee and by the qualified appraiser who prepared the qualified appraisal. A separate appraisal summary is required for each item of property contributed by the donor. If similar items are contributed during the same taxable year to more than one donee, a separate appraisal summary is required for each donee. A single appraisal summary can be used for all similar items contributed during the same taxable year to the same donee. See Treas Reg §1.170A-13(c)(4)(iv)(B).

The appraisal summary must contain the following information (Treas Reg §1.170A-13(c)(4)(ii)):

- The donor's name and taxpayer identification number;
- A detailed description of the property;
- For tangible property, a brief summary of its physical condition at the time it was donated;
- The manner and date of the donor's acquisition of the property or, if the donor created or produced the property, a statement indicating this fact and the approximate date on which the property was substantially completed;
- The donor's adjusted basis in the property;
- Identification of the donee;
- The date on which the donee received (or will receive) the property;
- A statement indicating whether the contribution was made by means of a bargain sale (see §23.60) and the amount of any consideration received from the donee for the contribution;
- Identification of the qualified appraiser who signed the appraisal summary;
- Identification of the business that employs or engages the appraiser;
- The property's appraised fair market value as of the contribution date;
- The appraiser's declaration of qualifications and knowledge of the effect of a fraudulent appraisal (see Treas Reg §1.170A-13(c)(5)(i)(D));
- The appraiser's declaration that the fee arrangement was not a prohibited fee arrangement (see Treas Reg §1.170A-13(c)(6)) and that the appraisal prepared by the appraiser is not being disregarded under 31 USC §330(c) as of the date the appraisal summary is signed; and
- Any additional information stated in the instructions to IRS Form 8283.

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§23.56 5. Contributions of More Than $500,000

When the contribution of property is valued at more than $500,000, a qualified appraisal must be attached to the income tax return that reports the contribution. IRC §170(f)(11)(D). Section 170(f)(11)(D) does not apply to contributions of cash, intellectual property to which IRC §170(e)(1)(B)(iii) applies, inventory, or publicly traded securities, and certain vehicle donations. IRC §170(f)(11)(A)(ii)(I).

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§23.57 6. Contributions of Securities

Charitable contributions of nonpublicly traded stock that has a value between $5000 and $10,000 is subject to a somewhat less burdensome rule than the general rule discussed in §23.50. For such stock, a donor is required to submit only a partially completed appraisal summary form with his or her return. Treas Reg §1.170A-13(c)(2)(ii).

A partially completed appraisal summary form is also required when contributions of certain publicly traded securities are made to a charitable donee. To be eligible for this rule (Treas Reg §1.170A-13(c)(7)(xi)(B)):

- The securities contributed must comprise a stock issue (1) that is regularly traded in a market reflected by the existence of an interdealer quotation system and (2) for which the issuer or agent computes the average trading price;
- The average trading price and the total volume of the issue must be published in newspapers;
- The issuer must keep books and records listing each transaction; and
- The IRS must have access to the issuer's books and records.

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§23.58 7. Contributions of Art

Contributions of art are generally subject to the same substantiation rules as are other kinds of property. However, when the art is very valuable, additional rules may apply. When the contribution of art is valued at $20,000 or more, IRS Publication 561 (Determining the Value of Donated Property) states that the full appraisal report must be attached to the donor's income tax return and a picture of the art must be provided on request. In addition, the same publication provides that an IRS "Statement of Value" may be obtained before filing the tax return when the value of the contributed property is $50,000 or more. For further discussion, see Estate Planning for Special Assets, chap 7 (Cal CEB 2004).

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§23.59 I. Encumbered Property

If a donor contributes property subject to an encumbrance or indebtedness, the value of the gift must be reduced by the amount of the indebtedness or the encumbrance (plus any interest attributable to the liability paid by the donor under IRC §170(f)(5)) regardless of whether the charitable organization assumes, or takes the property subject to, the indebtedness. See Treas Reg §1.170A-3(d), Examples 1-2. In addition, the transaction may require a "bargain sale" analysis. See §23.60.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.60 J. Bargain Sales

§23.60 J. Bargain Sales

When a transfer of property is made to an IRC §170(c) organization in exchange for consideration that is less than the fair market value of the property transferred to the donee, a "bargain sale" results. A bargain sale is analyzed as two transactions: a sale portion and a gift portion. The sale portion is the amount of the consideration received from the IRC §170(c) organization. The excess of the fair market value over the sale price is the gift portion.

NOTE: A bargain sale automatically arises when property encumbered with debt is contributed to a charitable donee. In such a case, the amount of the debt is treated the same as a payment to the seller-donor of the amount necessary to pay off the debt.

In analyzing a bargain sale, the planner must determine what portion of the property's basis is allocable to the sale portion, because gain may be recognized on the transfer, and the donor is not entitled to allocate his or her entire basis to reduce the amount realized for income tax purposes. Internal Revenue Code §1011(b) addresses the basis issue and permits only a prorata portion of the basis to be applied to the sale portion of the transaction. The balance is wasted on the gift transfer. The basis allocable to the sale portion of the transaction is determined as follows: (sale price/fair market value) × adjusted basis = basis allocated to sale.

EXAMPLE: X owns a piece of real property valued at $100,000 and having a basis of $40,000. If X sells the property to an IRC §170(c) organization for $60,000, the following analysis would apply:

- Determination of Sale Basis: ($60,000/$100,000) × $40,000 = $24,000
- Determination of Gain on Sale: $60,000 - $24,000 = $36,000 taxable gain (short-term or long-term gain depending on holding period)
- Determination of Charitable Contribution: $100,000 - $60,000 = $40,000 gift portion. The extent to which this portion will be deductible depends on analysis under the usual provisions of IRC §170.

NOTE: If no income tax charitable contribution deduction is allowable on the gift portion of the transaction for any reason, then the basis allocation under IRC §1011(b) is not required. Treas Reg §1.1011-2(a). In such a situation, the entire adjusted basis of the property may be applied against the amount realized in calculating gain from the transaction.

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§23.60A K. Individual Retirement Account Distributions

In general, an individual who withdraws funds from an IRA or other retirement account may have income tax consequences associated with the withdrawal of the funds. See chap 21. If the individual wishes to withdraw the funds and then contribute the funds to a charitable organization, the individual generally must realize income from the distribution and then seek an offsetting charitable deduction. However, IRC §408(d)(8) permits distributions to be made directly from the IRA to charity, subject to the following rules.

- Distributions can be made only from IRAs (and Roth IRAs). Other types of plans and accounts are not eligible.
- Distributions are limited to $100,000 per year.
- The donor must have attained age 70½ on the date of the distribution.
- The distribution must go directly from the IRA to the charity. It must not be deposited in the individual's account.
- The distribution must be otherwise deductible. For example, the distribution is not excludible from gross income if it represents payment for goods purchased at a charity auction.
- The distribution to charity may be used to satisfy the minimum distribution requirements.
- The distribution must be made outright to an organization described in IRC §170(b)(1)(A) (essentially public charities and private operating foundations) other than a supporting organization or donor-advised fund.

These rules apply to distributions made in taxable years beginning after December 31, 2005, and before January 1, 2010, unless extended by further legislation.

The result of a qualified charitable distribution is that the individual need not report income from the distribution, but also may not deduct the charitable contribution. For additional information, see Notice 2007-7, 2007-5 Int Rev Bull 395.

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III. ESTATE TAX CHARITABLE CONTRIBUTION DEDUCTION

§23.61 A. Allowable Estate Tax Deduction

Internal Revenue Code §2055(a) allows an estate tax charitable contribution deduction for the amount of cash and the value of property contributed by the donor to qualified charitable recipients (see §23.62) on the donor's death. The federal estate tax rate is 45 percent of the donor's taxable estate above $2 million (the current IRC §2010(a) estate tax applicable exclusion amount). Therefore, the estate tax charitable contribution deduction can be a very important component of an estate plan.

NOTE: The deduction in IRC §2055(a) is limited by its terms to estates of citizens or residents of the United States subject to estate tax under IRC §2001. Nonresidents who are not citizens also receive an estate tax charitable contribution deduction, but the list of qualified donees is restricted to domestic donees and uses. IRC §2106(a)(2). See also Treas Reg §20.2055-1(a). The estate tax applies to estates of nonresident noncitizens only with respect to property situated in the United States. IRC §2101(a).

Section 2055(e) provides that the estate tax charitable contribution deduction may be disallowed in certain circumstances. See also IRC §2522(c) (setting forth a similar list for the gift charitable contribution tax deduction), discussed in §23.83.

The requirements for the estate tax charitable contribution deduction are generally similar to those for the income tax charitable contribution deduction. On provisions applicable to both IRC §2055 and IRC §170, see §§23.63-23.68. On provisions of IRC §2055 not similar to IRC §170, see §§23.69-23.75. On considerations unique to the estate tax, see §§23.76-23.82.

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§23.62 B. Qualified Recipients: IRC §2055(a)

The list of qualified recipients in IRC §2055(a) generally refers to the same organizations listed in IRC §170(c)(2) (see §23.4), but it describes them differently. It also refers to some organizations not listed in §170(c). The organizations described in §2055(a) are the following:

- The United States, any state, any political subdivision thereof, or the District of Columbia, but only if the contribution is used for exclusively public purposes.
- IRC §501(c)(3) organizations established in nonprofit corporation form.
- IRC §501(c)(3) organizations established in charitable trust form.
- Certain veterans' organizations incorporated by Act of Congress.
- Employee stock ownership plans (ESOPs) to the extent the transfer constitutes a qualified gratuitous transfer of qualified employer securities.

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§23.63 C. Provisions Applicable to Both IRC §2055 and IRC §170

Section 2055 applies some rules that are similar to or identical to those found in IRC §170. Those rules include reduction or elimination of the deduction for quid pro quo contributions (see §23.64), conditional contributions (see §23.65), partial interests (see §23.66), earmarked contributions (see §23.67), and certain contributions to donor-advised funds (see §23.68).

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§23.64 1. Quid Pro Quo Contributions

When a contribution is made in exchange for consideration, the contribution is not deductible as a charitable contribution for estate tax purposes. For example, if an individual makes a gift by will or revocable trust to a charitable donee in satisfaction of an enforceable agreement to pay money to the charity, the contribution is not deductible as a charitable contribution. See §23.11.

NOTE: When the donor has made a pledge during his or her lifetime and a gift honoring the pledge at death, the analysis depends on the enforceability of the pledge under state law. If the pledge is enforceable as a matter of contract law, then the contribution is not deductible as a charitable contribution, but is likely deductible as a claim against the estate under IRC §2053. On the other hand, if the contribution satisfies an unenforceable pledge, the contribution should be deductible as a charitable contribution under IRC §2055.

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§23.65 2. Contributions Subject to Conditions

Contributions subject to a condition are deductible for estate tax purposes only to the extent that the chances that the event will occur are so remote as to be negligible. Treas Reg §20.2055-2(b). A similar rule applies for income tax purposes. See §23.16.

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§23.66 3. Partial Interests

The income tax rules on contributions of partial interests (see §23.17) also generally apply to contributions made on the death of the donor. See IRC §2055(e); Treas Reg §20.2055-2(e).

In addition, when a fractional interest in tangible personal property was contributed more than 10 years before death, the original gift tax deduction may be recaptured because the remaining interest was not contributed within 10 years. IRC §2522(e)(2). See §23.90.

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§23.67 4. Earmarked Contributions

Contributions made to a charitable donee but earmarked for noncharitable donees should be nondeductible for estate tax purposes under the rules applicable to earmarked contributions for income tax purposes. See §23.19.

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§23.68 5. Contributions to Donor-Advised Funds

Section 2055(e)(5) disallows the estate tax deduction for a contribution to a donor-advised fund in certain circumstances similar to those in which an income tax deduction is disallowed under IRC §170(f)(18). See §23.21.

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§23.69 D. Provisions of IRC §2055 Not Similar to IRC §170

Some of the rules applicable to the IRC §170 income tax charitable contribution deduction are not applicable in the context of the IRC §2055 estate tax charitable contribution deduction. Those rules include reduction or elimination of the deduction, which is based on the donor's contributor base (see §23.70), for income or capital gain potential (see §23.71), for gifts to foreign charities (see §23.72), for gifts to private foundations (see §23.73), for gifts "for the use of" public charities (see §23.74), and for gifts of partial interests in artwork (see §23.75).

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§23.70 1. No Maximum Estate Tax Deduction

Unlike IRC §170, IRC §2055 does not limit the estate tax charitable contribution deduction that can be claimed. Section 170(b) limits the contribution that may be claimed in a given year by reference to a donor's contribution base. See §23.37. Internal Revenue Code §68 further limits the aggregate itemized deductions that may be claimed. See §23.45. Under IRC §2055, however, it is entirely permissible to leave an entire estate to one or more charitable donees and avoid all estate tax. The only limit on the amount of the estate tax charitable contribution deduction is that it must not exceed the value of the transferred property included in the gross estate. IRC §2055(d).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.71 2. No Reduction for Income or Capital Gain Potential

§23.71 2. No Reduction for Income or Capital Gain Potential

Unlike IRC §170, there is no provision in IRC §2055 for the reduction of the deductible amount to take account of income or gain potential in the asset. See §§23.24-23.33.

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§23.72 3. Not Limited to Domestic Charities

Unlike IRC §170, there is no requirement in IRC §2055 that the charitable donee be organized in the United States or a possession of the United States. See §23.15. Further, the regulations under IRC §508 provide an exception from the general rule that an IRC §501(c)(3) organization must apply for recognition when a charitable donee raises 85 percent or more of its support from non-U.S. sources. IRC §§508(a), 4948(b); Treas Reg §§1.508-1(a)(2)(vi), 53.4948-1(b).

PRACTICE TIP: While the rule is very liberal, the planner is still faced with the need to determine whether the foreign donee would meet the requirements of IRC §501(c)(3) and whether the 85-percent threshold is met. Since most foreign charitable organizations have no desire to apply to the IRS for recognition of exemption under IRC §501(c)(3), making these determinations may not be easy.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.73 4. No Distinction Between Private Foundations and Other Charities

§23.73 4. No Distinction Between Private Foundations and Other Charities

Unlike IRC §170, IRC §2055 permits the same charitable contribution deduction regardless of the subcategory of charitable donee. See §§23.6-23.9. A contribution to a private foundation will generally yield the same estate tax deduction as a contribution to a public charity.

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§23.74 5. No Distinction Between Gifts "To" and "For the Use of" Charities

Unlike IRC §170, IRC §2055 does not distinguish between gifts "to" or "for the use of" charitable donees. A gift to a charitable donee may give rise to a deduction that is larger than a gift for the use of a donee, but that results from the nature of the interest given. There is no overall limitation for estate tax purposes that applies to gifts to charitable donees and not to gifts for the use of charitable donees, as there is for income tax purposes. See §23.40.

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§23.75 6. Artwork and Copyright Treated as Separate Property

Unlike IRC §170, IRC §2055 provides that a piece of art (tangible property) and the related copyright in the artwork (intangible property) are treated as two separate properties for purposes of the otherwise applicable partial-interest rules. Treas Reg §20.2055-2(e)(1)(ii). See §23.66. This means that, for estate tax purposes, a donor may contribute only the copyright or only the art and deduct the value of the respective contribution. In the income tax context, both must be contributed (if both are owned) to avoid a nondeductible partial interest. See §23.17.

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.76 E. Considerations Unique to the Estate Tax

§23.76 E. Considerations Unique to the Estate Tax

There are a number of situations that arise in an estate tax context that do not arise or are not relevant in an income tax context, including disclaimers resulting in a charitable contribution (see §23.77), fiduciary discretion to make charitable contributions (see §23.78), payment of estate tax from a charitable gift (see §23.79), charitable remainders in a QTIP trust (see §23.80), powers of appointment (see §23.81), and retirement plan contributions (see §23.82).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.77 1. Disclaimer Resulting in Charitable Contribution

§23.77 1. Disclaimer Resulting in Charitable Contribution

When a testamentary gift is disclaimed in a qualified disclaimer under IRC §2518 and—pursuant to the terms of the testamentary instrument—the property passes instead to a qualified charitable donee, an estate tax deduction is available under IRC §2055(a). The result is the same as if the property had been given in the first instance to the charitable donee. Treas Reg §20.2055-2(c).

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§23.78 2. Fiduciary Discretion and Charitable Contributions

Clients sometimes wish to give their fiduciary the discretion to make gifts to one or more charitable organizations before giving the balance to noncharitable beneficiaries. The advisor must exercise caution in such circumstances to avoid making a nondeductible conditional gift under Treas Reg §20.2055-2(b).

EXAMPLE: If a will or revocable trust provides that the executor or trustee may distribute up to $50,000 to organizations described in IRC §2055(a), the IRS may assert that no amount is deductible even if the entire $50,000 is in fact given. The possibility exists at the moment of death that nothing will be given. However, if the gift is reworded to provide that $50,000 shall be given to organizations described in IRC §2055(a) as the executor or trustee shall select, the entire amount should be deductible provided the gifts are in fact paid.

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§23.79 3. Estate Taxes Payable From Charitable Gift

Internal Revenue Code §2055(c) provides that the estate tax charitable contribution deduction is reduced by taxes payable from assets otherwise passing to charity. This provision merely states what should be common sense: If the funds are not payable to charity, the gift is not deductible as a charitable contribution. The regulations point out that a circular calculation may result from payment of estate taxes from a charitable gift. See Treas Reg §20.2055-3(a)(2).

EXAMPLE: X dies with an estate of $6 million. The terms of X's testamentary instrument provide that $4 million is payable to individual Y, and the balance of X's assets are to be distributed to a qualified charitable donee. The instrument further provides that all estate taxes are to be paid from the property passing to the charitable donee. Assuming X dies with the entire $2 million applicable exclusion amount remaining, the $4 million passing to Y will generate $900,000 (($4,000,000 - $2,000,000) ×.45) in federal estate taxes. Before considering the estate taxes payable on the gift to Y, the $2 million gift payable to the charitable donee is deductible. However, that gift will be reduced by $900,000 and, consequently, the charitable contribution deduction will be reduced. Estate taxes will increase by $405,000 ($900,000 ×.45). This amount will also be charged to the charitable gift, further reducing it, and again generating more estate tax. The results of such circular calculations can be quite surprising. In this case, the net charitable gift is $363,636 ($2,000,000 - $1,636,363) and the resulting federal estate tax is $1,636,363 ($3,636,363 ×.45) on a taxable estate of $3,636,363 ($4,000,000 - $363,636).

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§23.80 4. Charitable Remainder Interest in QTIP Trust

Sometimes a donor wishes to establish a trust for the benefit of a spouse for life with the remainder passing to one or more charitable donees. This can be accomplished by creating a standard charitable remainder trust, with an annuity or unitrust amount payable to the surviving spouse for life. See chap 24. The entire transfer is deductible for estate tax purposes because the value of the annuity or unitrust interest qualifies for the marital deduction under a special rule (IRC §2056(b)(8)) and the value of the remainder interest qualifies for the estate tax charitable contribution deduction.

An alternative is to create a qualified terminable interest property (QTIP) trust with a charitable remainderman that initially qualifies for a full marital deduction under IRC §2056(b)(7)(B). The trust will be included in the estate of the surviving spouse under IRC §2044, but will qualify for an IRC §2055 estate tax deduction when it passes to charity at that time.

PRACTICE TIP: Before making a final decision on which device to use, the planner needs to consider that the inclusion of the QTIP trust in the survivor's estate changes the composition and magnitude of that estate. This may have either a positive or negative impact on the ability of the survivor's estate to qualify for certain tax benefits under IRC §§303 (redemption of stock to pay tax), 2032A (special-use valuation of real property), and 6166 (installment payment of estate tax).

A QTIP trust provides considerably more flexibility than a charitable remainder trust because the QTIP trust is not deemed a charitable trust for tax purposes during the spouse's lifetime. Accordingly, the trust terms can permit invasion of principal if the spouse needs additional funds. Further, the spouse may have the flexibility to purchase assets from the QTIP trust for fair market value, even though this transaction would constitute prohibited self-dealing in the context of a charitable remainder trust.

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§23.81 5. Powers of Appointment

Internal Revenue Code §2055(b) provides that an estate tax charitable contribution deduction will be available when assets pass to one or more charitable donees after inclusion in the decedent's gross estate by reason of IRC §2041. See Treas Reg §20.2055-1(b). Section 2041 provides that assets are includable in the gross estate of a decedent if the assets were subject to a general power of appointment. See chap 9. Thus, if a decedent dies holding a general power of appointment and the assets pass to one or more charitable donees, an estate tax deduction is allowable in the estate of the powerholder. On the other hand, if the power of appointment is a limited power of appointment, the assets generally will not be includable in the decedent's gross estate and thus no deduction is necessary or allowed.

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§23.82 6. Retirement Plans and Charitable Giving

When a donor plans to make bequests to both charitable beneficiaries and noncharitable beneficiaries at death and the donor participates in one or more tax-deferred retirement plans, he or she should consider allocating the interests in the retirement plans to the charitable beneficiaries first if permitted by the rules governing the plan. See chap 21. The reason is that the funds in the retirement plans will be subject to income tax as income in respect of a decedent (IRD) under IRC §691 when they are paid to noncharitable beneficiaries, but not when they are paid to charitable beneficiaries, because the charitable beneficiaries are generally exempt from income taxation. See §23.5. The funds are allocated to the charitable gift by designating the charitable beneficiaries as the designated beneficiaries of the retirement plan.

PRACTICE TIP: If a donor wishes to name his or her estate or revocable trust as the beneficiary of a retirement plan and name a charitable beneficiary under his or her will or revocable trust, the advisor must be extremely careful not to accelerate the income in respect of a decedent (IRD) under IRC §691. The result of accelerating the IRD could be that the estate or trust would be taxable on the income and the charitable beneficiary would receive only the balance after income taxes.

NOTE: Donors who have attained age 70½ may contribute directly to charities from their individual retirement accounts. The contributions are excluded from gross income. IRC §408(d)(8). This avoids the income tax deduction limitation based on the donor's contribution base. The amount that may be contributed annually is limited to $100,000. The exclusion does not apply to tax years after 2009 unless extended. See §23.60A.

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§23.83 IV. GIFT TAX CHARITABLE CONTRIBUTION DEDUCTION

Citizens and residents of the United States may receive deductions for gift tax purposes for gift transfers to qualified organizations. IRC §2522(a). Nonresidents who are not citizens also receive a gift tax charitable contribution deduction, but the list of qualified donees is restricted to domestic donees and uses. IRC §2522(b).

NOTE: This restriction is generally consistent with the scope of the tax. Nonresidents who are not citizens are taxed only on gifts of property situated in the United States. IRC §2501(d)(2). The estate tax also applies to estates of nonresident noncitizens only with respect to property situated in the United States. IRC §2101(a). See chap 16.

The gift tax charitable contribution deduction is important because, without it, contributions to charities would use up the donor's applicable exclusion amount and eventually generate gift tax or estate tax. The estate tax rules discussed in §§23.61-23.82 generally apply to the gift tax charitable deduction. Certain loans of artwork to charity, however, are specifically excluded from the gift tax and do not rely on the gift tax deduction. See IRC §2503(g). Certain contributions to political organizations are also excluded. See IRC §2501(a)(4).

Section 2522(c) provides that the gift tax charitable contribution deduction may be disallowed or recaptured in certain circumstances. See also IRC §2055(e) (setting forth a similar list for the estate tax deduction). The gift tax deduction will be disallowed in the following circumstances:

- Contributions to organizations described in IRC §508(d) (organizations subject to the IRC §507(c) termination tax for violating the private foundation rules or that do not meet the organization requirements for qualified donees). IRC §2522(c)(1).
- Contributions to organizations described in IRC §4948(c)(4) (certain organizations that have engaged in prohibited transactions). IRC §2522(c)(1).
- Contributions of nondeductible partial interests in property. IRC §2522(c)(2). See §23.66.
- Certain contributions to donor-advised funds. IRC §2522(c)(5). See §23.68.
- Certain contributions of undivided interests in tangible personal property. IRC §2522(e). See §23.90.

WARNING: The rule on tangible personal property is a potential pitfall. A gift of a fractional interest in tangible personal property to a qualified charitable donee can give rise to federal gift tax if recapture applies under IRC §2522(e).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.84 V. SPLIT-INTEREST CHARITABLE GIFTS

§23.84 V. SPLIT-INTEREST CHARITABLE GIFTS

As a general rule, no deduction is allowable for income, estate, and gift tax purposes when a taxpayer contributes less than his or her entire interest in the property. IRC §§170(f)(3), 2055(e)(2), 2522(c)(2). A contribution of the right to use property is a contribution of less than the contributor's entire interest in the property for this purpose. Treas Reg §1.170A-7(a)(1).

PRACTICE TIP: Because of the general rule, advisers need to be careful in structuring transactions that provide income interests to noncharitable beneficiaries, with the remainder passing to charity. For example, wills sometimes provide that all trust income is payable to a noncharitable beneficiary for life and the remainder is payable to a 170(c) organization. No charitable contribution deduction is allowed for transfers to such a trust. While IRC §§170, 2055, and 2522 all contain provisions for reforming such trusts into qualifying charitable remainder trusts, reformation is not always possible. See chap 24.

The principal exceptions to this rule are the following:

- Charitable remainder trusts (see §23.85);
- Charitable lead trusts (see §23.86);
- Remainder interests in a personal residence or farm (see §23.87);
- Contributions of certain undivided interests (see §§23.88-23.90);
- Pooled income funds (see §23.91);
- Charitable gift annuities (see §23.92);
- Qualified conservation contributions (see §§23.93-23.102).

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§23.85 A. Charitable Remainder Trusts

A charitable remainder trust (CRT) is an irrevocable trust benefiting one or more noncharitable beneficiaries for an initial term and thereafter benefiting one or more IRC §170(c) organizations. A properly established CRT is exempt from income taxation, except as to unrelated business taxable income. IRC §664(c). The donor is entitled to an income tax charitable contribution deduction for the calculated present value of the remainder interest passing to charity at the end of the initial term. IRC §170(f)(2)(A). The calculated present value of the remainder interest is also deductible for estate and gift tax purposes. IRC §§2055(e)(2)(A), 2522(c)(2)(A). CRTs are discussed in detail in chap 24.

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§23.86 B. Charitable Lead Trusts

A charitable lead trust (CLT) is an irrevocable trust benefiting one or more IRC §170(c) organizations for an initial term and thereafter benefiting noncharitable beneficiaries. CLTs are taxable as complex trusts under Subchapter J (IRC §§641-679), unless the trust is structured as a defective grantor trust. No income tax deduction is allowed for a contribution to a CLT, unless the CLT is structured as a defective grantor trust. IRC §170(f)(2)(B). In that case, an income tax deduction is allowed for the calculated present value of the charitable lead interest. The calculated present value of the charitable lead interest is also deductible for estate and gift tax purposes. IRC §§2055(e)(2)(B), 2522(c)(2)(B). CLTs are discussed in detail in chap 23A.

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§23.87 C. Remainder Interest in Personal Residence or Farm

A donor may contribute his or her personal residence (*e.g.,* principal residence or vacation home) or farm and retain the right to the rent-free use of the residence or farm for life. The calculated value of the remainder interest passing to charity is deductible for income, estate, and gift tax purposes, subject to all of the previously discussed limitations. IRC §§170(f)(3)(B)(i), 2055(e)(2), 2522(c)(2). If the property has been depreciated, an adjustment is required to recapture the depreciation benefit previously taken. Rev Rul 76-473, 1976-2 Cum Bull 306.

PRACTICE TIP: The benefit of this technique is that an older client can obtain a large current income tax deduction without giving up the use of the asset given. This can be a very good technique for the right client.

The term "personal residence" means any property used by the donor as a personal residence whether or not it is the donor's principal residence. For example, a vacation home can qualify as a personal residence. Treas Reg §1.170A-7(b)(3). A charitable deduction for the remainder interest in a residence may be allowed even though the testator directs that the residence be sold on the death of the life tenant and the sale proceeds distributed to charity. See *Estate of Eliza W. Blackford* (1981) 77 TC 1246. The term "farm" means any land used by the donor or his or her tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. Treas Reg §1.170A-7(b)(4).

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§23.88 D. Contributions of Undivided Interests

A donor generally may contribute an undivided interest in property and deduct the value of the contribution for income, estate, and gift tax purposes, subject to previously discussed limitations. However, the rules applicable to tangible personal property interests (see §23.90) have departed substantially from the rules applicable to all other types of property interests (see §23.89).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.89 1. Property Other Than Tangible Personal Property

§23.89 1. Property Other Than Tangible Personal Property

A contribution of an undivided interest in property other than tangible personal property (*e.g.,* real property) is deductible, subject to the usual limitations on all contributions of property. IRC §§170(f)(3)(B)(ii), 2055(e)(2), 2522(c)(2). An undivided interest in real property includes, for example, a tenancy in common interest, whereby each owner of a fractional interest has the right to possession of the entire property. Treas Reg §1.170A-7(b)(1).

WARNING: This exception applies only to fractional, undivided interests. It is very important to ensure that a partial interest intended to satisfy this rule truly is an undivided interest in the entire property.

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§23.90 2. Tangible Personal Property

A contribution of an undivided interest in tangible personal property may be deductible, provided some additional requirements are met. IRC §§170(f)(3)(B)(ii), 170(o), 2055(e)(2), 2522(c)(2), (e). To be deductible for income tax and gift tax purposes, the donor (or the donor and the donee together) must own the entire property and the remaining portion of the property must be contributed by the donor to the same charity within 10 years or on the donor's earlier death. If the donor or the donor and the donee together do not own the entire property when a fractional-interest contribution is made, no deduction is allowed. IRC §§170(o)(1), 2522(e)(1). The deduction for additional contributions of interests in the same property will be based on the fair market value of the property at the time of the initial contribution. IRC §170(o)(2). Further, if a contribution of a fractional interest is made, but the donor fails to contribute the balance of the property within 10 years, the donor will be required to include in income the amount of the charitable contribution deduction allowed. IRC §170(o)(3). In addition, an interest charge (*i.e.,* a penalty) applies. See also IRC §2522(e)(2) (recapture of gift tax deductions).

NOTE: Before the enactment of IRC §170(o), a donor could donate an undivided interest in a painting or other asset and donate the balance at any time or never. In addition, the donor could receive a charitable contribution deduction for any partial interest, provided the partial interest constituted his or her entire interest in the property. For example, if an individual had always owned a 20-percent undivided interest in real property, contribution of the entire 20-percent interest was not considered the contribution of a partial interest and thus was deductible as discussed in §23.89. Section 170(o) changes this rule for tangible personal property and requires that the donor or the donor and the donee IRC §170(c) organization own the entire property when the first fractional-interest gift is made. IRC §170(o)(1)(A). However, the IRS is authorized to issue regulations to provide exceptions in cases when all owners of an interest in the property make proportional contributions of an undivided portion of the entire interest. IRC §170(o)(1)(B).

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§23.91 E. Pooled Income Funds

A pooled income fund is a trust maintained by a public charity to which a donor may contribute property while reserving a life income interest to himself or herself. IRC §642(c)(5). A charitable contribution deduction is generally available for the calculated present value of the remainder interest. See IRC §§170(f)(2), 2055(e)(2)(A), 2522(c)(2)(A) (each providing that the rule of nondeductible partial interests does not apply to pooled income funds). Because pooled income funds have significant disadvantages relative to a charitable remainder trust or charitable gift annuity, such funds are becoming scarce in practice.

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§23.92 F. Charitable Gift Annuities

A charitable gift annuity involves a transfer of property to a charity in exchange for an annuity—normally an annuity for the benefit of the donor or a joint and survivor annuity for the donor and the donor's spouse. The amount transferred will exceed the value of the annuity (as valued under IRC §7520). An immediate income tax deduction is allowed for the excess value. IRC §170(c); Treas Reg §1.170A-1(d). The obligation to pay the annuity is a general obligation of the issuing charity; the payment is not made from a specified fund as in a charitable remainder trust (see chap 24) or a pooled income fund (see §23.91). The annuity can be immediate or deferred. Some charities will issue charitable annuities in exchange for a remainder interest in a residence or farm (see §23.87), and this technique can be quite favorable for the right client.

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§23.93 G. Conservation Contributions

The Internal Revenue Code provides substantial tax benefits for owners of real property who make contributions for conservation purposes. The benefits include income tax (see §§23.94-23.97) and estate and gift tax (see §§23.98-23.102) deductions and exclusions.

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§23.94 1. Income Tax Deduction

Section 170(h) provides an income tax deduction for a "qualified conservation contribution." That term requires a contribution of a "qualified real property interest" (see §23.95) to a "qualified organization" (see §23.96) exclusively for "conservation purposes" (see §23.97). IRC §170(h)(1); Treas Reg §1.170A-14(a).

NOTE: The amount of the income tax deduction allowed under IRC §170(h) is reduced to take account of any tax credits allowed to the donor under IRC §47 (rehabilitation credit) in the preceding 5 years.

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§23.95 a. Qualified Real Property Interest

The term "qualified real property interest" is defined in IRC §170(h)(2) and Treas Reg §1.170A-14(b). The term includes contributions of remainder interests in property, contributions of the donor's entire interest in property (*e.g.,* the donor owns only an undivided portion of the property), and contributions of a restriction (granted in perpetuity) on the use that may be made of the property. The restriction in perpetuity is often referred to as a "conservation easement." IRC §170(h)(2)(C).

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§23.96 b. Qualified Organization

The meaning of the term "qualified organization" is very restricted. The only organizations that may receive qualified conservation contributions are governmental units and public charities. IRC §170(h)(3); Treas Reg §1.170A-14(c).

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§23.97 c. Conservation Purpose

The term "conservation purpose" is defined in IRC §170(h)(4). Such a purpose includes preservation of land for outdoor recreation or education, protection of the natural habitat of plants or animals, preservation of open space, or preservation of an historically important land area or a certified historic structure. The conservation purpose must be protected in perpetuity. IRC §170(h)(5)(A).

Qualifying purposes are clarified at some length in Treas Reg §1.170A-14(d). In *Charles F. Glass* (2005) 124 TC 258, the court held that easements limiting development of portions of lakefront property were qualified because they protected a "relatively natural habitat" for bald eagles and two endangered plants under Treas Reg §1.170A-14(d)(3). Contributions for open space are particularly restricted, with the regulations requiring, among other things, substantial public benefit and furtherance of a "clearly delineated federal, state, or local government conservation policy." Treas Reg §1.170A-14(d)(4)(i)(A). In *Kiva Dunes Conservation, LLC*, TC Memo 2009-145, however, the court allowed a $28.7 million deduction for the donation of a conservation easement that effectively preserved the current use of a golf course. Under the facts of the case, the value of the easement was the value of the golf course land before the contribution of the easement, minus the value of that land after the contribution, minus an increase in the value of land owned by a related party that resulted from the easement. Treas Reg §1.170A-14(h)(3)(i).

Additional rules apply to so-called "façade easements." A façade easement is an easement whereby the donor contributes a restriction on modifying the exterior of a building in a registered historic district. Section 170(h)(4)(B) provides special rules on what constitutes a conservation purpose in the context of a façade easement. Section 170(f)(13) requires the payment of a $500 filing fee with the tax return claiming an income tax deduction for a façade easement if the deduction is in excess of $10,000. In *Whitehouse Hotel Ltd. Partnership* (2008) 131 TC 112, the court held that a partnership grossly overstated the value of its donation of a façade easement in a downtown New Orleans historic building. The court concluded that the taxpayer's appraiser's income approach, which included an annual expenditure for a "façade replacement reserve" based on the estimated cost of replacing the entire glazed terra cotta façade, was not reliable and should be rejected in favor of a comparable sales approach. In *Dorothy Jean Simmons*, TC Memo 2009-208, the court concluded that façade easements for two residences in historic districts of Washington, D.C., reduced the values of the residences by 5 percent (not the claimed 13 and 11 percent, respectively).

In *J. Maurice Herman*, TC Memo 2009-205, the court disallowed a $21,850,000 income tax deduction claimed for a contribution of a conservation easement that reduced possible future enlargement of a Fifth Avenue, New York City historic building because it did not preserve a "historically important land area" or a "certified historic structure" within the meaning of IRC §170(h)(4)(A)(iv). The court found that the easement did not preserve anything because it did not prevent the taxpayer from totally altering the appearance of the building, or even prevent him from demolishing it.

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§23.98 2. Estate and Gift Tax Deduction

An estate tax deduction under IRC §2055 is permitted for a qualified conservation contribution at death. The requirements to qualify for the deduction generally are the same as for the income tax deduction. Treas Reg §20.2055-2(e)(2)(iv). See §23.94. The estate tax deduction rules for qualified conservation contributions are unusual in that it is sometimes possible to claim an estate tax deduction for a contribution of a conservation easement made by a member of the decedent's family or by his or her fiduciary. See §23.102.

A gift tax deduction under IRC §2522 is permitted for a charitable interest that is a qualified conservation contribution as defined in Treas Reg §1.170A-14 for income tax purposes. Treas Reg §25.2522(c)-3(c)(2)(iv). This has the effect of reducing the estate tax value of the retained property interest eventually included in the donor's taxable estate.

PRACTICE TIP: Generally, it is preferable to convey the easement before the donor's death because an income tax deduction will usually be available, in addition to a reduction in the estate tax value of the property.

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§23.99 3. Estate Tax Exclusion

Section 2031(c) provides for an estate tax exclusion for a portion of the value of real property that is "land subject to a qualified conservation easement." See §23.100. This exclusion benefit is something of a "double dip" because it is in addition to the benefit of the reduced estate tax value of the property under IRC §2031(a) resulting from the creation of the easement during life, or the IRC §2055 charitable deduction for creation of the easement at death. On calculation of the exclusion amount, see §23.101.

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§23.100 a. Land Subject to Qualified Conservation Easement

The estate tax exclusion is available for "land subject to a qualified conservation easement." That term is defined as follows (IRC §2031(c)(8)(A)):

- Land located in the United States or a possession of the United States;
- Land owned by the decedent or a member of the decedent's family for the past 3 years; and
- Land with respect to which a qualified conservation easement has been made in a timely fashion under IRC §2031(c)(8)(B) (which may be postmortem, as discussed in §23.102).

Section 2031(c)(8)(B) borrows the definition of "qualified conservation easement" in IRC §170(h), as discussed in §23.94, but modifies it somewhat (*e.g.,* the definition does not include preservation of historically important land areas or certified historic structures).

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Source: Estate Planning/California Estate Planning/23 Charitable Giving/§23.101 b. Calculation of Exclusion Amount

§23.101 b. Calculation of Exclusion Amount

The maximum estate tax exclusion is the lesser of (IRC §2031(c)(1)(A)-(B), (c)(3)):

- $500,000; or
- The "applicable percentage" of the value of the land subject to the easement.

The applicable percentage is 40 percent, reduced (but not below zero) by 2 percentage points for each percentage point (or fraction of a percentage point) by which the value of the qualified conservation easement when created is less than 30 percent of the value of the land (determined without regard to the value of the easement and reduced by the value of any retained development right (as defined)). IRC §2031(c)(2).

EXAMPLE: The decedent owned a small vineyard in the Napa Valley with a date-of-death value of $3 million. Five years before death, when the property was worth $2.5 million, the decedent granted a conservation easement limiting development of the property, which reduced the value of the property to $2 million. Because the easement when created reduced the value of the property by only 20 percent (from $2.5 million to $2 million), rather than 30 percent, the applicable percentage will be 20 percent (40 percent reduced by 2 percentage points for each percentage point difference between 20 percent and 30 percent). The "applicable percentage" of the value of the property is 20 percent of the $3 million date-of-death value of the property (determined without consideration of the easement), or $600,000. The estate tax exclusion is limited to $500,000.

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§23.102 c. Postmortem Imposition

Section 2031(c) permits the estate tax exclusion for conservation easements even if the easement is created by the decedent's executor or a member of the decedent's family. The easement must be created before the deadline for making the election on the estate tax return. See IRC §2031(c)(6), (8)(A)(iii). In such situations, it is also possible to obtain an estate tax deduction, but the heirs cannot claim an income tax deduction as well. IRC §2031(c)(9).

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§23.103 VI. CHARITABLE GIVING VEHICLES

Often a donor will wish to make a large contribution in the current year for tax reasons but select the ultimate beneficiary or beneficiaries of the contribution in future years. For example, a large sale of appreciated securities or a large bonus in a given year may create an unusually high income tax liability for the donor in that year. The donor may wish to offset that gain or income with an income tax charitable contribution deduction. There are three principal avenues by which this may be accomplished. The donor may establish a private foundation (see §§23.104-23.106), a donor-advised fund (§23.107), or a supporting organization (§23.108).

Another alternative to a private foundation is a donor-directed fund. See IRC §170(b)(1)(F)(iii). This fund is a hybrid entity—it is a private foundation treated as a public charity for purposes of determining the charitable contribution income tax deduction. In this type of fund, the donor retains the right to direct how the income and principal from the fund will be distributed to public charities. Although the right may be exercised by a nondonor spouse, all retained rights terminate with the death of the second to die of the donor and the spouse, at which time the entire donor-directed fund is distributed to qualifying public charities.

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§23.104 A. Private Foundations

A private foundation is an entity established under state law (usually as a trust or nonprofit corporation). Private foundations are defined in IRC §509(a). They include any domestic or foreign organizations described in IRC §501(c)(3), other than private operating foundations, distributing foundations, or organizations maintaining a common fund. See IRC §509(a)(1)-(4). The organizational documents usually are stated broadly so that all purposes permissible under IRC §501(c)(3) are authorized. In practice, a private foundation is often little more than organizational documents (*e.g.,* articles of incorporation and bylaws for nonprofit corporations, and trust agreements for trusts), bank and brokerage accounts standing in the name and taxpayer identification number of the foundation, and a board of directors and officers (in the case of a nonprofit corporation) or one or more trustees (in the case of a trust). On advantages of private foundations, see §23.105. On disadvantages of private foundations, see §23.106.

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§23.105 1. Advantages of Private Foundations

The principal advantage of a private foundation is autonomy and control. Subject to the limitations of the Internal Revenue Code and local law, a donor can administer the foundation as he or she pleases. He or she may select the ultimate charitable donees, the amount and frequency of distributions, and any other matters to be decided on. For example, a donor may doubt that the public charity will apply the donated assets to the charitable purpose desired by the donor. By donating the assets to a tax-exempt charitable organization that the donor controls, he or she is assured that if circumstances change, the donor and not a third party will decide alternative uses for the assets.

PRACTICE TIP: Clients forming private foundations often ask whether a contribution made before IRS approval is deductible. The general rule is that recognition of exemption is retroactive to the date of formation. Therefore, so long as the corporation has been incorporated or the trust agreement has been executed, a contribution will be deductible, so long as the IRS ultimately approves. However, if the IRS requires any changes to the organizational documents before issuing a favorable determination letter, recognition of exemption may relate back only to the date of the change. Consequently, practitioners should exercise caution in recommending contributions before formal IRS recognition.

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§23.106 2. Disadvantages of Private Foundations

The disadvantages of a private foundation include relatively high expenses of operation, significant and sometimes complex legal limitations, and unfavorable income tax charitable contribution rules. See §§23.29-23.31, 23.37-23.41. Moreover, private foundations pay a small income tax on net investment income under IRC §4940. Excise taxes are imposed on private foundations under IRC §§4941-4945. These taxes, the result of an effort by Congress to prevent perceived abuses by private foundations and their contributors, can be quite restrictive and the penalties severe. Until the enactment of the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780), these penalties applied exclusively to private foundations and not to public charities. They continue to apply primarily to private foundations.

PRACTICE TIP: Generally, there is a threshold asset size beneath which a private foundation cannot be financially justified. The dollar amount of this threshold, which some practitioners place in the millions of dollars and others place much lower, is a matter of debate. Although it may sometimes be possible to operate a private foundation with only $200,000, counsel and the client should carefully consider philanthropic alternatives if a private foundation is to hold less than $1,000,000 in assets. The relevant considerations include the cost of preparing annual filings, legal fees as compared to expected net investment income, and the time required to review unsolicited grant proposals.

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§23.107 B. Donor-Advised Funds

A donor-advised fund is a fund established by a donor as part of a large publicly supported charity (*e.g.,* a community foundation). The fund is normally an account bearing the name of the person or family establishing it. The public charity has the ultimate legal control over the assets contributed to the fund, and distributions from the fund must meet the public charity's criteria. The donor generally enters into an agreement with the public charity whereby the donor may "advise" the public charity on how and when distributions from the fund should be made. So long as the donor's advice meets the public charity's criteria, the advice is generally followed.

The principal benefits of a donor-advised fund account are simplicity and favorable rules regarding income tax charitable contribution deductions. The principal disadvantages include fees charged to administer the fund, possible limitations on investment flexibility, and weakened control over distributions.

PRACTICE TIP: In recent years, donor-advised funds have become extremely popular for donors of relatively small amounts as well as for some donors of large amounts. These funds are often the best choice for donors contributing amounts that are not economically feasible for a stand-alone private foundation. For larger donors, they must be compared with the advantages and disadvantages of a private foundation or supporting organization.

Congress is beginning to take an interest in the operation of donor-advised funds. The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) contains a number of provisions on the subject of donor-advised funds, including a 20-percent excise tax on sponsoring organizations on taxable distributions from donor-advised funds and a 5-percent tax on fund management that agrees to the taxable distribution. IRC §4966(a). Distributions from an IRC §4966(d)(2) donor-advised fund to a donor or donor-adviser and related persons will be treated as excess benefit transactions under IRC §4958(c)(2). Moreover, IRC §4943, relating to excess business holdings, has been expanded to apply to donor-advised funds. It is likely that the rules applicable to donor-advised funds will continue to evolve.

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§23.108 C. Supporting Organizations

A supporting organization is an IRC §501(c)(3) organization that obtains public charity status by virtue of its close relationship with an established public charity. See IRC §509(a)(3). This entity allows an organization that receives little, if any, support from the general public to qualify as a publicly supported charity for tax purposes, on the basis of its relationship to one or more public charities. To do so, the supporting organization must meet an organizational test, an operational test, a relationship test, and a control test. See Treas Reg §1.509(a)-4. The rules relating to supporting organizations are somewhat complicated, and even a general description of supporting organizations is difficult. Suffice it to say that there is a close connection to the public charity, and there is a limited amount of control the donor may exercise.

The principal advantage of supporting organizations is that they are treated as public charities. As a result, favorable rules regarding income tax charitable contribution deductions apply. The principal disadvantages are the lack of control by the donor and the expenses of operation. New excess benefit transaction rules also apply to supporting organizations. See IRC §4958(c)(3).

As with donor-advised funds (see §23.107), Congress is beginning to take an interest in certain supporting organizations. See, *e.g.,* IRC §§4942(g)(4) and 4943(f).

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23A

Charitable Lead Trusts

Jeffrey A. Dennis-Strathmeyer

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§23A.1 I. INTRODUCTION

A charitable lead trust (CLT) is a trust that initially makes all distributions to charity. To qualify for an income tax deduction under IRC §170, a gift tax deduction under IRC §2522, or an estate tax deduction under IRC §2055, the charitable interest must be in the form either of an annuity interest (a right to receive periodic payments of a specific amount of money at least annually) or of a unitrust interest (a right to receive periodic payments of a fixed percentage of the net fair market value of the trust assets, determined annually). Treas Reg §1.170A-6(c)(2)(i)-(ii). If the charitable interest is an annuity, the trust is referred to as a charitable lead annuity trust (CLAT). If the charitable interest is a unitrust interest, the trust is referred to as a charitable lead unitrust (CLUT).

This chapter is primarily devoted to nongrantor CLTs, because of the relative disadvantage of grantor trusts. See §23A.2. The discussion also assumes that the noncharitable beneficiaries of the trust will not include the grantor or the grantor's spouse, because the primary benefit of a CLT is the ability to gift and devise property to others at a reduced transfer tax cost. Finally, because the emphasis is on transfer tax savings, the discussion devotes relatively little attention to charitable lead unitrusts (CLUTs), although it refers to CLTs in general when the statements apply to all charitable lead trusts. Charitable lead annuity trusts (CLATs) produce better transfer tax results than CLUTs. See §23A.3. On tax considerations in using a CLT, see §§23A.4-23A.11. On selection of a CLAT trustee, see §23A.12. On CLAT drafting requirements, see §§23A.13-23A.16. On avoiding grantor trust status, see §23A.17. On using nonqualified charitable lead trusts, see §23A.18. For discussion of charitable remainder trusts, see chap 24.

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§23A.2 A. When CLT May Be Appropriate

Historically, CLTs provided a wide variety of tax planning opportunities. Today these opportunities are limited, and CLTs are suitable only in specialized situations. CLTs may be designed as grantor trusts (*i.e.,* the trust income is taxed to the grantor under IRC §671 during the term of the charitable interest) or nongrantor trusts (*i.e.,* the trust income is taxed to the trust or its beneficiaries). A substantial limitation on the utility of CLTs is the rule that an income tax deduction is allowed only when the trust is a grantor trust, and the trust assets remain taxed to the grantor. IRC §170(f)(2)(B). This result is significantly inferior to the result that occurs in the case of an outright gift, because future income from outright gift property is no longer taxed to the grantor. See §23A.4.

As a consequence, CLTs are most likely to be used when the donor's income tax deduction is no longer important—typically because the transfer occurs at death. There is no income tax deduction for transfers at death, so nothing is lost. In the inter vivos context, the absence of an income tax deduction may be irrelevant when a wealthy individual is effectively not eligible for further income tax deductions because his or her charitable gifts already exceed the applicable percentage of income limitations under IRC §170(b) and will continue to exceed them during the subsequent 5 years of the allowable carryover period. This may occur if the donor is making gifts of appreciated property to a private foundation, because the annual charitable deduction limitation is only 20 percent of the donor's contribution base. IRC §170(b)(1)(D). See chap 23.

The primary benefits of a CLT result from the fact that the estate or gift tax deduction for the transfer is calculated under IRC §7520 using an assumed rate of return equal to 120 percent of the federal midterm interest rate for the month of the transfer (or either of the 2 previous months). If the CLT is a CLAT and actual investment return during the charitable term exceeds the IRC §7520 rate of return, the excess amount passes to the remainder beneficiaries without being subject to estate tax or gift tax. See §§23A.6-23A.7. Special generation-skipping transfer (GST) tax rules applicable to CLATs reduce, but do not eliminate, CLAT benefits in GST tax situations. See §§23A.8-23A.11.

For more detailed discussion of CLATs with forms, see Drafting California Irrevocable Trusts, chap 18A (3d ed Cal CEB 1997). See also California Will Drafting §§14.81-14.99 (3d ed Cal CEB 1992).

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§23A.3 B. When to Use Nongrantor CLATs

To assess the benefit of using a CLAT, it is helpful to compare the results of using such a device with the alternative of making two separate gifts:

(1) An outright gift to charity of an amount equal to the present value of the charitable interest in the proposed CLAT (as determined by using the IRC §7520 interest rate); and

(2) A gift to a trust for remainder beneficiaries of the present value of the remainder interest in the proposed CLAT. Assume that the trust for the remainder beneficiaries will accumulate all income until the end of the charitable term for the proposed CLAT.

If, hypothetically, the selected trust investments for both the proposed CLAT and the alternative proposed trust for remainder beneficiaries have a total investment return for the term that is equal to the rate assumed under IRC §7520, the result is a wash. At the end of the proposed term, the assets that remain in the proposed CLAT will have the same value as the assets in the separate trust for the remainder beneficiaries.

If, however, the actual rate of investment return is higher or lower than the rate assumed under IRC §7520, the value of the remaining assets in the CLAT will similarly be higher or lower than under the proposed trust for remainder beneficiaries. Accordingly, a CLAT is desirable only when the IRC §7520 rate is relatively low or there is otherwise reason to believe that actual investment performance will exceed the assumed rate.

EXAMPLE 1: Suppose that a donor makes a gift of $1 million to a CLAT with a 2-year term. The CLAT will pay $500,000 at the end of each year to the charity. The IRC §7520 rate for the year is 5 percent. Accordingly, the IRS will value the present value of the charitable interest at $929,700 and the present value of the remainder interest at $70,300. These figures assume that the future value of the remainder interest—the amount that will be left in the trust at the end of the term—will be $77,500, which is equal to $70,300 invested at 5 percent for 2 years compounded annually.

EXAMPLE 2: Now assume that the actual rate of investment return is 7 percent. At the end of the 2-year term, the amount in the trust will be $109,910. If, instead, the donor had made a $70,300 gift in trust for 2 years and that sum had grown at the 7-percent rate, that trust would have a value of only $80,486. As a result of using the CLAT, the remainder beneficiaries will receive an additional $29,424 without any increase in gift tax liability. Even if we appropriately discount this figure back to the time of the gift to determine the extra amount that the donor would have been required to invest at 7 percent for 2 years to generate the additional $29,424, the amount that has escaped the transfer tax system is $25,700. The CLAT produces better results because the remainder beneficiaries receive the benefit of improved investment performance on a much larger fund than would be the case if they had been the beneficiaries of a smaller separate trust benefiting only themselves.

EXAMPLE 3: Suppose instead that the donor makes a gift of $1 million to a CLUT with a 2-year term. The CLUT will pay 73.5 percent of the trust assets at the end of each year to the charity. The IRC §7520 rate for the year is 5 percent. Accordingly, the IRS will value the present value of the charitable interest at $929,774 and the present value of the remainder interest at $70,226—approximately the same values as in Example 1. Now assume that the actual rate of investment return is 7 percent as indicated in Example 2. In the first year, the charity receives $786,450 ($1,070,000 ×.735), and $283,550 is left in the trust. In the second year, the trust grows to $303,400 ($283,550 × 1.07) and the charity receives $223,000 ($303,400 ×.735). At the end of the 2-year term, the amount in the trust will be $80,400—the same amount as would be left in a separate trust funded with an initial gift of $70,226. This is because a proportionate share of the growth of trust assets goes to the charity. The CLAT produces better results in Example 2 because the remainder beneficiaries of the CLAT receive the benefit of the improved investment performance of the entire trust—not just the share of the trust representing the value of the remainder interest.

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II. TAX CONSIDERATIONS

§23A.4 A. Grantor's Income Tax Deduction for Contribution

Entitlement to income tax deductions for transfers to a qualifying charitable lead trust is subject to the percentage of contribution base limitations of IRC §170(b). Entitlement is further restricted by IRC §170(f)(2)(B), which provides that no deduction is allowed if the grantor is treated as the owner of the trust under IRC §671.

Under this provision and Treas Reg §1.170A-6(c)(4), the price of obtaining an income tax deduction in the current year for the present value of the lead interest will be the inclusion of the trust income in the income of the grantor for the charitable term. If the deduction is initially claimed and the donor later dies or otherwise avoids the impact of IRC §671, a portion of the original deduction will be recaptured by then including in the grantor's income the present value of the remaining charitable interest. Although it is sometimes suggested that the impact of subsequent inclusion of trust income in the donor's taxable income can be mitigated by having the trust invest in municipal bonds, a donor could still obtain greater tax benefits by making an outright gift to charity and shifting other investments to municipal bonds. Even if this were not the case, investing exclusively in municipal bonds would likely violate the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054) because of the lack of diversity and expected low rate of total return. Finally, and perhaps most importantly, it is extremely unlikely that municipal bonds will outperform the IRC §7520 rate that is used to value the charitable interest in the first place, with the result that the remaindermen will end up worse off than if the donor had simply made outright gifts to the charity and the remaindermen of amounts equal to the IRC §7520 present values of the respective interests each would have received in a CLT if a CLT had been created.

The income tax detriment of grantor trust status also may be less than the benefit of the initial deduction if trust income is primarily capital gains, but the grantor would still be better off making an outright gift to the charity, thereby completely avoiding tax liability on future income from the transferred property.

If a CLT is not a grantor trust, trust income will be taxed to the trust, but the trust will be entitled to an IRC §642(c)(1) unlimited deduction for amounts of income distributed to the charity. See §23A.5.

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§23A.5 B. Trust's Income Tax Deduction

Although in most situations a properly drafted CLT will not have a significant income tax liability, a CLT is not exempt from income taxes. It is generally taxed as a complex trust and is entitled to a deduction for amounts distributed to charity under IRC §642(c)(1). There are no percentage limitations, but the deduction cannot exceed the trust's gross income for the year of the deduction. The trustee may elect to treat amounts paid in 1 calendar year as if made in the preceding calendar year.

The governing instrument generally can affect the income tax characterizations of the distributions to the charity. IRC §662(b); Treas Reg §1.643(a)-5(b). At least one commentator has suggested that, to maximize the benefit of the deduction and reduce the taxes imposed on the trust's accumulated income (or the income distributed to the remainder beneficiaries in the final year of the trust), the trust instrument should provide that the charitable distributions are to be paid first from ordinary income, followed in order of priority by short-term capital gain income, long-term capital gain income, unrelated business income (or perhaps that distributions should be made from 50 percent of unrelated business income before long-term capital gains), tax-exempt income, and finally principal. See Teitell, Charitable Lead Trusts §1.05 (1986). The order of payment is significant because no deduction is allowed under IRC §642(c) for any amount allocable to the trust's unrelated business income for the taxable year. IRC §681(a). However, the efficacy of the suggested provision is in doubt. The IRS has issued proposed regulations that expressly state that income-ordering provisions will not be honored unless they have economic effect independent of income tax consequences. Prop Treas Reg §§1.642(c)-3(b)(2), 1.643(a)-5(b). Rather, the distributions will consist of the same proportion of each class of the items of income as the total of each class bears to the total of all classes. See §13.11A.

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§23A.6 C. Estate Tax Deduction

If a qualifying CLT is established at death, the settlor's estate is entitled to an unlimited estate tax deduction for the value of the charitable annuity. IRC §2055. The deduction is also allowable to a surviving spouse's estate when a qualified terminable interest property (QTIP) trust, includable in the survivor's estate under IRC §2044, provides for establishing a CLT on the death of the surviving spouse. The value of the charitable annuity is determined under the IRC §7520 rate at the date of death. An estate tax deduction also will be allowed when a qualifying inter vivos CLT is includable in the estate of the donor under IRC §2036 or §2038, but the value of the deduction is limited to the value of the charitable interest at that time.

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§23A.7 D. Gift Tax Deduction

A gift tax deduction is allowed for the gift of the qualifying charitable annuity or unitrust lead interest when the gift is complete for gift tax purposes. IRC §2522. Assuming that the trust is intended to be a nongrantor CLT with the value of the gift of the remainder determined under the IRC §7520 rate at the time of the transfer (or either of the previous 2 months), the donor cannot retain a power to designate or change the charitable beneficiary. A gift tax return is required for the year that the gift becomes complete. No annual gift tax exclusions are allowable for the gifts to the remainder beneficiaries, because these are gifts of future interests. See IRC §2503(b).

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E. Generation-Skipping Transfer Tax

§23A.8 1. Normal Inclusion Ratio Calculation

The generation-skipping transfer (GST) tax makes specific provisions with respect to CLATs and CLUTs and treats them differently. For purposes of the GST tax, charities are not skip persons (persons assigned two or more generations below the grantor). IRC §2613(b). Accordingly, a transfer to a CLT is never a direct skip. If the trust benefits skip persons, there will eventually be one or more generation-skipping transfers. These may be taxable terminations (when all remaining beneficiaries are nonskip persons) or taxable distributions (whenever a distribution is made to a skip person) or both. IRC §2612. The tax is computed by multiplying the value of the property subject to the transfer by the maximum estate tax rate (45 percent in 2007-2009). IRC §§2001, 2641.

This amount is then further multiplied by the inclusion ratio. The GST tax treatment of CLTs is strongly influenced by the rules for computing the inclusion ratio. For further discussion of GST tax, see chap 11.

In simple situations, the inclusion ratio is equal to one minus the applicable fraction. The denominator of the applicable fraction is the value of the transferred property at the time of the transfer, and the numerator is the amount of the donor's GST exemption that the donor chooses to allocate to the particular transfer. IRC §2642(a)(2). Without special provisions, these rules would make it virtually impossible to create a CLT that would benefit skip persons in a manner that makes optimum use of GST exemption. It would be foolish, for example, to allocate $1 million of GST exemption to a $1 million trust (which would produce a fully exempt trust with an applicable fraction of one and, therefore, an inclusion ratio of zero) if the primary trust beneficiary was a charity, because the remainder beneficiaries would receive substantially less than the trust's $1 million value.

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§23A.9 2. Special CLT Inclusion Ratio Rules

Because of the problem described in §23A.8, the GST tax contains one special rule that applies to all generation-skipping CLTs, and two additional rules that apply to charitable lead annuity trusts but not to charitable lead unitrusts. The rule applicable to all CLTs provides that, for purposes of determining the applicable fraction, the value of the denominator is the value of the property in the trust *reduced by* any gift tax or estate tax charitable deduction allowed for the transfer to the trust. IRC §2642(a)(2)(B)(ii)(II).

EXAMPLE: If (1) the donor gives $1 million to a CLUT, (2) the present value of the remainder interest under IRC §7520 is $200,000, and (3) the present value of the tax-deductible income interest is $800,000, the donor need allocate only $200,000 of the donor's IRC §2631 GST exemption to the trust to create a fully exempt (applicable fraction of one and inclusion ratio of zero) trust. No matter what the value of the trust assets at the end of the charitable lead term, the inclusion ratio will remain zero because that ratio is already determined.

Two additional rules produce very different results for CLATs. First, the applicable fraction is not determined at the beginning of the trust, but instead is determined immediately after the end of the term of the charitable lead interest. IRC §2642(e)(1)(B). The clear purpose of this rule is to prevent excessive leveraging of the GST exemption in the case of annuity trusts. If investment results are good, it would otherwise be possible to create a CLAT that initially has a value of near zero, make the trust fully GST tax exempt with an allocation of very little GST exemption, and then end up with a very large GST tax-exempt trust at the end of the charitable term. Such excessive leveraging is less of an issue with a unitrust because unexpectedly high investment performance benefits *both* the charity and the remainder beneficiaries, inasmuch as the annual unitrust payment fluctuates with the value of the trust assets.

The second rule applicable only to annuity trusts provides that the numerator of the applicable fraction is the "adjusted" GST exemption allocated to the trust. IRC §2642(e)(1)(A). The adjusted GST exemption is the actual exemption allocated to the trust increased by interest at the IRC §7520 rate used to calculate the amount of the gift or estate tax deduction for the charitable lead annuity interest. IRC §2642(e)(2). See IRS Letter Ruling 200107015 (assignment of CLAT remainder interest by donor's child to child's own children attempted to treat child as GST transferor of only "present value" of interest and might circumvent purpose of IRC §2642(e)).

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§23A.10 a. Example of Annuity Inclusion Rules

The annuity inclusion ratio rules work well when the actual investment rate of return is identical to the rate assumed under IRC §7520.

EXAMPLE 1: A $1 million CLT is established in a month when the IRC §7520 rate is 5 percent. The trust pays an annuity of $200,000 at the end of each year for 5 years. On the basis of the assumed rate of investment return of 5 percent, the annuity has a present value of $865,900 and the remainder has a *present* value of $134,100, a value that assumes that the actual *future* value of the property left in the trust at the end of the charitable term will be $171,149. If the donor allocates $134,100 of GST exemption to the trust at the beginning of the term, the adjusted GST exemption will be calculated by increasing this amount by the same 5 percent per annum. At the end of the 5 years, the adjusted GST exemption will be exactly equal to the $171,149 remaining in the trust at that time, resulting in a GST tax inclusion ratio of zero. In terms of GST tax, the trust ends up in the same situation as would have occurred if the donor had made an outright gift to the charity of $865,900, together with an outright gift to a trust for issue of $134,100 that received an identical allocation of GST exemption.

However, donors establishing CLATs are gambling that the actual rate of return on trust investments will exceed the IRC §7520 rate.

EXAMPLE 2: Suppose that the actual rate of return for the trust in Example 1 is 7 percent rather than 5 percent. At the end of the term, the remaining balance in the trust will be $252,404, but the adjusted GST exemption is still $171,149. If the donor wants the trust to be fully exempt from GST tax, the donor must allocate an additional $81,255 of GST tax exemption to the trust. Alternatively, the donor could and should have been adding GST exemption to the trust at earlier dates inasmuch as "the adjusted GST exemption" rule allows GST exemption to "grow" once it is allocated.

In any event, from a GST tax perspective, a CLAT does not produce any special benefits for a trust that will be protected by GST exemption.

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§23A.11 b. Implications of Annuity Inclusion Rules

Two points are useful to remember about the GST tax inclusion ratio rules for CLATs. First, a CLAT remains superior to a CLUT in generation-skipping situations even though the inclusion ratio for CLUTs is determined at the beginning of the term. It would not be necessary to add additional GST exemption to a CLUT, but under the best of normal circumstances the value of a CLUT remainder grows so slowly that the CLAT will produce better total results even if GST tax must be paid on the increased value. It is simply the price of success.

The second point involves the impact of the GST tax when the CLAT will distribute to skip persons but the donor has no remaining GST tax exemption. A CLAT is useful in these situations, but only to the extent that the planner is able to overcome the fact that GST transfers to skip persons should normally be made in the form of a direct skip, because the GST tax on a direct skip is calculated on a tax-*exclusive* basis (the tax rate is *not* applied to the money to be used to pay the tax), whereas the GST tax on taxable terminations and taxable distributions is calculated on a tax-*inclusive* basis (the tax rate *is* applied to the money to be used to pay the tax).

PRACTICE TIP: To overcome the disadvantage of losing the opportunity to make a direct skip, it is simply necessary to make sure that the value of property transferred to the trust that otherwise would be available to make a comparable direct skip is negligible. If, for example, a proposed $1 million nonexempt generation-skipping CLAT produces a charitable lead interest with a present value of $900,000 and a remainder interest with a present value of $100,000, the transaction should be recast so that only $900,000 goes to the CLAT and the remaining $100,000 is used to make a separate direct skip transfer to a trust benefiting only skip persons.

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§23A.12 III. SELECTION OF CLAT TRUSTEE

No special trustee selection issues are imposed by the rules for obtaining a charitable deduction for a CLAT. However, trustee selection still presents the usual issues involved in designing an irrevocable trust that is intended to avoid estate tax inclusion as well as grantor trust status. See Drafting California Irrevocable Trusts, chap 10 (3d ed Cal CEB 1997). Because the trustee typically has no distribution discretion during the charitable term, it may sometimes be feasible to permit the donor or the donor's spouse to be the trustee during that period, with a successor taking over before discretionary distributions can be made to other beneficiaries. However, an independent trustee (and other restrictions on the role of the donor) may be necessary or desirable if the trust will make distributions to a private foundation. See IRS Letter Ruling 200404009. For discussion of private foundations, see chap 23.

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§23A.13 IV. CLAT DRAFTING REQUIREMENTS

Generally, the requirements for drafting a CLAT are somewhat simpler than for a charitable remainder annuity trust (CRAT). See chap 24. The fundamental requirements for a CLT are that the charitable interests must be annuity or unitrust interests and that all of these payments must be made before payments can be made to noncharitable beneficiaries. (It is permissible to establish a completely separate share of the trust to make earlier distributions to noncharitable beneficiaries, but it is simpler to accomplish this with a separate trust.) Depending on the size of the charitable interest, most or all of the private foundation excise tax rules will apply to the trust, resulting in modest governing instrument requirements. Because of the limited tax benefits for CLATs, the remaining restrictions are relatively modest. In contrast to a charitable remainder trust (CRT), there are no minimum or maximum term requirements, except for the applicable rule against perpetuities, nor is there a minimum charitable benefit requirement. In Rev Proc 2007-45, 2007-29 Int Rev Bull 89, the IRS issued sample forms for inter vivos and testamentary charitable lead annuity trusts. The sample forms prohibit additional contributions to the trust after the initial contribution, even though this is not required, and it is recommended that a custom-drafted CLAT include the prohibition.

In the context of inter vivos trusts, the more complicated drafting problems are likely to involve the usual desirability of ensuring that the trust is not a grantor trust for income tax purposes (see §23A.14) and that the donor does not retain any powers that could result in the trust's being included in the grantor's estate.

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§23A.14 A. Guaranteed Annuity Interest

The CLAT must provide the charity with a "guaranteed annuity interest" under Treas Reg §1.170A-6(c)(2)(i). For the most part, these requirements are straightforward as long as the drafter is not attempting to do something unusual.

- The trust must be irrevocable, and the payments to charity cannot be subject to conditions.
- The amount of the payments can be stated in terms of a fixed dollar amount or as a percentage of the value of the trust assets on the date of the transfer.
- In contrast to requirements for charitable remainder trusts, there are no minimum or maximum distribution requirements.
- The annuity amount can be described as a formula that will produce a charitable deduction equal to a specified percentage of the value of the trust. This is primarily useful in the context of a testamentary CLAT, because the drafter will not know what the IRC §7520 rate will be at the settlor's death.

There is also no limitation on the term of the trust, although the term should be less than the period allowed under the Rule Against Perpetuities. Because it is rarely appropriate for a CLAT to define the lead interest with reference to lives in being, the term will usually be stated as a specific number of years. If so, for a trust created in California, the Rule Against Perpetuities will not be violated as long as the trust will terminate in 90 years. Prob C §21205(b).

The regulations limit the class of persons whose lives can be the measuring lives for the charitable lead interest. Permissible measuring lives include the settlor, the settlor's spouse, and any individual who, with respect to all noncharitable remainder beneficiaries, is either a lineal ancestor or the spouse of a lineal ancestor. The regulations permit the naming of unrelated contingent remainder beneficiaries if there is less than a 15-percent probability that the remainder will pass to a person who does not have a permitted relationship to the measuring-life individual. Treas Reg §1.170A-6(c)(2)(i)(A).

Because the interest of the charity must be determinable at the outset, the IRS contends that the trust must prohibit commutation during the trust term. Rev Rul 88-27, 1988-1 Cum Bull 331.

It might be noted that there are exceptions to the general rule that a CLAT cannot permit distributions for private purposes during the term of the charitable annuity. The regulations allow a deduction for a charitable interest in a CLAT even though a private interest begins before the expiration of the charitable interest if the private interest is in the form of a guaranteed annuity interest and the trust instrument does not provide any preference or priority in payment of the private annuity as opposed to the charitable annuity, or the private annuity is payable only from a group of assets devoted exclusively to private purposes. Treas Reg §1.170A-6(c)(2)(i)(E). It is difficult to conceive of a situation in which it would be desirable to draft a trust that would make use of these exceptions.

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§23A.15 B. Private Foundation Prohibitions

Generally, a CLT is subject to private foundation excise taxes imposed under IRC §§4941-4945. IRC §4947(a)(2). See §§24.8-24.10. Under IRC §§508(e) and 4947(a)(2) the governing instrument generally must contain prohibitions concerning those sections. In the rare case that the present value of the lead interest at the inception of the trust is less than 60 percent of the total assets of the trust on that date, the trust will not be subject to IRC §§4943-4944, in which case the prohibitions concerning those sections may be deleted. IRC §4947(b)(3)(A); Treas Reg §1.170A-6(c)(2)(i)(D).

In IRS Letter Ruling 200029033, the IRS ruled that noncharitable remaindermen of a 20-year CLAT could have the power to select charitable recipients of payments from the trust after the grantor's death and may select private foundations without violating the self-dealing rules, even if they are managers of the selected foundations, because any benefit to the manager will be "incidental or tenuous." Treas Reg §53.4941(d)-2(f)(2).

Private foundations are generally subject to a 2-percent excise tax on net investment income. IRC §4940(a). In Notice 2004-35, 2004-1 Cum Bull 889, the IRS stated that it will propose regulations clarifying that net investment income does not include distributions from trusts or estates, and that the distributions will not retain their character in the hands of the foundation for purposes of determining net investment income under IRC §4940(c). In Notice 2004-36, 2004-1 Cum Bull 889, the IRS stated that it will propose regulations consistent with *Ann Jackson Family Found.* (1991) 97 TC 534, aff'd (9th Cir 1994) 15 F3d 917. In that case, the Tax Court and the Ninth Circuit held that a private foundation need not include the income portion of trust distributions in "distributable amounts" for purposes of the IRC §4942 tax on undistributed income, as required by Treas Reg §53.4942(a)-2. These two notices greatly facilitate the use of charitable lead trusts. See 16 Prob Prac Rep 10 (June 2004).

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§23A.16 3. Charitable Deduction Savings Clause

Although not expressly required, it is good practice to provide a savings clause that clarifies the intended tax deductions and provides for selection of an alternate charitable recipient if the named charity later fails to qualify. If the CLAT is not intended to qualify for an income tax deduction, it is not necessary for the clause to refer to IRC §170. Indeed, this could be undesirable inasmuch as the estate and gift tax deduction provisions in IRC §§2055 and 2522 allow a broader group of recipients than the income tax provisions as a result of the absence of the IRC §170(c) requirement that the recipient be created under the laws of the United States, a state, the District of Columbia, or a possession of the United States. California has a savings statute for CLATs. Prob C §21541.

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§23A.17 V. AVOIDING GRANTOR TRUST STATUS

Merely stating that a CLAT is a "nongrantor" trust that is not taxed to the grantor under IRC §671 does not produce that result. The drafter of a nongrantor CLAT confronts the same issues that are confronted with any inter vivos irrevocable trust that is not to be taxed to the grantor and not to be included in the grantor's estate. In IRS Letter Ruling 200404009, the IRS issued extensive favorable rulings concerning CLATs that made most charitable distributions to a private foundation but allowed the noncharitable remainder beneficiaries to appoint some distributions to other charities. The IRS ruled that the powers to appoint among charities did not cause grantor trust status, because of the express terms of IRC §674(b)(4). While the trust document and ruling request may be more detailed than necessary, they provide something of a checklist that drafters may find helpful. For a general discussion of the grantor trust rules, see §§13.92-13.134.

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§23A.18 VI. NONQUALIFIED CHARITABLE LEAD TRUSTS

In rare cases, a gift tax deduction may be available for interests in a nongrantor CLT that is not a CLAT or CLUT. As with all nongrantor CLTs, the grantor does not receive an income tax deduction for the contribution to the trust. See §23A.4.

For example, if the grantor retains the right to designate the charities to receive the income each year, the gift of the income interest will be incomplete, but the grantor will be treated as making a gift and receive an IRC §2522 gift tax deduction each year as the income is paid at the grantor's direction. The income interest will be disregarded in valuing the remainder interest under IRC §2702, however, if a spouse, sibling, ancestor, or descendant of the grantor, or spouse of a sibling, ancestor, or descendant, has the remainder interest. As a result, this technique is effective only for transfers to nonfamily members or more distant relations, such as nieces and nephews.

If the income interest is divided among many charities so that the value of the interest of each charity on creation of the trust is less than $12,000, the gift of the income interest to each charity is a gift of a present interest that should be eligible for the IRC §2503(b) annual gift tax exclusion. If the trust is not a grantor trust, the grantor will not be taxed on the income. This exclusion from income has the same effect as an annual income tax deduction but is not subject to the percentage limitations of IRC §170.

Finally, if the grantor sells the remainder interest for its actuarial value as determined under IRC §7520 and makes a gift of the income interest to charity, the grantor may receive an IRC §2522 gift tax deduction for the income interest under an exception to the general rule of disallowance of the deduction for partial interests. See IRS Letter Ruling 8008105. The income interest will not be disregarded in valuing the remainder interest under IRC §2702, even if a spouse, sibling, ancestor, or descendant of the grantor, or spouse of a sibling, ancestor, or descendant, has the remainder interest, because the grantor does not retain an interest in the trust.

For further discussion of these techniques, see McCaffrey, *Charitable Lead Trusts—Estate Planning for the Philanthropic Optimist*, Estate Planning 2003, chap 7 (Cal CEB 2003). See also Grumet, *Choosing the Best Charitable Lead Trust to Meet a Client's Needs*, 30 Est Plan 86 (2003).

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24

Charitable Remainder Trusts

Erik Dryburgh

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§24.1 I. BASIC FEATURES OF CHARITABLE REMAINDER TRUST

A charitable remainder trust is a form of trust that provides payments to one or more noncharitable beneficiaries (*i.e.*, recipients) for their lifetimes or a term of years. On the death of the final recipient or at the end of the term, the trust terminates and the balance of the principal is distributed to charity. A trust remainder interest passing to charity will be deductible for federal and California income, federal estate, and federal gift tax purposes only if it is made in the form of a charitable remainder annuity trust (IRC §664(d)(1)) or a charitable remainder unitrust (or its alternative, a charitable remainder income-only unitrust) (IRC §664(d)(2)-(3)). IRC §§170(f)(3)(B) (income tax), 2055(e)(2) (estate tax), 2522(c)(2) (gift tax). See chap 23.

NOTE: This requirement that the trust must be in the form of an annuity trust or unitrust is strictly construed. In *Zabel v U.S.* (D Neb 1998) 995 F Supp 1036, for example, no charitable deduction was allowed for a testamentary trust providing that 50 percent of net trust income was to be distributed in equal shares to two charities that were also the remainder beneficiaries of the trust after 21 years or on the earlier death of specified individuals entitled to the other 50 percent of trust income. The court held that the trust was a single split-interest trust that was not an annuity trust or a unitrust, despite the argument that the charities in effect received 50 percent of the trust. In *Galloway v U.S.* (3d Cir 2007) 492 F3d 219, no charitable deduction was allowed for a trust that provided that 50 percent of each of two distributions (first one-half of the residue, then the remainder of the trust) would go to charity. The court concluded that the trust was a split-interest trust under the plain language of IRC §2055(e)(2), even though the trust did not present the potential for abuse that caused Congress to enact the statute. In *Estate of Tamulis v Commissioner* (7th Cir 2007) 509 F3d 343, the court held that the doctrine of substantial compliance could not be applied to excuse a failure to timely file a state court proceeding to reform a defective charitable remainder trust into a unitrust.

This chapter focuses on the question "Should I recommend that my client create a charitable remainder trust?" It addresses how to evaluate whether a charitable remainder trust is appropriate (see §§24.2-24.11), and if so, what form of trust best suits the client's needs (see §§24.12-24.23). It also covers certain issues raised by the asset used to fund the trust. See §§24.24-24.28.

This chapter does not discuss the technical issues involved in creating or drafting a charitable remainder trust. For detailed discussion of those issues, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

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II. EVALUATING USE OF CHARITABLE REMAINDER TRUST

A. When to Recommend Charitable Remainder Trust

§24.2 1. Charitable Intent

Clients are often motivated to create a charitable remainder trust because they sincerely want to make a gift to their favorite charity. A charitable remainder trust can be a very tax-effective gift vehicle for accomplishing this purpose. Although a genuine altruistic motive is not a statutory requirement, the lack of charitable intent should send up a red flag.

PRACTICE TIP: A client without genuine charitable intent should create a charitable remainder trust only after very careful consideration. It is certainly possible to assemble financial projections that indicate that it will be to a client's financial advantage to liquidate an asset via a charitable remainder trust as opposed to an outright sale, *i.e.*, projections that show the client will net more funds, after tax, on a present value basis by using a charitable remainder trust than by not using a charitable remainder trust. See §24.11. In the author's experience, however, clients who lack a meaningful charitable motive are more likely to be upset if the financial projections prove to be unduly optimistic and are less willing to tolerate the costs and restrictions generated by a charitable remainder trust. On other methods of charitable giving, see chap 23.

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§24.3 2. Appreciated Assets

The classic candidate for a charitable remainder trust is a client with a highly appreciated asset that he or she wishes to sell. The benefits to contributing the asset to a charitable remainder trust and then selling the asset include:

- The gift to the charitable remainder trust generates an income tax deduction for the value of the remainder interest (IRC §170(a); Rev & T C §17201);
- The trust's sale of the asset does not generate any current capital gains tax because a qualified charitable remainder trust is a tax-exempt entity (IRC §664(c));
- The gift to the charitable remainder trust does not trigger gift or estate tax (assuming that the donor, the donor's spouse, or both are the only income beneficiaries);
- The income beneficiary receives an income stream for life or a term of years; and
- At the termination of the trust term, assets are distributed to the charities selected by the donor.

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§24.4 3. Other Reasons

A charitable remainder trust can be an appropriate vehicle in other situations. A parent with a spendthrift child may find that a testamentary charitable remainder trust is a good means of providing income to the child without giving the child access to principal, and will generate a partial estate tax deduction as well.

A charitable remainder trust may also be suitable when a mature child is supporting elderly parents and worries that his or her premature death would create a financial hardship for them. Creating a testamentary trust for the parents might require substantial funds, all of which would be subject to estate tax, even though the parents' need is only to receive an income stream for a relatively finite number of years. A testamentary charitable remainder trust payable to the parents can allow enough funds to be allocated to the trust to ensure a substantial income stream, while still generating a substantial estate tax deduction.

Unmarried couples often find that creating a testamentary charitable remainder trust allows one partner to leave an income stream to the surviving partner while at the same time generating an estate tax deduction for a portion of the transfer. For couples without children, the remainder gift to charity often is in complete alignment with the decedent's overall testamentary wishes.

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B. Disadvantages of Charitable Remainder Trust

§24.5 1. Irrevocability

Despite its attractiveness, a charitable remainder trust is clearly not advisable for all clients. Clients must be aware that a charitable remainder trust is irrevocable and many of its terms may not be amended. For example, the noncharitable beneficiary is entitled to receive only the stated annual payments. See IRC §664(d). In Chief Counsel Advice 200628026, the IRS ruled that the payment by a charitable remainder unitrust of a debt secured by trust property on which the grantor remained personally liable was a constructive distribution to the grantor under IRC §677(a) that caused the grantor to be treated as the owner of the entire trust under the grantor trust rules. Treas Reg §1.677(a)-1(d). Thus, a client who might need access to the trust's principal would not be a good charitable remainder trust candidate. The trust also may be disqualified if the trustee fails to make the stated annual payments to the noncharitable beneficiary. See *Estate of Melvine A. Atkinson* (2000) 115 TC 26, aff'd (11th Cir 2002) 309 F3d 1290. Thus, the client must be able to carefully administer the trust in accordance with the terms of the trust instrument.

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§24.6 2. Lack of Liquidity

As charitable remainder trusts have become an ever more common planning technique, they are increasingly recommended to clients of relatively modest net worth. Great caution needs to be taken before tying up too much of a client's liquid assets in an irrevocable trust. The limitations of a charitable remainder trust can also pose a problem to an entrepreneurial donor. Such clients need to understand that the charitable remainder trust assets may not be easily available for investment in business opportunities or other creative ventures, given the constraints imposed on the investment of trust funds by the Uniform Prudent Investor Act (Prob C §§16045-16054), the adverse consequences of earning unrelated business income (see §24.27), and the stringent self-dealing rules (IRC §§4941, 4947(a)(2); see §24.9).

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§24.7 3. Difficulties of Administration

The administration of a charitable remainder trust can be burdensome. For example, despite being a tax-exempt vehicle, a California charitable remainder trust must file three tax returns—IRS Forms 5227 (Split Interest Trust Information Return) and California FTB Form 541-A (Trust Accumulation of Charitable Amounts) and FTB Form 541-B (Charitable Remainder and Pooled Income Trusts)—in addition to providing the beneficiary with IRS and California Schedules K-1. Although there are no firm guidelines, in the author's experience, a charitable remainder trust with an asset balance of less than $250,000 usually requires very efficient administration to be economically viable.

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§24.8 4. Compliance With Private Foundation Rules

Some of the excise tax provisions imposed on private foundations under Chapter 42 of the Internal Revenue Code also apply to charitable remainder trusts, specifically the rules prohibiting self-dealing (IRC §4941) and taxable expenditures (IRC §4945). IRC §4947(a)(2). However, the private foundation prohibitions against excess business holdings and jeopardizing investments do not apply to charitable remainder trusts. IRC §4947(b)(3). See Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

NOTE: The IRS prototype documents for charitable remainder annuity trusts (Rev Procs 2003-53—2003-60, 2003-2 Cum Bull 230) and charitable remainder unitrusts (Rev Procs 2005-52—2005-59, 2005-2 Cum Bull 326) properly refer only to the self-dealing and taxable expenditure prohibitions.

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§24.9 a. Self-Dealing Rules

The self-dealing rules essentially prohibit "disqualified persons" from engaging in certain prohibited transactions with the trust. See IRC §4941(a)(1). The term "disqualified person" includes (see IRC §4946(a)(1)(A)-(G)):

- Anyone who is a substantial contributor to the trust (see IRC §4946(a)(1)(A));
- Anyone who is a trustee of the trust;
- Anyone who owns more than 20 percent of an entity that is a substantial contributor;
- Certain family members of someone who is a substantial contributor, trustee, or owner of more than 20 percent of an entity that is a substantial contributor; and
- Entities in which any of the persons described above have more than a 35-percent interest.

Prohibited transactions include (IRC §4941(d)):

- The sale, exchange, or lease of property;
- Lending of money, or any extension of credit;
- Furnishing of goods, services, or facilities;
- Payment of compensation or reimbursement of expenses, unless the compensation is for personal services that are reasonable and necessary to the trust's purposes and the amount of compensation or reimbursement is reasonable; and
- Transfer or use of the trust's income or assets (which is a general provision that bars the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the trust).

PRACTICE TIP: The self-dealing rules are not based on fairness or the rule of reason, and they can apply even if the transaction is "fair" to the trust in every respect. As a consequence, a donor cannot rent property held by the trust or purchase an investment held by the trust, even at more than fair market value. In IRS Letter Ruling 200614032, for example, the Service revoked an earlier ruling which had concluded that early termination of a charitable remainder unitrust with a private foundation remainder beneficiary and the division of trust assets between the donor and the foundation according to the current value of the lead and remainder interests valued under IRC §7520 would not result in self-dealing. The Service views such early terminations as essentially a sale by the income beneficiary of the income interest in the trust to the remainder beneficiary. As such, the transaction is a prohibited act of self-dealing between the income beneficiary and the private foundation as to which the income beneficiary is a disqualified person. See §24.10B. But in certain situations, a division of the trust is not considered a sale or prohibited act of self-dealing. See §24.10C. Similarly, the donor cannot charge interest on a loan to the trust. However, the donor may make an interest-free loan to the trust, in which case the donor may have imputed income from the loan as a gift loan under IRC §7872.

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§24.10 b. Taxable Expenditures

Internal Revenue Code §4945 imposes penalties on "taxable expenditures." Although this provision was drafted with private foundations in mind, and thus does not necessarily translate perfectly in the context of a charitable remainder trust, taxable expenditures include amounts paid for (IRC §4945(d)):

- Lobbying;
- Attempting to influence the outcome of a public election;
- Making grants to individuals;
- Making grants to organizations that are not public charities; and
- Expenditures other than for charitable purposes.

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C. Termination of Charitable Remainder Trust

§24.10A 1. Termination by Gift

Some donors wish to terminate their charitable remainder trusts early, and "accelerate" the gift to the charity. Often, the trust has a small principal balance and has become uneconomical to administer. Occasionally, the donors have concluded that they don't really need the income any longer, and wish to complete the gift to the charity so that it can begin to make use of their gift.

The Service has approved numerous such early terminations. See Rev Rul 86-60, 1986-1 Cum Bull 302 (annuity trust). See also IRS Letter Ruling 200633011 (unitrust). In so doing, the IRS has ruled that the income interest is a capital asset, the value of which should be calculated at time of gift, using the income beneficiary's current age, the then-current fair market value of the trust assets, and the applicable federal rate for the month of termination. The value of the income interest will qualify for the income and gift tax charitable contribution deductions. Securing an appraisal of the income interest is recommended. See IRC §170(f)(8).

NOTE: As well as reviewing the federal tax issues, it is important to consider the California state law issues presented by the proposed termination of the trust. Once the income beneficiary has given the income interest to the charity, the trust may (in some cases) automatically terminate under the equitable doctrine of merger. In other cases, it may be possible to terminate the trust upon the consent of all settlors and beneficiaries under Prob C §15404, while other trust terminations may require a court order. See California Trust Administration §§16.10-16.21 (2d ed Cal CEB 2001).

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§24.10B 2. Termination in Favor of Income and Remainder Beneficiaries

In several rulings, the IRS has allowed all the parties to a charitable remainder trust to agree to terminate the trust and distribute the assets to the income and remainder beneficiaries based upon their respective actuarial values. The Service has ruled that income beneficiary's income interest is a long-term capital gain asset with a zero basis, and that the beneficiary "sold" it for the value of the assets received in the termination. See, *e.g.*, IRS Letter Ruling 200127023. The Service has also ruled that that the payment to income beneficiary is "derived solely" from the right to the income amount, and that the termination payment is thus excluded from the prohibition against self-dealing in IRC §4941. See §24.9. However, the IRS has ruled that a proposed partial termination of a trust having assets in excess of those necessary to continue payment of annuities to the noncharitable beneficiaries and early distribution to the charitable remaindermen would not result in any recognition of gain or loss because the interests of the beneficiaries would not differ materially as a result of the transaction. See IRS Letter Ruling 200922013.

The value of the income and remainder interests should be calculated at time of gift, using the income beneficiary's current age, the then-current fair market value of the trust assets, and the applicable federal rate for the month of termination. See IRS Letter Ruling 200739004. Note that if the trust is a net-income unitrust, the income interest should be valued using the lower of the stated unitrust percentage or the applicable federal rate for the month of gift. See IRS Letter Rulings 200725044, 200733014. Note also that this technique will *not* work if the remainder beneficiary is the donor's private foundation, as the deemed "sale" of the income interest is an act of self-dealing between the donor and the private foundation. See IRS Letter Rulings 200614032. Finally, the IRS has required the income beneficiary, and sometimes his or her physician, to certify that the income beneficiary has no health issue that would reduce his or her normal life expectancy.

This can be a very useful technique for those clients who diversified the holdings of their charitable remainder trust but not their personal holdings, and now have a large trust and not much else in the way of investments.

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§24.10C D. Division of Charitable Remainder Trust

In Rev Rul 2008-41, 2008-30 Int Rev Bull 170, the IRS addressed a number of tax issues that are encountered when a charitable remainder trust (CRT) is divided pro rata into several trusts, one for each of the original income beneficiaries. The ruling describes two similar but distinct fact situations. In the first situation, the CRT is divided into two identical trusts. Each new trust has the same terms as the original trust except that each has only one income beneficiary, and each trust asset is divided equally between the two new trusts. The unitrust or annuity trust payments are reduced accordingly. When the current recipient of one trust dies, the assets of that trust go to the other trust, and the subsequent unitrust or annuity payments are increased accordingly. In the second and more common situation, the facts are the same except that the income beneficiaries are a married couple in the process of dissolution. Their single CRT is divided into two separate trusts, each of which will terminate and distribute the remainder to charity on the death of the income beneficiary. Neither spouse will have any rights in the other's trust.

In Rev Rul 2008-41, the IRS concluded that (1) the pro rata division of the trusts into separate trusts will not affect the qualification of either the old trust or the new trusts as CRTs under IRC §664(d); (2) the division will not be treated as a sale, exchange, or other disposition that produces taxable gain or loss, and each new trust takes the property received in the division with a tax basis and holding period carried over from the old trust; (3) the division will not cause a taxable termination under IRC §507; and (4) the division will not constitute either an act of self dealing under IRC §4941 (see §24.9) or a taxable expenditure under IRC §4945 (see §24.10).

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§24.10D E. Abuse of Termination Procedure

The IRS has identified certain transactions involving sales of charitable remainder trust interests as transactions of interest. Notice 2008-99, 2008-47 Int Rev Bull 1194. The Notice announces that the IRS is aware that a particular type of transaction may have the potential for tax avoidance or evasion. Persons engaging in such transactions must report them.

As with most charitable remainder transactions, the donor transfers low basis property to the trust. The trust sells the property but does not recognize gain because of its exempt status. The trust then either retains the cash sale proceeds or acquires new assets (which would have a tax basis equal to the purchase price). Thereafter, in a single transaction, the donor and the charitable remainder beneficiary sell or otherwise dispose of their respective interests in the trust to an unrelated third party for an amount that approximates the fair market value of the assets. The trust is then terminated and its assets are distributed to the third party.

The donor then takes the position that, because there was a sale of all interests in the trust, IRC §1001(e)(1), which disregards basis in the case of a sale of a term interest, does not apply under the exception in IRC §1001(e)(3). Instead, the donor is entitled to a portion of the trust's basis in the new assets at the time of sale. The arguable net result is that the gain on the sale of the originally donated appreciated assets is never taxed, even though only a small portion of the proceeds of the sale ends up in the hands of the charity.

As a result of the transaction being designated a "transaction of interest," persons engaging in the transaction must report the transaction on their income tax returns using Form 8886 (Reportable Transaction Disclosure Statement). Failure to comply can result in the imposition of penalties under IRC §6707A.

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§24.11 III. EVALUATING FINANCIAL IMPACT TO CLIENT

The majority of situations in which a charitable remainder trust is proposed involve an asset that is about to be sold. If a client wishes to retain the asset, contributing it to a charitable remainder trust will generate an income tax deduction at the cost of imposing significant limitations on the ability to use and deal with the asset due to the trust's irrevocable nature (see §24.5) and the federal self-dealing rules (see §24.9). Although these limitations are acceptable to some clients, many may decide instead to retain ownership of the asset.

For clients who are actively considering the sale of an asset, it is relatively easy to prepare projections of the economic consequences of employing a charitable remainder trust. Several companies offer software focusing on charitable remainder trusts and other charitable giving vehicles. The software allows the attorney to calculate the charitable contribution deduction generated by the gift to the trust and the projected after-tax cash flow, using selected earnings, actuarial factors, tax rates, and other assumptions. The attorney can then discount the after-tax cash flow stream back to present value dollars. The present value of the cash flow, when added to the tax savings generated by the income tax deduction, is one measure of the financial benefit to the client from selling an asset via a charitable remainder trust. That amount, when compared to after-tax sales proceeds from an outright sale of the asset, can show the benefit (or cost) of employing a charitable remainder trust.

PRACTICE TIP: If the attorney does not own charitable giving software, some charities with an active planned giving office will prepare calculations at no cost.

The above analysis ignores many important factors, such as the legal complexities and costs of establishing and administering a charitable remainder trust, and the practical consequences to the client of having to live with having a portion of his or her wealth held in a fairly restrictive trust vehicle. It also assumes that the income beneficiary will receive income for the full expected term of the trust (typically the beneficiary's life).

If the risk of a premature death is of concern to the client, he or she might consider using a portion of the additional cash flow generated by the charitable remainder trust to purchase permanent life insurance (especially if an irrevocable life insurance trust is employed).

Alternatively, a client can protect a portion of the principal contributed to the trust by using the tax savings to purchase a single premium life insurance policy. Often, the deduction generated by using a charitable remainder trust creates sufficient tax savings to purchase a policy with a face value of up to 50 percent of the trust principal.

Another technique is to structure the charitable remainder trust to run for life or a term of years (not to exceed 20), whichever is longer. See Treas Reg §§1.664-2(a)(5), 1.664-3(a)(5). If the income beneficiary dies prematurely, the charitable remainder trust will continue for the balance of the term. The trust document will need to direct the remaining payments if the income beneficiary predeceases the term (*e.g.*, to another named individual or heirs-at-law).

NOTE: Designing a trust to run for life or a term of years is a technique that works best in a single-life trust. In a joint husband and wife trust, adding other contingent beneficiaries can defeat the gift and estate tax marital deductions otherwise available for one party's transfer of the successive income interest in his or her portion of the trust to the other. See IRC §§2056(b)(8), 2523(g).

Despite this financial analysis, it should be noted that focusing too intently on the projected economic consequences ignores the positive aspects of making a charitable gift, which is often an important motivation for clients. See §24.2.

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§24.12 IV. DESIGNING CHARITABLE REMAINDER TRUSTS

A charitable remainder trust can provide one of several different formulas for determining the amount of the income beneficiary's annual payout. The selection of the payout formula and payout percentage can have a dramatic impact on the income beneficiary's payments and the remainder beneficiary's gift.

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A. Types of Trusts

§24.13 1. Charitable Remainder Annuity Trust

A charitable remainder annuity trust (CRAT) pays the recipient a fixed annuity, set forth in the trust document as either a fixed dollar amount or a fixed percentage of the initial value of the trust. See IRC §664(d)(1). The amount must be at least 5 percent and not more than 50 percent of the initial net fair market value of the trust. IRC §664(d)(1). This sum may be paid to any "person," as defined in IRC §7701(a)(1). If the person is other than an individual, the term of the trust may not exceed 20 years. If the person is an individual, the trust term may run for the life or lives of the individual or individuals in being when the trust is created or for a term not to exceed 20 years. The property remaining in the trust passes to charitable beneficiaries on the recipient's death or the expiration of the term of years. The value of the charitable remainder must be at least 10 percent of the initial fair market value of the trust assets, and the probability that the annuity will exhaust the trust cannot exceed 5 percent. IRC §664(d)(1)(D); Rev Rul 77-374, 1977-2 Cum Bull 329.

A CRAT provides no inflation protection, but does protect against a reduction in income payments if the portfolio value drops. A CRAT is generally used with elderly clients (and occasionally in other situations) when security is more essential than inflation protection. Note that no additional contributions are allowed to a CRAT. Treas Reg §1.664-2(b).

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2. Charitable Remainder Unitrust

§24.14 a. Standard Unitrust

A standard charitable remainder unitrust (CRUT) pays a fixed percentage of the trust's net fair market value, as annually determined. IRC §664(d)(2). The amount paid to the recipient must be at least 5 percent and not more than 50 percent of the assets valued annually. IRC §664(d)(2)(A). This sum may be paid to any "person," as defined in IRC §7701(a)(1). In IRS Letter Ruling 200622005, the IRS approved a reformation of a testamentary charitable remainder trust that was defective because the unitrust amount was only 4 percent. The reformation apparently gave the charity a 1-percent unitrust interest which the IRS treated as a "qualified interest" so that the difference in value of the charity's interest in the trust resulting from increasing the unitrust amount from 4 to 5 percent was less than 5 percent of the value of the reformable interest, as required by IRC §2055(e)(3)(B)(i). If the person is other than an individual, the term of the trust may not exceed 20 years. If the person is an individual, the trust term may run for the life or lives of the individual or individuals living when the trust is created or for a term not to exceed 20 years. IRC §664(d)(2)(A). During the term of the trust, no amount other than the unitrust amount can be paid to any person other than a charitable organization. IRC §664(d)(2)(B). The property remaining in the trust passes to charitable beneficiaries on the recipient's death or the expiration of the term of years. IRC §664(d)(2)(C). The value of the charitable remainder with respect to each contribution of property to the trust must be at least 10 percent of the net fair market value of the contribution. IRC §664(d)(2)(D).

This form of charitable remainder trust can provide for a measure of inflation protection. If the payout percentage is less than the trust's net investment returns over time, the income payments will increase over time as excess earnings are added to principal. On the other hand, payments from a unitrust can decrease from year to year when the payout percentage exceeds trust earnings.

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b. Net Income Unitrust

§24.15 (1) Definition of Net Income Unitrust

A net income unitrust pays the lesser of (IRC §664(d)(2), (3)):

- A fixed percentage of the trust's net fair market value (*i.e.*, the same approach as used in the standard unitrust; see §24.14), or
- The trust's actual net income for the year.

This form of trust is often coupled with a makeup provision that allows the trustee to record a deficiency each year in which the payout is less than the standard unitrust amount (*i.e.*, the net income limitation is effective). IRC §664(d)(3)(B). If in a subsequent year the trust's net income exceeds the amount determined under the standard unitrust formula, the excess income can be paid out up to the amount of the accumulated deficiency.

This type of trust is also known as a charitable remainder income-only unitrust. It may also be referred to as a NICRUT (if there is no makeup clause) or a NIMCRUT (if there is a makeup clause).

A net income unitrust is appropriate for a client who does not want to invade trust principal and is willing to receive only the trust's annual income. It is also useful when the contributed asset is illiquid and non-income producing.

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§24.16 (2) Determination of Income

Income from a net income unitrust is generally determined under California law and the terms of the trust instrument. Treas Reg §1.664-3(a)(1)(i)(b)(3). See IRC §643(b); Treas Reg §1.643(b)-1. A long-running issue with the IRS has been whether capital gains can be defined as income in the trust instrument (absent a specific provision, gains are generally allocated to principal under Prob C §16355). Regulations expressly allow the trust instrument to define net realized capital gains earned by the trust (other than the pre-contribution gain inherent in the asset at the date of contribution) as income for this purpose. See Treas Reg §1.664-3(a)(1)(i)(b)(3). The trustee cannot, however, have a discretionary power to allocate gains to income; as a result, gains must either be defined as income in the instrument or be allocated pursuant to state law. The regulations also accept the power a trustee has under Prob C §16336 to adjust between principal and income. However, this adjustment power may not be exercised by a trustee who is also a beneficiary (Prob C §16336(b)(7)), which is often the case. The trustee also cannot determine income for these purposes by reference to a fixed percentage of the annual fair market value of trust property by exercising the power to convert the income interest to a unitrust interest of not less than 3 percent and not more than 5 percent of the net fair market value of trust assets under Prob C §§16336.4-16336.7. See Treas Reg §1.664-3(a)(1)(i)(b)(3). For further discussion of unitrust conversion, see chap 24A.

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§24.17 (3) Use as Retirement Vehicle

Some clients use a net income unitrust as a form of retirement vehicle. The general plan is to structure trust investments so that, for some period of time, the trust corpus grows but the trust does not earn distributable net income. Then, when the client desires additional income, the trust investments are revised to generate income. Done successfully, the trust can grow for a period of time essentially tax-free, providing an even larger trust corpus to generate income in the retirement years. The difficulty lies in coordinating the definition of income in the trust document and the investment strategy so as to be able to achieve both deferral in the early years and distributable income in the later years. For example, defining income to exclude gains facilitates the deferral of income payments in the early years, but makes it difficult to generate sufficient income in the later years. Conversely, defining gains as income can make it difficult to defer payments in the earlier years.

PRACTICE TIP: To facilitate using the trust as a retirement vehicle, certain creative investment vehicles can be used that grant the trustee some measure of control over the timing of income, including investing the charitable remainder trust assets in a deferred variable annuity product or closely held partnership. However, careful coordination is required between trust drafting and investment approach. Additionally, the IRS has expressed some discomfort with charitable remainder trusts that appear to provide too much control over the timing of income. (Although the IRS approved a charitable remainder trust that involved a deferred annuity in IRS Letter Ruling 9825001, the issue is one on which the IRS "ordinarily" will not issue a ruling. See Rev Proc 2009-3, §4.01(37), 2009-1 Int Rev Bull 107.)

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§24.18 c. Comparison of Standard Unitrust and Net Income Unitrust

A standard unitrust (CRUT) (see §24.14) is easier to administer than a net income unitrust (see §24.15). Careful tracking of income and principal is not required. The beneficiary's payment can be calculated easily as the payout percentage multiplied by the net fair market value of the trust on the valuation date. With a net income unitrust, careful tracking of trust income is required, and the actual payment due to the beneficiary is not known until after the close of the year when the trust's net income is calculated. In IRS Letter Ruling 200338006, the Service approved conversion of a net income unitrust into a standard unitrust by court order to correct a scrivener's error after the trust was administered for several years as a standard unitrust. In IRS Letter Ruling 200649027, however, the IRS declined to approve judicial reformation of a net income unitrust because in its view the proposed reformation would not be made for the purpose of correcting a scrivener's error. The moral of the ruling is that, if the settlor wants a net income unitrust to "flip" into a standard unitrust, the trust should be drafted that way. See §24.19.

Additionally, the investment adviser of a CRUT is not confined by the need to earn the amounts that would be included in the trust's definition of income. Even if a net income trust defines net realized gains as income (so the adviser is at least not confined to generating ordinary income), the adviser may have to accelerate gains or defer selling loss positions in order to maintain the desired level of trust income.

Although a CRUT may be easier to administer, there is another difference that favors a net income unitrust. The trustee of a CRUT (or a CRAT) is required to make the payment provided for in the trust document. At best, the regulations allow the payment to be deferred under certain circumstances for only a reasonable time after the close of the taxable year. See, *e.g.,* Treas Reg §1.664-2(a)(1)(i). If an illiquid or non-income-producing asset is contributed to a CRUT or a CRAT and does not sell by year end, the trustee may not have sufficient funds to make the required payment. On the other hand, when such an asset is contributed to a net income unitrust, income payments are required during the time the trust holds the asset only to the extent the asset actually generates net income. Once the asset is sold, the proceeds can be reinvested to earn income, hopefully in an amount sufficient to satisfy the beneficiary's payout desires. On the use of flip trusts for illiquid assets, see §24.19.

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§24.19 d. Flip Unitrust

A flip unitrust is a combination of the net income unitrust and standard unitrust payment formulas, specifically allowed under Treas Reg §1.664-3(a)(1)(i)(c). A flip unitrust operates as a net income unitrust (with or without a makeup provision) for a period of time, and then "flips" to a standard unitrust. The flip triggering event must be a specific date or event not in the control of the donor or trustee, *e.g.*, sale of the contributed asset, marriage or divorce. Treas Reg §1.664-3(a)(1)(i)(d). The payout formula must actually change as of the beginning of the year following the triggering event. Treas Reg §1.664-3(a)(1)(i)(c)(3). If the payout formula pre-flip included a makeup provision, any unpaid deficiency is lost.

PRACTICE TIP: Flip unitrusts are commonly used in lieu of net income unitrusts when illiquid, non-income-producing assets are contributed. Once the contributed asset has been sold and the trust has flipped, it is, in the author's experience, noticeably easier to administer than a net income unitrust, both from an investment and an accounting standpoint.

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§24.20 B. Considerations in Selecting Payout Rate

The payout rate in a charitable remainder trust must be at least 5 percent and cannot be more than 50 percent. IRC §664(d)(1)(A), (d)(2)(A). The most obvious consequence of selecting a particular payout rate is its impact on the charitable deduction: the higher the payout rate, the lower the charitable deduction (as determined under IRC §7520).

NOTE: The value of the remainder interest in each contribution to a charitable remainder trust must be at least 10 percent of the asset's value. IRC §664(d)(1)(D), (d)(2)(D). This rule has the impact of limiting how high a payout rate can be used in any particular trust situation. In fact, very young clients may find that they cannot create a charitable remainder trust that pays for life at all; even with a 5-percent payout rate, the deduction falls below 10 percent due to their long life expectancy.

Although the deduction issue is relevant, clients are often more concerned about the impact of the payout rate on the trust's long-term performance. With unitrusts, a higher payout results in less growth (growth that is tax-free or on which tax is deferred) in the trust. At some point in the future, a lower payout unitrust will actually begin to pay more to the beneficiary than a higher payout trust due to the accelerated growth in trust corpus. Good software can assist the attorney in determining the likely crossover point. See §24.11.

It is also important to take the effects of inflation into account.

EXAMPLE: If the client and his or her financial advisers believe that inflation will average 3 percent over the life of the trust, selecting a payout rate 3 percent less than the projected net investment return should produce a unitrust payment that grows over time at roughly the rate of inflation, thereby providing the beneficiary with constant purchasing power over the life of the trust.

PRACTICE TIP: The example above is simplistic, if for no other reason than that earnings and inflation do not proceed on a steady basis over the life of the trust. Careful coordination with the trust's investment adviser and economic modeling can be very helpful. However, the author has seen far more beneficiaries disappointed by a high payout trust that is paying out more than its earnings (and thus starting to lose value) than by a trust with a payout rate that is too low.

The issue is more extreme with a CRAT. Because the payout selected is fixed over the life of the trust, the dollar amount paid to the income beneficiary is generally not affected by the earnings history of the trust (the effect is solely on the remainder beneficiary). However, if the trust fails to earn a sufficient return to meet the payout over an extended period of time, causing an annual invasion of principal, the trust may literally run out of money before the stated termination date.

NOTE: Once an annuity trust starts to invade principal to meet a high payout rate, the consequences may be irreversible. For example, a $10,000 annuity payment due from a trust with a $100,000 corpus is a 10-percent payout rate. If the trust balance drops to $80,000, the payout rate effectively rises to 12.5 percent.

A charitable remainder trust's payout rate can also impact the trustee's investment strategy. Selecting a high payout rate can force a trustee to adopt a more aggressive investment strategy than he or she might otherwise recommend, subjecting the trust to more volatility and risk.

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§24.21 C. Selecting Income Beneficiaries

Often the client is both the donor and the only income beneficiary of the charitable remainder trust. In that situation, transfers to the trust completely escape gift tax because the value of the remainder interest qualifies for a gift tax charitable deduction (IRC §2522(c)(2)(A)), and the retention of the interest does not constitute a transfer to begin with. At death, the value of the trust is included in the donor's estate (IRC §2036), but qualifies fully for a charitable deduction (IRC §2055). If the donor's spouse is an income beneficiary (either solely or with the donor), the spouse's interest will qualify for a gift and estate tax marital deduction. IRC §§2056(b)(8), 2523(g). Gift and estate tax issues will arise, however, if anyone other than the donor and his or her spouse is included as a beneficiary. The actuarial value of the other beneficiary's interest is subject to gift and estate tax. Further, unless the spouse is the only income beneficiary (other than the donor), his or her interest will fail to qualify for the marital deduction for gift and estate tax purposes. IRC §§2056(b)(8), 2523(g).

NOTE: The IRS has held that a charitable remainder trust cannot be funded by more than a single donor, at least if the donors are also beneficiaries. IRS Letter Ruling 9547004. The theory of this ruling was that a trust funded by multiple donors failed to qualify as a trust, and was more appropriately classified as an association. Although not stated in the ruling, IRS personnel have stated in various private and public conversations that the holding of the ruling would not apply to a charitable remainder trust funded by husband and wife.

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§24.22 D. Selecting Charitable Beneficiaries

It is not required that the donor irrevocably designate a single charitable remainder beneficiary. The donor can name multiple beneficiaries, and can keep the right to amend the designation of the charitable beneficiaries. Rev Rul 76-8, 1976-1 Cum Bull 179.

The trust document must contain language providing that if a named charity is no longer qualified at the termination of the trust, the trustee must select a new entity that is qualified. The IRS has provided the following language for this purpose (Rev Proc 2005-52, 2005-2 Cum Bull 326):

> If the Charitable Organization is not an organization described in sections 170(c), 2055(a), and 2522(a) of the Code at the time when any principal or income of the trust is to be distributed to it, then the Trustee shall distribute the then principal and income to one or more organizations described in §§170(c), 2055(a), and 2522(a) as the Trustee shall select, and in the proportions as the Trustee shall decide, in the Trustee's sole discretion.

PRACTICE TIP: The language quoted above contains a potential trap for the unwary. If used as is, with only a reference to IRC §170(c), the language would permit the trustee to redirect the trust assets on termination to a private foundation, rather than to a public charity (which are described in IRC §170(b)(1)(A), as well as in §170(c)). In that situation, the donor's deduction would be determined as if he or she were contributing the remainder interest to a private foundation, which could result in a less generous charitable contribution tax deduction. See IRC §170(b)(1)(A)-(D), (e)(1)(B)(ii), (e)(5). Unless the donor actually wishes to direct the charitable remainder trust assets to a private foundation, a reference to IRC §170(b)(1)(A) should be added to the IRS text. See Rev Proc 2005-52, §6.04.

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§24.23 E. Selecting Trustee

The trustee of a charitable remainder trust is faced with many of the same duties and obligations as is the trustee of any other trust. See California Trust Administration, chaps 2-8 (2d ed Cal CEB 2001). However, there are additional obstacles imposed by the unique characteristics of a charitable remainder trust that complicate the role of trusteeship. These include the need to:

- Monitor investments to ensure that the trust does not earn unrelated business income (see §24.27);
- Monitor trust transactions to guard against acts of self-dealing (see §24.9);
- Understand and comply with the intricate payout and four-tier accounting rules (see Drafting California Irrevocable Trusts §18.31 (3d ed Cal CEB 1997)); and
- Complete and file a unique set of four tax returns (see Irrevocable Trusts §18.31).

NOTE: Failure to administer a charitable remainder trust properly can lead not only to a breach of fiduciary action by the income or remainder beneficiaries, but also to loss of tax-exempt status for the trust and possible action by the State Attorney General's Office. Thus, careful selection of the trustee is essential.

Any individual, including the donor, can serve as trustee. IRS Letter Rulings 8035078, 8033026. Donors often prefer to name themselves as trustees, as it gives them a sense of control over the trust and their future income streams. However, a donor may not serve as trustee if the trust document grants the trustee the power to sprinkle the annuity or unitrust amount among a class of income beneficiaries. Rev Rul 77-285, 1977-2 Cum Bull 213.

PRACTICE TIP: Because most individuals are not well equipped to manage either trust investments or reporting requirements, an individual trustee should usually hire, as agents, both an investment adviser and a tax preparer. The author finds that this approach works best if both agents are familiar with charitable remainder trusts and are willing to stay in communication with the donor-trustee and other agents. Even with such a team, the donor-trustee needs to realize that he or she is the fiduciary, and has the responsibility to ensure that nothing is overlooked.

PRACTICE TIP: A professional or corporate trustee is often a good choice, especially if the donor is not particularly interested in staying closely involved in the trust management. Although corporate trustees are often viewed as expensive, their fees are often not much greater than the combined fees of an investment adviser and a tax preparer. Because some banks and trust companies have far more experience with charitable remainder trusts than others, it is worth interviewing potential corporate trustees as to the number of these types of trusts they have administered.

A donor who is not a beneficiary or trustee should expressly reserve any desired powers to enforce the trust—if the donor wishes to have that power. Only the state Attorney General ordinarily has standing to enforce a charitable trust under Prob C §17210, but courts have held that the donor may have standing to compel accountings by the trustee if provided in the trust instrument. *Patton v Sherwood* (2007) 152 CA4th 339, 61 CR3d 289; *L.B. Research & Educ. Found. v UCLA Found.* (2005) 130 CA4th 171, 181, 29 CR3d 710.

A California nonprofit corporation can serve as trustee of a trust incidental to its purposes. Corp C §5140(k). Many large California charities serve as trustees of numerous charitable remainder trusts, often at a nominal charge to the trust. Of course, to secure such a beneficial relationship, the charity usually requires that it be named as the sole irrevocable remainder beneficiary of the trust. The charity may be willing to have its legal advisers prepare the draft trust document at no cost to the donor.

NOTE: For purposes of determining the annuity or unitrust amount, an independent trustee (as defined in Treas Reg §1.664-1(a)(7)(iii)) is required to value any unmarketable assets held by the trust, unless the assets are valued pursuant to a qualified appraisal. Treas Reg §1.664-1(a)(7).

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§24.24 V. FUNDING CHARITABLE REMAINDER TRUSTS

In addition to ensuring that a charitable remainder trust is appropriate and properly designed, questions often arise regarding the asset to be contributed. Issues can arise under contract law (*e.g.*, whether the property is subject to a buy-sell agreement that prevents a gift), securities law (*e.g.*, whether the shares are subject to SEC restrictions), and tax law (*e.g.*, whether the mere transfer of the asset will trigger adverse tax consequences), just to name a few. Although a detailed discussion is beyond the scope of this chapter, §§24.25-24.28 include an overview of some common issues that arise in funding charitable remainder trusts.

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§24.25 A. Acceleration of Income

Federal tax law provides that the mere transfer of certain types of assets will accelerate any untaxed gain or income. For example, transferring an installment note to a charitable remainder trust will cause the acceleration of the remaining gain. IRC §453B(a). Likewise, transferring shares received through the exercise of an incentive stock option (see chap 22) before the expiration of the requisite holding periods will trigger compensation income. See IRC §422(a). Obviously, a donor should not transfer these types of assets to a charitable remainder trust with the expectation that the gain or income will be realized by the trust.

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§24.26 B. Assignment of Income

Under the assignment of income doctrine, if a donor transfers appreciated property to a charitable remainder trust after his or her right to the sale proceeds has matured, the donor will realize the gain despite the fact that the sale was technically consummated by the trustee. See *Morgan Guar. Trust v U.S*. (Ct Cl 1978) 585 F2d 988. On the other hand, the mere anticipation that a sale will occur does not constitute an assignment of income. See *Greene v U.S*. (2d Cir 1994) 13 F3d 577. Whether a particular transaction has crossed the line obviously depends on the specific facts and circumstances. It also depends on the legal standard to be applied. Practitioners have long relied on *Daniel D. Palmer* (1974) 62 TC 684, aff'd (8th Cir 1978) 523 F2d 1308, acq 1978-2 Cum Bull 2, nonacq 1978-2 Cum Bull 4, disapproved on other grounds in *Blake v Commissioner* (2d Cir 1982) 697 F2d 473, 476, and Rev Rul 78-197, 1978-1 Cum Bull 83, for the proposition that the proceeds of a sale will be attributed back to the donor only if the charitable remainder trust is legally bound or could be compelled by the buyer to sell. This relatively bright-line standard has been potentially undercut by *Ferguson v Commissioner* (9th Cir 1999) 174 F3d 997. The court stated that it is the reality and substance of events that determine the tax consequences; the question of whether there is a legally enforceable right to income is merely one factor to be considered. The question is whether the sale is "practically certain" to occur. 175 F3d at 1001. In *Gerald A. Rauenhorst* (2002) 119 TC 157, however, the Tax Court held that the IRS could not pursue a taxpayer based on the *Ferguson* standard because to do so would be to take a litigation position inconsistent with Rev Rul 78-197. The court held that the result of that long-standing ruling was to be treated as a concession by the IRS. The IRS followed *Rauenhorst* in IRS Letter Ruling 200321010.

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§24.27 C. Trade or Business Issues

Although a charitable remainder trust is generally exempt from taxation, it will be subject to a 100-percent federal excise tax on any unrelated business taxable income (UBTI) within the meaning of IRC §512. IRC §664(c). This rule is effective for tax years beginning on or after January 1, 2007, and replaces the prior treatment, in which the trust lost its tax-exempt status for any year during which it had UBTI. California has not yet conformed to this change, and it is not yet clear if, or when, it will. UBTI is the gross income derived from an unrelated trade or business regularly carried on, less any allowable deductions. IRC §512(a)(1). Certain types of income, such as dividends, interest, rent from real property, and capital gains, are generally excluded from UBTI. See IRC §512(b).

Transferring a sole proprietorship into a charitable remainder trust can thus be problematic. If the asset resides in the charitable remainder trust for a period of time before it is sold, the trust is likely to earn UBTI and incur significant tax.

NOTE: It is important to remember that seemingly passive investments can generate UBTI. In *Leila G. Newhall Unitrust v Commissioner* (9th Cir 1997) 105 F3d 482, the asset in question was a limited partnership interest in a partnership that conducted a trade or business. Because the character of the income generated by the partnership flowed through to the partners, the charitable remainder trust was deemed to have received UBTI. See IRC §512(c).

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§24.28 D. Encumbered Property

Contributing encumbered property to a charitable remainder trust is particularly problematic. At a minimum, the following issues must be considered:

Gift value. The value of the gift must be reduced by the amount of the liabilities. See Treas Reg §1.170A-3(d).

Bargain sale. Under Treas Reg §1.1011-2, the amount of the liabilities that the donor is relieved of because of the gift constitutes an amount realized; the donor is thus considered to have engaged in a bargain sale potentially generating taxable gain.

Self-dealing. Unless the mortgage was placed on the property more than 10 years before the gift, the "sale" portion of a bargain sale may constitute self-dealing. IRC §4941(d)(2)(A).

Unrelated business income. Property acquired subject to a mortgage or lien can be considered "debt-financed" property if it is in a charitable remainder trust. IRC §514(c)(2). The sale of debt-financed property can generate unrelated business taxable income (UBTI) to the charitable remainder trust. As discussed in §24.27, recognizing UBTI inside a charitable remainder trust will trigger a 100-percent federal excise tax. A charitable remainder trust also may realize UBTI through its investment activities if it acquires or improves trust assets with debt. For example, courts have held that securities purchased on margin by a tax-exempt trust were "debt-financed property" and that the income derived from the sale of the securities was debt-financed income subject to unrelated business income tax. *Henry E. & Nancy Horton Bartels Trust for the Benefit of Univ. of New Haven v U.S.* (2d Cir 2000) 209 F3d 147, cert denied (2000) 531 US 978; *Henry E. & Nancy Horton Bartels Trust for the Benefit of Cornell Univ. v U.S.* (Fed Cl 2009) 2009-2 USTC ¶50,475, 104 AFTR2d 5117. See IRC §§512(b)(4), 514(b)(1); Treas Reg §1.514(b)-1.

Grantor trust status. The IRS has ruled that if a donor transfers property to a charitable remainder trust that is subject to a recourse debt, the trust is to be taxed as a grantor trust under Treas Reg §1.677(a)-1(d). IRS Letter Ruling 9015049. As such, it is disqualified as a charitable remainder trust.

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§24.29 E. Appreciated Property

The IRS has identified certain transactions involving sales of charitable remainder trust interests as transactions of interest. Notice 2008-99, 2008-47 Int Rev Bull 1194. The Notice announces that the IRS is aware that a particular type of transaction may have the potential for tax avoidance or evasion. Persons engaging in such transactions must report them.

The transaction in question begins with a donor transferring low basis property to a charitable remainder trust. The trust sells the property but does not recognize gain because of its exempt status. The trust then acquires new assets and has a basis in those assets equal to the purchase price. Thereafter, in a single transaction, the donor and the charitable remainder beneficiary sell or otherwise dispose of their respective interests in the trust to an unrelated third party, for an amount that approximates the fair market value of the assets. The trust is then terminated and its assets are distributed to the third party.

The donor then takes the position that, because there was a sale of all interests in the trust, IRC §1001(e)(1), which disregards basis in the case of a sale of a term interest, does not apply under the exception in IRC §1001(e)(3). Instead, the donor is entitled to a portion of the trust's basis in the new assets at the time of sale. The arguable net result is that the gain on the sale of the originally donated appreciated assets is never taxed, even though only a small portion of the proceeds of the sale ends up in the hands of the charity.

As a result of the transaction being designated a "transaction of interest," persons engaging in the transaction must report the transaction on their income tax returns using Form 8886 (Reportable Transaction Disclosure Statement). Failure to comply can result in the imposition of penalties under IRC §6707A. Presumably, the most distinguishing feature of the transaction is the simultaneous sale of all interests in the trust to the same buyer. Therefore, the transaction may not fall within the description in the Notice until that sale occurs.

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24A

Noncharitable Unitrusts

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§24A.1 I. MODERNS USES OF UNITRUSTS

The Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) permits the drafting of fixed percentage noncharitable unitrusts that will qualify under federal tax laws as trusts, *e.g.,* marital QTIP trusts, that are required to pay out "all income." See §§24A.5-24A.8. The statute also permits a traditional net income trust to be converted into a noncharitable unitrust and to be converted from a noncharitable unitrust back into a traditional net income trust. Prob C §§16328, 16336.4-16336.7. See §§24A.9-24A.23. These provisions are intended to take advantage of IRS regulations that facilitate the use of unitrusts as total return trusts. See §§24A.2-24A.3. On other uses of noncharitable unitrusts, see §24A.4. For a detailed discussion of charitable remainder unitrusts, see chap 24. For a brief discussion of charitable lead unitrusts, see chap 24A.

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§24A.2 A. Unitrusts as Total Return Trusts

In 1997, the National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated the Uniform Principal and Income Act (UPAIA) to update the Revised Uniform Principal and Income Act, which had been promulgated in 1962. A major thrust of the UPAIA was to give trustees of net income trusts the ability to invest for total return in accordance with the Uniform Prudent Investor Act (UPIA) (Prob C §§16045-16054), instead of having to adopt sub-optimal investment strategies to provide the current income beneficiary with a targeted level of income. The centerpiece of this effort was the "power to adjust," which permits trustees to make allocations between income and principal as necessary to provide the income beneficiary with an appropriate level of income. Without the power to adjust, trustees have routinely exercised discretion in designing an investment portfolio that would produce a particular level of trust accounting income. With the power to adjust, trustees are exercising discretion to establish a target level of benefits rather than the traditional target level of trust accounting income. To the extent the trust accounting income is inadequate to meet the target level of benefits, the trustee may exercise the power to adjust for the purpose of augmenting the trust income with an allocation of principal.

In 2000, California adopted a version of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375). The power to adjust is codified in Prob C §16336. By 2003, many other states had adopted a version of the UPAIA; several of these states permitted the conversion of net income trusts to noncharitable unitrusts as an alternative to the power to adjust. For example, New York passed a statute that equated the right to income with a 4-percent annual unitrust payment. There were uncertainties about the federal tax consequences of these innovations in state trust law. For example, would a trust that expressly provided for payment of a unitrust amount (a "drafted unitrust") qualify for a QTIP marital deduction? Could the power to adjust be exercised in a way that would provide the surviving spouse with less than all of the net income (computed using traditional principal and income accounting principles) of a marital QTIP trust? Most of the taxation uncertainties surrounding noncharitable unitrusts were resolved when the IRS issued final regulations under IRC §643. See §24A.3.

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§24A.3 B. Effect of IRS Income Regulations

Final regulations under IRC §643 make clear that the IRS will permit a beneficiary entitled to "net income" to have that net income determined either through exercise of the power to adjust between principal and income or by a noncharitable unitrust with a payout percentage of not less than 3 percent and not more than 5 percent and will permit trusts to switch methods of determining net income without adverse tax consequences so long as a state statute authorizes these innovations. Treas Reg §1.643(b)-1; TD 9102, 2004-1 Cum Bull 366. Under a total-return investment strategy (see §24A.2), trust assets are invested for total positive return, that is, ordinary trust accounting income plus appreciation, to maximize the value of the trust. Thus, under certain circumstances, equities, rather than bonds, would constitute a greater portion of trust assets than they would under traditional investment standards. The preamble to the proposed regulations recognized that this investment shift could adversely affect income beneficiaries. REG-106513-00, 2001-1 Cum Bull 1076.

The definition of net income is incorporated by reference in the estate and gift tax marital deduction regulations. Treas Reg §§20.2056(b)-5(f)(1), 25.2523(e)-1(f)(1). The regulations require that the surviving spouse must have a right to all income from the marital deduction qualifying trust. The definition is further incorporated in the QTIP regulations (Treas Reg §20.2056(b)-7(d)), which require that the surviving spouse must have a qualifying income interest for life, and the QDOT regulations for trusts designed to hold property passing to a noncitizen spouse (Treas Reg §20.2056A-2(b)), which require that the trust must qualify for the estate tax marital deduction. As a result, these marital deduction qualifying trusts can be drafted to give the spouse a unitrust interest instead of a traditional income interest, and a marital deduction qualifying trust that gives the spouse a traditional income interest can be converted into a noncharitable unitrust that satisfies the alternative unitrust definition of net income and reconverted into a traditional net income trust. For further discussion of marital deduction qualifying trusts, see chap 17.

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§24A.4 C. Other Uses of Noncharitable Unitrusts

Unitrust interests can be used in noncharitable trusts that are not required by law to pay out all income, but this may not often be the preferred solution for a particular client problem. In the view of some practitioners, the problem with unitrusts is that they typically establish distribution amounts that have little, if any, relationship to the client's objectives in establishing the trust. In most cases, the initial trust value, and therefore the initial trust distributions, will be a matter of happenstance. Because the unitrust concept attempts to preserve the purchasing power of this initial amount, the distribution amounts will remain a matter of happenstance indefinitely. For trusts that need not satisfy the statutory requirements of a QTIP trust or other tax-motivated net income trust, the desired result can usually be achieved with some combination of inflation-adjusted annuity interests and discretionary withdrawal powers. For further discussion, see Dennis-Strathmeyer, *You're Not Writing Noncharitable Unitrusts? Neither Am I*, 21 CEB Est Plan Rep 160 (June 2000).

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§24A.5 II. CALIFORNIA UNITRUST STATUTE

The California unitrust statute permits estate planners and trust administrators to take advantage of the various opportunities offered by the IRC §643 regulations by providing an alternative definition of trust income in Prob C §16328. See §24A.6. The statute permits the settlor to use a drafted unitrust instead of a traditional net income trust that gives the trustee the power to adjust between principal and income. See §24A.7. Alternatively, the settlor may continue to use a traditional net income trust and allow the trustee to decide whether or not to exercise the adjustment power or convert the trust into a unitrust. See §24A.8.

NOTE: Probate Code §16336(b)(7) prohibits exercise of the adjustment power by a trustee who is a beneficiary of the trust. Presumably this prohibition includes a trustee who is only a remainder beneficiary. A unitrust conversion may be the only practical alternative for a beneficiary-trustee who wishes to adopt a total return investment program.

The emphasis of the California unitrust statute is on rules for converting net income trusts into unitrusts and for "reconverting" such trusts into net income trusts. Although the statute permits the drafting of noncharitable unitrusts that will provide beneficiaries with the equivalent of "net income," the statute leaves drafters with a great deal of flexibility to provide the various details, such as rules for annual valuation of assets, that are detailed in the provisions governing unitrust conversions. Drafters of unitrusts may wish to incorporate by reference some of the statutory language providing these details, including perhaps an option to convert the drafted unitrust into a traditional net income trust to which the adjustment power could be applied. See §§24A.9-24A.23.

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Source: Estate Planning/California Estate Planning/24A Noncharitable Unitrusts/§24A.6 A. Alternative Definition of Net Income

§24A.6 A. Alternative Definition of Net Income

Probate Code §16328 provides for three alternative definitions of "net income":

- The traditional definition of net income (total receipts minus total disbursements) determined pursuant to the provisions of Prob C §16335;
- Net income as determined under Prob C §16336 (the "power to adjust"); and
- A "unitrust amount" that is "no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis."

The unitrust definition of "net income" tracks the definition in the IRS income regulations. Treas Reg §1.643(b)-1. This allows a marital deduction qualifying trust to give the spouse a unitrust interest instead of a traditional net income interest. See §24A.3.

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§24A.7 B. Comparison of Adjustment Power and Noncharitable Unitrust

The power to adjust between principal and income under Prob C §16336, generally available to all trustees who are not beneficiaries, remains the most flexible method of providing an income beneficiary with an appropriate level of beneficial enjoyment in the context of a total-return investment strategy. See §24A.2. In addition, while some trustees exercise the power to adjust in accordance with guidelines that change from year to year depending on the circumstances of the trust, the beneficiaries, and economic conditions, many trustees already informally use the unitrust method when exercising the power to adjust, because it eliminates speculation about the trustee's motives. In many cases, the trustee can begin its analysis with the assumption that the income beneficiary would receive an annual distribution in the range of 3 to 4 percent of trust principal. This range reflects a widespread recognition that the 4-percent level is the highest that can be maintained in the long term without reducing the purchasing power of the principal, even if the trust portfolio is heavily weighted toward growth investments. See Skootsky, *The New Principal and Income Act: California Trustees Adjust to the Power to Adjust*, 22 CEB Est Plan Rep 37, 40 (Oct. 2000). Nevertheless, there will be circumstances in which the power to adjust will not be available or desirable.

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§24A.8 C. Drafted Unitrust Versus Converted Unitrust

Probate Code §16328 is the only provision of the statute that specifically refers to a drafted unitrust. By their terms, the remaining unitrust provisions of the Uniform Principal and Income Act (UPAIA) (Prob C §§16320-16375) apply only to trusts that describe a beneficiary's interest by referring to "income." These remaining provisions permit conversion of net income trusts into unitrusts and "reconversion" of converted unitrusts back into net income trusts. Prob C §§16336.4-16336.7. The statute does not authorize converting a "drafted unitrust" into a net income trust, but such a conversion could be authorized in the trust document. Section 16336.4(h)(1) prohibits the conversion when to do so would change the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust's assets. Settlors, therefore, will need to include those conversion features in any unitrusts they establish. It may be convenient for these settlors to make reference to the statutes containing features that they want to imitate in their unitrusts.

For example, Prob C §16336.4(e)(4)(A) provides that any residential property that current beneficiaries of the trust have the right to occupy shall not be included in determining the unitrust amount. This feature minimizes the mandatory payment to the income beneficiary on the assumption that the income beneficiary is receiving reasonable enjoyment of the property through the right to reside in it.

Section 16336.4(e)(2) provides that the unitrust amount is based on the net fair market value of trust assets, determined no less often than annually, averaged over the lesser of the 3 preceding years or the life of the trust. Settlors may wish to provide for a longer or shorter averaging period.

Alternatively, under certain circumstances, settlors may wish to continue to define a beneficiary's interest by simply referring to "income," because traditional net income trusts offer the most flexibility. With a net income trust, the trustee may use the power to adjust under Prob C §16336 or the trust may be converted into a unitrust or even reconverted back into a net income trust. For example, continued use of the net income approach may be preferred in the establishment of a marital deduction qualifying trust when the remainder beneficiaries are the children of the surviving spouse. On the other hand, a drafted unitrust may be preferred when the remainder beneficiaries are the children of the deceased spouse by a former marriage, unless the settlors wish to leave the unitrust percentage to negotiation between the surviving spouse and the children.

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§24A.9 IV. TRUSTEE POWER TO CONVERT ON NOTICE OF CONVERSION

Probate Code §16336.4 permits a trustee who is required to pay out all income to the lead beneficiary to convert the trust into a unitrust without a court order upon notice to the beneficiaries that complies with the requirements for a notice of proposed action under Prob C §§16500-16504. See §24A.10. This conversion is possible as long as the payout percentage is 4 percent and no beneficiary objects within the 45-day notice period of Prob C §16502(d), or longer period specified in the notice. Probate Code §16336.4(b)(4). In addition, unlike the power to adjust under Prob C §16336, this conversion may be accomplished by a trustee who is also a beneficiary. See §24A.11.

The conditions of Prob C §16336(a) must be satisfied, *i.e.,* the trust must be administered under the prudent investor rule, the trust must be a net income trust, and the trustee must be unable to meet its duty of impartiality without exercising the adjustment power or converting the trust to a unitrust. Prob C §16336.4(b)(1). As is the case with the power to adjust under Prob C §16336, the trustee's power to convert must be exercised impartially relative to the competing interests of the different classes of beneficiaries. Prob C §16335(b). However, this impartiality rule does not restrict the trustee from following the settlor's wishes when the trust instrument provides that the trustee shall or may favor one or more of the beneficiaries. See Prob C §16003.

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§24A.10 A. Notice Requirements

The notice of conversion provided to the beneficiaries under Prob C §16336.4(b)(3) (including notice to a beneficiary who is a minor and to the minor's guardian, if any) must include (1) the effective date of the conversion, (2) descriptions of the method for computing the fair market value of the trust's assets, (3) the amount of net income actually distributed to the income beneficiary during the previous accounting year before the conversion, (4) the unitrust amount that would have been distributed to the income beneficiary if the trust had been administered as a unitrust during the previous accounting year, and (5) information about various discretionary decisions made by the trustee pursuant to Prob C §16336.4(f), such as the frequency of payments, the frequency and timing of valuations, how nonliquid assets will be valued, and how the unitrust payout will be characterized for income tax reporting purposes. Prob C §16336.4(c).

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§24A.11 B. Additional Requirements for Converted Unitrust

The statute includes several mandatory requirements for a trust converted to a unitrust by the notice procedure, including the following (Prob C §16336.4(b)(2), (e)):

- The unitrust payout percentage must be fixed at a 4-percent annual distribution.
- The unitrust amount must be based on the "net fair market value of the trust's assets" averaged over the lesser of the preceding 3 years or "the period during which the trust has been in existence." Prob C §16336.4(e)(2).
- The net fair market value of each asset of the trust must be determined annually, but the following assets may be excluded from the calculation (Prob C §16336.4(e)(4)):
- Residential property or tangible personal property occupied or possessed by "one or more current beneficiaries," which property "shall be administered… as though no conversion to a unitrust had occurred";
- Specifically devised property, when including such property in the calculation would create "a material risk of exhausting other trust assets prior to termination of the trust"; and
- Any asset held in a testator's estate or a terminating trust.
- During each "accounting year" following the noticed conversion and "as early in the year as is practicable," the trustee must provide each income beneficiary with a computation of the unitrust amount for that accounting year. Prob C §16336.4(e)(3). Trustees may consider providing the presumptive remainder beneficiaries with the computation.
- The unitrust amount must be reduced or increased proportionately for any "material" distributions or additions. See §24A.12.
- In the case of a short year when the beneficiary's right to payments commences or ceases, the trustee must prorate the unitrust amount on a daily basis. Prob C §16336.4(e)(6).
- The unitrust amount is a *net amount*. Expenses that would otherwise be charged to income may not be deducted from the unitrust amount. Prob C §16336.4(e)(8).
- The trustee must provide a characterization of the unitrust distribution for income tax purposes. See §24A.13.

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§24A.12 1. Adjustments to Unitrust Amount

The unitrust amount must be reduced or increased proportionately for any "material" distributions or partial terminations, other than distributions of the unitrust amount, or additions to the trust during the calendar year. Prob C §16336.4(e)(5).

"Material" is defined as an addition or distribution that exceeds 10 percent of the value of the assets used to compute the unitrust amount as of the beginning of the accounting year. Curiously, the statute also contains its own "power to adjust," because the trustee may adjust the unitrust amount by reason of additions or distributions even if this "definition of materiality" is not satisfied. Prob C §16336.4(e)(5).

Moreover, Prob C §16336.4(g) confirms that a unitrust conversion does not affect provisions in the governing instrument regarding the trustee's powers to distribute principal or powers of withdrawal or appointment.

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§24A.13 2. Income Taxation of Unitrust Amount

The trustee of a converted unitrust must provide a characterization of the unitrust distribution for income tax purposes. Unless otherwise provided by the governing instrument or determined by the trustee, the unitrust amount is considered paid in the following order (Prob C §16336.4(e)(7); Treas Reg §1.643(a)-3(e), Examples 11-14):

- From "net taxable income" determined as if the trust were not a unitrust;
- From net realized short-term capital gains;
- From net realized long-term capital gains;
- From tax-exempt and other income;
- From principal.

The reference to "net taxable income" in Prob C §16336.4(e)(7) appears to be a misstatement that should be changed in any "cleanup" legislation. The IRC §643 regulations refer to "ordinary income," not "net taxable income." Treas Reg §1.643(b)-1. Until the statute is modified, a trustee who wishes to use the notice procedure to convert a net income trust into a unitrust should indicate in the notice that "net taxable income" shall be interpreted as "ordinary income" and will be the first item considered paid in the unitrust distribution. The Internal Revenue Code may dictate this result in any event. The regulations permit the trustee to determine whether the realized capital gains are distributed as part of the income (Treas Reg §1.643(a)-3(b); see §13.24) but do not give such flexibility in the question of distributing ordinary income. In other words, the trustee (despite the language of the California statute) may not elect to pay the taxes on ordinary income where it is less than or equal to the unitrust payment.

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§24A.14 C. No Conversion of Drafted Unitrust or Annuity Trust

If the payment of the unitrust amount would change the amount payable to a beneficiary as a fixed annuity or fixed fraction of the value of the assets, the trustee may not convert the trust into a unitrust under the statute. Prob C §16336.4(h)(1). Thus, the trustee cannot use the reconversion provisions of Prob C §16336.6 to convert a drafted unitrust into a net income trust unless authorized to do so by the terms of the drafted unitrust. See §24A.20.

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§24A.15 D. Provisions Protecting Against Adverse Tax Consequences of Conversion

The trustee may not convert the trust if the unitrust distribution would then be made from any amount permanently set aside for charitable purposes when a federal gift or estate tax deduction had been taken. Prob C §16336.4(h)(2). In one of the more mysterious provisions, Prob C §16336.4(h)(3)-(4) prohibits conversion by the trustee when the possession or exercise of the power to convert would result in various adverse tax and other consequences, including when an individual would be treated as the "grantor" for income tax purposes and when the trust assets would then be subject to federal gift or estate taxes with respect to an individual. Section 16336.4(h)(5) prohibits conversion by the trustee when the possession or exercise of the power would result in "a disallowance of a federal estate tax or gift tax marital deduction."

The provisions protecting against adverse tax consequences were duplicated from provisions of Prob C §16336(b) dealing with the power to adjust. These provisions of the power to adjust, however, were drafted before the IRS issued the IRC §643 regulations. See §24A.3. In Treas Reg §§20.2056(b)-5(f)(1) and 25.2523(e)-1(f)(1) (finalized at the same time as the IRC §643 regulations), the IRS confirms that a unitrust conversion pursuant to state law will not disqualify a marital deduction trust if the statute provides a "reasonable apportionment" between the income and remainder beneficiaries, *i.e.,* between 3 and 5 percent. Treasury Regulation §1.664-3(a)(1)(i)(b)(3) provides that the income of an income-only charitable remainder unitrust may not be defined as a unitrust amount. This would produce the absurd result of having the required distribution be the lesser of two fixed percentages. See §24.15. It would be very helpful if cleanup amendments were proposed for both the power to adjust and the unitrust statute to eliminate the tax-related provisions that may not be necessary. For discussion of additional protective provisions, see §24A.16.

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§24A.16 E. Additional Provisions Affecting Conversion Powers Held by Tax-Sensitive Trustees

Probate Code §16336.4(i) permits a cotrustee to exercise the conversion power alone when another cotrustee's possession or exercise of the conversion power would cause the adverse tax consequences described in Prob C §16336.4(h)(2)-(5). See §24A.14. Probate Code §16336.4(j) permits a trustee to release the power to convert to a unitrust if the trustee is uncertain whether these tax consequences will occur, or when the trustee determines that possession or exercise of such power would deprive the trust of a tax benefit or impose a tax burden not otherwise described. These provisions also were duplicated from Prob C §16336. These provisions, however, with the exception of their relationship to the generation-skipping transfer tax (see below), were not specifically dealt with by the IRC §643 regulations.

For example, IRC §643 says nothing about the application of unitrust-conversion or adjustment-power statutes to a beneficiary's potential IRC §678 income tax liability. Nevertheless, under §678, the most income that a beneficiary could be taxed on under the unitrust conversion statute would be the amount that is distributed to him or her under the notice procedure. Section 678 requires that the beneficiary have the "sole" power to vest income or corpus in himself or herself in order to be treated as the "grantor," but the unitrust conversion statute does not allow such a beneficiary to operate alone. The statute requires the consent of the other beneficiaries in order for the lead beneficiary to receive anything other than 4 percent, so the lead beneficiary would not be treated as the "grantor" under this provision. Alternatively, the statute allows the trustee-beneficiary to convert the trust to a unitrust without specific consent, but with at least a lack of objection, for a 4-percent unitrust. A similar analysis would apply if the trustee were a remainder beneficiary instead.

The IRS should amend the regulations provided under IRC §2041 to make clear that using or holding a unitrust conversion power or a power to adjust will not have adverse estate tax consequences. The IRC §643 regulations (see §24A.3) provide that a grandfathered generation-skipping trust will not lose its exempt status if the trustee converts to a unitrust or uses the power to adjust, as long as the state statute allowing such action provides a "reasonable apportionment" between income and remainder beneficiaries. Nor will such action give rise to any gift tax consequences. Treas Reg §26.2601-1(b)(4)(i)(D)(2), (E), Examples 11-12. If it is good enough for the generation-skipping transfer tax and the gift tax, it should be good enough for the estate tax. In the meantime, practitioners will have to hope these matters are adequately covered by Treas Reg §20.2041-1(b)(1), which states that a management power that does not "enlarge or shift any of the beneficial interests [in the trust] except as an incidental consequence of the discharge of such fiduciary duties is not a power of appointment" for estate tax purposes.

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§24A.17 F. Nonliability of Trustee of Converted Unitrust

If a trust is converted under the provisions of Prob C §16336.4, the trustee is not liable to beneficiaries who received notice but failed to object under Prob C §16336.7(b), which incorporates the Prob C §16503(b) nonliability provision of the Probate Code provisions permitting notice of proposed trustee actions. Under Prob C §16503(b), the protection does not apply with respect to beneficiaries who are minors or lack capacity, unless the notice was served on a guardian of the estate or a conservator of the estate. Perhaps more significantly, Prob C §16338 provides that the sole remedy in a proceeding with respect to the exercise or nonexercise of the conversion power is to obtain an order directing the trustee to convert the trust to a unitrust, to reconvert from a unitrust, to change the distribution percentage, or "to order any administrative procedures the court determines to be necessary or helpful for the proper functioning of the trust."

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§24A.18 IV. CONVERSION WITH CONSENT OF BENEFICIARIES

Deviations from the otherwise mandatory requirements of Prob C §16336.4(e) are permitted without a court order if the trustee follows the notice procedure described in §24A.9 and obtains the specific written consent of all beneficiaries entitled to notice under Prob C §16501, *i.e.,* discretionary or mandatory beneficiaries of income or beneficiaries who would receive distributions if the trust were terminated at the time notice is given. If the trustee obtains such consent, the unitrust payout percentage must be at least 3 percent and no more than 5 percent. In the case of minor or incompetent adult beneficiaries, however, the liability-releasing provision of Prob C §16503(b) is applicable only when notice has been served on a guardian or a conservator of the estate, respectively. Therefore, if there are minor beneficiaries, the trustee may desire a court order approving the conversion.

The Prob C §16336.4(e) requirements (discussed in §24A.10 in connection with the notice procedure) were intended to provide trustees with a road map to meeting the trustee's fiduciary duties and reporting obligations. The consent provision permits deviations from the §16336.4(e) requirements. Most notably, it permits a unitrust percentage other than 4 percent (but not less than 3 percent or more than 5 percent) and it allows the value of the assets to be determined other than by the average over the 3 preceding years. Rather than rely on the trust's beneficiaries' assessments of their own sophistication, some trustees may prefer to obtain court approval of conversions to unitrusts if they wish to deviate from the provisions generally allowed under the conversion by notice provisions.

It is unclear whether the parties may agree on where the income tax burden falls. Section 16336.4(e) refers to mandatory requirements for a converted unitrust "[e]xcept to the extent that the court orders otherwise or the parties agree otherwise pursuant to Section 16336.5." Probate Code §16336.4(e)(7), however, seems to allow only the governing instrument or the trustee to determine where the income tax burden will fall. It does not appear that a restriction on the matters that may be agreed upon was intended by the statutory drafters. In any "cleanup" legislation, the issue of whether the burden of the income taxes may be addressed by consent under Prob C §16336.5(a) should be clarified.

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Source: Estate Planning/California Estate Planning/24A Noncharitable Unitrusts/§24A.19 V. CONVERSION BY COURT ORDER

§24A.19 V. CONVERSION BY COURT ORDER

A trustee may petition the court to approve conversion to a unitrust under the following circumstances (Prob C §16336.5(b)(1)(A)):

- When a beneficiary has objected after receipt of notice;
- When the trustee wishes to deviate from the provisions of Prob C §16336.4(e) but has not obtained the requisite consent from the beneficiaries;
- When no trustee is authorized to carry out the conversion because of Prob C §16336.4(h)(3) (a beneficiary being treated as the grantor for income tax purposes) or Prob C §16336.4(h)(4) (estate or gift tax consequences to a beneficiary as discussed in §24A.15); or
- When the trustee determines, in its discretion, that a petition is advisable.

A beneficiary also may petition the court to order a conversion to a unitrust. Prob C §16336.5(b)(2).

As with a conversion by consent (see §24A.18), the unitrust percentage ordered by the court must be within the IRS-approved guidelines of not less than 3 percent and not more than 5 percent. Prob C §16336.5(b)(1)(B).

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§24A.20 VI. RECONVERSION OF CONVERTED UNITRUST

Changes in the unitrust—most notably, a change back to the traditional definition of net income or a change in the unitrust percentage—may be made without a court order if 3 years have elapsed since the "most recent conversion to a unitrust." Prob C §16336.6(a). The requirements and rules in Prob C §§16500-16504 concerning notice of proposed action in regard to beneficiary objections must be met. In the case of a conversion back to a traditional net income trust, the notice must include information concerning the projected effect on the income beneficiary that is consistent with the requirements for conversion that are set forth in Prob C §16336.4(c). See §24A.10.

The trustee may also convert the unitrust to a traditional net income trust or change the unitrust payout percentage pursuant to a court order; a beneficiary may also petition for such a court order. Prob C §16336.6(b). In either case, the court must make a finding that the change "will enable the trustee to better comply with the provisions of" Prob C §16335(b), *i.e.,* the requirements that the fiduciary must administer the trust with impartiality except to the extent the trust instrument favors one or more of the beneficiaries, and that the court may not order a payout percentage less than 3 percent or more than 5 percent. Prob C §16336.6(b).

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§24A.21 VII. RETROACTIVITY OF UNITRUST CONVERSION

A practical issue not addressed by the California unitrust statute is whether the effective date of a unitrust conversion may be a date before the date that the conversion is authorized. The conversion may be authorized on the date of expiration of the minimum 45-day notice period required by Prob C §16502 (see §§24A.9-24A.17), on the date of consent of the beneficiaries (see §24A.18), or on the date of the court order authorizing conversion (see §24A.19). For considerations favoring retroactivity, see §24A.22. On the extent of retroactivity that may be allowed for converted unitrusts, see §24A.23.

Similar considerations apply to reconversion of a converted unitrust to a net income trust. The effective date of reconversion cannot be earlier than 3 years after the effective date of conversion under Prob C §16336.6(a) except pursuant to a court order. See §24A.20.

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§24A.22 A. Considerations Favoring Retroactivity

The matter of retroactivity of unitrust conversions has been the subject of litigation in New York. See *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262. The New York appellate court permitted a unitrust conversion made in 2003 to be retroactive to January 1, 2002, the effective date of the New York statute. The court did so on the basis of its conclusion that the statute in question permitted the trustee to specify the conversion's effective date. California now has a similar provision:

- For conversions pursuant to the notice-of-conversion method, Prob C §16336.4(f)(1) provides that the trustee shall determine, in the trustee's discretion, the effective date of the conversion.
- For conversions pursuant to the consent method, the beneficiaries presumably would specifically consent to an effective date (although the notice method is really consent by default). See Prob C §16336.5(a).
- For conversions pursuant to court order, the court presumably would order a specific effective date. See Prob C §16336.5(b).

In support of its holding, the New York appellate court also cites a portion of the New York statute that allows for a financial adjustment between the income beneficiary and the remainder beneficiaries in the event that the trustee elects to convert the trust to a unitrust. While California does not have such a specific provision, the California unitrust statute provides for proration in the event of a short year in which a beneficiary's right to payments commences or ceases. Prob C §16336.4(e)(6).

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§24A.23 B. Extent of Retroactivity Allowed

On the basis of the considerations discussed in §24A.21, the trustee may be able to convert a net income trust retroactively. But it is unclear how far back the legislature may have intended for the trustee to be able to go. There appear to be four possibilities:

- The effective date may be no earlier than the date the authority is granted or obtained for the conversion;
- The effective date may be no earlier than the first day of the accounting year during which the authority was granted or obtained for conversion;
- The effective date may be no earlier than the effective date of the legislation, *i.e.,* January 1, 2006, even if authority for the conversion was granted or obtained in a later accounting year; and
- The effective date may be no earlier than the date assets were first subject to the trust.

Of the four possibilities, the second (which would permit an effective date no earlier than the first day of the accounting year in which authority to convert the trust was granted or obtained) seems consistent with the terms of the new California statute, at least for conversions pursuant to the notice procedure. Probate Code §16336.4(c)(3)-(4) requires that the notice must contain information about "the amount actually distributed to the income beneficiary during the previous accounting year of the trust" as well as "the amount that would have been distributed to the income beneficiary during the previous accounting year of the trust had the trustee's proposed changes been in effect during that entire year." Section 16336.4(e)(3) requires the trustee to furnish "[d]uring each accounting year of the trust following its conversion into a unitrust… as early in the [accounting] year as is practicable… a statement describing the computation of the unitrust amount for that accounting year." It appears that the "previous accounting year" is used by the California statute as a baseline and that the statutory terms read the most sensibly if the effective date of a conversion is no earlier than the beginning of the accounting year during which the conversion has occurred.

No such statutory limitation seems to exist, however, for conversions pursuant to the beneficiaries' consent or by court order. As long as the beneficiaries consent or a court orders, then, the effective date may theoretically be any date no earlier than the date assets were first subject to the trust. The decision in *Matter of Heller* (2006) 816 NYS2d 403, 849 NE2d 262 (discussed in §24A.22) assumed without argument that the effective date of the conversion could not be before the effective date of the statute. After much discussion, even the authors could not agree what the legislature intended. In any "cleanup" legislation, it is strongly recommended that this issue be given careful consideration.

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Valuation Freeze Techniques

Jeffrey A. Dennis-Strathmeyer

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§25.1 I. VALUATION FREEZE CONCEPT

In the jargon of the estate planning community, a "valuation freeze" refers to an estate planning strategy that seeks to have a client's asset valued at its current value for gift, estate, and generation-skipping transfer (GST) tax purposes. The obvious assumption is that the current value is lower than the value that would be used to calculate taxes if the client were to delay estate planning transactions until a later time.

For a discussion of valuation freezes in the context of family businesses, see chap 18.

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§25.2 A. Outright Gift as Freeze Technique

The simplest example of a freeze technique is the immediate outright gift of an asset that is likely to appreciate in the future. However, clients and planners are acutely aware that the immediate outright gift may be undesirable for various reasons, *e.g.*:

- The client must immediately relinquish the use and control of the transferred property.
- The consequences of a later asset value drop are significant. If the donor makes a gift of $1 million in assets and the assets drop in value to $750,000, the amount of gift tax base wasted in the transaction is the full $250,000 difference between the $750,000 value and the $1 million IRC §2505(a)(1) gift tax applicable exclusion amount.
- The client loses the possibility of obtaining a stepped-up capital gain tax basis for the property on the client's death. This is a concern under IRC §1014, providing for a new basis on death. See chap 12.

NOTE: If estate taxes are repealed, and IRC §1014 is replaced by the IRC §1022 provisions for limited basis increases on death (see chap 12), the relevance of the loss of a basis increase for the transferred assets will depend on whether the client has sufficient other assets to fully utilize the benefits of IRC §1022.

- An outright gift does not provide any "leverage." Leverage in this context means that the value of the property received by the gift recipient exceeds the value of the property as determined for gift tax purposes. The client must make a gift of his or her entire interest in the property to remove the future appreciation from the estate. (The client can give up a fractional share interest in property, but the leverage problem is not improved because only the appreciation from that fractional share is removed from the estate.)

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§25.3 B. Avoiding Drawbacks of Outright Gift

Many modern freeze techniques successfully improve on outright gifts by avoiding the need to immediately relinquish control of assets and at the same time overcoming the leverage problem. The loss of a new IRC §1014 basis on death problem remains, although this may be modestly mitigated in some cases. Some techniques protect against the risk that the value of property will drop.

EXAMPLE: Consider the consequences of a zeroed-out grantor retained annuity trust (GRAT) (see §25.36). Assume that the settlor transfers $1 million in securities to a GRAT that will make two annual annuity payments to the settlor in amounts that result in the gift of the trust remainder having a nominal value of $10,000. The GRAT will satisfy the annuity by transferring securities back to the settlor. The settlor retains most of the use and value of the transferred assets, but all appreciation that occurs while the securities are still subject to the GRAT will be removed from the settlor's transfer tax base. The transaction is therefore highly leveraged. Further, most of the securities will be returned to the settlor and therefore will be eligible for a new basis on death. There is also protection against the possibility that the securities will drop in value. No matter how great the drop in value, the wasted gift tax transfer value remains fixed at $10,000.

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§25.4 II. STATUTORY LIMITATIONS ON FREEZE TECHNIQUES

Congress has enacted various tax statutes that directly or indirectly limit the availability of freeze techniques other than outright gifts. These notably include IRC §§2701-2702. The techniques still allowed are often heavily regulated by the statutes and implementing regulations. For grantor retained annuity trusts (GRATs) (see §§25.31-25.40) and trusts that permit a donor to remain in a residence after making a gift of the remainder interest, such as qualified personal residence trusts (QPRTs) (see §§25.29-25.30), the regulations provide detailed governing instrument requirements that must be satisfied in order to avoid severe tax consequences.

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§25.5 A. IRC §7520

As noted in §25.2, it is desirable to leverage freeze transactions and retain the use of assets after the transfer that establishes the value of the transferred property. Most freeze strategies attempt to accomplish these objectives by having the donor retain interests in the transferred property for a selected period of time. The objective is to make a gift that will have a gift tax value of the value of the asset as a whole *minus* the value of the interests retained by the donor. In this context, it is important to understand that IRC §7520 provides that certain interests in property are to be valued for transfer tax purposes using tables published by the IRS. Interests valued under IRC §7520 include rights to income, annuities, and unitrust payments. These rights may exist for fixed periods or for the lives of specified persons. In each situation, the IRS tables provide a "present value" for the interest based on an assumed interest rate that is redetermined monthly by the IRS based on prevailing market interest rates for obligations of the United States.

NOTE: "Present value" may be thought of as the amount of money one would need to invest today at the assumed interest rate in order to provide exactly the amount of money that would be needed to make each payment of the valued interest as the payment comes due, with no money left over at the end.

Valuation tables are used as a matter of practical necessity in view of the fact that future investment results are normally unknown. Although the IRS knows that many estate planning strategies are based on the assumption that a particular fund will produce better results than assumed by the IRC §7520 rates, in many situations the "game" is viewed as fair.

In other situations, however, the rules of the game are easily abused, so the IRS has promulgated limiting rules. For example, abuses involving life expectancy (*e.g.,* using an actuarial table to determine the life expectancy of a terminal cancer patient expected to die within the week) are addressed by Treas Reg §20.7520-3(b)(3), which provides that the tables are not to be used to determine life expectancy if the relevant person is terminally ill. Terminal illness is defined as follows: "For purposes of this paragraph (b)(3), an individual who is known to have an uncurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within 1 year." Treas Reg §20.7520-3(b)(3)(i).

On other valuation abuses addressed by IRC §§2701-2702 and regulations under those statutes, see §§25.6, 25.12.

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B. Retained Interest Trust Limitations Under IRC §2702

§25.6 1. Abuse Targeted by Statute

For many years, planners have used leveraged "freeze" transactions involving the creation of a trust that provided the settlor with a retained interest for a term of years in the form of a right to trust income. The settlor would then report a gift, calculated by taking the value of the property transferred to the trust and reducing that value by the value of the retained interest as determined under IRC §7520. The settlor might also retain a right to receive the entire trust estate in the event of death during the term. Retaining this right to a "reversion" interest costs the settlor nothing in terms of transfer taxes because death during the term of the retained income interest would in any event result in the trust estate being brought back into the settlor's taxable estate under IRC §2036.

In many situations, this valuation arrangement would undervalue the gift to the trust remainder beneficiary by overvaluing the retained income interest. This would occur, for example, if the trust were funded with assets that would generate very little "income" but would likely appreciate. Assets of this type include many publicly traded securities, interests in close corporations, and unimproved real estate with future development potential. If a trust were funded with such assets, the settlor would essentially claim a valuation reduction for future payments that would never be made.

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§25.7 2. Provisions of Statute

Under IRC §2702, the value of a gift to a trust (or a transfer deemed to result in a trust equivalent, such as a transfer with a retained term of years or a joint purchase in which one party purchases the term of years and the other purchases the remainder) is the entire value of the property transferred to the trust, reduced only by the value of retained "qualified interests." There are only three qualified interests (IRC §2702(b)):

(1) An annuity interest (a right to receive fixed amounts);

(2) A unitrust interest (a right to receive a fixed percentage of the fair market value of the property, determined annually); and

(3) A noncontingent remainder interest (if all other interests are annuity interests or unitrust interests).

The only common estate planning device that depends on the use of qualified interests is the grantor retained annuity trust (GRAT). See §§25.31-25.40.

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§25.8 3. Limitation of Statute to Family Members

The special valuation rules of §2702 do not apply when the trust remainder beneficiaries are not members of the family of the settlor. See IRC §2702(a)(1). Under IRC §2702(e), a "member of the family" of an individual is the same as in IRC §2704(c)(2):

- The individual's spouse;
- Any ancestor or lineal descendant of the individual and the spouse of any such person;
- Any ancestor or lineal descendant of the individual's spouse and the spouse of any such person; and
- Any brother or sister of the individual and the spouse of any such sibling.

Persons not considered a "member of the family" of a settlor whom the settlor nevertheless might want to benefit include nieces and nephews, issue of nieces and nephews, siblings of a spouse, and friends. When the statute does not apply because the beneficiaries are not members of the family as defined by the statute, it remains possible to favorably value a retained right to "trust income." See the discussion of grantor retained income trusts (GRITs) in §§25.22-25.26.

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§25.9 4. Personal Residence Exception

A transfer is not subject to IRC §2702 "if such transfer involves the transfer of an interest in trust all the property in which consists of a residence to be used as a personal residence by persons holding term interests in such trust." IRC §2702(a)(3)(A)(ii). The residence exception makes it possible to establish a GRIT for a primary residence or vacation home even if the beneficiaries are members of the settlor's family. Such GRITs are known as qualified personal residence trusts (QPRTs) and nonqualified personal residence trusts (PRTs). See §§25.29-25.30. In IRS Letter Ruling 200728018, the IRS ruled that property could be transferred to a PRT in exchange for an amount equal to the actuarial value of the remainder interest, to be paid to the settlors by another trust created by the settlors that will receive the property at the end of the PRT term, with the result that there will be no taxable gift by the settlors.

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§25.10 5. Tangible Personal Property Exception

The IRS has authority to provide exceptions to the general limitations of IRC §2702. IRC §2702(a)(3)(A)(iii). It has exercised its authority to permit a deduction for a retained "income" interest in tangible personal property for which no deduction for depreciation or depletion would be allowed if the property were used in a trade or business. Treas Reg §25.2702-2(c), (d)(2), Examples 6-8. This exception applies to such things as the retention of the right to possession of a work of art for a term of years. Because of the exception, the value of the retained interest is deductible when computing the value of the gift. However, when it is necessary to rely on this exception, the retained interest is not valued under IRC §7520 valuation tables. Instead, the settlor has the burden of proving the value of the retained interest using a willing-buyer, willing-seller standard. Treas Reg §25.2702-2(c)(1).

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§25.11 C. Business Entity Freezes and IRC §2701

Although it is technically possible to "freeze" the value of an interest in a business entity, planners usually no longer find this useful in view of other options available. The popularity of the business entity freeze essentially died as a result of the 1990 enactment of IRC §2701, a statute that in many ways takes a valuation approach similar to IRC §2702. See §§25.6-25.10. Today, the statute is primarily important due to the possibility of triggering it by mistake, although some planners contend business freezes may still be viable in particular circumstances. See, *e.g.*, Dees, *Using a Partnership to Freeze the Value of Pre-IPO Shares*, 33 U Miami Inst Est Plan, chap 11 (1999). See also chap 18.

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§25.12 1. Perceived Evil

Internal Revenue Code §2701 is most easily explained by discussing an example of the type of transaction that Congress wished to curb by enacting the statute. Assume that a mother and father own all of the 100 outstanding shares of Money Tree, Inc., common stock. There is only one class of stock outstanding. The company has a current value of $20 million and the corporation's business is expected to expand. The family is already concerned about the estate taxes that might be payable someday (if the estate tax is not permanently repealed).

Using a fairly typical pre-1990 freeze strategy, the mother and father would cause a corporate recapitalization in which the 100 shares of common stock were exchanged for 100 shares of voting preferred stock plus 100 shares of a new class of common stock. The preferred stock would be given rights designed to give it a current value as close to $20 million as possible but to limit its potential to increase in value as the company expanded in the future.

Thus, in addition to some or all of the voting rights, the preferred stock might have a par value of $200,000 per share ($20 million total). It might also have a noncumulative right to receive very substantial dividends before any dividends could be paid to the owners of the common stock. In the event of liquidation, the preferred stock would have a liquidation preference of the par value amount. The new common stock would be given whatever rights remained, including—in effect—most of the rights to future increases in the value of the corporation.

Following this reorganization, the mother and father would give the new common stock to their children, or to trusts for their children's benefit, valuing this gift very low because the supposedly high value of the retained preferred stock would result in a low value for the new common stock.

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§25.13 2. Basic Approach of IRC §2701

Internal Revenue Code §2701 attacks the technique outlined in §25.12 by changing the method of valuing the new common stock at the time the stock is given to the children. Under the statute, the parents' rights to dividends and to liquidate the corporation are generally ignored, and the value of the common stock is deemed to be the entire value of the corporation minus only the value of the parents' retained voting rights. The notable exception to the rule disallowing consideration of these retained interests allows the parents to choose to have the apparent value of retained dividend rights taken into account for valuation purposes. If they choose to do this, however, subsequent failures of the corporation to pay the anticipated dividends to the parents results in imposition of additional transfer taxes, with the parents being deemed to have received the unpaid dividends and then to have gifted them to the children.

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§25.14 3. Circumstances Triggering IRC §2701

The valuation rules of IRC §2701 are triggered only by specified circumstances. For corporations, all of the following circumstances are required:

- There is a transfer of an interest in a corporation (or other business entity).
- The transfer is to or for the benefit of a member of the transferor's family. "Member of the family" is defined in the same manner as for IRC §2702. IRC §2701(e)(1). See §25.8.
- There is an interest in the corporation that is retained by the transferor or an "applicable family member." An "applicable family member" is the transferor's spouse, an ancestor of the transferor, an ancestor of the spouse, or the spouse of an ancestor. IRC §2701(e)(2). (This prevents a transferor from giving preferred stock to a spouse and then later giving common stock to the children.)
- There are no readily available market quotations for the transferred interests as of the date of the transfer. IRC §2701(a)(2)(A). (Presumably valuation abuse is not a problem if there is a market.)
- The transferred interest is of a different class than the retained interest and not "proportionately the same as the transferred interest, without regard to nonlapsing differences in voting power." IRC §2701(a)(2)(B)-(C). In short, the statute does not apply if, for example, each share of a retained Class A voting common stock has the same rights, other than permanent voting power, as two shares of a Class B nonvoting common stock that is being transferred.
- The retained interest is an "applicable retained interest." Under IRC §2701(b)(1), an applicable retained interest is an interest with respect to which there is:
- A "distribution right," but only if there is control of the entity by the transferor and "applicable family members" immediately before the transfer (IRC §2701(b)(1)(A)); or
- A liquidation, put, call, or conversion right, *unless* (IRC §2701(b)(1)(B), (c)(2)(A), (c)(2)(B)(i)-(ii)):
- Exercise of the right is mandatory at a fixed amount, *or*
- The exercise or nonexercise of the right will not affect the value of the transferred interest.

A "distribution right" is a right to distributions from a corporation with respect to its stock, or a right to distributions from a partnership with respect to a partner's interest in the partnership. IRC §2701(c)(1)(A). A distribution right does not include a right to distributions with respect to any interest that is junior to the rights of the transferred interest. IRC §2701(c)(1)(B)(i).

NOTE: The definition of an applicable retained interest has the effect of excluding application of the statute when either of the following two statements is true:

- The only retained interest is common stock with income and capital rights that are junior to all other classes of equity interests. (It is therefore permitted to transfer a "senior" or preferred class of stock that has the right to receive distribution before distributions are made to the holders of the retained stock.)
- The only retained interest is a right to dividends that are supposedly not subject to family control. Under IRC §2701(b)(2), control is defined as the holding of at least 50 percent (by vote or value) of the stock of the corporation.

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§25.15 4. Initial Valuation and Elections

If a transfer is not excluded under the rules set forth in §25.14, the harsh valuation rules of IRC §2701 apply for purposes of determining *whether* the transfer is a gift and the *value* of a gift. The rights that caused the retained interest to be an applicable retained interest will be valued at zero unless an exception applies.

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§25.16 5. Exception: Qualified Payment

A "qualified payment" is a dividend payable on a periodic basis under a cumulative preferred stock to the extent that the dividend is determined at a fixed rate. IRC §2701(c)(3)(A). This rule is somewhat analogous to the IRC §2702 trust rule treating annuity and unitrust interests as qualified interests. See §25.7. To the extent that a retained distribution right is in the form of a qualified payment, its value is not ignored (unless the transferor elects otherwise). However, if the transferor takes advantage of this provision, the taxpayer or the taxpayer's estate can be subject to additional transfer taxes if there is later a failure to pay dividends. The transferor can waive qualified payment treatment.

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§25.17 6. Exception: Election to Treat as Qualified Payment

Other distribution rights can also be treated as rights to qualified payments if the transferor so elects. An affirmative election is needed in these situations, because the election requires specifying the amounts and times when the distributions will be made, in a manner consistent with the underlying terms of the instrument creating the distribution right. In other respects, there is no substantive difference between an inherently qualified payment interest and an interest entitled to qualified payment status as a result of the election. Electing qualified payment status triggers potential liability for additional transfer tax if there is a failure to pay dividends at the time and in the amounts specified in the election. See IRC §2701(d).

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§25.18 7. Certain Liquidation, Put, Call, and Conversion Rights

Under IRC §2701, certain liquidation, put, call, and conversion rights may not give the transferor the ability to manipulate the valuation (and value) of the transferred interest. In general, if the transferor has no discretion as to whether a right is exercised, or if the exercise of discretion does not affect the value of the transferred interest, the statute does not require valuing the right at zero. See IRC §2701(c)(2).

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§25.19 8. Combinations of Distribution Rights and Other Rights

Stock may confer a combination of rights under which it is certain that the owner will receive a benefit, but it is not clear what that benefit will be. Assuming that one of the benefits is a distribution right that is a right to a qualified payment (and therefore not valued at zero), IRC §2701 provides for valuing the combination of rights that includes the distribution right in a manner that produces the lowest value. IRC §2701(a)(3)(B). The Conference Committee report gives an example of a preferred stock that pays a $100 per year cumulative dividend and can be redeemed (presumably meaning the shareholder has a discretionary put right) at any time after 2 years for $1000. The value of the stock will be the lesser of (1) the present value of $100 per year paid in perpetuity, and (2) the present value of two $100 annual dividends immediately followed by a redemption. See HR Conf Rep No. 101-964, 101st Cong, 2d Sess (1990), reprinted in 1990 US Code Cong & Ad News 2374, 2839. Thus, in this situation, the put right is not valued at zero. IRC §2701(c)(2)(B)(ii).

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§25.20 9. Minimum 10-Percent Value for Transferred Interest

In no event may the value of a transferred "junior equity interest" be less than "the value which would be determined if the total value of all of the junior equity interests in the entity were equal to 10 percent of the sum of—(i) the total value of all of the equity interests in such entity, plus (ii) the total amount of indebtedness of such entity to the transferor." IRC §2701(a)(4)(A)(i)-(ii). This rule essentially takes the position that transferred common stock always has some value, and limits the extent to which the transferor can use high dividend assumptions for the retained stock in order to reduce the value of the transferred common stock.

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§25.21 D. Avoiding Application of IRC §2701

As evidenced by the cursory summary above, the rules of IRC §2701 are complex. Generally, problems under IRC §2701 can be avoided by the use of simple securities that have identical distribution rights and do not have rights that can shift value to younger generation family members as a result of the exercise or nonexercise of the rights. The rules of IRC §2701 are not triggered by differences in voting rights or, in the context of partnerships, the normal differences in the management rights of general partners compared to limited partners. Persons seeking to use more complex capitalization arrangements for family business entities must exercise extreme care.

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III. GRANTOR RETAINED INCOME TRUSTS (GRITs)

§25.22 A. Overview of GRITs

A grantor retained income trust (GRIT) is an irrevocable trust in which the settlor retains the right to all trust income for a specified term. For tangible property, the retained income right may be exercised by using the property in kind. At the end of the retained interest term, the remaining trust estate may be distributed outright to remainder beneficiaries or held retained in further trust for the benefit of desired beneficiaries. The remainder beneficiaries cannot be members of the settlor's family (not including nonmarital partners) except in a GRIT for a residence (*i.e.*, a QPRT or PRT; see §§25.27-25.28) or a GRIT for tangible personal property relying on the special rules described in §25.10. See §25.8. In the discussion in §§25.23-25.26, references to the "term" of the trust refer to the term of the retained interest even though the trust may continue thereafter for other purposes.

The trust instrument typically provides that, if the settlor dies during the trust term, the trust will terminate immediately and the trust estate will be distributed as appointed by the settlor or, if not so appointed, to the settlor's revocable trust or estate. This provision results in a retention of a reversionary interest and therefore reduces the value of a gift made by the transferor at the inception of the trust.

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§25.23 B. Valuation Benefits

GRITs are typically funded with assets that generate relatively little "trust income" but have appreciation potential. The trust may produce no income whatever if the trust is funded with a residence or other tangible property that the settlor will use in kind during the retained term. If the settlor survives the term, the remainder beneficiaries will receive the assets worth significantly more than the value of the gift for gift tax purposes. Consider the following examples involving a qualified personal residence trust (QPRT), which is a form of GRIT.

EXAMPLE 1: In April 2006, a 60-year-old widower transfers a house worth $800,000 (with a tax basis of the same amount) to a GRIT with a 7-year term that is not subject to the IRC §2702 valuation rules, because the trust meets the requirements of a QPRT or the beneficiary is not a member of the widower's family. The value of the gift, using the IRC §7520 interest rate for that month of 5.6 percent, is 61.099 percent of $800,000, or $488,792. (The value of the retained income interest is 30.266 percent, or $242,128, and the value of the reversionary interest—*i.e.,* the right to receive the entire trust estate in the event of death during the term—is 8.635 percent, or $69,080.) If the residence appreciates at 5 percent each year, the remainder beneficiaries will receive a house worth $1,125,680 at the end of the 7-year term. Assuming that the house is then sold by the beneficiaries and capital gains tax on the appreciation is paid, the beneficiaries will still have a fund of more than $1 million.

EXAMPLE 2: Instead of creating a QPRT, the widower makes an outright gift of $488,792 (the gift tax value for the QPRT). For the donee to have property worth $1 million at the end of 7 years, the donee would need an investment that would generate a rather unlikely after-tax rate of return of 10 percent per year. If the return rate is a more realistic 6 percent after tax, the donee would end up with a fund of $734,962. Thus, the QPRT has shifted approximately $265,000 of additional wealth out of the settlor's estate and into the hands of the donee.

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§25.24 C. Drawbacks of GRITs

Problems that arise from the use of GRITs include:

- Possible inclusion of the entire trust in the settlor's estate. If the settlor fails to survive the term of the retained interest in the trust, the entire trust estate will be included in the settlor's estate because of the retained income interest. IRC §2036. Inclusion in the estate may produce a result that is no worse than doing nothing, but the client may have lost the opportunity to take other estate planning actions. For example, the GRIT may have used up a significant portion of the settlor's $1 million IRC §2505(a)(1) gift tax applicable credit amount.
- Possible loss of a new tax basis for the trust assets on the settlor's death. See IRC §1014 (IRC §1022 if the settlor dies in 2010). This problem can be particularly serious if the property has a low basis, and the beneficiaries will want to sell the property after death. At least under IRC §1014, the property will be entitled to a new basis if the settlor fails to survive the term. Loss of new basis may be particularly unfortunate if the settlor survives until estate tax repeal is permanent.
- In a QPRT, the settlor may lose the ability to exclude $250,000 ($500,000 if married and filing a joint return) of capital gain on sale of a residence under IRC §121 unless the residence is sold to an unrelated third party while it is still owned by a trust deemed owned by the settlor for income tax purposes under IRC §671. See §25.29.
- In a QPRT, the settlor may need to pay rent for his or her own residence after the trust term or else move out of the residence at the end of the term. Otherwise the settlor may be deemed to have made an implied agreement with the remainder beneficiaries that effectively caused the settlor to retain a right of occupancy until his or her death. This would cause the residence to be included in the settlor's estate under IRC §2036. *Estate of Maxwell v Commissioner* (2d Cir 1993) 3 F3d 591.

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Source: Estate Planning/California Estate Planning/25 Valuation Freeze Techniques/§25.25 D. Selecting Term of Retained Interest

§25.25 D. Selecting Term of Retained Interest

A GRIT can be established for any term desired, but selecting a term involves a gamble. Increasing the term reduces the value of the gift because the gift is the value of the residence minus the retained income interest and the retained reversion interest. A long-term income interest is obviously more valuable than a short-term interest. A longer term, however, increases the risk that the settlor will fail to survive the term. This has a valuation benefit because it increases the value of the contingent reversion (the right to return of the property if the settlor fails to survive), but it also increases the risk that the benefits of the GRIT will be lost. Further, the benefit per year diminishes as the length of the term increases because each year added to the term of the retained interest reduces the gift by fewer dollars than the addition of the previous year. The following table illustrates this fact for a QPRT (*i.e.*, a GRIT for a residence):

Value of Gift per $100,000 of Fair Market Value of Residence Made by 55-Year-Old Settlor on Creation of QPRT, Calculated Using IRC §7520 Interest Rate of 5.6 Percent		
Term of Retained Interest (Years)	*Value of Gift*	*Reduction in Gift Due to Additional Year of Term*
0	$100,000	N/A
1	93,965	$6,035
2	88,231	5,734
3	82,778	5,453
4	77,589	5,189
5	72,652	4,937
6	67,957	4,695
7	63,498	4,459
8	59,266	4,232
9	55,248	4,018
10	51,433	3,815

The following table indicates the likelihood of the settlor's failing to survive a chosen term. These figures are derived from IRS Table 90CM found at the end of Treas Reg §20.2031-7(d)(7), which is used to calculate values under IRC §7520. This is an actuarial table that does not take into account gender, health status, health and diet habits, and accessibility to high-quality health care. The survival prospects of any particular individual may be substantially different.

Probability of Surviving Specified Number of Years After Given Age			
Surviving years	*Percentage after age 55*	*Percentage after age 65*	*Percentage after age 75*
1	99	98	96
2	98	96	92
3	97	94	87

4	96	92	83
5	95	90	78
6	94	87	73
7	93	85	68
8	92	82	63
9	90	79	58
10	89	76	53

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Source: Estate Planning/California Estate Planning/25 Valuation Freeze Techniques/§25.26 E. Calculating Value of Gift to Qualified Personal Residence Trust (QPRT)

§25.26 E. Calculating Value of Gift to Qualified Personal Residence Trust (QPRT)

The value of the gift that is made when a QPRT (*i.e.*, a GRIT for a residence) is created can be calculated by using the IRS Tables in IRS Pub 1457 or by using commercial estate planning computer software that incorporates the IRS tables. Commercial software is a sound investment. There is also a "quick and dirty" calculation that can be made with a typical hand calculator. The formula for is:

$$\text{Gift} = \text{FMV} \times 1 /(1 + i)^{N} \times \text{Survival Probability}$$

In this formula FMV is the full fair market value of the residence, i is the interest rate per interval, N is the number of intervals, and Survival Probability is the probability that the settlor will survive until the end of the term. The interval is usually 1 year. The calculation $1/(1+i)^{N}$ provides the present value of the right to receive $1 at the end of the term, sometimes described as the amount that must be invested today to produce a fund of $1 at the end of the term. This is multiplied by the Survival Probability because the remainder beneficiary of a standard QPRT receives nothing unless the settlor survives the term.

The interest rate is the IRC §7520 rate for the month of the transfer. This is published monthly in the Internal Revenue Bulletin and reprinted by major tax services. Under IRC §7520, the applicable interest rate is the rate (rounded to the nearest 0.2 percent) equal to 120 percent of the federal midterm rate, compounded annually, in effect under IRC §1274(d) for the month in which the valuation date falls.

The probability of survival is calculated using Table 90CM, found at the end of Treas Reg §20.2031-7(d)(6), which shows the number of people still alive at each year of age out of an original pool of 100,000 people. All 100,000 are alive at age zero, and 17 people are still alive at age 109. The chance that a person age *X* will survive until age *Y* is calculated by dividing the number of people alive at age *Y* by the number of people alive at age *X*. Thus, the chance that a newborn will survive to age 109 is 17/100,000.

EXAMPLE: The gift made when a 60-year-old person transfers an $800,000 residence to a QPRT with a 7-year term in a month when the IRC §7520 interest rate is 5.6 percent is:

$$\$800{,}000 \times 1/(1 + 0.056)^{7} \times 76{,}531/85{,}537$$

The present value of remainder interest without regard to the need to survive is 1/1.4644, or 68.287 percent. The probability of survival is 89.471 percent. The value of the gift is therefore $488,792.

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IV. GRITS FOR NON-FAMILY MEMBERS

§25.27 A. Governing Instrument Requirements

If the beneficiaries of a GRIT are not members of the settlor's family (see §25.8), the trust will not be subject to IRC §2702. The retained interests can be taken into account in valuing the gift. A trust for nonfamily members funded with a residence does not need to be a qualified personal residence trust (QPRT) or personal residence trust (PRT) (see §§25.29-25.30), and a trust funded with tangible personal property may be valued using the IRC §7520 tables rather than the willing-buyer, willing-seller rule (see §25.10). The governing instruments for such trusts contain relatively few custom terms except provisions for the specified trust term and for distributing the remainder after the term of the retained interest expires.

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§25.28 B. Asset Limitations

Any property can be used to fund a GRIT. Treasury Regulation §20.7520-3(b)(2)(ii)(A) provides, however, that the normal valuation principles of IRC §7520 may not be used in valuing the present value of an income interest unless

> the effect of the… governing instrument is to provide the income beneficiary with that degree of beneficial enjoyment of the property during the term of the income interest that the principles of the law of trusts accord to a person who is unqualifiedly designated as the income beneficiary of a trust for a similar period of time. This degree of beneficial enjoyment is provided only if it was the transferor's intent, as manifested by the provisions of the governing instrument *and the surrounding circumstances*, that the trust provide an income interest for the income beneficiary during the specified period of time that is consistent with the value of the trust corpus and with its preservation. In determining whether a trust arrangement evidences that intention, the treatment required or permitted with respect to individual items must be considered in relation to the entire system provided for in the administration of the subject trust. [Emphasis added.]

Thus, the IRS may argue that normal valuation principles should not be applied when trust terms "and surrounding circumstances" preclude the settlor from receiving income from the GRIT commensurate with the "degree of beneficial enjoyment" generally accorded income beneficiaries. Similarly, if the assets transferred to the GRIT produce income less than the income commensurate with the degree of beneficial enjoyment generally accorded income beneficiaries, and those assets are not converted into assets generating the requisite amount of income, the IRS may contend that the retained interest should not be valued under IRC §7520 in the first place or that the settlor's subsequent failure to demand the production and distribution of income results in additional gifts to the remainder beneficiaries as time passes. See *Eric F. Saltzman,* TC Memo 1994-641, rev'd on other grounds (2d Cir 1997) 131 F3d 87 (rejecting IRS argument that standard actuarial tables should not be used if GRIT property is unproductive).

For estate and gift tax purposes, the right to use property rent free is generally equated with an income interest. See, *e.g.,* IRC §2036(a)(1). Thus, a settlor could transfer a personal residence to a GRIT having non-family member remainder beneficiaries and retain the right to use the residence for a term certain without having to satisfy the onerous requirements of a QPRT or PRT under Treas Reg §25.2702-5.

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V. RESIDENCE AND VACATION HOME TRUSTS FOR FAMILY MEMBERS

§25.29 A. QPRTs Versus Personal Residence Trusts

Qualified personal residence trusts (QPRTs) are trusts that are exempt from the impact of IRC §2702. See IRC §2702(a)(3)(A)(ii); see discussion in §25.9. A trust that meets the detailed requirements of Treas Reg §25.2702-5(c) can be established for a residence or vacation home and will produce substantially the same benefits as a GRIT even though the remainder beneficiaries are members of the settlor's family.

NOTE: For these purposes, a residence may be either a principal residence or a vacation residence used at least 2 weeks a year. Treas Reg §25.2702-5(b)(2)(i)(A)-(B) (incorporating IRC §280A(d)(1)).

The value of a gift to a QPRT will be calculated in the same manner as for a GRIT. In addition to holding a residence, a QPRT can hold reasonable amounts of cash for operation expenses, although the cash must be held in a separate account. In addition, the trust instrument can permit the residence to be sold and a new one to be purchased. Treas Reg §25.2702-5(c)(5)(ii)(A).

The governing instrument for a QPRT must prohibit the trust from selling or transferring the residence, directly or indirectly, to the settlor, the settlor's spouse, or an entity controlled by the settlor or the settlor's spouse during the retained interest term of the trust, or at any time after the retained interest term that the trust is a grantor trust. Treas Reg §25.2702-5(c)(9). As a result, the settlor cannot repurchase the house without triggering recognition of capital gain. However, the settlor may rent the residence from the trust for fair market value after the expiration of the term of the settlor's retained interest. TD 8743, 1998-1 Cum Bull 543.

Residence trusts that are not "qualified" residence trusts—*i.e.,* residence trusts that satisfy the statutory requirements of IRC §2702(a)(3)(A)(ii) but not necessarily the additional requirements set forth in the regulations—are simply referred to as personal residence trusts (PRTs). With little, if any, legal authority, the IRS has attempted to regulate PRTs that are not QPRTs, and has tried to impose on PRTs the regulatory limitation on sales to the settlor and the settlor's spouse that applies to QPRTs. Treas Reg §25.2702-5(b). Many planners believe that this limitation is invalid in the context of a PRT because it creates a limitation on the unrestricted IRC §2702 exclusion for residences, but the typical client will not choose to become a test case. The great majority of residence trusts are QPRTs because of the desirability of having a trust that can also hold cash.

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§25.30 B. QPRT Drafting

The contents of a QPRT are rigorously regulated by Treas Reg §25.2702-5(c). The typical QPRT trust instrument contains few custom provisions other than those pertaining to names, dates, the trust term, the real property description, and the disposition at the end of the trust term. The IRS has issued a sample trust meeting the requirements of a QPRT, but the sample trust does not contain a standard provision for reversion to the grantor's estate if the grantor dies before the end of the term or a commonly used provision that the property will be transferred to another grantor trust at the end of the trust term if the grantor survives. Rev Proc 2003-42, 2003-1 Cum Bull 993.

PRACTICE TIP: If the disposition at the end of the term involves a trust, the terms of the continued trust may be incorporated into the QPRT instrument, but many practitioners prefer to use a separate trust instrument. A separate trust instrument emphasizes the fact that the "continued" trust is actually a different trust in terms of disposition scheme and tax consequences.

Regardless of whether a continuing trust or a second trust is used, the distributive provisions may not include any provisions that might cause the original transfer to the QPRT to be an incomplete gift under Treas Reg §25.2511-2(b).

Typical QPRT provisions include:

- Prohibitions on additions to the trust except as expressly authorized in the regulations. Treas Reg §25.2702-5(c)(5).
- Limitations on the assets that can be owned by the trust that are needed to comply with IRC §2702 and Treas Reg §25.2702-5(c)(1), (c)(5)(i)-(ii). Essentially, the trust can hold a residence and limited amounts of cash. See §25.29.
- Provisions giving the settlor a right to use the residence and a right to receive all income no less frequently than annually. Treas Reg §25.2702-5(c)(3).
- Mandatory provisions concerning sale or destruction of the residence. These may permit acquisition of a new residence within time limits stated in the regulations. If there is no such replacement, the trust must be converted into a retained annuity trust. Treas Reg §25.2702-5(c)(8).

For further discussion of QPRT requirements and relevant forms, see Drafting California Irrevocable Trusts, chap 17 (3d ed Cal CEB 1997).

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VI. GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

§25.31 A. Overview of GRATs

A grantor retained annuity trust (GRAT) is an irrevocable trust in which the settlor retains the right to an annuity for a specified term. A GRAT is subject to IRC §2702, but assuming there is compliance with applicable regulations, the annuity interest is a "qualified interest" under IRC §2702. Accordingly, the retained interest may be deducted from the value of the property transferred to the GRAT when calculating the value of the gift made by that transfer. At the end of the term of the retained annuity, the remaining trust estate is transferred to remainder beneficiaries or retained in further trust for their benefit. If the trust does not benefit members of the settlor's family as defined in IRC §2704(c)(2), it is not necessary to comply with the IRC §2702 regulations. See §25.8. The discussion in §§25.32-25.40 assumes that the GRAT benefits family members.

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§25.32 B. Objective of GRAT

The retained annuity interest of a GRAT is valued using IRC §7520 tables. These tables are based on interest rates that change monthly. If the assets of a GRAT yield a total return of income and appreciation that is exactly the same as the interest rate used by the tables to value the interest, a GRAT accomplishes nothing, but if the investments out-perform those assumptions, the benefits of the additional total return effectively pass to the remainder beneficiaries without being subject to gift tax. As is true of a GRIT, the settlor must survive the term; otherwise the trust assets will be included in the settlor's estate under IRC §2036.

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Source: Estate Planning/California Estate Planning/25 Valuation Freeze Techniques/§25.33 C. Required GRAT Governing Instrument Provisions

§25.33 C. Required GRAT Governing Instrument Provisions

The requirements and permissible terms for a GRAT for a member of the settlor's family are prescribed by Treas Reg §25.2702-3(b)-(d). As a result, the typical GRAT governing instrument contains relatively few custom terms except for provisions relating to the annuity to be paid to the settlor and the distribution of the remainder after the period of the settlor's retained interest expires.

A GRAT is subject to the following rules:

- It must provide the settlor with an irrevocable right to receive a "fixed" (*i.e.,* specified) amount. The annuity amount must be payable to or for the benefit of the person holding the term interest each year of the term. A right of withdrawal, even if cumulative, does not create a qualified interest. Treas Reg §25.2702-3(b)(1).
- The annuity payment may be made after the close of a calendar year, but it can be made no later than the due date of the trust's federal income tax return for that year, without regard for extensions, or within 105 days after the anniversary date of the creation of the trust. Treas Reg §25.2702-3(b)(1), (b)(4).
- The specified amount of the annuity can be expressed either as a dollar amount or as a percentage of the value of the property initially transferred to the GRAT, and it may increase from year to year, but the amount for any particular year cannot be more than 120 percent of the preceding year's annuity payment or 120 percent of the fixed fraction or percentage payable in the preceding year. Treas Reg §25.2702-3(b)(1)(ii). If the annuity amount is expressed as a percentage of the trust's initial value, the GRAT must contain provisions to adjust for:
- The proper annuity amount that should have been paid consistent with the requirements of Treas Reg §1.664-2(a)(1)(iii), which relate to adjustments for any incorrect determination of the fair market value of the property in the trust (Treas Reg §25.2702-3(b)(2)); and
- The proper prorated annuity amount that should be paid in a short taxable year (Treas Reg §25.2702-3(b)(3)).
- Additional contributions to the GRAT are prohibited. Treas Reg §25.2702-3(b)(5).

In addition, to prevent circumvention of the GRAT rules, the trust must:

- Meet the definition of and operate exclusively as a GRAT at all times (Treas Reg §25.2702-3(d)(1));
- Provide that the interest is not subject to any contingency other than the survival of the settlor or, in the case of a revocable interest under Treas Reg §25.2702-2(a)(6), the settlor's right to revoke the interest of the settlor's spouse (Treas Reg §25.2702-3(d)(2));
- Prohibit distributions to anyone other than the settlor during the trust term (Treas Reg §25.2702-3(d)(3));
- Have a stated term (Treas Reg §25.2702-3(d)(5));
- Prohibit a commutation of the settlor's interest, *i.e.*, a premature termination in which the settlor receives the present value of the remaining annuity interest and the remainder beneficiaries receive the rest of the trust assets (Treas Reg §25.2702-3(d)(5)); and
- Prohibit the trustee from issuing promissory notes or other instruments in satisfaction of the annuity obligation (Treas Reg §25.2702-3(d)(6)).

Under the regulations, the stated term of the GRAT may be for a term of years, the settlor's lifetime, or the lesser (but not the greater) of a term of years and the settlor's lifetime. Treas Reg §25.2702-3(d)(3). In actual practice, estate planners use a term of years and provide that payments are to be made to the settlor's estate if the settlor fails to survive the term of the retained annuity. See §25.36.

For further discussion of GRATs and appropriate forms, see Drafting California Irrevocable Trusts, chap 17 (3d ed Cal CEB 1997).

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§25.34 D. Funding a GRAT

Any property can be used to fund a GRAT, even unproductive property. Treas Reg §25.7520-3(b)(2)(v), Example 3. It must be kept in mind, however, that the trust must actually make the annuity payments and cannot use promissory notes for this purpose. Treas Reg §25.2702-3(d)(6). Because a typical GRAT will quickly make annuity payments in excess of the value of the property transferred to the GRAT (see §25.36), it is normally the case that annuity payments must be made by distributing back to the settlor a substantial portion of the same assets that the settlor transferred to the GRAT in the first place. Problems can arise if a GRAT is initially funded with an asset that will lose value if it is divided up. It would be unwise, for example, to fund a 2-year GRAT with 51 percent of the voting common stock of a corporation, because breaking up a block of stock that has voting control will result in there being two blocks of stock having an aggregate value that is less than the value of the 51-percent block. The GRAT will probably go broke trying to fund the annuity payments using minority interest blocks. Similar problems occur if a GRAT is funded with a single parcel of real property. For a discussion of such valuation discounts in connection with the valuation of family business interests, see chap 18.

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§25.35 E. Calculating Value of GRAT Gift

The value of the gift that is made when a GRAT is created can be calculated by using the Tables in IRS Publication 1457 or by using commercial estate planning computer software that incorporates the IRS tables. However, it is more practical to use the software.

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§25.36 F. Rolling, Short-Term, Zeroed-Out GRATs

The most commonly used GRAT in contemporary estate planning is a short-term (2 or 3 years) GRAT in which the annuity amount is set just high enough to "zero-out" the GRAT, *i.e.,* the annuity amount will exhaust the trust if the trust's total return investment performance exactly equals the rate assumed by the IRC §7520 tables. The philosophy behind this structure is that the settlor will "win some and lose some," *i.e.,* the settlor wins if the investment performance is greater than the table assumptions, and the settlor loses if the investment performance is less than the table assumptions. In the normal course of events, the investment performance will not exceed the IRC §7520 table assumption every single year and, indeed, there might be years in which there are losses. It is not desirable to have the benefits accrued in good years eaten up by later losses, when it would be just as easy to get the early profits safely into the hands of the remainder beneficiaries. It is also not desirable to have excess assets in a GRAT that might be subject to excess losses.

EXAMPLE: Consider a situation in which a settlor establishes a 2-year GRAT paying an annuity of $545,435 when the IRC §7520 rate is 6 percent. The trust is funded with $1 million in cash and the value of the gift is zero. If the total investment return on the trust over 2 years is less than 6 percent, the trust principal is exhausted by the payments to the settlor, but nothing is lost in terms of gift tax. The gift was valued at zero, which is exactly what the remainder beneficiaries received. But what if the settlor funds the same trust with an additional $100,000 and the trust fails to have a total return of 6 percent? Now there is a risk of a loss (*i.e.,* an ineffective use of gift tax exemption) because the value of the gift for gift tax purposes will be $100,000, but the remainder beneficiaries may receive far less.

The significant disadvantage of a short-term, zeroed-out GRAT arises from the fact that the assets that can generate benefits for the remainder beneficiaries are quickly removed from the trust. This problem can be addressed by having the settlor "roll" annuity payments into new GRATs—a "rolling GRAT" strategy.

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§25.37 G. Income Tax Considerations

The typical GRAT is intentionally designed as a grantor trust, with all income taxed to the settlor under IRC §671. This is usually accomplished by having the settlor retain an administrative power that would cause the settlor to be treated as the owner of the trust under IRC §675. For example (and most often), the settlor can retain a power, exercisable in a nonfiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value, thereby causing application of IRC §675(4)(C). It would also appear that grantor trust status is achieved under IRC §677 any time the retained annuity is payable from both income and principal (see IRS Letter Ruling 9444033), a condition that necessarily exists in all situations involving the high percentage payments required for a short-term, zeroed-out GRAT. See §25.34. Grantor trust status is highly desirable to avoid recognition of gain when assets are distributed in kind to satisfy the mandatory annuity payments. Grantor trust status also enables the GRAT to hold S corporation stock. IRC §1361(c)(2)(A)(i).

An unrelated tax issue is the loss of a stepped-up basis for the trust assets eventually passing to the remainder beneficiaries if the settlor survives the trust term. IRC §1014 (IRC §1022 if the settlor dies in 2010). In this situation, the income tax basis of the trust assets will equal their basis in the settlor's hands immediately before the transfer, increased to an amount not exceeding fair market value by the amount of any gift tax paid on the transfer. IRC §1015(a), (d). However, one advantage of the zeroed-out GRAT is that this basis problem applies only to the extent that the GRAT has been successful in transferring value. Typically, a substantial portion of the original assets will be returned to the settlor and receive a new basis at death. Another advantage of a GRAT that is a grantor trust is that the settlor can repurchase low basis assets immediately before termination of the trust without recognizing gain, substituting cash or assets that have a higher basis.

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§25.38 H. GRATs and Estate Tax Repeal

Although the possibility of estate tax repeal may generally reduce inter vivos gift-giving strategies, GRATs will likely continue to be used by wealthier clients. If repeal never comes, these clients will still have transfer tax problems that can be ameliorated through the use of GRATs. If repeal occurs, the GRAT will have proven to be unnecessary, but not deleterious as long as (1) the ultimate gift of the GRAT assets to the remainder beneficiaries is consistent with the settlor's nontax estate planning objectives, and (2) the settlor has other assets that can absorb the benefit of IRC §1022 basis increases, which are lost for GRAT assets (see §25.44). In addition, GRATs may allow wealthier clients to transfer substantial wealth during their lifetimes without triggering the gift tax that would apply to outright gifts in excess of $1 million under IRC §2505. See chap 8.

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§25.39 I. *Walton* GRATs

As a result of the decision in *Audrey J. Walton* (2000) 115 TC 589, and the IRS acquiescence in Notice 2003-72, 2003-2 Cum Bull 964, and revised qualified-interest regulations in Treas Reg §25.2702-3, decisions concerning the best method of structuring the retained qualified interest in a GRAT have been greatly simplified.

The IRS had long taken the view that a retained annuity for a term of years was a "qualified interest" only to the extent of the right to receive payments for the specified term or until the settlor's earlier death. According to the IRS, this was true even if the trust provided that any payments due a deceased settlor were to be made to the settlor's estate. Because a retained interest must be qualified to reduce the gift tax value of a transfer to a GRAT, the consequence of the IRS's position was to increase the value of the taxable gift by the value of the nonqualified right of the settlor's estate to receive the settlor's remaining annuity payments in the event of the settlor's death. The revised regulations make clear that a retained annuity for a term of years is a qualified interest for the specified term. Treas Reg §25.2702-3(e), Example 5.

In *Audrey J. Walton, supra,* the Tax Court held that the regulation reflecting the IRS's position was invalid. The case involved two identical 2-year, zeroed-out GRATs that were each funded with $100 million of Wal-Mart stock. From the revised regulations, it appears that *Walton* is now the law of the land. Proper gift tax return disclosure is needed, however, when reporting the gift to the GRAT to ensure that the value reported on the gift tax return value cannot be challenged after the 3-year limitations period has run. See the "adequate disclosure" provisions of IRC §§2001(f), 6501(c)(9). See also chap 18.

After *Walton,* the retained interest in a GRAT should be structured as a right to receive fixed payments for a fixed term. The fixed payments can vary in amount to the extent permitted by regulations. The trust should provide that, if the settlor dies, any remaining payments are to be made to the settlor's estate.

PRACTICE TIP: Prudence dictates taking the word "estate" (see language in Treas Reg §25.2702-3(e), Examples 5-6) literally for these purposes—a provision for payment to the settlor's revocable trust or for a payment otherwise subject to the settlor's power of appointment may not be sufficient. Former strategies involving payments to a spouse in the event of death are no longer desirable even though it is now clear that a revocable spousal annuity can be a qualified interest under IRC §2702. See Treas Reg §25.2702-3(d)(2)-(3), (e), Examples 8-9; *Schott v Commissioner* (9th Cir 2003) 319 F3d 1203. A *Walton* GRAT results in a lower gift tax value than a spousal annuity.

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§25.40 J. *Walton* GRATs and Marital Deduction

In some situations, drafters may wish to provide that zeroed-out GRAT assets are to pass in a manner qualifying for the marital deduction if the settlor fails to survive the term. This makes sense in zeroed-out scenarios in which the value of the initial gift is low, and it is relatively certain that virtually all of the remaining GRAT will be included in the settlor's estate in the event of death during the annuity term. In a *Walton* GRAT involving an annuity for a term of years with postdeath annuity payments being made to the settlor's estate (rather than directly to the surviving spouse), it appears that the marital deduction objective can be accomplished with a combination of (1) a testamentary devise to the spouse (or marital deduction trust) of any annuity payments made to the estate, and (2) a GRAT provision for distributing the entire remainder to the same person or marital deduction trust if the settlor has failed to survive. Although the devise of the annuity payments alone will not qualify for the IRC §2056 marital deduction because it is a transfer of a terminable interest, and the transfer of the GRAT remainder alone will not qualify by itself because it is a transfer of a future interest, the transfer of the combined interests would appear to satisfy the marital deduction statute.

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§25.41 VII. GRANTOR RETAINED UNITRUSTS (GRUTs)

A grantor retained unitrust (GRUT) interest is a qualified interest that may be deducted in valuing the gift made when assets are transferred to a trust making unitrust payments (a fixed percentage of the value of the assets of the trust revalued annually). IRC §2702(b)(2). However, there is little reason to use such a trust for a trust having a remainder beneficiary that is not a charity. The gift tax value is high because it is not possible to zero out the gift. The freeze benefit is low because good investment returns result in increased payments to the donor in later years. For a discussion of charitable remainder unitrusts, see §§24.14-24.19.

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VIII. SALES TO GRANTOR TRUSTS

§25.42 A. Overview of IDGTs

A commonly suggested alternative to a GRAT (see §§25.31-25.40) is a sale of property to a trust that is intentionally designed so that it will be deemed owned by, and therefore taxed to, the settlor under IRC §671. Such a trust is sometimes referred to as an intentionally defective grantor trust (IDGT). (This bizarre description for a perfectly good trust traces back to another era when income tax laws generally made it undesirable to have a trust deemed owned by the grantor and such a trust was therefore deemed "defective.") A typical GRAT is an IDGT, but is normally not referred to as such.

A sale to an IDGT is structured as an installment sale with the seller receiving an interest-bearing promissory note from the trust that supposedly has a value equal to the assets being sold. There is, accordingly, no gift and no gift tax payable. The trust then manages and invests the purchased assets and makes payments on the note. Any assets remaining in the trust after the note has been paid will pass gift tax-free to the remainder beneficiary at a zero gift tax cost. (For purposes of simplifying the explanation, the preceding sentence ignores the fact that these transactions are normally preceded by a seed money gift to the trust to reduce the risk that the Service might argue that the promissory note's value should have been discounted below face value because of the risk that the trust would not have sufficient assets to pay off the note.) This analysis assumes that the note is not a self-canceling installment note (SCIN) that is discharged on the death of the settlor, and that the payments are in fact made. (SCINs are sometime used so that the value of the note at death will not be included in the grantor's estate, but this also reduces the value of the consideration for the sale unless the face amount of the note or the interest rate on the note is increased to compensate the grantor for the risk of nonpayment.) The IRS frequently argues that a SCIN should be valued at zero when no payments are made and the self-canceling provision will, at least, reduce the value of the note. See *Estate of Costanza v Commissioner* (6th Cir 2003) 320 F3d 595; *Robert Dallas,* TC Memo 2006-212.

A significant advantage of such a sale in comparison to a GRAT is that the interest rate needed to avoid adverse gift tax consequences under IRC §7872 is the IRC §1274 rate. *Edwin H. Frazee* (1992) 98 TC 554. Although this rate will vary depending on the length of the term of the promissory note, the rate is virtually always lower than the IRC §7520 rate used in computing the value of a GRAT annuity. This makes it easier to "beat the table," *i.e.,* to have the sold assets appreciate at a rate greater than that necessary to fund the payment on the installment note. The opportunity for good performance can also be improved by creating a family limited partnership and then selling limited partnership units to the trust at a discounted value that reflects the lack of control and lack of marketability of the transferred limited partnership units. See chap 18. A future liquidation of the partnership would increase the value of the trust's assets because the whole of the assets is worth more than the sum of its discounted parts. Although GRATs can also be used in conjunction with limited partnership interests, the potential benefit is more limited because the discounted value must be taken into account when computing the annuity payments that are being paid back to the grantor. Another advantage of such a sale in the case of transfers to grandchildren and other skip persons is that generation-skipping transfer (GST) tax exemption can be immediately applied to the gift, whereas GST exemption cannot be applied to a GRAT until the end of the GRAT term under the ETIP rules, because the GRAT may be included in the estate of the settlor. See chap 11.

For further discussion of sales to IDGTs and appropriate forms, see Drafting California Irrevocable Trusts, chap 13A (3d ed Cal CEB 1997).

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§25.43 B. Income Tax Consequences of IDGTs

At least during the period that the IDGT remains a grantor trust, the sale transaction is ignored for income tax purposes. Rev Rul 85-13, 1985-1 Cum Bull 184; IRS Letter Ruling 9535026. No gain is recognized, the trust does not get a new purchase price basis in the assets, the settlor does not include interest in income, and the trust cannot deduct interest paid.

If the note is still unpaid when the trust ceases to be taxed to the grantor, usually because of the grantor's death, the tax consequences are unclear. Presumably, future interest payments are included in the income of the successor holder of the note, and the trust's ability to deduct the payments will be determined under the usual rules of IRC §163 (deductibility of interest paid).

Less certain is whether the cessation of grantor trust status before full payment of the note results, for income tax purposes, in a deemed transfer of the trust assets from the settlor to the trust in exchange for the note. This possibility is based on the argument that during the time the trust is a grantor trust, the trust assets are deemed owned by the taxpayer and not the trust for income tax purposes, but the assets shift to the trust when grantor trust status ceases. *Bernard Madorin* (1985) 84 TC 667 (relying on Treas Reg §1.1001-1(c), Example 5). If there is a deemed transfer, it appears that gain will be recognized. If the event causing loss of grantor trust status is the death of the settlor, it is unsettled whether this gain would be recognized by the settlor or the settlor's estate. See Mulligan, *Sale to Intentionally Defective Irrevocable Trust for Balloon Note: An End Run Around Chapter 14?*, Estate Planning 1999, chap 2 (Cal CEB 1999).

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§25.44 C. Sale to Grantor Trust Versus GRAT

There are two primary reasons a GRAT may be more beneficial than a sale to a grantor trust. First, the decision in *Audrey J. Walton* (2000) 115 TC 589 indicates that the gift tax cost of a GRAT can be reduced to zero or at least close to it. See §25.39. Sales to grantor trusts involve taxable gifts because of the necessity of making a gift of seed money. This consideration can be particularly significant if the settlor has already exhausted the settlor's $1 million IRC §2505 gift tax applicable exclusion amount. See §25.42.

Second, the increase in estate tax credit amounts through 2009, followed by estate tax repeal in 2010 (see chap 10), gives rise to the possibility that a taxpayer will need to be more concerned about capital gain taxes than estate taxes. In a typical GRAT, the opportunity for a new basis under IRC §1014 (or IRC §1022 in 2010) is lost only to the extent that successful GRAT performance results in extra assets passing to the remainder beneficiaries. In a sale to a grantor trust, such opportunities generally are given up for the transferred assets as soon as the sale takes place. With both transactions, there are ways to ameliorate the basis problem (*e.g.,* by swapping assets between the settlor and the trust while the trust is a grantor trust), but generally a GRAT is more advantageous with respect to basis.

In addition to these two considerations, planners should be aware of the following issues when comparing a GRAT with a sale to a grantor trust. These comparisons assume that the GRAT is actually a series of rolling, short-term, zeroed-out GRATs in which the settlor uses annuity payments to establish new GRATs (see §25.36) and that the sale to the grantor trust is made in exchange for a long-term note that provides for interest payments and a balloon payment at the end of the full amount of principal.

Protection against subsequent poor investment performance*.* In rolling GRATs, poor investment performance down the road will not eat into the benefits of early successes. However, a sale to a grantor trust remains exposed to this risk and also creates the further risk that it will be necessary to use the seed money to make payments on the note.

Protection of transfer tax benefits in the event of death in a short period of time. If there is a sudden jump in the value of the trust property immediately after funding the trust, and the settlor dies in a very short period of time, the benefit of a GRAT transaction will be lost if the settlor has not survived the term, whereas death of the settlor generally will be irrelevant for transfer tax purposes in the case of an IDGT. Of course, this consideration must be weighed against potential IDGT income tax burdens. See §25.43. Further, an immediate jump in value following a transfer will raise issues concerning the gift tax value of the transferred property regardless of whether the trust is a GRAT or an IDGT.

Grantor control. When there is a sale to a grantor trust, the benefit of the transaction will be lost if the grantor trust is included in the settlor's estate for estate tax purposes. Accordingly the settlor's powers with respect to the trust must be limited. In a GRAT, however, a high percentage of the assets of each particular GRAT is returned to the grantor and the grantor's control. Further, in rolling GRATs, the settlor can change remainder beneficiaries each time a new GRAT is created.

Change of law risk. In many situations tax laws are changed in ways that "grandfather" tax treatment for transactions that have taken place in the past. Accordingly, a current sale to an IDGT would probably be protected from any future law changes and continue to produce benefits for the term of the note. In contrast, the benefits of a rolling GRAT strategy (see §25.36) would end quickly if a law change suddenly reduced the desirability of newly established GRATs. The zeroed-out, rolling GRAT strategy would be adversely impacted, for example, by a rule providing that the gift on establishing a GRAT could not be less than 10 percent of the value of the assets transferred to a GRAT. Such a rule already applies in the context of business entity freezes. See IRC §2701(a)(4), discussed in §25.20.

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26

Asset Protection Considerations

Peter Spero

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§26.1 I. ASSET PROTECTION IN ESTATE PLANNING

There are many methods that individuals can use to shield assets from debt collection. Rudimentary asset protection involves using statutory exemptions from debt collection to the greatest extent possible. In California, however, the only secure exemption of any significant amount is for certain retirement plans; other exemptions are greatly limited. For discussion of California exemptions, see §§26.39-26.43.

Asset protection can be combined with estate tax planning. For instance, limited partnerships or LLCs are often used to consolidate assets and transfer substantial interests to heirs, while providing a discount in the value of the underlying assets. At the same time, debt collection against partnership assets is cumbersome. See §§26.65-26.67. On prebankruptcy planning, see §§26.68-26.71.

Long-term asset protection also involves asset-protection trusts. In California, a settlor cannot establish an asset-protection trust for his or her own benefit. To be effective, the trust must be created by another party, such as a parent or grandparent. Accordingly, it is appropriate to ask clients with children whether they want to provide asset protection for their children. Similarly, clients whose parents have significant assets may be informed that parents can leave assets to them in a manner designed to foster asset protection. There are several different types of asset-protection trusts. See §§26.14-26.38. Substantial assets also can be disposed of through a dynasty trust, which is designed to be free of the claims of most creditors and wealth-transfer taxes indefinitely. Foreign trusts can be used to protect substantial assets and are highly effective if funded and maintained properly. See §§26.26-26.33.

Many asset-protection plans involve more than one of these devices. Regardless of the type of asset-protection plan adopted, the fraudulent transfer laws must always be taken into account as the plan is devised and implemented. See §§26.5-26.13.

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§26.2 A. Estate Planner's Role in Asset Protection

It is likely that estate planners have a duty to engage in asset protection. This obligation (and possible liability arising from failing to counsel on asset-protection matters) can be satisfied by at least mentioning asset protection to the client and noting in the engagement letter (or similar correspondence) that the matter was discussed. If the estate planner does not wish to engage in asset protection, the matter should still be discussed and specifically excluded from the engagement.

Estate planners are in an ideal position to engage in asset protection. It is at the planning stage that all assets are listed and the ultimate disposition decided. It is appropriate to consider any risks associated with the client's occupation or other circumstances. Such risks include, without limitation, liabilities arising from business activities or risks associated with children who may drive or engage in similar activities.

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§26.3 B. Duty to Engage in Asset Protection

Whether advising clients on asset-protection matters is within the scope of an estate planner's duty will depend on the custom in the area where the estate planner practices. Mallen & Smith, Legal Malpractice §8.2 (5th ed 2000). The widespread discussion of asset-protection issues, evidenced by increasing numbers of seminars, articles, and books on the subject, may indicate that asset protection has entered the domain of "skill, prudence, and diligence as other members of the legal profession commonly possess and exercise." *Budd v Nixen* (1971) 6 C3d 195, 200, 98 CR 849. Thus, lawyers may now have a duty to advise clients to engage in asset-protection planning or to refer the client to another attorney qualified to do so.

An attorney may have a duty to counsel on asset-protection matters, even if these are beyond the scope of the matter for which he or she was retained. See *Nichols v Keller* (1993) 15 CA4th 1672, 19 CR2d 601 (attorney retained to pursue worker's compensation claim had duty to advise on potential third party claims). For example, taking an action that results in the loss of bankruptcy exemption causes damages that support an action for negligence. *State Farm Life Ins. Co. v Swift (In re Swift)* (5th Cir 1997) 129 F3d 792 (loss of a bankruptcy exemption constitutes damages required to maintain action for negligence when retirement plan and IRA were defective for tax purposes, negating bankruptcy exemption under applicable state law). Thus, estate planning counsel must consider preserving debtor-creditor exemptions. Similarly, failure to incorporate a business, thus leaving the client without the shield of corporate limited liability, is also actionable. *Gunn v Mahoney* (Sup Ct 1978) 408 NYS2d 896.

PRACTICE TIP: If counsel declines to engage in asset-protection planning, counsel can avoid liability by specifically excluding such matters from the scope of engagement in a writing acknowledged by the client.

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§26.4 C. Avoiding Problems in Handling Asset Protection

As with all legal advice, counsel should carefully document representations and statements made by asset-protection clients to prevent later exposure to criminal, civil, and disciplinary actions. See, *e.g.*, *Morganroth & Morganroth v Norris, McLaughlin & Marcus, P.C.* (3d Cir 2003) 331 F3d 406 (judgment creditor stated various causes of action against judgment debtor's attorneys who participated in client's unlawful conduct to hinder, delay, or fraudulently obstruct enforcement of judgment). This case is a reminder that an attorney advising clients with respect to asset protection needs to be careful that the client's problem does not become the attorney's problem. Actions far less egregious than those in the reported case may be sufficient for a creditor to allege, successfully or otherwise, that an attorney has conspired with a client with respect to a transfer that is fraudulent under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12). For a case involving a civil conspiracy cause of action in connection with a fraudulent conveyance, see *Monastra v Konica Bus. Machs., U.S.A., Inc.* (1996) 43 CA4th 1628, 1644, 51 CR2d 528. See also *Gutierrez v Givens* (SD Cal 1997) 989 F Supp 1033. Attorneys generally may rely on facts provided by clients, if the attorney has no reason to know of factual errors. See *Kline v First W. Gov't Sec. Inc.* (3d Cir 1994) 24 F3d 480, 487 (law firm can rely on facts provided by its client, but cannot escape liability by stating that its opinion is based on provided facts if it has reason to know that factual description of transaction provided by client is materially different from actual transaction). In particular, an attorney may rely on financial information provided by the client, which is crucial in determining whether the fraudulent transfer laws apply. In this regard, the attorney-client privilege will not prevent an attorney from defending himself or herself against charges of improper conduct or pursuing a claim for legal fees. *Arden v State Bar* (1959) 52 C2d 310, 320, 341 P2d 6 (defense against disciplinary charges); *Dubrow v Rindlisbacher (In re Rindlisbacher)* (BAP 9th Cir 1998) 225 BR 180, 183 (action for fees). An attorney cannot, however, cast a blind eye to facts that would put him or her on notice of improper conduct. When the circumstances clearly indicate unlawful activity, lack of actual knowledge will not be a defense. See *In re Bloom* (1987) 44 C3d 128, 135, 241 CR 726 (80-year-old attorney who had no prior disciplinary actions against him was disbarred for participating in scheme to transport explosives to Libya; court rejected defense that attorney thought scheme was authorized by National Security Council).

In any event, the attorney-client privilege does not apply if the communications are made for unlawful purposes or to further an illegal scheme (the crime-fraud exception), such as making fraudulent transfers. Evid C §956. See, *e.g., Geilim v Superior Court* (1991) 234 CA3d 166, 174, 285 CR 602; *Zolin v U.S.* (1989) 491 US 554, 105 L Ed 2d 469, 109 S Ct 2619; Anno, *Attorney-Client Privilege as Extending to Communications Relating to Contemplated Civil Fraud*, 31 ALR4th 458 (1984).

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§26.5 II. FRAUDULENT TRANSFER LAWS

Every asset-protection plan must take into account the fraudulent transfer laws. A violation of these laws can result in discipline, civil liability, and/or criminal liability. There are two broad categories of fraudulent transfers:

- Transfers made with "actual intent to hinder, delay, or defraud" a creditor (CC §3439.04(a)(1)); and
- Constructively fraudulent transfers.

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§26.6 A. Actual Fraud

Actual fraud can be established by direct evidence, although it is more likely established by the presence of the "badges of fraud," *i.e.,* factors courts have traditionally considered in inferring fraudulent intent. Although there are many badges of fraud, the most important are insolvency of the transferor and the lack of adequate consideration received in exchange for the transfer. As a rule, transfers undertaken for estate planning purposes lack consideration.

Badges of fraud listed in the statute include (CC §3439.04(b)):

- The transfer or obligation was to an insider;
- The debtor retained possession or control of the property transferred after the transfer;
- The transfer or obligation was concealed;
- Before the transfer was made or the obligation incurred, the debtor had been sued or threatened with suit;
- The transfer was of substantially all of the debtor's assets;
- The debtor absconded;
- The debtor removed or concealed assets;
- The value of consideration received was not reasonably equivalent to the value of the asset received or obligation incurred;
- The debtor was insolvent or became insolvent shortly after the transfer was made or obligation incurred;
- The transfer occurred shortly before or after a substantial debt was incurred; and
- The debtor transferred the essential assets of the business to a lienholder who transferred the assets to an insider.

The presence of these badges of fraud allows a court to infer that a transfer was fraudulent, in the absence of direct evidence of fraudulent intent. See, *e.g.*, *U.S. v Townley* (ED Wash, July 29, 2004, No. CS-02-0384-RHW) 2004 US Dist Lexis 29722, aff'd (9th Cir 2006) 97 AFTR2d 2484, in which the court held that irrevocable trust assets could be reached to satisfy a judgment against the settlors even though they were not named beneficiaries of the trust. The court concluded that there was direct evidence of intent to defraud in the form of a statement that the transfers were intended to protect the transferred assets from the claims of future judgment creditors. However, the court also concluded that the trust could be disregarded because it was the "alter ego" or "nominee" of the settlors under a six-factor test using traditional badges of fraud.

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§26.7 B. Constructive Fraud

Constructive fraud arises when a transfer is made without fair or adequate consideration, and the debtor:

- Is insolvent, or is rendered insolvent as a result of the transfer (CC §3439.05);
- Engages in a transaction or is about to do so with unreasonably small capital (CC §3439.04(a)(2)(A)); or
- Intended to incur or believed or reasonably should have believed that he or she would incur debts beyond his or her ability to repay (CC §3439.04(a)(2)(B)).

Constructive fraud does not require fraudulent intent.

Transfers made to implement estate planning will clearly be for inadequate consideration. For this purpose, adequacy of consideration is determined from the point of view of the creditor. *Travellers Int'l v Trans World Airlines (In re Trans World Airlines)* (3d Cir 1998) 134 F3d 188.

For purposes of fraudulent transfer law, insolvency is determined under a modified balance sheet approach that excludes assets that are not available to creditors, such as assets held in an exempt retirement plan and assets that are outside the jurisdiction and, therefore, unavailable to creditors. Contingent liabilities are taken into account at their probable values. See Spero, Asset Protection: Legal Planning and Strategies and Forms ¶3.04[1][c] (2002).

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§26.8 C. Disclaimers Not Fraudulent Transfers

A disclaimer can prevent creditors from reaching an inheritance and does not constitute a fraudulent transfer under California law. Prob C §283. The legal rationale for the protection afforded disclaimed property is that a disclaimer relates back for all purposes to the initial creation of the interest. Prob C §282. Consequently, under California law, one who makes a timely disclaimer is treated as never having owned the property. Although a disclaimer is effective with regard to ordinary commercial creditors, it is not effective to avoid a federal tax lien. *Drye v U.S.* (1999) 528 US 49, 145 L Ed 2d 466, 120 S Ct 474. See §§27.2, 27.10. *Drye* was based on federal tax statutes and has generally not been extended to commercial creditors. See, *e.g., Gaughan v Edward Dittlof Revocable Trust (In re Costas)* (9th Cir 2009) 555 F3d 790.

A planner advising on disclaimers must consider both federal tax laws and California state law. Failure to comply with federal gift tax law can result in a gift tax liability, whereas failure to comply with California rules can result in property being seized by creditors of the purported disclaimant. For discussion of predeath planning for disclaimers, see chap 27.

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D. Requirements for Disclaimers

§26.9 1. Period for Disclaiming

Federal gift tax law requires that a disclaimer be made within 9 months of the transfer creating the interest (or the day on which the person attains the age of 21, if later). IRC §2518(b)(2). Under California law, the disclaimer must be made within a "reasonable time" after the disclaimant acquired knowledge of the transfer, although 9 months is deemed reasonable as a matter of law. Prob C §279. In IRS Letter Ruling 200333023, the Service ruled that a minor beneficiary may disclaim within 9 months of attaining age 21 even though applicable state law generally required that the disclaimer be made within 9 months of the transfer, because the time limitation did not apply if interested parties consented. California law does not contain any provision expressly allowing an extension of time for making a disclaimer in the case of a person who is under age 21. Whether a transfer made 9 months after attaining age 21 would meet the "reasonable time" standard could be highly debatable if the disclaimant had actual knowledge for a prolonged period or accepted any benefits. California law precludes a disclaimer after acceptance. Prob C §285. In contrast, Treas Reg §25.2518-2(d)(4), Example 11, allows a disclaimer of stock notwithstanding the disclaimant's acceptance of dividends before age 21. It would appear, however, that Prob C §295—providing, in effect, that a disclaimer that is valid under federal transfer tax law is valid for state law purposes—is sufficient to validate a disclaimer for state law purposes even if the disclaimant accepts dividends or interest before age 21. See §26.10.

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§26.10 2. Acceptance of Interest Not Allowed

Under both federal tax law and California law, a disclaimer is not effective if the disclaimant in any way accepts the interest sought to be disclaimed. IRC §2518(b)(3); Prob C §285(a). "Acceptance" is a factual determination. Under California law, acceptance occurs when the beneficiary or someone acting on the beneficiary's behalf, makes a "voluntary assignment conveyance, encumbrance, pledge, or transfer of the interest or part thereof, or contracts to do so." Prob C §285(b)(1). Acceptance also occurs when the beneficiary "accepts the interest or any part thereof or benefit thereunder." Prob C §285(b)(3). In *Cassell v Kolb (In re Kolb)* (9th Cir 2003) 321 F3d 868, amended (9th Cir 2003) 326 F3d 1030, the court held that acceptance of a trust future interest occurred when the beneficiary listed the contingent interest on financial disclosures made to obtain a bank loan. Accordingly, the debtor's purported disclaimer of the interest was ineffective. Acceptance under federal tax law occurs if the "disclaimant has accepted the interest or any of its benefits, expressly or impliedly, prior to making the disclaimer." Treas Reg §25.2518-2(d)(1). Further, the "exercise of a power of appointment to any extent by the donee of the power is an acceptance of its benefits." Treas Reg §25.2518-2(d)(1). In *Estate of Leona Engelman* (2003) 121 TC 54, the court held that the exercise of a power during life that was to take effect at death could not be disclaimed by the donee's executor.

An exception is made for a beneficiary under the age of 21. Actions taken by a minor beneficiary or the custodian before the beneficiary attains the age of 21 will not constitute acceptance. Treas Reg §25.2518-2(d)(3). This exception can also apply under California law, under the provision that makes disclaimers that are effective under federal law effective for California state law purposes as well. Prob C §295.

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§26.11 3. Retention of Interest

One significant difference between federal and California law is the federal requirement that the disclaimed interest must pass, without direction on the part of the disclaimant, either to the decedent's surviving spouse or a person other than the person making the disclaimer. IRC §2518(b)(4). Under this provision, only a surviving spouse can disclaim and still retain some interest in the disclaimed property (effectively, a partial disclaimer). Other disclaiming beneficiaries (such as children) must forgo all interest in the disclaimed property. California law imposes no such requirement.

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§26.12 4. Writing Required

A disclaimer must be in writing under both federal tax law and California law. IRC 2518(b)(1); Prob C §278.

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§26.13 5. No Disclaimers in Bankruptcy

An exception to the disclaimer rules applies to beneficiaries or donees who have initiated bankruptcy proceedings. Under 11 USC §541(a)(5)(A), the bankruptcy estate includes property to which the debtor becomes entitled by devise, bequest, or inheritance within 180 days after filing the petition. This provision generally prevents a disclaimer of postpetition inheritances. *In re Chenoweth* (7th Cir 1993) 3 F3d 1111; *Chappel v Proctor (In re Chappel)* (BAP 9th Cir 1995) 189 BR 489. The estate may include spendthrift trust distributions. See §26.18.

Another special rule renders disclaimers ineffective to prevent a recovery by the state for Medicaid benefits received. 42 USC §1396p(e)(1).

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III. ASSET PROTECTION TRUSTS

§26.14 A. Types of Asset-Protection Trusts

There are many types of asset-protection trusts. In addition to spendthrift trusts, other trusts that serve in one way or another to shield assets from creditors include discretionary trusts, support trusts, and personal trusts. Furthermore, it is possible to cause a beneficiary's interest to change from spendthrift to discretionary or some other type of interest, *i.e.*, a shifting-interest trust.

An otherwise protective trust can be judicially invalidated under certain circumstances, for instance, if a trust is found to violate public policy or to have been created for fraudulent purposes (including facilitating a fraudulent transfer). Prob C §15203. See Spero ¶6.11[2]. Certain types of claims will more readily pierce protective trusts—*e.g*., claims for spousal or child support (Prob C §15305), basic necessities of the beneficiary (Prob C §15306), and certain claims of state and federal government. The beneficiary's behavior can also affect the protection of trust property. Specifically, damages caused by a beneficiary in the commission of a felony may be satisfied out of trust property if various conditions are satisfied. Prob C §15305.5. Furthermore, the asset-protection aspects of each type of trust are subject to the prohibition against self-settled trusts. See §§26.15-26.17, 26.22-26.25. For a more detailed discussion of the pros and cons of various protective devices, see Spero ¶6.10.

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§26.15 1. Prohibition Against Self-Settled Trusts

Creditors of a settlor who funds a trust for his or her own benefit can reach trust assets to the extent of the settlor's power of revocation. Prob C §15304(a). Self-settled trusts include the revocable living trusts formed by many clients for estate planning purposes—these trusts provide no particular creditor protection. A person who provides consideration for a trust, directly or indirectly, is treated as the settlor. Restatement (Second) of Trusts §156, Comment f (1959); Restatement (Third) of Trusts §58, Comment f (2003). Self-settled trusts are prohibited because it would be a blatant abuse and would violate public policy to allow settlors to establish asset-protection trusts for themselves. *Nelson v California Trust Co.* (1949) 33 C2d 501, 202 P2d 1021.

The prohibition against self-settled trusts can arise in a number of estate planning situations. For instance, in a split-interest trust the settlor retains an interest for a term of years; the settlor's retained interest can be reached by creditors. CCP §709.010(b). Additionally, *Crummey* powers are often employed in connection with estate planning trusts such as irrevocable life insurance trusts. *Crummey* powers give the power holder the right to withdraw trust contributions for a period of time after a gift is made to the trust and qualify the gift for the present-interest annual exclusion under IRC §2503(b). *Crummey v Commissioner* (9th Cir 1968) 397 F2d 82. See §10.104. "When a *Crummey* power is used, the trust may constitute a self-settled trust to the extent of property subject to the power." Spero ¶5.04. See Spero ¶¶5.05[4], 6.08[1].

A trust can also be ignored under an alter ego or nominee theory. See, *e.g., Wood v Elling Corp.* (1977) 20 C3d 353, 142 CR 696 (trust can be attacked under alter ego doctrine); *U.S. v Landsberger* (9th Cir 1999) 1999-1 USTC ¶50,318, 83 AFTR2d 1485. But see *Laycock v Hammer* (2006) 141 CA4th 25, 44 CR3d 921 (decedent's borrowing of money from life insurance policy he had transferred to irrevocable life insurance trust did not result in trust's being treated as revocable and therefore subject to claims of his creditors).

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§26.16 a. Availability of Trust Assets

A creditor of a settlor of a self-settled trust can reach trust assets to the maximum extent that the trustee could distribute or apply those assets for the settlor-beneficiary's benefit. Prob C §15304(b). Under this rule, if the settlor transfers a remainder interest to a third party, the settlor's creditors cannot reach it. Similarly, if the trustee of a self-settled trust can make principal distributions to the settlor-beneficiary only if income is insufficient for support, then the creditor will not be able to reach principal unless the settlor-beneficiary's circumstances require invasion of principal. (The creditor would be able to reach the income interest required to be distributed.) *DiMaria v Bank of Cal. Nat'l Ass'n* (1965) 237 CA2d 254, 46 CR 924.

Exemptions under California law apply to an interest in a revocable living trust. Prob C §18201. Furthermore, an exemption, to the extent necessary, should also apply to the beneficiary's interest in an asset protection trust. Restatement (Second) of Trusts §149, Comment b (1959); Restatement (Third) of Trusts §56, Comment d (2003) (statutory exemptions for property, such as for homesteads, attach to the equitable interests in property in trust even though legal title is held by a trustee for the debtor's benefit).

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§26.17 b. Exceptions to Prohibition

There are exceptions to the prohibition against self-settled asset-protection trusts. Many foreign jurisdictions have adopted special legislation to allow self-settled asset-protection trusts. See generally Spero, chap 7. United States courts have generally not recognized these foreign laws. See, *e.g.*, *Marriage of Dick* (1993) 15 CA4th 144, 161, 18 CR2d 743. Furthermore, a growing number of states have adopted similar legislation, notably Alaska, Delaware, and Nevada. These laws generally will not be effective for California residents, although it is possible to move to one of those jurisdictions if and when a creditor problem arises. See §26.22. One area in which the self-settled asset-protection trust is effective is for retirement plans subject to ERISA. *Patterson v Shumate* (1992) 504 US 753, 119 L Ed 2d 519, 112 S Ct 2242. See §26.39.

Notwithstanding the general prohibition against self-settled trusts, the settlor can retain a limited power of appointment over trust assets without compromising asset-protection goals. Prob C §681. In contrast, creditors of the holder of a general power of appointment can generally reach assets subject to the power if and when it is exercisable. Prob C §682. Furthermore, creditors of the donor of a general power of appointment exercisable by another in favor of the donor can reach property subject to the power regardless of whether the power is presently exercisable. Prob C §683.

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§26.18 2. Spendthrift Trusts

California's statutory scheme adopts the common-law rule that protects both the income and principal of a spendthrift trust. Prob C §§15300-15301. The protection ends after distributions become due and payable. Prob C §15301(b). There is no protection, however, for claims for spousal support or child support. Prob C §15305. Other creditors may reach up to an aggregate of 25 percent of trust income, unless such amounts are necessary for the beneficiary's support. Prob C §15306.5. See *e.g.*, *In re Neuton* (9th Cir 1990) 922 F2d 1379. For this purpose a station-in-life standard is used to determine what support is necessary. Comment to Prob C §15307; *Canfield v Security-First Nat'l Bank* (1939) 13 C2d 1, 87 P2d 830. A court can order the trustee to satisfy all or part of a judgment out of trust distributions to which the beneficiary is entitled or that the trustee, in the exercise of the trustee's discretion, determines to pay to the beneficiary. Prob C §15307. Under 11 USC §541(a)(5)(A), the bankruptcy estate of a debtor may include trust distributions received by the debtor within 180 days after filing the petition. See *Birdsell v Coumbe (In re Coumbe)* (BAP 9th Cir 2003) 304 BR 378.

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§26.19 3. Discretionary Trusts

A discretionary trust is the most powerful asset-protection trust available. The cost of this level of protection is that it weakens the rights of beneficiaries, who must rely on the trustee to exercise discretion to make distributions. The substantial protection afforded an interest in a discretionary trust results from the tenuous nature of the beneficiary's interest. With a discretionary trust, the trustee has uncontrolled discretion to pay trust income and principal to or for the benefit of beneficiaries without regard to any ascertainable standard. Prob C §15303; Restatement (Second) of Trusts §155, Comments b, d (1959); Restatement (Third) of Trusts §60, Comments a, d (2003).

California law provides protection for an interest in a discretionary trust even if the trustee's powers to make distributions are subject to a standard. Prob C §15303(c). For a trust to qualify as a discretionary trust, the trustee's discretion must be so complete that the trustee need not make any distributions at any time, provided that the trustee's conduct is not abusive. Restatement (Second) of Trusts §155, Comments c-d (1959); Restatement (Third) of Trusts §60, Comments d-e (2003). Beneficiaries of a discretionary trust are protected against the trustee's abuse of discretion. This is true even if the trustee's discretion is "absolute" or "uncontrolled." Prob C §16080. See *Estate of Ferrall* (1953) 41 C2d 166, 173, 258 P2d 1009.

DRAFTING CONSIDERATIONS: A beneficiary's interest in a discretionary trust can be assigned, at least in the absence of a spendthrift clause. Consequently, it is appropriate to include a spendthrift clause even in a discretionary trust. See Prob C §15303(b).

A creditor attempting to reach the interest of a beneficiary in a discretionary trust is put in the same position as the beneficiary: powerless and hoping that the trustee will make distributions. Prob C §15303(a). Thus, the creditor of a beneficiary of a discretionary trust can be thwarted if trust distributions are lowered to a level that provides only for support and education. Comment to Prob C §15307. The trustee has no duty to oppose a creditor's collection efforts on behalf of a beneficiary, and is not liable for its action or inaction. Prob C §15306.5(e).

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§26.20 4. Support Trusts and Personal Trusts

A support trust instructs the trustee to apply as much of the income and principal as is necessary for the education and support of the beneficiary. A beneficiary's interest in a support trust is not subject to the claims of his or her creditors, at least until payments are actually distributed. Prob C §15302. See also Restatement (Second) of Trusts §154 (1959); Restatement (Third) of Trusts §60 (2003). "Support" generally includes the needs of the beneficiary's spouse and minor children. *Smith v Smith* (1942) 51 CA2d 29, 38, 124 P2d 117. A support trust should also include a spendthrift clause to protect, among other things, any undistributed income.

A personal trust confers on the beneficiary a nonassignable right to use property. For instance, a trust that permits an individual to occupy a certain room in a house or raise cattle on land constitutes a personal trust that cannot be reached by creditors. See *Davis v Harrison* (9th Cir 1917) 240 F 97, 101; Restatement (Second) of Trusts §160 (1959). See also Restatement (Third) of Trusts §60, Reporter's Notes on Comment a (2003). Although there is no specific statutory description of a personal trust under California law, the concept of a personal trust is part of the common law that prevails in California, unless changed by statute. Prob C §15002. One problem with a personal trust is inflexibility. For example, if a beneficiary given the right to use a residence finds it necessary to move to a retirement facility, a personal trust would lack the flexibility to accommodate this change. Consequently, personal trusts are rarely used.

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§26.21 5. Dynasty Trusts

A dynasty trust is designed to last in perpetuity. Its purpose is to hold property for indefinite generations free of the claims of most commercial creditors and free of federal estate tax and generation-skipping transfer tax (GST tax). The ideal jurisdiction in which to form a dynasty trust is one that does not have a rule against perpetuities or similar restriction and does not impose an income tax.

Two jurisdictions that combine both of these features are Delaware and Alaska. (California has neither.) As of this writing, Alaska has the edge, because it also has legislation that allows beneficiaries to exercise limited powers of appointment without triggering an estate tax, thereby avoiding the "Delaware tax trap." See IRC §2041(a)(3). For discussion of the Delaware tax trap, see §9.32; Spero, Supp ¶5.07B[1].

The GST tax can be avoided by allocating the settlor's GST tax exemption to the transfer creating the trust. IRC §2631(c). A deemed allocation rule applies to indirect skips made after December 31, 2001. IRC §2632(c). The rule is intended to alleviate the problems created when the taxpayer fails to allocate the GST tax exemption to an indirect skip. For further discussion of the GST tax exemption allocation, see §§11.12-11.27. Under current laws, once the GST tax exemption is allocated to any portion of the trust, the GST tax will never apply again to that portion of the trust. Although federal estate and gift tax also will not apply on creation of the trust, the gift will use all or a portion of the settlor's lifetime combined gift and estate tax exclusion.

It is generally possible to avoid future federal estate taxes by not giving trust beneficiaries a power that constitutes a general power of appointment. See IRC §2041. Of course, this assumes that the beneficiary is not also the settlor. Even if the beneficiary holds only a limited power of appointment, the federal estate tax may still be imposed if its exercise triggers the Delaware tax trap. See Spero, Supp ¶5.07B[1]. Asset protection is generally greater if the trust is settled in certain foreign jurisdictions. Furthermore, the potential for the imposition of state income tax is also reduced; however, the state where the beneficiary or settlor is domiciled may still tax trust income. California taxes the portion of trust income accumulated for a California resident even if the trust is not administered in California and has no other contact with California. *McCulloch v FTB* (1964) 61 C2d 186, 37 CR 636. Spero, Supp ¶5.07B[2].

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§26.22 6. Self-Settled Trusts Under Alaska- and Delaware-Type Statutes

A number of jurisdictions in the United States have passed laws designed to allow self-settled asset-protection trusts. These laws mimic the debtor-friendly trust laws of certain offshore jurisdictions. States that have enacted such laws include Alaska (Alaska Stat §34.40.110), Delaware (12 Del Code Ann §§3571-3572), Missouri (Mo Ann Stat §456.5-502), Nevada (Nev Rev Stat §§166.010-166.170), and Rhode Island (RI Gen Laws §§18-9.2-1—18-9.2-7). The laws of states that authorize self-settled asset protection trusts are discussed in Spero ¶6.08B. For further discussion of Delaware trusts, see Nenno & Sullivan, *Delaware Asset Protection Trusts Create Obstacles for Creditors*, 33 Est Plan 3 (Dec. 2005); Nenno & Wolken, *DAPT Lite: A Practitioner-Friendly Guide to Delaware Asset Protection Trusts*, 32 Tax Mgmt Est, Gifts & Trust J 227 (Sept.-Oct. 2007). See also Stein, *The Importance of Trusts in Asset Protection*, 12 Cal Trusts & Est Q 17 (Winter 2007). These laws, however, are vulnerable to creditor attack when the settlor-beneficiary is not a resident of one of those states. Further, the Bankruptcy Code includes provisions that are designed to thwart the use of such trusts. See §26.35. See also Nenno & Sullivan, *Delaware Asset Protection Trusts Should Survive Bankruptcy*, 33 Est Plan 31 (Jan. 2006).

One of the consequences of creating a self-settled asset protection trust is that it may subject advisors to both criminal and civil liability. Spero ¶¶2.05A-2.05B.

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§26.23 a. Limited Protection for Nondomiciled Settlors

For persons living outside of the states with enabling statutes, establishing a self-settled asset-protection trust involves considerable peril. The IRS has declined to rule that trust assets will not be included in the settlor's estate. IRS Letter Ruling 9837007. However, trust assets will not be included in the estate of a resident settlor. IRS Letter Ruling 200944002. Under IRC §2036, assets transferred to a trust that remain subject to the claims of the settlor's creditors are included in the settlor's estate for federal estate tax purposes. Treas Reg §20.2036-1(b)(2). Thus, settlors of such trusts may create a gift tax liability on creation of the trust *and* have an estate tax liability on their death. Of course, the gift tax liability can be avoided by retaining a testamentary limited power of appointment, which is authorized by applicable laws. However, to the extent distributions are made to persons other than the settlor, the gift would be complete.

PRACTICE TIP: A self-settled asset-protection trust established under the laws of a state that allows such a trust (*i.e.*, Alaska, Delaware, Missouri, Nevada, or Rhode Island) could work if the settlor moved to that state if a creditor problem arises. Residency makes it more likely that public policy concerns will not invalidate the asset-protection trust. See Spero ¶6.08[5][b][ii].

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§26.24 b. Self-Settled Trusts and Public Policy

California (and other states) will not recognize laws of sister states that violate their own public policy. This principle was demonstrated in *Marine Midland Bank v Portnoy (In re Portnoy)* (Bankr SD NY 1996) 201 BR 685, in which the court declined to recognize the trust law of New Jersey and instead applied New York law to determine that a self-settled trust was part of the bankruptcy estate. In declining to apply New Jersey law, the court noted that affording protection to a self-settled trust offended both New York and federal bankruptcy policy. See also *Franchise Tax Bd. v Hyatt* (2003) 538 US 488, 155 L Ed 2d 702, 123 S Ct 1683 (Nevada courts were not required to apply California law granting Franchise Tax Board total immunity from suit for intentional torts); *Nevada v Hall* (1979) 440 US 410, 422, 59 L Ed 2d 416, 99 S Ct 1182 (California courts were not required to apply Nevada's $25,000 limitation of waiver of immunity to accident involving Nevada-owned vehicle: "the Full Faith and Credit Clause does not require a State to apply another State's law in violation of its own legitimate public policy"); *Tucker v R.A. Hanson Co.* (10th Cir 1992) 956 F2d 215, 218 (indemnity provision enforceable under California law was not enforceable in New Mexico when it violated New Mexico's public policy); 3 Scott & Ascher on Trusts §15.4 (5th ed 2007).

Given the long-standing prohibition against self-settled asset-protection trusts in California, it is very likely that the Alaska- and Delaware-type trust laws will violate the public policy of California. Note that the creditor must litigate this issue in the forum that will rule on the public policy issue, *i.e.*, California.

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§26.25 c. Creditor Collection of Trusts Assets

If a judgment is obtained in a California state court, the court must have jurisdiction over the trustee to enforce the judgment. *Hanson v Denckla* (1958) 357 US 235, 2 L Ed 2d 1283, 78 S Ct 1228. Absent such jurisdiction, the creditor may be forced to pursue the judgment in Alaska or Delaware, where the trustee is domiciled. If the public policy issue is litigated in Alaska or Delaware, it is likely (but not certain) that the legislation will be upheld. See Spero ¶6.08[4].

If the matter is litigated in a bankruptcy court in California, creditors should be able to reach assets of the trustee regardless of the trustee's presence in California. The bankruptcy court has the power to seize assets anywhere in the United States. 28 USC §1334(e). See Spero ¶6.08[5][b][i]. It is unclear whether a federal court in California would have similar powers. See Fed R Civ P 69; Spero ¶6.08[5][b][ii].

Courts, including state courts, may have jurisdiction over the trust and the trustee by virtue of trust property being located in the applicable judicial district. See *Hanson v Denckla* (1958) 357 US 235, 245, 2 L Ed 2d 1283, 78 S Ct 1228 (suggesting that presence of trust property would have been sufficient to give Florida jurisdiction over Delaware trustee with no Florida contacts); 5A Scott & Fratcher, The Law of Trusts §571 at 181 (4th ed 1989) (the exercise of jurisdiction should not unduly interfere with the control of the administration by courts of the situs). But see *Shaffer v Heitner* (1977) 433 US 186, 53 L Ed 2d 683, 97 S Ct 2569 (mere presence of property in state is not sufficient to establish jurisdiction; whether state has jurisdiction depends on whether there are sufficient contacts to satisfy fairness standard of *International Shoe Co. v Washington* (1945) 326 US 310, 90 L Ed 95, 66 S Ct 154, and its progeny). In *Shaffer*, the Court noted that the rationale of focusing on the presence of property, as a sufficient basis to confer jurisdiction, is that a wrongdoer should not be able to avoid payment of his obligations simply by moving his assets to a place where he is not subject to in personam jurisdiction. The rationale would seem to apply to situations in which a debtor settles a trust in a state other than his state of domicile and the trustee of the trust owns property in the state of domicile. The very purpose of the trust is to avoid payment of debts simply by establishing the situs of the property elsewhere, *i.e.*, in a state that recognizes asset protection trusts. If this rationale is insufficient to confer jurisdiction, then the mere presence of trust property in a state should not cause the trustee to be subject to the jurisdiction of courts located in the state in which trust property is located. See also *Burnham v Superior Court* (1990) 495 US 604, 628, 109 L Ed 2d 631, 651, 110 S Ct 2105 (concurring opinion of Brennan, J.) (finding personal jurisdiction based on presence in state, noting that presence of property in state alone is insufficient to satisfy demands of due process); *Base Metal Trading, Ltd. v OJSC "Novokuznetsky Aluminum Factory"* (4th Cir 2002) 283 F3d 208 (mere presence of property in state insufficient to confer jurisdiction; exercise of jurisdiction must be consistent with Due Process Clause and minimum-contacts standard enunciated in *International Shoe*). To avoid this issue, the settlor should consider transferring all property to the situs of the trust, Alaska, or Delaware. Alternatively, the settlor can structure investments through the use of a limited partnership or a limited liability company. Funding the trust with interests in such entities will establish the situs of the trust at the location of the trustee, rather than the actual location of the underlying assets. See Spero ¶7.02[2]. This general rule applies to both real property and personal property.

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§26.26 7. Foreign Asset-Protection Trusts

Generally, self-settled asset-protection trusts are ineffective for creditor avoidance purposes, as a matter of public policy, in the United States. See, *e.g., Nelson v California Trust Co.* (1949) 33 C2d 501, 202 P2d 1021; see §26.15. However, several offshore jurisdictions have enacted special legislation authorizing self-settled trusts as a way of fostering a trust industry. These jurisdictions include the Cook Islands and Nevis. The benefits of a foreign asset-protection trust are twofold. First, the trust is settled in a jurisdiction that allows self-settled asset-protection trusts, so the settlor can fund the trust with his or her own assets. Second, the assets are transferred to an offshore location (which need not be the situs of the trust). When assets are offshore, it is difficult for creditors to reach those assets or litigate the validity of the trust, because United States courts will not have jurisdiction over the assets.

In most foreign asset-protection situations, for historic reasons grounded in U.K. law, a discretionary trust is used. In addition, foreign asset-protection trusts often use shifting-interest trusts. In such a trust, interests and entitlements can shift from one beneficiary to another. In addition, a trust can shift from one type of asset-protection trust to another. See Spero ¶6.07. Thus, another level of protection can be achieved by providing that a beneficiary's interest can be extinguished in the event of a creditor attack, only to reappear when the creditor threat has abated.

Special provisions relative to self-settled trusts in bankruptcy also apply to foreign trusts. See §26.35. Further, "rabbi trusts" that have a foreign situs are penalized under IRC §409A(b). See discussion in Spero ¶13.03[12].

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§26.27 a. United States Control Over Foreign Trusts

Several United States courts have refused to recognize foreign laws that authorize self-settled trusts. See, *e.g., Marriage of Dick* (1993) 15 CA4th 144, 18 CR2d 743 (labyrinth of offshore trusts and corporations disregarded); *Marine Midland Bank v Portnoy (In re Portnoy)* (Bankr SD NY 1996) 201 BR 685 (court declined to recognize foreign trust law and instead applied New York state law to determine that self-settled trust was part of the bankruptcy estate). The guiding principles are set forth in the Restatement (Third) of Foreign Relations (1987), which provides that the following factors are to be taken into account in determining when a United States court will recognize foreign laws (Restatement (Third) of Foreign Relations §403 (1987)):

- The extent to which the activity takes place in the country or has a "substantial, direct, and foreseeable effect" on or in the country.
- Factors such as nationality, residence, or economic activity between the regulating state and the parties.
- The character of the activity, the importance of the regulation to the regulating state, and the degree to which the desirability of such regulation is generally accepted.
- "[T]he existence of justified expectations that might be protected or hurt by the regulation."
- The extent to which the regulation is consistent with traditions of the international system.
- The extent to which another state has an interest in regulating the activity.
- "[T]he likelihood of conflict with regulation by another state."

In addition, if there is a conflict between two states, "a state should defer to the other state if that state's interest is clearly greater." Restatement (Third) of Foreign Relations §403(3) (1987). Other factors include whether the law is reasonable and "reciprocity," *i.e.*, whether the regulating state would consider it reasonable for the other state to exercise regulatory jurisdiction if the circumstances were reversed. Restatement (Third) of Foreign Relations §403, Comment a (1987), Reporters' Notes 1, 5. Notwithstanding United States law, a foreign jurisdiction will likely uphold its own trust laws.

These rules apply only to personal property such as limited partnership interests, because the deemed location or situs of personal property is the residence of the trustee that holds legal title to the property. *Stanford v City & County of San Francisco* (1900) 131 C 34, 63 P 145. See Anno, *Property Tax: Business Situs of Intangibles Held in Trust in State Other Than Beneficiaries Domicile*, 59 ALR 3d 837, 839 (1974) (generally situs is domicile of the trustee, regardless of the domicile of beneficiaries).

When real property is involved, the law of the situs of the property governs the validity of the trust. Restatement (Second) of Conflict of Laws §280 (1971); Scott & Fratcher, The Law of Trusts, §660, p 607 (4th ed 1987). See *Hardy v Hardy* (1958) 164 CA2d 77, 330 P2d 278. In California "[r]eal property within the State is governed by the law of this State, except where the title is in the United States. CC §755. See *Estate of Patterson* (1980) 108 CA3d 197, 208, 166 CR 435 (probate sale of California property in ancillary administration of Maryland decedent's estate governed by California law). However, real property can be readily converted into personal property by transferring it to a limited partnership, limited liability company or corporation and funding the offshore trust with the equity interest in the selected entity. See, *e.g., Blodgett v Silberman* (1928) 277 US 1, 11, 72 L Ed 749, 48 S Ct 410 (under applicable law, limited partnership interest was personal property even though it held real property).

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§26.28 b. Structure of Foreign Trusts

Foreign asset-protection trusts can be structured in a variety of ways with many variations within these structures. The settlor can be the beneficiary of a discretionary trust. Depending on the jurisdiction selected, this structure will be asset protected. If the settlor-beneficiary develops a creditor problem, the trust can shift and name others as beneficiaries, such as a spouse and children. (The settlor would retain a limited power of appointment to prevent a taxable gift. See Treas Reg §25.2511-2(b). The retained power cannot be exercised by the settlor's creditors.) After a lapse of years, the trust can shift back to naming the settlor as the main beneficiary of the trust. Furthermore, the trustee can be granted the discretionary power to shift the beneficial interest in the trust among beneficiaries.

If creditor problems are imminent, a settlor's spouse and children can be named as initial beneficiaries. The settlor retains a limited power of appointment to prevent imposition of a gift tax. After a specified term of years, the beneficial interest can shift to the settlor. Alternatively, the trustee can be given the discretion to shift the trust or extend the period of time during which the spouse and children are beneficiaries. Treas Reg §25.2511-2(c). Generally, it is contemplated that the settlor will become the beneficiary when it is clear that no creditor problems are present.

When all or most of a person's assets are transferred to a foreign asset-protection trust, and there is a history of many transactions, an inference can arise that the arrangement is an agency rather than a trust. This is significant because if the settlor-debtor files a petition in bankruptcy, discharge may be denied if the foreign trust is not recognized and the arrangement is treated as an agency. The debtor's failure to comply with an order to retrieve assets can result in a denial of discharge in bankruptcy. See, *e.g.*, 11 USC §727(a)(6)(A) (failure to obey court order).

Even if creditors are willing to allow the debtor to, in effect, purchase a discharge by negotiated payments, court approval is required for discharge. A bankruptcy court may refuse to allow a debtor to purchase a discharge because it violates public policy. Compare *In re Traxler* (Bankr ED Tex 2002) 277 BR 699 and *In re Moore* (Bankr ED Tenn 1985) 50 BR 661, 664 (in both cases, court denied discharge notwithstanding negotiated settlement with creditors) with *In re Nicolosi* (Bankr WD La 1988) 86 BR 882, 889 n4 (compromise settlement allowed on grounds that it promoted efficient administration of justice) and *In re Margolin* (Bankr D Colo 1992) 135 BR 671, 673 (settlement allowed based in part on withdrawal of objection to discharge). Contempt and incarceration also are possible if the arrangement is treated as an agency and not a trust or if the debtor has retained too much power and control over trust assets. *FTC v Affordable Media, LLC* (9th Cir 1999) 179 F3d 1228.

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§26.29 c. Drafting Considerations

Among the most important decisions and drafting considerations is selection of the protector, who acts as a liaison between the trustee and the settlor. The settlor cannot hold powers over the trust directly, so a protector is often required. The protector controls major decisions. Another important drafting consideration is the selection of an investment advisor. It is best to maintain assets entirely outside the United States Indirect control is retained by selection of an investment advisor who can, if necessary, be replaced by the protector. Careful attention must be paid to crafting the relationship between these parties and delineating their respective duties and rights. See generally Spero, chap 7.

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§26.30 d. Selection of Trustee

A foreign trustee should be selected that is not subject to the jurisdiction of United States courts. It should not have a direct or indirect presence in the United States through subsidiaries or parent. If there is any United States presence, a United States court can exercise coercive power over the foreign trustee by imposing a penalty on the United-States-affiliated company until compliance is obtained. See, *e.g., In re Grand Jury Proceedings Bank of Nova Scotia* (11th Cir 1984) 740 F2d 817. A United States court can also obtain jurisdiction over a foreign trustee if any trust assets are located in the United States See *Hanson v Denckla* (1958) 357 US 235, 245, 2 L Ed 2d 1283, 78 S Ct 1228 (suggesting that presence of trust property would have been sufficient to give Florida jurisdiction over Delaware trustee with no contacts to Florida). Accordingly, it is best to maintain all trust assets outside the United States.

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§26.31 e. Selection of Offshore Jurisdiction

The desired characteristics of an offshore jurisdiction are:

- The jurisdiction should not enforce United States judgments.
- The local tax consequences should be neutral and the country should have a policy of encouraging local investment without taxation.
- The trust law of the situs should grant beneficiaries a right to enforce the trust and allow the situs of the trust to change.
- The country should be politically and economically stable.
- The infrastructure of the country should be developed, and it should have adequate banking and trust facilities.
- It should not impose any currency controls.

Suitable jurisdictions include the Cook Islands, Nevis, and many others. For a complete assessment of various jurisdictions, see Spero, Apps A-E.

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§26.32 f. Recognition of Gain on Transfer to a Foreign Trust

Transfers of property to a foreign trust or estate are treated as a sale or exchange for an amount equal to the fair market value of the property. IRC §684(a). A domestic trust that becomes a foreign trust is treated as having transferred its assets to a foreign trust for purposes of the deemed sale and exchange. IRC §684(c). This general rule for recognition of gain does not apply "to the extent that any person is treated as the owner of such trust under [IRC] §671" (referring to grantor trusts). IRC §684(b). Thus, in many circumstances the §684 sale and exchange will not apply, because the settlor is usually treated as the owner of the trust for tax purposes. For discussion of grantor trusts, see chap 13. Treasury Regulation §1.684-3 provides that gain is not recognized if, at the grantor's death, the property transferred is included in the grantor's gross estate for United States estate tax purposes. The basis of the property in the hands of the foreign trust is determined under IRC §1014(a) (providing for step up in basis at grantor's death).

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§26.33 g. Reporting Requirements

One of the primary considerations in deciding whether to use a foreign or domestic asset-protection trust is the substantial reporting requirements imposed on trusts considered "foreign trusts" for United States tax purposes. A "foreign trust" is one that is administered in a foreign country, with respect to which no United States court is able to exercise primary supervision, which has foreign trustees, and which has no United States trustee with the authority to control any substantial decision concerning the trust. IRC §7701(a)(30)(E), (a)(31)(B). Failure to comply with the reporting requirements may result in confiscatory penalties. IRC §6677. The reporting requirements are described in detail in Spero ¶7.04.

Some commentators suggest that a domestic trust be used initially to avoid the cost of complying with the reporting requirements. To qualify as a domestic trust, the trust must be subject to United States jurisdiction. IRC §7701(a)(30)(E) (trust is subject to United States jurisdiction when subject to supervision by United States court and United States person has authority to control all substantial decisions of trust). However, this requirement undermines the benefit of having a foreign trust, namely that no United States court has jurisdiction over the trustee, and, therefore, trust assets. To avoid U.S. jurisdiction, proponents of this method suggest having the United States trustee resign and transfer complete control of the trust to a foreign trustee as soon as a creditor problem arises. The problem with this method is that resignation by the United States trustee under these circumstances will likely constitute a fraudulent transfer. See §§26.5-26.8. A "transfer" for this purpose is very broad, and includes inaction and making a tax election. See Spero ¶3.03. Such a characterization could cause the trustee and those advising the trustee to be liable for engaging in a fraudulent transfer.

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B. Scope of Asset Protection

§26.34 1. Collection From Trusts Under California Law

Absent protective trust provisions, a judgment debtor's interest in a trust may be applied to the satisfaction of a money judgment by such means as the court, in its discretion, determines are proper, including but not limited to imposition of a lien on or sale of the judgment debtor's interest, collection of trust income, and liquidation and transfer of trust property by the trustee. CCP §709.010(b). All enforcement proceedings against a trust interest must be pursued in the court having jurisdiction over administration of the trust under Prob C §17000. The scope of asset protections for California trusts is set forth in Prob C §§15300-15309.

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§26.35 2. Protection in Bankruptcy

Trusts that are exempt from creditor attachment under local law are excluded from the debtor's estate in bankruptcy. 11 USC §541(c)(2). Accordingly, to the extent an interest in an asset-protected trust is exempt under California law, it cannot be reached by creditors in bankruptcy. However, transfers to self-settled trusts are considered fraudulent transfers if accomplished with the intent to hinder, delay, or defraud. 11 USC §548(e). Such transfers are subject to a special 10-year statute of limitations. It is unclear whether the statute applies with respect to "future creditors." Under state uniform fraudulent transfer laws, transfers made out of caution are normally not avoidable as fraudulent transfers. The breadth of the statute is unclear and it is possible that the 10-year statute of limitations will apply with respect to future creditors in connection with a transfer that was made out of caution. See Spero ¶6.08A[2]. The statute appears to apply to trusts that were formed before its 2005 effective date. See Spero ¶6.08A[4].

In *IRS v Snyder* (9th Cir 2003) 343 F3d 1171, the court held that an IRS claim for delinquent taxes secured by a lien on the debtor's interest in a retirement plan was not secured in bankruptcy under 11 USC §506(a) because the debtor's interest in the plan was excluded from the bankruptcy estate. In *Rhiel v Adams (In re Adams)* (BAP 6th Cir 2003) 302 BR 535, however, the court held that the debtor's IRC §403(b) retirement plan assets were not excluded from the bankruptcy estate because the assets were held by an insurance company rather than a trust. Assuming a debtor elects California estate law exemptions, an IRC §403(b) plan is probably protected by the CCP §704.110 exemption for public retirement benefits. See §26.41. A plan sponsored by a nonprofit organization may be exempt as a private retirement plan under CCP §704.115. See §26.40.

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3. Applicable Law

§26.36 a. Validity of Trust

A settlor can select the law of the state that will govern the validity of a trust of intangible or tangible personal property. See Prob C §21103; Restatement (Second) of Conflict of Laws §§268(1), 270, Comment b (1971). The settlor's choice is subject to public policy considerations. If the designated law violates a strong public policy of the state having the most significant relationship with the trust, the designation will be void. See, *e.g.*, *Frame v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1971) 20 CA3d 668, 673, 97 CR 811; Restatement §270, Comment b; Spero ¶7.02[2]. See §26.24. California courts usually respect choice-of-law clauses. See *Nedlloyd Lines B.V. v Superior Court* (1992) 3 C4th 459, 11 CR2d 330.

If a trust includes only real property and immovable tangible personal property with a permanent situs (sometimes collectively referred to as real property), the traditional rule is that the law of the situs of the property governs the validity of the trust. See, *e.g., Hartsfield v Lescher* (ED Ark 1989) 721 F Supp 1052. Other factors, such as the settlors' intentions regarding the law to be applied, the place of administration of the trust, and the domicile of the settlors, beneficiaries, and trustee are usually considered to be immaterial. For example, in California "[r]eal property within the State is governed by the law of this State, except where the title is in the United States." CC §755. See *Estate of Patterson* (1980) 108 CA3d 197, 208, 166 CR 435 (probate sale of California property in ancillary administration of Maryland decedent's estate governed by California law).

Real property can be converted into intangible personal property by transferring it to a partnership or limited liability company. The interest in the entity can then be transferred into a trust. If the settlors have not designated the law to apply, and their intents cannot be ascertained from the trust instrument or other circumstances, the law of the owner's (*i.e.*, the trustee's) domicile governs rights in personal property. See CC §946. See also Spero ¶7.02[2]. If the place of administration has not been fixed, validity will be determined by the law of the state having the most significant relationship to the trust. See Drafting California Irrevocable Trusts, chap 20 (3d ed Cal CEB 1997).

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§26.37 b. Interpretation and Construction of Trust

The settlor can generally designate the law of any state to apply to interpretation and construction of a trust of real or personal property, regardless of the amount of contact between the trust and the designated state, if the law selected is not contrary to the public policy of a state having a close connection with the trust. 5A Scott & Fratcher, The Law of Trusts §§575, 648(1) (4th ed 1987); Restatement (Second) of Conflict of Laws §277 (1971). From a practical standpoint, it is usually advisable to designate the law of the trustee's place of business to govern interpretation and construction, because a corporate trustee may refuse to act if these matters are to be governed by the law of another state.

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§26.38 4. Loss of Protection Due to Excess Control

If a debtor is the sole beneficiary and sole trustee of an asset-protection trust, the interest in the trust is not protected from creditors. Restatement (Second) of Trusts §152, Comment m (1959); Restatement (Third) of Trusts §58, Comment b (2003). Asset protection is preserved if the beneficiary who acts as sole trustee is only one of the beneficiaries, or is the sole beneficiary and merely one of the trustees. Restatement (Second) §152, Comment m; Restatement (Third) §58, Comment b. For this purpose, remainder beneficiaries are considered beneficiaries. See *Ammco Ornamental Iron, Inc. v Wing* (1994) 26 CA4th 409, 31 CR2d 564. See also *Birdsell v Coumbe (In re Coumbe)* (BAP 9th Cir 2003) 304 BR 378 (interest of sole current beneficiary and sole trustee was protected in bankruptcy—except for monies distributed within 180 days after filing petition—when his children were remaindermen; court refused to ignore interest of his children as illusory simply because it was contingent on debtor's death).

PRACTICE TIP: Notwithstanding *Ammco*, in the author's opinion it is still the better practice for the sole beneficiary of a trust not to act as sole trustee, even if there are remainder interests.

A closely related rule is that protection is lost if the beneficiary has unfettered discretion and excessive control over trust assets. Thus, if the beneficiary is immediately entitled to all funds from the trust, rather than to the mere right of support or some other standard imposed by the trust agreement, the protective provisions of the trust will not be effective for either income or principal. Restatement (Second) of Trusts §153(2) (1959); Restatement (Third) of Trusts §58, Comment b (2003) (equivalent of ownership). See *Ehrenberg v Southern Cal. Permanente Med. Group (In re Moses)* (9th Cir 1999) 167 F3d 470 (California law does not allow a participant with excessive control over his or her trust to shield that trust with antialienation provision lacking true substance).

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IV. ASSETS EXEMPT FROM COLLECTION

A. Retirement Plans

§26.39 1. Federal Law

Under the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461), each qualified retirement plan is required to include an antialienation clause. 29 USC §1056(d). This spendthrift clause prevents creditors of plan participants from reaching retirement plan assets. *Patterson v Shumate* (1992) 504 US 753, 119 L Ed 2d 519, 112 S Ct 2242; *Retirement Fund Trust of Plumbing, Heating & Piping Indus. v Franchise Tax Bd.* (9th Cir 1990) 909 F2d 1266. The protection afforded under ERISA should apply to a surviving spouse as well. *Guidry v Sheet Metal Workers Nat'l Pension Fund* (1990) 493 US 365, 107 L Ed 2d 782, 110 S Ct 680 (protection of retirement fund under ERISA was intended to "safeguard a stream of income for pensioners and for their dependents"); but see *Sticka v Wilbur (In re Wilbur)* (9th Cir 1997) 126 F3d 1218 (court denied state law exemption for retirement benefits to a participant's ex-spouse when payment was not attributable to period of employment). ERISA does not apply unless a nonowner is covered under the plan. See *Watson v Proctor (In re Watson)* (1998) 161 F3d 593 (ERISA did not apply to benefit plan when sole participant was sole shareholder of corporation; accordingly, interest in plan was part of bankruptcy estate). Thus, when the debtor and the debtor's spouse are the sole participants in the plan, it is not protected by ERISA. *Gill v Stern (In re Stern)* (9th Cir 2003) 345 F3d 1036, cert denied (2004) 541 US 936. ERISA protection also may not apply to IRC §403(b) plan assets held by an insurance company rather than a trust. See §26.35.

Most IRS qualified retirement plans are also exempt in bankruptcy. Such plans include IRAs and IRC §457 plans. IRAs are subject to a $1 million limitation (adjusted for inflation), but the cap does not apply with regard to most rollovers from other kinds of plans. 11 USC §522(n) (referring to IRC §§408, 408A, and 408(p), and rollovers described in IRC §§402(c), 402(e)(6), 403(a)(4), 403(a)(5), and 403(b)(8)). The $1 million cap can also be increased "if the interests of justice so require." Further, rollovers and trustee-to-trustee transfers will not affect the exemption. 11 USC §522(b)(4)(C), (D). Rollovers must, however, comply with the 60-day period in 11 USC §522(b)(4)(D)(ii)(II). These rules apply regardless of whether a state has opted out of the federal exemption scheme. See §26.40. See also Spero ¶13.03[6][b].

Further, the Bankruptcy Code protects amounts withheld by an employer from the wages of an employee or received by the employer from the employee for contributions to a broad range of retirement plans and health insurance plans, including ERISA-qualified plans, governmental plans under IRC §414(d), IRC §457 plans, and IRC §403(b) tax-deferred annuities—generally plans maintained by charitable organizations. Such amounts are excluded from the bankruptcy estate. 11 USC §541(b)(7).

In *Nelson v Ramette (In re Nelson)* (BAP 8th Cir 2002) 274 BR 789, 792, the court held that an interest in a plan granted under a qualified domestic relations order (QDRO) is also protected by ERISA. The interest of a "beneficiary" is protected by ERISA and a "beneficiary" is defined as "a person designated by a participant, or by the terms of an employee benefit plan, who is or may become entitled to a benefit thereunder." 29 USC §1002(8). Accordingly, the interest received under a QDRO is protected under ERISA. See also *Ostrander v Lalchandani (In re Lalchandani)* (BAP 1st Cir 2002) 279 BR 880, 885. These decisions are consistent with the Supreme Court's decision in *Guidry v Sheet Metal Workers Nat'l Pension Fund, supra*. There are, however, at least two decisions to the contrary. See *Johnston v Mayer (In re Johnston)* (Bankr ED Va 1998) 218 BR 813, 817 (spouse entitled to qualified plan under QDRO not protected by ERISA "because the debtor is not a plan participant or a beneficiary"); *In re Hageman* (Bankr SD Ohio 2001) 260 BR 852, 857 (interest in pension plan obtained pursuant to QDRO not protected under ERISA because debtor's property interest did not emanate from retirement plan itself but rather from QDRO).

NOTE: The *Johnston* decision appears to confuse the issue of whether funds distributed are protected (they are not) and whether the money in the plan would be protected. The decision appears wrong to the extent that it holds that assets held by an ERISA plan are not protected from creditors.

The ERISA exemption does not apply after funds have been distributed. *Velis v Kardanis* (3d Cir 1991) 949 F2d 78, 83. Furthermore, plans that cover only the owner of a business and his or her spouse are not subject to ERISA, and therefore do not benefit from its safeguards. 29 CFR 2510.3-3. The Ninth Circuit Court of Appeals broadened California's exemption of Keogh plans, *i.e.*, noncorporate retirement plans, in *Moses v Southern Cal. Permanente Med.*

Group (In re Moses) (9th Cir 1999) 167 F3d 470. In *Moses*, the debtor's interest in a Keogh plan was established by a partnership of which the debtor was a member with many others. The court assumed that it was not an ERISA-qualified plan, but held that it was nevertheless an asset-protected trust. This case is suspect because under the California Probate Code a "trust" does not include a trust "for the primary purpose of paying… pensions, or employee benefits of any kind." Prob C §82(b)(13). Furthermore, it ignores the rule that one can become a settlor through the indirect transfer of property. See Spero ¶6.08[1].

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§26.40 2. California Law

California law provides its own exemption for IRS qualified plans for (CCP §704.115(b)):

Individual retirement accounts (IRAs) and some Keogh plans, *i.e.*, when ERISA does not apply. An individual retirement account (IRA) is not subject to ERISA if no contributions are made by the employer and the employee's contributions are made voluntarily (29 CFR §2510.3-2(d)) or when the retirement plan covers only the owner and the owner's spouse (29 CFR §2510.3-3).

NOTE: A Keogh plan is a plan established by a sole proprietorship, partnership or S corporation. If the Keogh plan covers employees other than the sole owner or the owner's spouse, in the author's opinion a reasonable inference can be made that these plans are subject to ERISA.

California's exemption for IRAs and Keogh plans is subject to the "reasonably necessary" standard. CCP §704.115(a)(3), (e). That standard allows an exemption from creditor claims (CCP §704.115(e)):

> only to the extent necessary to provide for the support of the judgment debtor when the judgment debtor retires and for the support of the… dependents of the judgment debtor, taking into account all resources that are likely to be available for the support of the judgment debtor when the judgment debtor retires. In determining the amount to be exempt under this subdivision, the court shall allow the judgment debtor such additional amount as is necessary to pay any federal and state income taxes payable as a result of [satisfying a judgment with IRA funds.]

This standard is generally interpreted to provide for only basic needs, unrelated to the former status in society or lifestyle to which the debtor may have been accustomed. However, the special needs of retired and elderly debtors are taken into account. The following factors are considered in determining the size of the debtor's exemption:

- A debtor's present and future living expenses;
- A debtor's present and future income;
- The age of the debtor and dependents;
- The health of the debtor;
- The debtor's ability to work and earn;
- The debtor's job skills, training, and education;
- The debtor's other assets available for support, including exempt assets;
- Liquidity of other available assets;
- The debtor's ability to save for retirement;
- Special needs of the debtor and dependents; and
- The debtor's other financial obligations.

See, *e.g., In re Switzer* (Bankr CD Cal 1992) 146 BR 1; see also *Moses v Southern Cal. Permanente Med. Group (In re Moses)* (9th Cir 1999) 167 F3d 470; *In re Herzog* (Bankr ND Ohio 1990) 118 BR 529, 532; *In re Miller* (Bankr D Minn 1983) 33 BR 549, 553; *In re Taff* (Bankr D Conn 1981) 10 BR 101, 106.

PRACTICE TIP: The difference between the various types of retirement plans may become less important, given the portability of plans under IRC §408(d)(3)(H)(ii)(II). Thus, IRA and Keogh plans could readily be transferred to a C corporation plan to qualify for the greater protection under California law.

Private retirement plans, whether or not qualified under the Internal Revenue Code. To be an IRS-qualified plan, a "private retirement plan" in most circumstances must be sponsored by a C corporation rather than an S corporation, partnership or sole proprietorship. *In re Cheng* (9th Cir 1991) 943 F2d 1114. This exemption is not subject to the "reasonably necessary" standard. CCP §704.115(a)(1)-(2), (e). However, California law requires a private plan to be "designed and used" for retirement purposes. *Yaesu Electronics Corp. v Tamura* (1994) 28 CA4th 8, 14, 33 CR2d 283 (exemption denied when debtor testified that purpose of plan was to save taxes and provide for his children, and amounts were not in fact used for his retirement). See also *Schwartzman v Wilshinsky* (1996) 50 CA4th 619, 629, 57 CR2d 790 (court considered control over "contributions, management, administration, and use of funds"); *Jacoway v Wolfe (In re Jacoway)* (BAP 9th Cir 2000) 255 BR 234, aff'd (9th Cir 2002) 284 F3d 1323 (IRA was exempt private retirement plan even though debtor began receiving distributions at age 50 to supplement her income; primary purpose was still to provide for retirement).

State exemptions should protect not only the plan participant, but the surviving spouse as well. See *In re Abbatta*

(Bankr ND NY 1993) 157 BR 201, 204 (state law exemption protected ex-spouse's interest in plan benefit). But see *Sticka v Wilbur (In re Wilbur)* (9th Cir 1997) 126 F3d 1218 (court denied state law exemption for retirement benefits to a participant's ex-spouse when payment was not attributable to period of employment).

After distributions have been made. See CCP §§703.080 (exempt fund must be traceable to a "deposit account or [be] in the form of cash or its equivalent") and 704.115(d). Courts have split on the question of whether private retirement plan assets that are transferred to an IRA continue to be completely exempt from levy by judgment creditors under the tracing rule. See *McMullen v Haycock* (2007) 147 CA4th 753, 54 CR3d 660 (more limited exemption applicable to IRAs does not apply to rollover assets). But see *In re Mooney* (Bankr CD Cal 2000) 248 BR 391 (full exemption for private retirement plan assets must be altered to fit the exemption that applies to the new account into which the funds are transferred). The *Mooney* court appears to have the better of the argument, because the tracing rule appears to be designed to cover the case of funds transferred to the retiree's checking account just prior to being spent. For bankruptcy debtors, the question is largely moot because rollover IRAs (and contributory IRAs up to $1 million) are completely exempt under 11 USC §522(b)(3)(C). However, as a result of the *McMullen* decision, judgment debtors with rollover IRAs in California may not need to file a bankruptcy petition to obtain protection from judgment creditors.

For a discussion of the complex problem of ERISA preemption of state statutes, see Spero ¶13.03[2][c].

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§26.41 B. Life Insurance

The California exemption for life insurance is provided in CCP §704.100, which states that life insurance proceeds are exempt to the extent "reasonably necessary" for the support of the judgment debtor and the dependents. As noted in §26.40, this standard has generally been interpreted narrowly. The exemption is broad, however, because it can apply to many individuals. The Comment to CCP §704.100 provides that the exemption:

> is available to the judgment debtor regardless of whether the judgment debtor was the insured or the beneficiary under the policy. This is consistent with prior law. [Citations omitted.]… the exemption may be asserted against creditors of the insured or of the spouse or dependents of the insured.

PRACTICE TIP: If each of these various family members is entitled to assert an exemption, then it may be appropriate to shift some portion of the insurance proceeds to the issue of the decedent. This can be accomplished by a disclaimer. The disclaimer mechanism is especially important because it does not constitute a fraudulent transfer. Prob C §283. See §27.10.

There is authority that an insured's designation of his or her spouse as beneficiary of a life insurance policy that has not been changed at death makes the policy proceeds the spouse's separate property even if the premiums had been paid for with community funds. *Estate of Miller* (1937) 23 CA2d 16, 18, 71 P2d 1117; *Estate of Lissner* (1938) 27 CA2d 570, 577, 81 P2d 448. See *Sieroty v Silver* (1962) 58 C2d 799, 804 n2, 26 CR 635, overruled on other grounds in *Estate of Baglione* (1966) 65 C2d 192, 197, 53 CR 139; 11 Witkin, Summary of California Law, *Community Property* §47 (10th ed 2005). This principle is significant if the deceased spouse has creditors. It is unclear whether such a transfer could be deemed a fraudulent transfer. See Ins C §§10132, 10170-10171 (proceeds exempt if clause prohibits payment to creditors).

California provides a number of exemptions for other insurance benefits: disability and health (CCP §704.130); unemployment insurance and strike pay (CCP §704.120); and fidelity bonds (Lab C §404). California allows a limited exemption for certain annuity payments. CCP §704.110. Homeowner's insurance on homestead property is exempt for 6 months in the amount corresponding to the debtor's allowable homestead exemption. See CCP §704.720(b). Matured life insurance benefits are exempt to the extent reasonably necessary for support (CCP §704.100(c)), while the loan value of an unmatured life insurance policy is exempt up to $9700, with doubling allowed by spouses (CCP §704.100(b)).

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§26.42 C. Homestead Exemption

California uses a sliding-scale system for calculating the size of the homestead exemption. Real or personal property used as a residence (including a mobilehome, boat, stock cooperative, condominium, planned development, or community apartment) is exempt to a specific value, depending on the individual debtor. See CCP §704.710. For a single person who is not disabled, the exemption amount is $75,000. CCP §704.730(a)(1). The exemption rises to $100,000 for families (CCP §704.730(a)(2)) and up to $175,000 if the debtor is age 65 or older (CCP §704.730(a)(3)(A)).

The state law homestead exemption is generally limited to $125,000 per debtor in bankruptcy. 11 USC §522(p). See §26.71. However, unmarried debtors with a joint ownership interest in the same homestead are generally entitled to multiple exemptions in bankruptcy, while spouses in California are entitled to only one exemption unless otherwise specifically provided. CCP §703.110(a). Thus, unmarried debtors with a child together each may be entitled to a $100,000 family exemption without exceeding the bankruptcy limitation. But see *Rabin v Schoenmann (In re Rabin)* (Bankr 9th Cir 2006) 359 BR 242 (California registered domestic partners with child limited to one combined homestead exemption because they were "married" judgment debtors under state law).

The $175,000 exemption may also be claimed if the debtor is physically or mentally disabled and unable to engage in substantial gainful employment. CCP §704.730(a)(3)(B). Furthermore, a debtor over the age of 55 who is single and earns under $15,000 in gross income, or under $20,000 aggregate gross income if the debtor is married or has a registered domestic partner, and who is forced to sell the homestead may claim the $175,000 homestead exemption. CCP §704.730(a)(3)(C); Fam C §297.5(a). Finally, sale proceeds received are exempt for 6 months. CCP §704.720(b) (proceeds are not exempt if a homestead exemption is applied to other property). The judgment debtor continues to be entitled to the exemption if the debtor is not currently residing in the homestead, but the debtor's separated former spouse continues to reside in or exercise control over possession of the homestead. CCP §704.720(d).

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§26.43 D. Other California Exemptions

Most of the other exemptions under California law are relatively minor and are set forth below. California has two sets of exemptions available for debtors, found at CCP §§703-704. The exemption amounts were adjusted in 2007 and are scheduled to be adjusted again in 2010. See CCP §703.150. These include exemptions for:

- Aid to needy. CCP §§704.170 (exempting social services aid); 704.180 (exempting relocation benefits); 704.190 (exempting financial aid to students); 703.140(b)(10)(A) (exempting local public assistance benefits).
- Alimony. CCP §703.140(b)(10)(D) (exempt to extent reasonably necessary for support of debtor and any dependent of debtor).
- Bank deposits directly deposited from Social Security Administration to $2700. CCP §704.080 (amount increases to $4050 for a husband and wife).
- Building materials. CCP §704.030 (exempting building material used for repair or improvement of a residence up to $2700).
- Burial plot. CCP §704.200.
- Business or professional licenses. CCP §695.060.
- Certain personal property. CCP §§704.020 (exempting household furnishings, appliances, provisions, wearing apparel, and other personal effects to extent ordinarily and reasonably necessary for debtor and family of debtor); 704.040 (exempting jewelry, heirlooms, and works of art to aggregate equity of $6750); 704.050 (exempting reasonably necessary health aids); 703.140(b)(2) (exempting motor vehicle to $3300); 704.010 (exempting motor vehicle or proceeds of sale or insurance to $2550; proceeds exempt for 90 days).
- Compensation to crime victims. CCP §703.140(b)(11)(A).
- Lost future earnings. CCP §703.140(b)(11)(E) (exempting to extent reasonably necessary for support).
- Partnership property. Corp C §15025 (right in specific partnership property exempt except on claim against partnership).
- Personal injury recoveries. CCP §704.140 (exempting to extent necessary for support of debtor, spouse, and dependent of debtor; if installments are paid then at least 75 percent exempt).
- Social Security. CCP §703.140(b)(10)(A).
- Tools of trade to $6750 or to $13,475 if both spouses in same trade. CCP §704.060 (exemption includes vehicle used in trade; maximum amount of total exemption for vehicle is $4850, or $9700 if doubling allowed).
- Trust funds for correctional facility inmates to $1350. CCP §704.090 (doubling allowed).
- Unemployment and disability compensation. CCP §§704.120, 703.140(b)(10)(A).
- Union benefits from labor dispute. CCP §704.120.
- Veteran's benefits. CCP §703.140(b)(10)(B).
- Wages. CCP §§704.070 (exempting 75 percent of paid earnings); 704.113 (exempting vacation credits of state employees; if amounts representing vacation credits paid periodically or in lump sum, then exempting 75 percent, same as paid earnings); 706.011 (earnings defined as compensation payable by employer to employee for personal services, whether in the form of wages, salary, commission, bonus, or otherwise).
- Worker's compensation. CCP §704.160.
- Wrongful death recoveries. CCP §§704.150, 703.140(b)(11)(C) (exempting to extent reasonably necessary for support if deceased was spouse or person debtor was dependent on).

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§26.44 V. PROTECTING MARITAL AND DOMESTIC PARTNERSHIP PROPERTY

All community property of spouses and registered domestic partners is subject to creditor claims for community debts. Fam C §§297.5, 910. These debts include business or professional endeavors undertaken to earn community property. *Brunvold v Victor Johnson & Co.* (1943) 59 CA2d 75, 138 P2d 32. These activities are often the ones from which liability will arise. Separate property is subject to creditor claims only of the owner of the separate property. Fam C §913. Accordingly, one asset-protection tool is to abandon the community property system and to hold all property as separate property. See §§26.61-26.64.

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§26.45 A. Types of Marital and Partnership Property

Each spouse or registered domestic partner owns a present vested one-half interest in community property. Fam C §§297.5, 751. Absent an agreement, all property acquired during marriage or domestic partnership is rebuttably presumed to be community property. Fam C §§297.5, 760, 803(c). Separate property is all property owned before marriage or registration of domestic partnership or acquired thereafter by gift or inheritance and the income therefrom. Fam C §§297.5, 770. Quasi-community property is separate property that would be community property except for the fact that it was acquired in a common-law jurisdiction and is generally treated as community property. Fam C §§63, 125. Earnings during the marriage or domestic partnership are community property; consequently, if the value of separate property increases as a result of a spouse's or partner's efforts, the increase in value can constitute community property to the extent it is attributable to those efforts. See, *e.g., Beam v Bank of America* (1971) 6 C3d 12, 17, 98 CR 137. See also 11 Witkin, Summary of California Law, *Community Property* §§121-128 (10th ed 2005).

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§26.46 B. Liability of Community Property

Community property can be seized to satisfy a liability arising from death or injury to person or damages to property if the loss was incurred while performing activities for the community. Fam C §1000(b). If the liability arose from noncommunity activities, separate property of the tortfeasor is subject to seizure first in satisfaction of the claim, then community property. Fam C §1000(b)(2). Community property can be seized to satisfy debts incurred by either spouse or registered domestic partner before or during marriage or domestic partnership, regardless of who has management and control of the property and regardless of whether one or both spouses or partners are parties to the debt or to a judgment for the debt. Fam C §§297.5, 910. For this purpose, quasi-community property is treated the same as community property. Fam C §912. There is an exception for earnings under certain circumstances; during marriage or domestic partnership, a person's earnings can be exempt from the premarital or prepartnership debts of his or her spouse or partner *provided that* earnings are not commingled with other community property and are held in an account on which the person's spouse or partner has no right to withdraw. Fam C §§297.5, 911.

Notwithstanding the exemption provided for nontortious liabilities, a spouse's or partner's earnings and other community property are generally subject to federal or state tax liens arising from nonpayment of taxes by the other spouse or partner. *State Bd. of Equalization v Woo* (2000) 82 CA4th 481, 98 CR2d 206 (wife's future earnings were subject to husband's sales tax debt). Earnings are community property in which a delinquent taxpayer has a one-half interest. Any state exemptions arising from the ability of a spouse to manage property, or otherwise, are not effective as to federal tax liability. *Medaris v U.S.* (5th Cir 1989) 884 F2d 832, 833.

In bankruptcy, all community property is property of the bankruptcy estate. 11 USC §541(a)(2). The nondebtor spouse or domestic partner loses whatever right he or she had to manage and control the community property in the bankrupt's estate, because this right passes to the bankruptcy trustee or the debtor in possession. 5 Collier on Bankruptcy ¶541.13[3] (15th ed 1996). In contrast, only one-half of joint tenancy property purchased with community property funds is included in the bankrupt's estate. *Hanf v Summers (In re Summers)* (9th Cir 2003) 332 F3d 1240.

The unified treatment of community property also applies to community liabilities. Thus, when spouses file a joint petition for bankruptcy, but one of them is denied discharge, all subsequently acquired community property can be seized to satisfy the nondischarged debts, including the community property interest of the spouse whose debts were discharged. *Valley Nat'l Bank v LeSueur (In re LeSueur)* (Bankr D Ariz 1985) 53 BR 414, 416; see also *In re Soderling* (9th Cir 1993) 998 F2d 730 (federal court criminal restitution order that was nondischargeable for husband's separate property was also nondischargeable for community property when all community property was potentially liable for the debt represented by the claim); Collier ¶524.02[3].

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§26.47 C. Liability of Separate Property

Separate property can be seized to satisfy the debts of the owner of that property. Fam C §913(a). Separate property is not subject to seizure to satisfy debts incurred by the person's spouse or registered domestic partner before or during marriage or domestic partnership. Fam C §§297.5, 913(b). For this purpose, child or spousal or partner support in connection with a prior marriage or domestic partnership is a debt incurred before marriage or domestic partnership. Fam C §§297.5, 915(a). Separate property can be seized to satisfy liability for injury or damage caused by the other spouse or domestic partner if he or she would otherwise be liable if the marriage or domestic partnership did not exist, such as under agency principles. Fam C §1000(a). In the dissolution context, separate property can be used to satisfy community debts when the debts exceed the community and quasi-community property. Fam C §2622(b). In addition, the separate property of each spouse or registered domestic partner is liable for family necessaries. Fam C §§297.5, 914(b).

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§26.48 D. Marital and Partnership Agreements

There are several kinds of marital agreements, such as a premarital or a postnuptial agreement. An agreement to transmute the character of property can also be characterized as a type of marital agreement, although a transmutation agreement is narrower in scope than most other kinds of marital agreements. While most marital agreements deal with a broad range of issues, a transmutation agreement simply changes the character of a spouse's property from community to separate, from separate to community, or from the separate property of one spouse to the separate property of the other spouse. Fam C §§850-853. Other marital agreements can also change the character of property, but they may potentially be able to do things that a transmutation agreement cannot, *e.g.,* waive or limit spousal support.

A transmutation of real or personal property must be in writing and made or accepted by the spouse whose interest in the property is adversely affected. Fam C §852(a). A transmutation of real property must be recorded to be effective. Fam C §852(b). Articles of a personal nature that are not substantial in light of all the circumstances of the marriage are exempted from this requirement. Fam C §852(c). These rules also apply to real or personal property of registered domestic partners. Fam C §297.5.

In *Hanf v Summers (In re Summers)* (9th Cir 2003) 332 F3d 1240, however, the court held that real property acquired by spouses taking title as joint tenants using community property funds was separate property of the spouses rather than community property. The court held that the usual statutory requirements for transmutation of community property into separate property did not apply because the acquisition of property is not a transmutation. For further discussion of transmutation by spouses and registered domestic partners, see §§4.38-4.40, 4.61-4.63.

An agreement characterizing property as separate will be effective for creditor avoidance and bankruptcy purposes unless it is fraudulent (Fam C §851; *State Bd. of Equalization v Woo* (2000) 82 CA4th 481, 98 CR2d 206) or undertaken under an arrangement or understanding in which the debtor is intended to be the beneficial owner of the property held by his or her spouse. See *Abbey v Deyo* (1871) 44 NY 343, 347 (transfer from husband to wife (or others) will be ineffective when transferee acts as mere agent for transferor).

It is good practice to record a marital or partnership property agreement to place the world on constructive notice of the parties' agreement. See Fam C §1502. However, even if the creditor is unaware of the agreement, he or she will be prevented from recovering against assets changed into the separate property of the noncontracting spouse or partner because the creditor could have easily avoided the risk of unknown interspousal transfers by obtaining both spouses' or partners' signatures on the contracts or notes. *Leasefirst v Borrelli* (1993) 13 CA4th Supp 28, 17 CR2d 114 (creditor is bound by undisclosed prenuptial agreement classifying the nonliable spouse's earnings as separate property); *American Olean Tile Co. v Schultze* (1985) 169 CA3d 359, 364, 215 CR 184 (marital settlement agreement); *Wolf v Chenich (In re Chenich)* (BAP 9th Cir 1988) 87 BR 101.

DRAFTING CONSIDERATIONS: In drafting marital or partnership property agreements, counsel should consider whether to demand the right to financial information. This issue bears on each spouse's or partner's liability for the tax attributable to the other spouse's or (for California income tax purposes) partner's income in filing a joint return. IRC §6013(d)(3); Rev & T C §18521(d). If one has access to all financial information, it may be difficult to benefit from the "innocent spouse" rules. IRC §6015(b)(1)(C). How this is handled depends on the circumstances of each party. One solution is to file separate returns. In that case joint and several liability for income taxes will not arise. *Edith Stokby* (1956) 26 TC 912, acq 1957-2 Cum Bull 7.

Once community property is changed into separate property, it generally remains the separate property of the spouse or registered domestic partner, even if the parties' marriage or domestic partnership is later dissolved. See Fam C §§297.5, 2550; *Marriage of Hillerman* (1980) 109 CA3d 334, 167 CR 240 (only community property and not separate property may be divided by court on dissolution). This fact may suggest protective devices for the at-risk transferor spouse or domestic partner, such as retention of a limited power of appointment over gifted property or, for a spouse, a use of a qualified terminable interest trust, as discussed in chap 17.

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1. Limitations to Marital and Partnership Property Agreements

§26.49 a. Employee Retirement Benefits

A nonparticipating spouse has no rights in a qualified pension plan or profit-sharing plan, regardless of state law, and such rights cannot be assigned to the nonparticipating spouse except in a divorce. 29 USC §1056(d); *Boggs v Boggs* (1997) 520 US 833, 138 L Ed 2d 45, 117 S Ct 1754; *Ablamis v Roper* (9th Cir 1991) 937 F2d 1450 (federal law preempts community property law so that nonparticipating spouse cannot bequeath one-half interest); but see Fam C §853(b) (waiver of joint and survivor rights under ERISA is not a waiver of community property interest). Accordingly, a marital agreement that purports to assign an interest in an ERISA-qualified plan to a nonparticipating spouse is invalid. However, these rules do not apply to California registered domestic partners, because they are not treated as spouses under federal law. See 1 USC §7.

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§26.50 b. Prospective Application Only

Marital and partnership agreements generally apply prospectively only. The parties cannot ordinarily alter the nature and extent of preagreement liability attributable to community property. Transfers between spouses or registered domestic partners (see Fam C §297.5) are usually ineffective to eliminate the rights of preexisting creditors to reach property transferred. *Frankel v Boyd* (1895) 106 C 608, 39 P 939; *Vest v Superior Court* (1956) 140 CA2d 91, 95, 294 P2d 988; *Wikes v Smith* (9th Cir 1972) 465 F2d 1142; *In re Hough* (Bankr SD Cal 1980) 4 BR 217 (liquor license transferred to wife's separate property corporation was held to be community property because trade creditors were in existence before the transfers).

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§26.51 c. Transmutation of Future Earnings

A spouse or registered domestic partner (see Fam C §297.5) has a present interest in his or her spouse's or partner's future earnings; consequently, any agreement that purports to give up the right to earnings can be attacked as a fraudulent transfer. *State Bd. of Equalization v Woo* (2000) 82 CA4th 481, 98 CR2d 206 (marital agreement that spouse's earnings were separate property was fraudulent transfer; under California law, debtor spouse had an existing interest in spouse's future earnings; the agreement constituted a transfer for this purpose, and because spouses entered into the agreement to prevent creditor from attaching future earnings, the transfer was made with actual fraudulent intent); *Moen v Hull (In re Hull)* (BAP 9th Cir 2000) 251 BR 726 (any agreement purporting to declare debtor's spouse's income separate could be attacked as a fraudulent transfer regarding claims existing at the time of the agreement, because under Washington law the debtor has a present interest in the spouse's future earnings).

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§26.52 2. Premarital Versus Postnuptial Agreements

A premarital agreement is an agreement between prospective spouses or partners that is made in contemplation of marriage or domestic partnership and is intended to be effective on marriage or registration of domestic partnership. Fam C §§297.5, 1610(a). A postnuptial agreement is an agreement between the spouses or partners, executed during an intact marriage or domestic partnership, that affects marital or partnership rights and obligations.

Family Code §1500 provides that the property rights of husband and wife or registered domestic partners prescribed by statute may be altered by a premarital agreement or another marital or partnership property agreement. For discussion of transmutation agreements, see §26.48. Although case law on waivers of spousal or partner support has generally involved premarital agreements, and the case law has been modified by statute, the same results may apply to marital and partnership agreements. See *Marriage of Pendleton & Fireman* (2000) 24 C4th 39, 99 CR2d 278 (premarital waivers of spousal support not per se unenforceable, and in circumstances presented in that case, can be enforced without violating any public policy); California Marital Settlement and Other Family Law Agreements, chaps 17-18 (3d ed Cal CEB 2005). For discussion of premarital agreements and Fam C §1615(a)(2), see §26.53.

PRACTICE TIP: When effecting a transmutation of community property, counsel should discuss, among other things, the tax consequences, *e.g.,* loss of step-up in tax basis at death, and the consequences of dissolution, *e.g.,* that separate property is not divided on dissolution. Such discussions should be documented in writing.

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§26.53 a. Requirements for Premarital Agreements

California has adopted the Uniform Premarital Agreement Act (Fam C §§1600-1620). Notable features include: (1) the agreement is enforceable without consideration (Fam C §1611), and (2) the agreement is not valid if it is unconscionable when executed and certain conditions are present (Fam C §1615(a)(2)). The Act applies to agreements entered into by registered domestic partners before the date of registration. Fam C §297.5(k)(1).

NOTE: The Act also applies to agreements entered into by registered domestic partners after the date of registration if they registered with the state before January 1, 2005, and the agreement was fully executed and in force as of June 30, 2005. Fam C §297.5(k)(2). Partnership agreements entered into after the date of registration would otherwise need to satisfy the requirements for postnuptial agreements discussed in §26.54.

California law generally requires representation by counsel and sufficient time to contemplate the agreement. Specifically, a premarital agreement is not enforceable against a party unless that party (Fam C §1615(c)):

- Was represented by independent legal counsel or, after being advised to seek independent legal counsel, expressly waived such representation in a separate writing;
- Had not less than 7 days to review the agreement and seek legal counsel before signing the agreement;
- If unrepresented by legal counsel, was fully informed of the terms and basic effect of the agreement as well as the rights and obligations the party was giving up by signing the agreement. The explanation must be in writing. For additional requirements, see Fam C §1615(c)(3)-(5).

In addition, a waiver of spousal or partner support is not enforceable against a party if that party was not represented by independent legal counsel at the time the agreement was signed, or if the waiver is unconscionable at the time of enforcement. A party may not waive representation by independent legal counsel with respect to an agreement regarding spousal or partner support, and an otherwise unenforceable agreement does not become enforceable against a party solely because that party was represented by independent counsel. Fam C §§297.5, 1612(c).

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§26.54 b. Requirements for Postnuptial Agreements

Postnuptial agreements must adhere to the standard for enforcement of contracts generally. *Marriage of Dawley* (1976) 17 C3d 342, 131 CR 3. To be valid, a contract must be the product of the free, mutual consent of the parties communicated by each to the other. CC §§1550(2), 1565. Accordingly, an apparent consent is invalid when obtained through fraud, duress, menace, undue influence, or mistake. CC §1567; *Marriage of Saslow* (1985) 40 C3d 848, 221 CR 546. Because the parties are spouses or registered domestic partners, they owe each other a fiduciary duty. Fam C §§297.5, 721(b). This requires each party to act with a high degree of good faith. If the parties enter into an agreement "in which one party gains an advantage, the advantaged party bears the burden of demonstrating that the agreement was not obtained through undue influence." *Marriage of Bonds* (2000) 24 C4th 1, 27, 99 CR2d 252, citing *Marriage of Haines* (1995) 33 CA4th 277, 297, 39 CR2d 673 (transmutation agreement). In *Marriage of Delaney* (2003) 111 CA4th 991, 4 CR3d 378, the court of appeal held that the trial court properly applied the presumption of undue influence, in finding that one spouse used undue influence to acquire a joint tenancy interest in a residence originally purchased by the other spouse. In *Marriage of Mathews* (2005) 133 CA4th 624, 35 CR3d 1, the court held that the husband successfully rebutted the presumption of undue influence when the wife quitclaimed her interest in a residence because the husband could obtain a better home loan interest rate if he purchased the property alone. The *Matthews* court found that the quitclaim deed was freely and voluntarily made, with full knowledge of all of the facts and with a complete understanding of the effect of the quitclaim deed, citing *Marriage of Haines* (1995) 33 CA4th 277, 296, 39 CR2d 673. Thus, a postnuptial agreement probably is subject to a higher degree of scrutiny than a premarital agreement. Note, however, that Fam C §1615(c) does not apply to postnuptial agreements.

Marital and partnership agreements enable spouses and registered domestic partners to structure their relationship—during marriage or domestic partnership, on dissolution, and on death—in ways different from those otherwise provided by law. The validity of various provisions, however, depends to a significant extent on the specific subjects addressed. Courts will not enforce provisions that (1) purport to waive statutory child support obligations or to bind the court regarding child custody or visitation or (2) violate public policy requirements. Certain rights arising at death can be waived only if a fair and reasonable disclosure of property was provided to the surviving spouse or domestic partner and he or she was represented by independent legal counsel. Prob C §§140-147; Fam C §297.5(c).

Postnuptial agreements must also be supported by adequate consideration. The consideration is present by virtue of rights that are waived and obligations that are assumed. See *Messenger v Messenger* (1956) 46 C2d 619, 297 P2d 988; *Helvern v Helvern* (1956) 139 CA2d 819, 294 P2d 482 (both cases dealing with property settlement agreements). A transmutation agreement alone, however, may occur with or without consideration. Fam C §850.

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§26.55 (1) Avoiding Dual Representation

Because of the almost certain conflict of interest between the spouses or domestic partners, it is preferable that each party to a marital or partnership agreement have his or her own attorney. When parties have a potential conflict of interest, an attorney may not represent both of them without the informed written consent of each. Cal Rules of Prof Cond 3-310(C)(1). See *Estate of Gagnier* (1993) 21 CA4th 124, 133, 26 CR2d 128. The disclosure to clients must include the warning that if the spouses or partners later become involved in a controversy, the attorney may have to withdraw from representing either side. Cal Rules Prof Cond 3-310; House and Ross, Guide to the California Rules of Professional Conduct for Estate Planning, Trust and Probate Counsel, 29 (1997). Moreover, the attorney must reasonably believe that the representation will not adversely affect either of the parties. ABA Model Rules of Prof Cond 1.7(a)(1), (b)(1).

Even with the requisite consent, dual representation increases the possibility that the agreement will later be set aside. Failure to make a full disclosure also exposes the attorney to liability for malpractice. *Lysick v Walcom* (1968) 258 CA2d 136, 147, 65 CR 406; *Ishmael v Millington* (1966) 241 CA2d 520, 50 CR 592.

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§26.56 (2) Dealing With Unrepresented Party

If one of the spouses or domestic partners is unrepresented, any communications with the unrepresented party should include advising that party, preferably in writing, that the interests of the two spouses or partners are adverse, that the attorney represents the interests of his or her client alone, and that the other party is strongly encouraged to seek independent legal advice. This advice should be repeated before the unrepresented party's signing of a proposed prenuptial agreement.

If the unrepresented spouse or domestic partner continues to refuse to obtain legal advice before signing the agreement, he or she should be asked to sign an acknowledgment, set forth as a provision of the agreement, stating that the unrepresented party was advised to obtain independent counsel and that the advice was voluntarily rejected. For a sample provision, see §26.56A.

The lack of independent counsel generally will not affect the validity of the agreement if the spouse or domestic partner had an opportunity to select independent counsel. See *Marriage of Bonds* (2000) 24 C4th 1, 27, 99 CR2d 252. This is not true of premarital agreements. See §26.53.

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§26.56A (3) Form: One Party Unrepresented by Counsel

§26.56A-1 One party unrepresented by counsel

This agreement has been prepared by _ _[*name*]_ _, attorney for _ _[*Husband/Wife/First Partner*]_ _. _ _[*Wife/Husband/Second Partner*]_ _ has not been represented in the negotiation or preparation of this agreement. _ _[*Wife/Husband/Second Partner*]_ _ acknowledges that _ _[*Husband's/Wife's/First Partner's*]_ _ attorney has informed _ _[*her/him*]_ _ that the attorney represents only _ _[*Husband/Wife/First Partner*]_ _, that _ _[*Wife/Husband/Second Partner*]_ _ has the right to obtain independent legal advice, and that _ _[*Wife/Husband/Second Partner*]_ _ should do so, but that _ _[*she/he*]_ _ has voluntarily declined to obtain such advice. _ _[*Wife/Husband/Second Partner*]_ _ further acknowledges that _ _[*she/he*]_ _ has carefully read this agreement in its entirety and voluntarily chooses to execute it.

Comment: Dealing with an unrepresented party presents special dangers. The attorney should give the unrepresented party the advice set forth in this provision, preferably in writing.

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§26.57 3. Agreements That Encourage Dissolution

Because a marital or partnership agreement addresses what occurs on dissolution of the marriage or domestic partnership, among other things, it necessarily "facilitates" dissolution. In the past, this factor led courts to invalidate all marital agreements. The contemporary reality that many marriages end in divorce, together with the social utility of such agreements derived from reduced litigation, have convinced most jurisdictions to uphold them. The public policy of encouraging marriage (applicable to domestic partnership under Fam C §297.5), however, can still affect the validity or interpretation of marital or partnership property agreements. The former rule has been recast to invalidate only those agreements that "encourage" divorce. *Marriage of Dawley* (1976) 17 C3d 342, 350, 131 CR 3. In *Marriage of Bellio* (2003) 105 CA4th 630, 129 CR2d 556, for example, the court upheld a premarital agreement provision requiring the husband to pay the wife $100,000 in the event of death or divorce. The provision was intended to compensate the wife for loss of spousal support paid by a former spouse. The court found that it did not encourage divorce and may have encouraged the marriage. However, the line between agreements that merely facilitate divorce and those that encourage divorce is often blurred.

Generally, an agreement that provides a financial incentive to a spouse or partner either to obtain a dissolution of the marriage or domestic partnership or to goad the other spouse or partner into obtaining a dissolution of the marriage or domestic partnership is suspect. The financial incentive is present if the agreement provides that the spouse or partner will receive property to which he or she would not otherwise be entitled. Cases are not uniform, however, and appear to also consider the length of the marriage, the amount of property, and the simple fairness of the overall arrangement. See, *e.g., Estate of Nelson* (1964) 224 CA2d 138, 36 CR 352.

EXAMPLE 1: An agreement between a wealthy man and woman without means that provided the woman would receive the greater of $500,000 or 50 percent of husband's assets on divorce was invalid as encouraging divorce when the marriage ended in 7½ months. *Marriage of Noghrey* (1985) 169 CA3d 326, 215 CR 153.

EXAMPLE 2: A dowry agreement, part of a foreign marriage contract between two Jordanians, that gave wife a nominal amount on performance of the marriage and a more substantial amount on the husband's death or dissolution of the marriage was held invalid because it encouraged dissolution by providing for payment in the event of a dissolution. *Marriage of Dajani* (1988) 204 CA3d 1387, 1389, 251 CR 871.

EXAMPLE 3: An agreement to transfer 5 percent of stock from husband to wife for every year of marriage for 10 years, but granting 50 percent of the stock if husband then filed for divorce, was held invalid because it encouraged the wife to goad the husband into filing for divorce. *Neilson v Neilson* (Utah App 1989) 780 P2d 1264, 1269.

DRAFTING CONSIDERATIONS: As with other contracts, a marital agreement must be drafted with sufficient specificity to be enforceable. Vague provisions such as "if I ever leave my spouse I will give her certain property to have and to hold for the benefit of our children and herself" will render a provision too vague to be enforced. See CC §§1635-1663; Fam C §3. See, *e.g., Matthews v Matthews* (NC App 1968) 162 SE2d 697. Further, the provisions must be consistent with the statutory scheme. In *Diosdado v Diosdado* (2002) 97 CA4th 470, 118 CR2d 494, for example, the court held that a contract providing for liquidated damages in the event of sexual infidelity was unenforceable because it was inconsistent with California's no-fault divorce laws under which recovery is limited to one-half of community property, appropriate support, and attorney fees.

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§26.58 E. Gifts Between Spouses and Domestic Partners

Gifts can be used for asset-protection purposes. A valid gift places property beyond the reach of the donor's creditors, assuming it does not violate the fraudulent transfer laws. Generally, for a gift to be valid, the following conditions must be met:

- The donor must be competent;
- There must be donative intent;
- There must be sufficient delivery of the property to vest the donee with unconditional and immediate possession;
- The gift must be accepted by the donee; and
- The gift must be present and fully executed.

See, *e.g.*, *Passante v McWilliam* (1997) 53 CA4th 1240, 1249 n7, 62 CR2d 298; *Jaffe v Carroll* (1973) 35 CA3d 53, 110 CR 435; CC §1146.

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§26.59 1. Relinquishing Possession

Generally, a gift is not complete unless the donor relinquishes possession. See CC §3440. Gifts of personal property may be accomplished by change of possession and the delivery of a duly executed written instrument or bill of sale of property. *Driscoll v Driscoll* (1904) 143 C 528, 535, 77 P 471. A gift can be completed by delivering it to a third person who acts as agent, trustee, guardian, or bailee for the donee. *Yamaha Corp. v State Bd. of Equalization* (1999) 73 CA4th 338, 357, 86 CR2d 362. A delivery can be valid if there is a constructive or symbolic delivery. *Estate of Escolle* (1933) 134 CA 473, 480, 25 P2d 860 (key to safe deposit box delivered by ill donor and bank instructed to permit entry). Although there are many alternatives available to ensure that a gift is complete, the best course is to deliver the evidence of ownership to the donee in the form of a certificate or in some other form evidencing ownership.

Under CC §3440, a transfer of personal property, including a transmutation of community property between husband and wife or registered domestic partners (see Fam C §297.5), that does not result in a change of possession is conclusively presumed to be fraudulent with respect to creditors at the time of the transfer and those who become creditors while the donor remains in possession of the property, even in the absence of bad faith. *In re Black & White Cattle Co.* (9th Cir 1986) 783 F2d 1454, 1462.

The California statute requiring a change of possession also applies to the transfer of corporate stock. Stock can be transferred by separate assignment; it is not necessary to enter the transfer on the books of the corporation. *Stowe v Harvey* (1916) 241 US 199, 60 L Ed 953, 36 S Ct 541; *Crane v Reardon* (1933) 217 C 531, 20 P2d 49 (delivery of unendorsed stock certificates); *Bacon v Traders' Oil Corp.* (1921) 52 CA 172, 175, 201 P 477. There is also some authority that placing stock in joint tenancy constitutes a complete gift, as does merely transferring title on the corporate books. See Anno, *Creating Joint Tenancy in Stock as Gift*, 5 ALR4th 373 (1981); Anno, *Stock-Transfer on Books a Gift*, 6 ALR4th 250, §3, 260 (1981); see Anno, *Gift of Stock Delivery*, 23 ALR2d 1171 (1952).

California provides a number of exceptions to the change-of-possession requirement, including personal property not located within the state (CC §3440.1(i)) and a thing in action, such as accounts receivables (CC §3440.1(a)). See also *Bank of the W. v Commercial Credit Fin. Servs., Inc.* (ND Cal 1987) 655 F Supp 807, rev'd on other grounds (9th Cir 1988) 852 F2d 1162. See also §26.60 on publicizing the gift under CC §3440.1(h).

In addition, personal property used in connection with a leaseback is exempt from the delivery requirement if the transferee purchased the property for value and in good faith within the meaning of Com C §10308(c). CC §3440.1(k). To fall within this exception the transaction must constitute a true lease and not merely be a financing arrangement that seeks to arrange security for a loan. *Berez v Drovers Nat'l Bank (In re Berez)* (9th Cir 1981) 646 F2d 420. These rules are relevant in connection with leaseback of property transferred to a children's trust or a family limited partnership.

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§26.60 2. Publicizing the Gift

California provides an exemption from the change-of-possession requirement for personal property if the following two conditions are met (CC §3440.1(h)):

- Before the date of the intended transfer, the transferee files a financing statement for the property to be transferred (this statement must be signed by the transferor and filed with the office of the Secretary of State); and
- The transferee and transferor publish a notice of the intended transfer in a newspaper of general circulation in the jurisdiction in which the personal property is located.

Publication must be completed at least 10 days before the transfer occurs. The statute provides that (CC §3440.1(h)(2))

> [t]he notice shall contain the name and address of the transferor and the transferee and a general statement of the character of the personal property intended to be transferred, and shall indicate the place where the personal property is located and a date on or after which the transfer is to be made.

These two steps must be taken before the transfer occurs. The transferor can, however, comply with this two-step process after the transfer of property and thereby render such transfers effective as against creditors whose claims arise after compliance. CC §3440.2.

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§26.61 F. Dissolution as an Asset-Protection Tool

If the parties are going to dissolve their marriage or domestic partnership, the timing of a dissolution can be an effective asset-protection tool. In community property states, the historic rule is that community property can be seized to satisfy community debts even after a divorce. In California, however, this rule has been changed so that community property awarded to a nondebtor spouse or partner as separate property at dissolution will be protected from the claims of his or her ex-spouse's creditors, even if the debts are community debts, if the debt has been assigned to the ex-spouse or ex-partner. Fam C §§297.5(b), 916(a)(2). For discussion of marital settlement agreements and fraudulent transfers, see §26.64.

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§26.62 1. Assignment of Debts in Dissolution

Generally, in the absence of a statute to the contrary, the ability of creditors to seize community property to satisfy community debts is not eliminated by dissolving the marriage or domestic partnership. For example, in *Wikes v Smith* (9th Cir 1972) 465 F2d 1142, 1146, the court held that a division of community property that existed at the time creditors had extended credit was ineffective to shield any portion of the property from liability because "all such creditors extended credit while the property retained its community status." See also *Vest v Superior Court* (1956) 140 CA2d 91, 95, 294 P2d 988.

However, a dissolution can purge community property of liability for a debt incurred by a spouse or registered domestic partner if the liability is assigned to that spouse or partner. Fam C §§297.5(b), 916. One can obtain the statutory protection by either obtaining a dissolution or by entering into a settlement agreement. *McCoy v Bank of America (In re McCoy)* (BAP 9th Cir 1990) 111 BR 276, 279; *Marriage of Braendle* (1996) 46 CA4th 1037, 54 CR2d 397. Consequently, if the parties are eventually going to dissolve their marriage or domestic partnership, it is appropriate to commence the process sooner to salvage some portion of the community property. Before dissolution and after division of community and quasi-community property, the liability of the parties is as follows:

- Separate property owned by the married person or registered domestic partner and property received by the person under the division of property is liable for a debt incurred before or during marriage or domestic partnership by the person, whether or not the debt is assigned for payment by that person or that person's spouse or partner. Fam C §§297.5(b), 916(a)(1).
- Separate property owned by a married person or registered domestic partner at the time of the division and other property received by that person is not liable for debts incurred by the person's spouse or partner before or during marriage or domestic partnership, and the person is not liable for such debt unless it was assigned to him or her in the division of property. Fam C §§297.5(b), 916(a)(2).
- Separate property and other property received by a married person or registered domestic partner will be liable for debts incurred by the person's spouse or partner before or during marriage or domestic partnership, and the person will be personally liable for the debt if it was assigned for payment by the person under the division of property. Fam C §§297.5(b), 916(a)(3).

Federal law may supersede any conflicting state law. For example, in *In re Porter* (ND Cal 1993) 93-2 USTC ¶50,543, 72 AFTR2d 6197, citing *U.S. v Overman* (9th Cir 1970) 424 F2d 1142, the court held that a state law purging separate property awarded to a spouse in a dissolution action of liability for debts was not effective to prevent the IRS from subjecting such property to a tax claim. The *Porter* court held that an IRS tax lien under IRC §6321 superseded state law.

For discussion of the right of reimbursement, see §26.63.

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§26.63 2. Right of Reimbursement Between Spouses and Domestic Partners

If one spouse or registered domestic partner pays a debt that is assigned to the other spouse or partner, a right of reimbursement accrues to the extent of the payment, together with interest at the legal rate plus reasonable attorney fees incurred in enforcing the right. Fam C §§297.5(c), 916(b), 920. The reimbursement provisions apply to liabilities regardless of when the debt was incurred and can be applied retroactively. Fam C §930.

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§26.64 3. Dissolution and Fraudulent Transfers

In *Mejia v Reed* (2003) 31 C4th 657, 3 CR3d 390, the California Supreme Court held that a collusive divorce decree or property settlement intended to defraud creditors may be set aside under the Bankruptcy Code's version of the fraudulent transfer act (11 USC §548), citing *Webster v Hope (In re Hope)* (Bankr D Col 1999) 231 BR 403, 415; *Britt v Damson* (9th Cir 1964) 334 F2d 896, 902, cert denied (1965) 379 US 966. The court rejected the argument that allowing marital settlement agreement transfers to be considered fraudulent would result in needlessly complicating the dissolution process, noting that dissolution was already complex by reason of dealing with pension plans and income tax consequences. 31 C4th at 669.

In determining whether adequate consideration supports a property division, other factors are examined, such as any provision for future support, particularly when one of the parties is under a disability such as blindness. *Britt v Damson* (9th Cir 1964) 334 F2d 896, 903 n13, cert denied (1965) 379 US 966. For a settlement to be given effect, it should be within the range of results that would have been realized if the matter had been actually litigated. *In re Sorlucco* (Bankr D NH 1986) 68 BR 748, 753; *In re Riso* (Bankr D NH) 102 BR 280, 290 (following *Sorlucco* in applying Florida's equitable distribution law). It is possible, however, that the bankruptcy court may be estopped from relitigating the issue of adequate consideration. *Falk v Hecker (In re Falk)* (Bankr D Minn 1988) 88 BR 957, 964, aff'd (D Minn 1989) 98 BR 472.

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§26.65 VI. PARTNERSHIPS AND LLCS

A limited partnership among family members has several tax and asset-protection uses. The tax aspects are beyond the scope of this chapter. (Note, though, that family limited partnerships may be scrutinized closely in connection with estate and gift taxes. See Spero ¶9.05.) The asset-protection aspects involve:

- Shifting income to family members;
- Sharing assets with family members (*i.e.,* if the debtor does not own the asset, the creditors cannot reach it);
- Valuation discounts (*e.g.*, for minority interests, lack of marketability) relative to partnership interests (*i.e.*, the value of a properly structured limited partnership interest is generally much lower than the proportionate value of the underlying partnership assets (see Spero ¶9.04)); and
- The charging order (see §26.66).

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§26.66 A. Charging Order

Special highly protective rules applicable to collection against an interest in a partnership or LLC make these business entities effective asset-protection devices. Partners have no right in specific partnership property. Corp C §§15907.01, 16203, 16501. See, *e.g., Nickless v Aronson (In re Katz)* (Bankr D Mass 2006) 341 BR 123, 132 (bankruptcy trustee's strong-arm powers do not give it the right to sell partnership assets; trustee is limited to partner's state law remedy, which in turn is limited to sale of partnership interest owned by debtor). A "charging order" is the exclusive remedy available to a creditor of a partner, superseding all other methods of attachment and execution against partnership property. CCP §§699.720, 708.310-708.320; Corp C §§15907.03 (limited partnership), 16504(e) (general partnership); *Evans v Galardi* (1976) 16 C3d 300, 128 CR 25 (no exception if partnership is owned entirely by judgment debtors). (For the few situations in which the creditor may execute directly on partnership assets, *e.g.,* when partnership assets have been transferred in fraud of creditors, see 8 Witkin, California Procedure, *Enforcement of Judgment* §296 (5th ed 2008).) A charging order directs that distributions made with respect to the debtor-partner's interest are made to the creditor instead of the debtor-partner. See Corp C §§15907.02-15907.03 (judgment creditor has rights of an assignee), 16504(a).

Charging orders are designed to allow creditors to satisfy their judgment out of partnership profits or liquidating distributions while minimizing the disruption of the partnership operation—a disruption that could destroy its going-concern value and impair the security interests held by creditors of the partnership itself. *AgriTech Servs., Inc. v Groff (In re Groff)* (10th Cir 1990), 898 F2d 1475; *Crocker Nat'l Bank v Perroton* (1989) 208 CA3d 1, 255 CR 794. If the limited partnership agreement contains a provision that restricts the sale of an interest, it also appears that the interest cannot be sold under a charging order. See Corp C §15907.02(f); see also Spero ¶9.02[1][b].

A charging order applies only to a partner's interest in the partnership. It does not take priority over the partnership's creditors. See CCP §699.720. Once a charging order has been issued, the debtor-partner remains a partner, but is no longer entitled to receive profits, surplus, and the proceeds of liquidating distributions until the charging order is satisfied. See Corp C §15907.02(b); Bromberg & Ribstein on Partnership §3.72 (1988). There appears to be no limitation on other payments to partners in capacities other than as partner, such as for wages or consulting fees.

The remedies imposed under a charging order are progressively more drastic. The applicability of these remedies to creditors with respect to limited partnership interests is unclear, however, because Corp C §15907.02 does not include a list of remedies. See Spero ¶9.02[1]. The remedial structure reflects a balancing of the equities of the partners and the creditor whose claim remains unsatisfied. The initial level, the diversion to the creditor of all distributions with respect to the partnership interest charged, is similar to a garnishment. Corp C §§15907.03(a), 16504(a). The next level of remedy allows a court to appoint a receiver to facilitate collection of the judgment. *Evans v Galardi* (1979) 93 CA3d 291, 295, 155 CR 505 (cost of receivership is borne by defendant). The receiver's role is limited, however, to receiving monies due with respect to the partnership interest charged, conserving partnership property, and preventing fraudulent transfer of partnership property. *Mitchell v Superior Court* (1972) 28 CA3d 759, 104 CR 921.

If the foregoing remedies are ineffective, the court ultimately has the power to sell the debtor's interest in a partnership. Corp C §§15907.03(b), 16504(b); *Crocker Nat'l Bank v Perroton* (1989) 208 CA3d 1, 255 CR 794. If a sale of the interest is authorized, a purchaser's rights are limited. He or she cannot compel liquidation of the partnership, has no voice in the management of the partnership, cannot control partnership investment or require partnership distributions. *Estate of Bruno Bischoff* (1977) 69 TC 32, 49.

The procedural safeguards and concern for nondebtor partners usually result in a time-consuming process of obtaining judicial approval for each step. The prospect of facing these hurdles, the outcome of which is by no means certain, may induce creditors to settle. See *In re Skyline Condominiums* (Bankr SD Tex 1986) 64 BR 778 (creditors took nearly 5 years to obtain charging order, finally granted in bankruptcy proceeding).

See generally Advising California Partnerships (3d ed Cal CEB 1999).

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§26.67 B. Bankruptcy Aspects

The bankruptcy trustee cannot sell partnership property. *Martin Mach. Co. v Williams (In re Newman)* (8th Cir 1989) 875 F2d 668 (debtor and trustee in bankruptcy were entitled only to distributive share of profits and liquidating distributions). Furthermore, a bankruptcy trustee generally cannot exercise a general partner's powers. A limited partnership agreement usually is an executory contract that cannot be assumed without the consent of all of the limited partners. 11 USC §365(c)(1)(A)-(B); *Crocker Nat'l Bank v Perroton* (1989) 208 CA3d 1, 255 CR 794. Although a partnership interest can be sold by the bankruptcy trustee (11 USC §§363(b)(1), 363(*l*)), a partnership ordinarily is not required to liquidate if the partnership agreement provides for a successor general partner. Sale of a general partnership interest can be prevented when the foreclosure would unduly interfere with the partnership business. *Helman v Anderson* (1991) 233 CA3d 840, 284 CR 830 (court considered whether debtor-partner possesses essential managerial skills and would no longer participate in business if interest sold).

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VII. PREBANKRUPTCY PLANNING

§26.68 A. Conversion of Nonexempt Into Exempt Assets

Prebankruptcy planning involves the tension between the right of creditors to, among other things, avoid fraudulent transfers and the right of debtors to utilize exemptions.

There is a right to convert nonexempt property into exempt property. *In re Johnson* (9th Cir 1973) 472 F2d 589 (deposit of business receipts into joint tenancy bank account not fraudulent per se; property exempt under state law); *Wudrick v Clements* (9th Cir 1971) 451 F2d 988 (the purposeful conversion of nonexempt assets to exempt assets on the eve of bankruptcy not fraudulent per se); *Schwartzman v Wilshinsky* (1996) 50 CA4th 619, 629, 57 CR2d 790 (transfer of assets to a retirement plan "which might otherwise be fraudulent is permitted if funds qualify for an exemption"); *Roosevelt v Ray (In re Roosevelt)* (BAP 9th Cir 1994) 176 BR 200 (debtor's right to convert nonexempt property into exempt property includes the transfer of property that, although nonexempt, cannot be levied on, such as the value of an education and the medical practice). A minority of decisions in other jurisdictions hold to the contrary. See, *e.g.*, *Mickelson v Anderson* (Bankr D Minn 1982) 31 BR 635; see generally Spero ¶12.02.

Whether conversion of nonexempt into exempt assets is effective depends on whether there is extrinsic fraud. When the court finds extrinsic fraud it can employ any of the following remedies:

- Denial of discharge (11 USC §727(a)(2));
- Denial of the exemption;
- Avoidance of the transfer on the grounds that it violates the fraudulent transfer laws; or
- Dismissal of the bankruptcy petition (11 USC §707(b)).

Extrinsic fraud is not easily defined, but courts seem to "know it when they see it." Some courts have looked for a pattern of sharp dealings, deception, and misrepresentation; such behavior will be characterized as fraudulent, and a discharge will be denied. In one case a court relied on the following factors to find extrinsic fraud, resulting in a denial of discharge: (1) arranging to postpone payment on a loan (which also hindered and delayed a creditor); (2) diverting funds from a business to an account unknown to creditors; (3) converting borrowed money into exempt property. *In re Reed* (5th Cir 1983) 700 F2d 986. In *In re Oberst* (Bankr CD Cal 1988) 91 BR 97 (discharge denied because debtor withdrew nonexempt equity from her home for purpose of hindering ex-spouse from collecting on judgment), the court stated the following test (91 BR at 101):

> If the debtor has a particular creditor or series of creditors in mind and is trying to remove his assets from their reach, this would be grounds to deny the discharge. If the debtor is merely looking to his future well-being, the discharge will be granted. This is an uncomfortable test and does not seem equitable; but it is the law.

Protecting excessive amounts has been treated as extrinsic fraud, although the Ninth Circuit has not yet so held. A leading case in this area is *In re Zouhar* (Bankr D NM 1981) 10 BR 154:

> While a bankrupt is entitled to adjust his affairs so that some planning of one's exemptions under bankruptcy is permitted, a wholesale sheltering of assets which otherwise would go to creditors is not permissible.

But see *Smiley v First Nat'l Bank of Belleville (In re Smiley)* (7th Cir 1989) 864 F2d 562 (full use of exemptions within the limits of the law not fraudulent but discharge denied because debtor intended to hinder or delay creditors). Furthermore, the exempt assets must be used for exempt purposes. For instance, purchasing a home that is not suitable for the debtor will result in a failed conversion. *Sholdan v Dietz* (8th Cir 1997) 108 F3d 886.

The Ninth Circuit has held that the debtor can reverse a fraudulent transfer and still obtain a discharge "if he reveals the transfers to the creditors, recovers substantially all of the property before he files his bankruptcy petition, and is otherwise qualified for a discharge." *In re Adeeb* (9th Cir 1986) 787 F2d 1339, 1345. But see *In re Davis* (11th Cir 1990) 911 F2d 560 (fraudulent transfer of a residence by a debtor to his wife and the retransfer of the residence back to the debtor immediately before a petition was filed constituted a fraudulent transfer that resulted in a denial of discharge).

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§26.69 B. Continuation of Estate Planning

Intrafamily gifts and other transfers made to further estate planning objectives are an important aspect of asset protection. Such transfers are exempt from the requirement of fair consideration if the plan is formulated well in advance of any financial difficulties. Thus, transfers made to irrevocable life insurance trusts, children's trusts, and perhaps any other regular and continuous gift-giving program will not be avoided as fraudulent transfers. See, *e.g., In re Cataldo* (BAP 9th Cir 1998) 224 BR 426; *In re Atkinson* (Bankr WD Wis 1986) 63 BR 266. But see *Kirkland v Risso* (1979) 98 CA3d 971, 978, 159 CR 798 (although there is no presumption that transactions between close relatives are per se fraudulent, "the parties are held to a fuller and stricter proof of the consideration and the fairness of the transaction" when such a confidential relationship is shown to exist).

Estate planning considerations cannot be used as a ruse to justify fraudulent transfers, however. Thus, transfers that purport to be tax-motivated will nonetheless be characterized as fraudulent when the tax considerations are nonexistent. *Citizens State Bank v Leth* (Minn App 1990) 450 NW2d 923. See generally Spero ¶3.04[2][e].

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§26.70 C. Preserving Attorney-Client Privilege

Evidence of consulting counsel in connection with prebankruptcy planning can support a finding of extrinsic fraud. See, *e.g., In re Levine* (11th Cir 1998) 134 F3d 1046; *In re Schwarb* (Bankr MD Fla 1992) 150 BR 470. See generally Spero ¶12.02[7][h]. Unfortunately, an unexpected waiver of attorney-client privilege can occur in connection with prebankruptcy planning when the attorney engaging in planning is also the attorney who prepares the bankruptcy petition. Under these circumstances some information may not be privileged, on the grounds that it was communicated to the attorney to be incorporated into a public document, a circumstance that prevents the privilege from attaching. See, *e.g., In re French* (Bankr D SD 1994) 162 BR 541; see also Spero ¶12.01[4][c]. This suggests that, to maximize the protection of the privilege, debtors should use separate attorneys for prebankruptcy planning and the filing of the petition. See generally Spero ¶12.01[4].

The attorney-client privilege cannot be preserved when the crime-fraud exception applies. See *U.S. v Chen* (9th Cir 1996) 99 F3d 1495 (defendants used their attorneys' services to conceal tax fraud).

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§26.71 D. Moving to Another State

For a debtor to claim the exemptions under state law, the debtor generally must be domiciled in the state for 730 days preceding the filing. If the debtor moved to the state within the 730-day period, the debtor is required to use the exemptions of the state in which the debtor was domiciled for the 180 days immediately preceding the 730-day period (or for a longer portion of the 180-day period than in any other place). 11 USC §522(b)(3)(A). If these rules result in the debtor's ineligibility to use any state exemption scheme, then the debtor would be relegated to the federal exemption scheme. 11 USC §522(b)(3) (flush language). Domicile is determined in an ordinary conflicts-of-law sense. Generally, domicile is the place where a person has a permanent residence to which the person intends to return after an absence and where the person exercises political rights. See Spero ¶12.03[2][c]. A debtor cannot, however, move to a state solely for the purpose of exploiting that state's exemption scheme.

PRACTICE TIP: It is still possible for a debtor to move to another jurisdiction to obtain generous exemptions, but the new rules relative to the required period of domicile as well as the expanded exemption for retirement plans (see §26.39) seem to make such planning less important.

In the past, debtors often moved to a state to obtain the benefit of a generous homestead exemption. This maneuver is now curtailed, if not eliminated. The conversion of nonexempt assets in a homestead are not allowed if accomplished with the intent to hinder, delay or defraud a creditor. A special 10-year statute of limitations applies to this restriction. 11 USC §522(o).

A $125,000 limitation is imposed on the value of a homestead that may be claimed in bankruptcy if the homestead is acquired within 1215 days before the filing of the bankruptcy petition. 11 USC §522(p)(1). The $125,000 limitation is subject to an automatic 3-year inflation adjustment under 11 USC §104(b). The original $125,000 amount was increased to $136,875 effective April 1, 2007, and is scheduled to be adjusted again April 1, 2010. Excepted from this restriction is an interest in a principal residence acquired within the 1215-day period that is rollover from a residence that was acquired before the 1215-day period. 11 USC §522(p)(2)(B).

NOTE: A case interpreting this provision has limited its application to a debtor who resides in a state that has not opted out of the federal statutory scheme of exemptions, *i.e.*, a non-opt out state (see *In re McNabb* (Bankr D Ariz 2005) 326 BR 785, 788), although this result appears to be a drafting error that will likely be corrected in a technical amendment to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub L 109-8, 119 Stat 23). However, many courts have disagreed with the reasoning in *McNabb*. See, *e.g., In re Rasmussen* (Bankr MD Fla 2006) 349 BR 747; *In re Summers* (Bankr D Ariz 2006) 344 BR 108; *In re Kaplan* (Bankr SD Fla 2005) 331 BR 483; *In re Virissimo* (Bankr D Nev 2005) 332 BR 201. Most states, including California, have opted out of the federal exemptions.

A $125,000 limitation on the value of a homestead is also imposed if the debtor has a debt arising from serious criminal and tortuous conduct, *i.e.,* (i) conviction of a felony, the circumstances of which "demonstrates that the filing of the case was an abuse" of the bankruptcy laws (11 USC §522(q)(1)(A)), or (ii) the debt arises from one of the following (11 USC §522(q)(1)(B)):

- Violation of state or federal securities laws;
- Fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of certain registered securities;
- Civil remedies under RICO (18 USC §1964); or
- "[A]ny criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years."

The $125,000 limitation does not apply to the extent the property subject thereto "is reasonably necessary for the support of the debtor and any dependent of the debtor." 11 USC §522(q)(2).

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26A

Special Needs Trusts

Sterling L. Ross, Jr.
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§26A.1 I. PURPOSE OF SPECIAL NEEDS TRUST

The principal purpose of a special needs trust (SNT) is to preserve public benefits for disabled or aged beneficiaries. The benefits at issue are primarily benefits that are "asset sensitive," that is, benefits that require the recipient to have resources and income below a certain level to qualify.

A properly designed and administered trust can provide funds to supplement a disabled or aged beneficiary's public benefits without interfering with those benefits. Although tax law frequently affects the terms of the trusts discussed in this book, the terms of an SNT are principally controlled by public benefits law. Consequently, attorneys who prepare SNTs must be familiar with the requirements of the programs for which the beneficiary may be eligible. Wealthy clients may wish to combine SNTs for disabled beneficiaries with more familiar tax-saving irrevocable trust devices such as QPRTs and GRATs (see chap 25), CRTs (see chap 24), or CLATs (see chap 24A). For further discussion, see Sandoval, *Tax-Efficient Funding of a Lifetime Special Needs Trust*, 32 Est Plan 32 (Oct. 2005).

The field of public benefits is often difficult to navigate for the following reasons:

- The statutes, regulations, and policies are difficult to find, are complex, and contain contradictory directives and guidelines;
- Local program administrators cannot be relied on for authoritative advice; and
- The law governing eligibility may change during the term of an SNT.

Several trust clauses suggested in this chapter are designed to preserve benefits even if the law or the beneficiary's condition changes during the term of the SNT. Attorneys who draft SNTs must, nonetheless, stay current on developments in the law to be able to adequately advise new clients and trustees or beneficiaries of previously drafted trusts.

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§26A.2 II. TYPES OF SPECIAL NEEDS TRUSTS

For purposes of this chapter, SNTs are divided into two principal groups: the first party SNT and the third party SNT. An SNT established to manage litigation proceeds on behalf of a disabled plaintiff, with funds that belong to the disabled plaintiff, is referred to as a litigation special needs trust (LSNT) and is a type of first party SNT designed to satisfy the safe-harbor exception of 42 USC §1396p(d)(4)(A). An SNT established in traditional estate planning, *i.e.,* by parents for a disabled son or daughter, is referred to as a third party SNT, because the assets that fund the trust belong to a third party, not the disabled SNT beneficiary.

When drafting an SNT, it is critically important at the outset to determine whether the trust is a third party or first party SNT. The distinction will control the drafting of the trust, the funding of the trust, and the validity of claims by state and federal agencies against trust assets on the termination of the trust. An increasing number of financial eligibility restrictions have been imposed on a person's ability to transfer funds to an SNT for his or her benefit.

Because first party SNTs must meet all the requirements of third party SNTs and more, third party SNT requirements are discussed first, in §26A.3, and the additional first party SNT requirements are discussed in §26A.4.

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§26A.3 A. Third Party SNT

A third party SNT is an SNT established and funded by a person other than the applicant for public benefits. It is usually established by a parent for a disabled child. It may also be established by a grandparent, a sibling, or any other third party.

A third party SNT may be created by either an inter vivos or a testamentary instrument:

- An inter vivos trust is commonly used to receive gifts from several donors. For example, parents may establish an inter vivos SNT for a disabled child and then notify the grandparents of its existence. If the grandparents wish to leave assets to the disabled person, the inter vivos SNT can be used to consolidate asset management in a single entity, preserve public benefits, and alleviate the need for the grandparents to establish a testamentary SNT in their wills. See §26A.4.
- A testamentary trust is commonly used by parents, who provide in their wills for distribution to the trustee of an SNT of the portion of their estate intended for their disabled child under terms set forth in the wills. See §26A.5.

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§26A.4 1. Inter Vivos SNT

A third party SNT need not be irrevocable to preserve public benefits. As long as the trust is not revocable by the special needs beneficiary, the trust assets should not constitute countable resources for SSI and Medi-Cal eligibility purposes. See §26A.12.

A revocable inter vivos third party SNT gives the trustor the flexibility to modify the trust if the law changes or there are changes in other circumstances. This flexibility allows the trustor to test the trust with public agencies by funding it, reporting it, and defending it. If the trust is found to be improper, it can be amended or revoked.

If the inter vivos trust is likely to receive gifts from several sources, practitioners frequently prefer that it be irrevocable. Donors may feel more comfortable in transferring assets to a trust that will not be modified later. Also, the power to revoke will cause the trust assets to be includable in the trustor's estate if the trustor predeceases the beneficiary. IRC §2038. Irrevocable SNTs are discussed in detail with sample forms in Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008).

A third party SNT also may be established in a revocable inter vivos trust to be operative on the death of the surviving parent. Because SNTs in this context are established on the death of a parent rather than during life, they share the advantages of testamentary trusts. See Drafting California Revocable Trusts §§7.95-7.112 (4th ed Cal CEB 2003).

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§26A.5 2. Testamentary SNT

Like the revocable inter vivos third party SNT, the testamentary trust has the advantage of flexibility. Because the trust is not effective immediately, its terms may be modified if the law or circumstances change. Testamentary SNTs are discussed in detail with sample forms in California Will Drafting, chap 23 (3d ed Cal CEB 1992).

PRACTICE TIP: For Medi-Cal eligibility purposes, some attorneys prefer SNTs established by will because testamentary trusts are specifically exempted from the restrictive trust rules of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) (Pub L 103-66, §13611, 107 Stat 622). 42 USC §1396p(d)(2)(A). See §26A.25. The restrictive trust provisions of OBRA 1993, however, apply only to trusts that are considered to be established by the applicant or the applicant's spouse. Because an SNT created under the terms of a revocable inter vivos trust utilized by someone other than the applicant's spouse as a will substitute is clearly not established by the applicant, it is as effective in preserving Medi-Cal as an SNT established by will.

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§26A.6 B. First Party SNT

The types of first party SNTs in current use under the safe-harbor exceptions in 42 USC §1396p(d) are the following:

- Court-established (d)(4)(A) SNT. See §26A.7.
- Non-court-approved (d)(4)(A) SNT. See §26A.8.
- The (d)(4)(C) SNT. See §26A.9.

First party SNTs are generally beyond the scope of this book. For a complete discussion of LSNTs and other first party SNTs with sample forms, see Drafting California Irrevocable Trusts, chap 13 (3d ed Cal CEB 1997).

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§26A.7 1. Court-Established (d)(4)(A) SNT

This is the most commonly used form of first party SNT and includes the LSNT. The court-approved (d)(4)(A) SNT might also include assets of a disabled person other than litigation proceeds. For example, court approval might be obtained under the substituted-judgment provisions of Prob C §2580(b)(5) to transfer the assets of a conservatee to a first party SNT. At least one court has held that the court has jurisdiction under Prob C §2580(b)(5) to create a special needs trust for an inheritance. *Conservatorship of Kane* (2006) 137 CA4th 400, 40 CR3d 378. However, it would have been preferable for the conservatee's parent to create a third party SNT to receive the funds after the parent's death. The court order might not satisfy the requirements of 42 USC §1396p(d)(4)(A) because a trust approved by substituted judgment is arguably established by the conservatee rather than the court. If the trust is established to receive an inheritance, a petition to distribute property from the decedent's estate to the trust also might be filed under Prob C §11640 or §11700, but the trust might still be treated as established by the beneficiary. It also appears that a parent of a minor child or a conservator for an adult child may petition the court for modification of a testamentary trust under Prob C §15403 (consent of all beneficiaries) as guardian ad litem under Prob C §15405 or under Prob C §15409 (changed circumstances) consistent with the requirements of 42 USC §1396p(d)(4)(A). Other avenues for obtaining court approval are Prob C §4541(b) (petition by an attorney-in-fact for the principal) and Prob C §17200(b)(6) (petition for instructions to trustee) but the approved trust might still be treated as established by the beneficiary. Moreover, Prob C §3613 allows a disabled individual with capacity to use the procedure for a minor or incompetent person in Prob C §§3601-3612 to establish an LSNT, but the statute by its own terms only applies to money or property paid or delivered pursuant to a compromise or judgment. See Prob C §3600.

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Source: Estate Planning/California Estate Planning/26A Special Needs Trusts/§26A.8 2. Non-Court-Approved (d)(4)(A) SNT

§26A.8 2. Non-Court-Approved (d)(4)(A) SNT

In some situations, court involvement may be unavailable. For example, the disabled person may receive an inheritance and be mentally competent. In this scenario, the disabled individual may transfer assets to a trust established by a parent or grandparent that meets the other (d)(4)(A) requirements. See §26A.19. Note, however, that SSI policy requires that the person establishing the trust must have legal authority to act with regard to the assets of the individual. This is typically done by having the competent disabled individual execute a power of attorney authorizing the establishment and transfer of assets into the first party SNT.

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§26A.9 3. Pooled First Party Trust

The (d)(4)(C) exception applies to pooled first party trusts that meet the following conditions:

- The trust is established and managed by a nonprofit association;
- A separate account is maintained for each beneficiary of the trust, but for purposes of investment and management of funds the trust pools the funds in these accounts;
- Accounts in the trust are established solely for the benefit of disabled individuals by the individual, by the parent, grandparent, or legal guardian of the individual, or by a court; and
- To the extent that any amounts remaining in the beneficiary's account on the death of the beneficiary are not retained by the trust, the trust pays to the state the amount remaining in the account up to an amount equal to the total amount of medical assistance paid on behalf of the beneficiary under the state Medicaid plan. To meet this requirement, the trust must include a provision specifically providing for such payment.

A pooled trust is sometimes called a "master trust" because it contains the assets of many different individuals, each in separate accounts for the benefit of a separate individual. Pooled SNTs have recently become available in California and are a good option in the right circumstances.

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III. AVAILABLE PUBLIC BENEFITS

§26A.10 A. Overview of SSI and Medi-Cal

Supplemental Security Income (SSI) and Medi-Cal are the most important public benefits available to the disabled and aged. SSI provides a monthly cash subsistence grant to disabled, blind, or aged (65 or older) persons. Medi-Cal (California's version of the Medicaid program) pays for a broad array of medical (but not most dental) treatments and is the only government program that pays for long-term nursing home care.

Both programs are based on need and available only to those with minimal financial resources. Persons who are eligible for SSI benefits are eligible for Medi-Cal. Persons not eligible for SSI benefits may be eligible for Medi-Cal only if they are "medically needy." For Medi-Cal eligibility categories, see §26A.16.

If a person receives Medi-Cal or SSI benefits while he or she is ineligible for the benefits, the cost of the benefits received must be repaid. Welf & I C §14009(c), (e) (repayment of Medi-Cal when overpayment caused by recipient's failure to provide requisite information truthfully and fully); 20 CFR §416.560 (refund of SSI overpayments; reduction of future benefits used as adjustment; see 20 CFR §416.543).

Administration of SSI and Medi-Cal is subject to federal and state guidelines:

- The Social Security Administration's Program Operations Manual System (POMS) governs administration of SSI.
- Medi-Cal is governed by California Department of Health Care Services (DHCS) All-County Welfare Directors (ACWD) Letters. Medi-Cal is also governed by the California guidelines of the federal Centers for Medicare & Medicaid Services (CMS), which administers the Medicaid program.

Both SSI and Medi-Cal are based on federal legislation providing the basic program requirements. SSI is administered by the Social Security Administration, although the state supplements the basic SSI grants. See Welf & I C §§12000-12700, governing the State Supplementary Program. Because Medi-Cal is state administered and partially state funded, the attorney must consult both state and federal statutes and regulations regarding these programs. For SSI, the basic sources are 42 USC §§1381-1383c and 20 CFR §§416.101-416.2227. For Medi-Cal, the sources are 42 USC §§1396-1396u and 42 CFR §§430-456.657 (federal Medicaid); Welf & I C §§14000-14196 and 22 Cal Code Regs §§50000-58082 (state Medi-Cal). On transfers in Medi-Cal planning, see chap 30. For a detailed discussion of Medi-Cal, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chaps 9-12 (Cal CEB 2003).

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§26A.11 B. SSI Benefits and Eligibility for Disabled and Aged Poor

SSI provides a monthly stipend to supplement the recipient's income to a maximum amount defined by regulation. The amount of the benefits is determined by guidelines in 20 CFR §§416.401-416.435 (see 20 CFR §§416.410 (individual rate), 416.412 (eligible couple rate)). These payments are increased by a state supplement administered by the Social Security Administration. For federal regulations governing state supplements, see 20 CFR §§416.2001-416.2099. The benefit amounts are adjusted annually and published in the Federal Register each February, effective April 1.

SSI eligibility requirements are described in 20 CFR §§416.200-416.269. The first requirement is that the applicant be disabled, blind, or over age 65. 20 CFR §416.202(a). The second requirement is that the applicant not have more than the permitted income and resources to pay for food and shelter. 20 CFR §416.202(c)-(d). Excess income and resources coming to an SSI recipient will cause the SSI monthly benefits to be reduced dollar for dollar. 20 CFR §416.420. Therefore, retaining SSI eligibility and payments for an SNT beneficiary requires familiarity with the program's eligibility requirements and system for counting income and resources. For resource limits, see §26A.12. For income rules, see §§26A.13.

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§26A.12 1. Limitation on Resources

An otherwise eligible person is not entitled to SSI if the applicant's own countable resources and those of the applicant's spouse exceed $3000. 42 USC §1382(a)(2)(B), (3)(A). For an otherwise eligible single person, the resource limit is $2000. 42 USC §1382(a)(1)(B), (3)(B). See also 20 CFR §416.1205. A personal residence owned by the beneficiary is excluded from the beneficiary's resources, regardless of its value. 20 CFR §416.1210(a). Furniture, clothing, and personal care items are excluded to the extent that their total value does not exceed a "reasonable amount." 42 USC §1382b(a)(2)(A); 20 CFR §§416.1210(b), 416.1216. An automobile of any value is also excluded if it is used as transportation. 20 CFR §416.1218. Certain burial spaces, types of life insurance contracts, and other miscellaneous assets are also excluded from resources. 20 CFR §416.1210.

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§26A.13 2. Benefits Reduced by Income

Income is either "earned" (see 20 CFR §416.1110) or "unearned" (see 20 CFR §§416.1120-416.1121). Both types of income count against benefits. Gifts, inheritances, and additions to trusts are categories of unearned income. Not all income is counted, however. Some items are specifically excluded from income for policy reasons. For example, the first $20 per month of general unearned income is not counted, nor is the first $60 per calendar quarter of "infrequent" and "irregular" unearned income. 20 CFR §416.1124(c)(6), (12). Likewise, the first $65 of general earned income is not counted, nor is the first $30 per calendar quarter of "infrequent" and "irregular" earned income and one-half of remaining earned income. 20 CFR §416.1112(c)(2), (5), (7). For other rules on counting income and income exclusions, see 20 CFR §§416.1111-416.1112 (what counts as earned income), 20 CFR §§416.1123-416.1124 (what counts as unearned income). Special rules apply to in-kind support and maintenance. See §26A.14.

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Source: Estate Planning/California Estate Planning/26A Special Needs Trusts/§26A.14 3. Reduction for In-Kind Support and Maintenance

§26A.14 3. Reduction for In-Kind Support and Maintenance

There is a special category of in-kind income called "in-kind support and maintenance" (ISM). This is food or shelter provided directly to the recipient or paid for by a third party. However, clothing can be supplied by the trust without penalty because clothing is excluded from the in-kind support and maintenance-income reduction.

The provision of ISM reduces SSI, but not dollar for dollar as with cash. The maximum reduction is subject to either the one-third reduction rule or the presumed maximum value (PMV) rule. 20 CFR §§416.1130-416.1148. Under the PMV rule, ISM is valued at the lesser of its actual value or at its "presumed" value of one-third of the federal benefit portion ($674 in 2009), plus the $20 general income exclusion described in §26A.13. 20 CFR §416.1140(a). Any time the beneficiary receives anything that constitutes food or shelter, the beneficiary's SSI will be reduced by either $244.66 or the actual value of benefits received, whichever is smaller. For example, if the trustee directly pays the beneficiary's rent, the beneficiary's SSI will be reduced by $244.66, even if the rent is $800.

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§26A.15 C. Medi-Cal Benefits

Medi-Cal provides payment for hospitalization, treatment in medical clinics, doctors' services, lab tests, X-rays, home health care, nursing home care, and a host of related medical services. The program also pays for community mental health and drug abuse services and intermediate care facilities for the developmentally disabled. 42 USC §1396a(a)(10) (requisite provision of "medical assistance" by state plan implementing Medicaid); 42 USC §1396d(a)(1)-(5), (17), (21) (services for which state plan must provide assistance); Welf & I C §§14131.15, 14132, 14132.95, 14133.10, and 14133.22; 22 Cal Code Regs §§51301-51365 (descriptions of covered services). On Medi-Cal eligibility generally, see §26A.16. On recovery of payments to Medi-Cal recipients, see §26A.17.

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§26A.16 1. Medi-Cal Eligibility Generally

Two main categories of persons are eligible for Medi-Cal benefits. First, subject to certain limited exceptions, if an individual receives SSI, or other public cash grant assistance, he or she automatically qualifies for Medi-Cal. Such an individual is "categorically needy." 42 CFR §435.4 and Welf & I C §14050.1 (definition); Welf & I C §14005.1 and 22 Cal Code Regs §50201 (eligibility).

Second, an individual whose income level is too high to meet SSI eligibility requirements may nevertheless be eligible for Medi-Cal if medical expenses will deplete the applicant's income to below a "maintenance need" level. Such a person is "medically needy." 42 CFR §435.4 (definition); Welf & I C §§14005.7, 14005.12 (eligibility and maintenance need income level); 22 Cal Code Regs §§50201(4) (eligibility of medically needy for Medi-Cal), 50203 (who is medically needy). A substantial number of the medically needy are nursing home residents.

There are special property and income limits for applicants seeking Medi-Cal as medically needy persons. These rules are found in 22 Cal Code Regs §§50401-50489.9 (property inclusion and valuation) and 50501-50570 (income determination). The resource limits for purpose of Medi-Cal eligibility are similar to the rules for SSI eligibility. See §26A.8. (The Medi-Cal regulations use the term "property," while the SSI and federal Medicaid rules both refer to "resources.")

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§26A.17 2. Recovery for Payments to Medi-Cal Recipients

Medicaid recovery rules apply with respect to estates of recipients of Medi-Cal benefits.

- *Mandatory recoveries.* All states *must* implement programs to recover medical assistance benefits as follows (42 USC §1396p(b)(1)):
- In the case of an institutionalized individual regardless of age, from the individual's estate or on sale of the property subject to a lien imposed on account of medical assistance paid on his or her behalf. See §26A.13.
- In the case of an individual 55 years of age or older when he or she received medical assistance for nursing facility services, or home and community-based service (or for other medical assistance at the option of the state), from the individual's estate.
- *Permissive recoveries.* The state may enact recovery programs for persons over age 55 for any items or services under a state plan. 42 USC §1396p(b)(1)(B)(ii). California has opted to include permissive recoveries. 22 Cal Code Regs §50961(b).
- *Prohibited recoveries.* States may not enact recovery programs against the estates of persons who were under age 55 when the services were received and were not residing in a "nursing facility, intermediate care facility for the mentally retarded, or other medical institution." 42 USC §1396p(a)(1)(B). The law provides that a claim must be made against estates of persons who were inpatients in nursing facilities. Welf & I C §14009.5(b)(1). However, DHCS has stated that it has no plans to implement this provision.

For purposes of Medicaid recovery, a decedent's "estate" may include not only probate estate assets, but assets conveyed to another "through joint tenancy, tenancy in common, survivorship, life estate, living trust, or other arrangement". 42 USC §1396p(b)(4).

State law provides that the Department of Health Care Services (DHCS) *must* claim against the estate of a deceased beneficiary, or against any recipient of the property of that beneficiary, by distribution or survival, an amount equal to the payment for the health care services received, or the value of the property received by any recipient from the decedent by distribution or survival, whichever is less. Welf & I C §14009.5(a). However, the DHCS may not claim against a surviving spouse during his or her lifetime or against a surviving child who is under age 21 or who is blind or permanently and totally disabled. Welf & I C §14009.5(b). See §26A.19.

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§26A.18 a. Estate Recovery Regulations

Effective May 10, 2006, DHCS adopted estate recovery regulations (R-32-00) intended to comply with the statutory requirements. The regulations generally provide that DHCS must claim against the estate of a decedent, or against any recipient of the decedent's property, for all Medi-Cal payments made on behalf of the decedent. 22 Cal Code Regs §50961(a)-(b).

WARNING: Before advising their clients, practitioners are warned to seek updates from groups and attorneys active in Medi-Cal planning. One such source of information is the website of California Advocates for Nursing Home Reform (CANHR) at http://www.canhr.org.

The regulations provide that DHCS must claim against a variety of life estate interests, including the actuarial value of life estate interests when the decedent held a life interest only and the fair market value of real property when the decedent held a life estate and made a revocable transfer of the remainder interest in the property. 22 Cal Code Regs §50961(i). DHCS had previously maintained an informal policy of not claiming against life estates. The regulations appear to preclude planning techniques involving the transfer of a residence to an irrevocable trust with a retained right of occupancy that were designed to give the decedent a life estate or retained interest for estate tax purposes under IRC §2036 or §2038 and to give the remainder beneficiaries a stepped-up capital gains tax basis on the decedent's death without exposing the home to estate claims by DHCS.

The regulations define "life estate" as "an interest in real property whose duration is limited to the life of the estate holder or some other designated person, that grants the life estate tenant the right of occupancy." 22 Cal Code Regs §50960.29. Any such interest will be valued according to a specified table that generally places a high value on life estates. However, DHCS has since issued proposed regulations (R-14-04) that would eliminate this provision and has issued a statement that it will not initiate or pursue recovery against life-estate-only interests. CANHR has reported, after informal discussions with DHCS, that "there are no plans to limit the ability of recipients and applicants to transfer the home." Some advocates had argued that this definition of "life estate" contradicts a provision that limits the amount of estate claims to the lesser of all payments made on behalf of the decedent or the decedent's "equity interest" in the property. 22 Cal Code Regs §50961(a).

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§26A.19 b. Recovery From Estate of Surviving Spouse or Child

Under Welf & I C §14009.5(b)(2)(A), on the death of the surviving spouse, DHCS must make a claim against his or her estate, or against any recipient of property from the surviving spouse obtained by distribution or survival, for either the amount paid for the medical assistance given to the decedent or the value of any of the decedent's property received by the surviving spouse through distribution, whichever is less.

NOTE: Federal law limits claims to "the individual's estate, or upon sale of the property subject to a lien" (42 USC §1396p(b)(1)(A)), and does not mention claims against the estate of the beneficiary's spouse.

DHCS may not make a claim if there is a surviving child of the deceased beneficiary who is under 21, or who is blind or permanently and totally disabled. Welf & I C §14009.5(b)(2)(B)-(C); 22 Cal Code Regs §50961(d)(3)-(4). Federal law appears to prevent *any* state recovery in these cases. 42 USC §1396p(b)(2). California follows federal law, *i.e.,* the state is barred from making a claim for recovery—no matter who actually receives the decedent's property. See *Dalzin v Belshé* (ND Cal 1997) 993 F Supp 732 (proportionate share rule in Welf & I C §14009.5(b)(3) held to violate federal law). Even if a deceased Medi-Cal beneficiary leaves a home to several children, *e.g.,* only one of whom is disabled, all recovery is barred. The same reasoning can be expected to apply if there is a surviving child under age 21. The state's regulations now comply with the *Dalzin* case. 22 Cal Code Regs §50961(d)(3)-(4).

Property passing to the blind or disabled child may continue to be exempt from recovery after the child's death if the child in turn has a surviving child. In *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488, the court held that DHCS had no right of reimbursement for health care provided to the beneficiary of a special needs trust when the trust property passed to the beneficiary's child, who was permanently and totally disabled and received Social Security disability benefits.

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§26A.20 D. Social Security and Medicare Distinguished

Social Security and Medicare are employment-related public insurance programs that are neither need based nor means tested. They provide benefits to wage earners who have qualified for the program by payroll tax contributions.

Social Security provides "old age" (retirement) benefits and disability benefits. In addition to disability benefits for a disabled worker, Social Security provides benefits for a disabled adult child of a covered worker. When a covered worker dies, becomes disabled before age 65, or retires, his or her disabled child is eligible for benefits.

A child is considered disabled if he or she is either (1) blind or (2) unable "to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months." 42 USC §§402(d)(1)(B), 423(d); 20 CFR §404.350(a). The disability must have begun before the child attained age 22.

PRACTICE TIP: Many disabled persons and their families confuse Social Security disabled child benefits with SSI benefits. This is understandable because the cash payments are almost the same and the checks come from the Social Security Administration. If the only government benefits involved are Social Security and Medicare, an SNT may be unnecessary. On the other hand, the planner may determine that an SNT is nevertheless necessary or advisable to preserve the disabled child's future eligibility for Medi-Cal. If the disabled person or the family is uncertain about the nature of the benefits received, the planner should request a copy of the monthly check or bank statement if on direct deposit and inquire with the local Social Security office, if necessary.

Eligibility for Medicare is tied to eligibility for Social Security or Railroad Retirement benefits. Medicare Part A (Hospital Insurance) provides hospital benefits, limited posthospital skilled nursing facility care, part-time home health services, and hospice care.

Medicare Part B (Supplemental Medical Insurance) is a voluntary program of health insurance covering physicians' services, certain outpatient services, home health care, diagnostic tests, and medical appliances. 42 USC §§1395-1396r.

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IV. SSI SPECIAL NEEDS TRUST RULES

§26A.21 A. When Trust Assets Are Resources

If the beneficiary of a third party SNT cannot control the amount or frequency of trust distributions and cannot revoke the trust and use the funds for the beneficiary's personal benefit, the trust assets are not a countable resource to the beneficiary for SSI eligibility purposes. Under POMS SI 01120.200D.2:

> If an individual does not have the legal authority to revoke the trust or direct the use of the trust assets for his/her own support and maintenance, the trust principal *is not* the individual's resource for SSI purposes.

The revocability of a trust and the ability to direct the use of the trust principal depend on the terms of the trust agreement and state law. If a trust is irrevocable by its terms and under state law the beneficiary cannot use the trust assets for support and maintenance, the assets are not considered resources of the beneficiary. See §26A.22.

Although the POMS are only administrative guidelines, the trust rules are consistent with federal regulations. To be countable as a resource, property must be owned by the applicant (without restrictions on his or her right to liquidate the property) and convertible to cash to be used for the applicant's support and maintenance. 20 CFR §416.1201.

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Source: Estate Planning/California Estate Planning/26A Special Needs Trusts/§26A.22 B. Effect of Revocability

§26A.22 B. Effect of Revocability

If the trust is revocable by the grantor, the entire trust is a resource to the grantor. 42 USC §1382b(e)(3)(A); POMS SI 01120.201D.1.

NOTE: In some cases outside California, the Social Security Administration (SSA) has successfully argued that a special needs trust (SNT) that was irrevocable on its face was revocable and therefore invalid under the common-law doctrine of merger and the doctrine of worthier title. See Hook & Begley, *When Is an Irrevocable Special Needs Trust Considered to Be Revocable?*, 31 Est Plan 205 (Apr. 2004). However, the doctrine of worthier title is abolished as a rule of construction in California by Prob C §21108, and the application of the doctrine of merger is restricted by Prob C §15209.

PRACTICE TIP: To bypass any SSA argument on the subject of the Note above, it is advisable to include a named remainder beneficiary to the SNT rather than leaving it "to the beneficiary's estate" or "to the beneficiary's legal heirs." For example, the SNT could provide: "On the death of the beneficiary, the trustee shall pay $100 to the beneficiary's brother, John Smith, and the remainder to the beneficiary's heirs at law."

In California, a trust that is irrevocable by its terms may not be revoked by unilateral action of the grantor. Revocation may occur only in the following situations:

- If all beneficiaries consent to revocation, and the court approves revocation. Prob C §15403.
- If the grantor and *all* beneficiaries consent. Prob C §15404. If the remainder beneficiaries are unascertained or unborn, a guardian ad litem must be appointed by the court to represent them.
- If the trust has an uneconomically low principal, and the court approves its termination. Prob C §15408.
- If the court approves termination because of changed circumstances. Prob C §15409.

Under California law, as long as the trust names "residual" beneficiaries, the grantor of an irrevocable trust does not have the unilateral authority to revoke the trust.

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§26A.23 C. First Party SNT Rules

For trusts established on or after January 1, 2000, the SSI resource rules are the same as the restrictive first party rules implemented for Medicaid by OBRA 1993. See §26A.24. The SSI resource rules incorporate by explicit reference the (d)(4)(A) and (d)(4)(C) safe-harbor exceptions in 42 USC §1396p. 42 USC §1382b(e)(5). If the safe-harbor exceptions do not apply, the portion of the trust from which payments can be made to or for the benefit of the beneficiary or the beneficiary's spouse is a countable resource. 42 USC §1382b(e)(3)(B); POMS SI 01120.201D.2.

NOTE: If the trust holds title to a house as a home for the beneficiary, the house would not be a resource of the beneficiary regardless of whether the trust is a third party SNT or first party SNT. It would also not be a resource if the beneficiary moved from the house. If the trust purchases the house outright, the house would be income in the form of "in-kind support and maintenance" (ISM) in the month of purchase only. If the trust does not purchase the house outright, payment of the monthly mortgage is a disbursement from the trust to a third party that results in receipt of ISM in the form of shelter. POMS SI 01120.201I.1, SI 01120.200F. See §26A.14.

For further discussion of the (d)(4)(A) safe-harbor exception as it applies to first party SNTs, see Begley & Hook, *Drafting Issues in Self-Settled Special Needs Trusts*, 31 Est Plan 510 (Oct. 2004).

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§26A.24 D. SSI Transfer Rules

If a person disposes of resources for less than fair market value on or after a certain "look-back" date, the person is ineligible for SSI for a number of months determined by dividing the value of all gift transfers by the SSI benefit rate. The period of ineligibility, however, shall not exceed 36 months. 42 USC §1382b(c).

The SSI transfer rules are similar to the Medicaid transfer rules, but with several differences. An important distinction is that the SSI rules apply to transfers of "resources" but not "income." The Medicaid rules apply to both resources and income. See §26A.28.

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V. MEDI-CAL SPECIAL NEEDS TRUST RULES

§26A.25 A. Federal Medicaid Law

Extremely restrictive rules apply to trusts that are "established" by the applicant. Under these rules, a trust is established by the applicant if (42 USC §1396p(d)(2), (h)(1)):

- His or her assets or the spouse's assets are used to form part of the corpus; and
- Any of the following individuals establish the trust: the applicant, the applicant's spouse, a person with legal authority to act on behalf of the applicant (including a court), or a person "acting at the direction or upon the request of the individual or the individual's spouse."

If the trust established by the applicant is revocable, the corpus is considered to be an available resource, payments to or for the beneficiary are considered to be income, and payments to anyone else are considered to be transfers. 42 USC §1396p(d)(3)(A).

If the trust is irrevocable, any portion of the income or principal from which payment could be made for the applicant is considered to be an available resource. If the irrevocable trust is one from which the applicant could not benefit, any portion of the corpus or income from which no payment could be made to the applicant is considered to be a transfer as of the date of establishment of the trust. 42 USC §1396p(d)(3)(B).

The following trusts are exempt from these rules:

- A trust that contains the assets of a disabled individual under age 65, established for his or her benefit by a parent, a grandparent, a "legal guardian," or the court, if the state will receive all amounts remaining in the trust on the beneficiary's death up to the amount of Medi-Cal benefits paid. 42 USC §1396p(d)(4)(A). These trusts are commonly known as (d)(4)(A) trusts or first party SNTs.
- A trust that is composed only of pension, Social Security, and other income in a state that does not allow income "spend down" (*i.e.,* not California). 42 USC §1396p(d)(4)(B). These trusts are commonly known as "Miller Trusts" (after *Miller v Ibarra* (ED Colo 1990) 746 F Supp 19).
- A trust that contains the assets of a disabled individual if (a) the trust is established and managed by a nonprofit corporation and uses separate accounts of pooled assets; (b) the accounts are established by a parent, a grandparent, a "legal guardian," the individual beneficiary, or the court; and (c) the state will, on the beneficiary's death, receive all amounts remaining in the beneficiary's account (unless the account is retained in the trust) up to the amount of Medi-Cal benefits paid. 42 USC §1396p(d)(4)(C). These trusts are commonly known as (d)(4)(C) trusts or pooled SNTs.

It is a common misconception that a testamentary SNT must include a "(d)(4)(A) provision" directing reimbursement to DHCS for benefits paid during the existence of the trust. This is incorrect for either of two reasons. First, the rules apply to trusts established "other than by will." 42 USC §1396p(d)(2)(A).

Second, trusts established by a third party other than the applicant's spouse are not subject to the rules; therefore, they need not qualify under the "(d)(4)(A)" exception. The trust restrictions apply only to trusts established other than by will by the applicant, the applicant's spouse, a person with legal authority to act on behalf of the applicant, or a person acting at the direction or on the request of the applicant or the applicant's spouse. 42 USC §1396p(d)(2), (e)(1). On the Medi-Cal trust regulations, see §26A.26. On the use of self-settled trusts as a planning strategy for Medi-Cal eligibility, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide §§11.87-11.92 (Cal CEB 2003).

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§26A.26 B. Medi-Cal Trust Regulations

The California Department of Health Care Services (DHCS) has adopted regulations complying with the Medicaid trust rules (see 42 USC §1396p(d)) described in §26A.25. See 22 Cal Code Regs §§50489.1, 50489.5, 50489.9.

The regulations divide trusts into the following three categories:

- Medicaid Qualifying Trusts established before August 11, 1993. 22 Cal Code Regs §50489.1. See §26A.27.
- OBRA 1993 trusts established on or after August 11, 1993 (see 22 Cal Code Regs §50489.5). See §26A.28.
- Trusts other than those described in 22 Cal Code Regs §50489.1 or §50489.5 (see 22 Cal Code Regs §50489.9). See §26A.29.

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§26A.27 1. Medicaid Qualifying Trusts

The former Medicaid Qualifying Trust (MQT) rules (former 42 USC §1396a(k)(1)) that were repealed by the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) are restated in 22 Cal Code Regs §50489.1. These rules still apply to trusts established before August 11, 1993.

An MQT is a trust "or similar legal device" established (other than by will) by an individual or individual's spouse with their assets under which (22 Cal Code Regs §§50489(b)(10), 50489.1(a)):

- The individual may be the beneficiary of all or part of the payments from the trust; and
- The trustee has discretion in distributing funds of the trust.

Contrary to what its name suggests, the MQT is a trust that *disqualifies* the beneficiary from receiving Medi-Cal benefits.

Under Medi-Cal, the maximum amount that the trustee could distribute to the individual or individual's spouse if the trustee were to exercise its full discretion is deemed an available resource. There is no requirement that the trustee actually exercise its discretion—only that the trustee have the power to do so.

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§26A.28 2. OBRA 1993 Trusts

Title 22 Cal Code Regs §50489.5 applies to a trust or "similar legal device" established (other than by will) by an individual (or an individual's spouse) on or after August 11, 1993, that does not satisfy any of the exempt trust exceptions of 22 Cal Code Regs §50489.9. See §26A.27.

If the trust is irrevocable, the portion of the trust income or principal from which payments could be made under any circumstance to the individual or the individual's spouse will be considered to be available resources. Title 22 Cal Code Regs §50489.5(f)(4) differs from OBRA 1993 by:

- Providing that the value of the assets transferred includes the amount of assets used to establish the trust *and* any assets added to that portion;
- Looking only to those portions of the trust that cannot benefit the applicant or spouse; and
- Eliminating the OBRA 1993 provisions for determining the date of transfer.

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Source: Estate Planning/California Estate Planning/26A Special Needs Trusts/§26A.29 3. Third Party Trusts and Exempt Trusts

§26A.29 3. Third Party Trusts and Exempt Trusts

The types of trusts that will preserve the Medi-Cal eligibility of the beneficiary are contained in 22 Cal Code Regs §50489.9. Third party SNTs and LSNTs are covered under the provisions of this section.

Third party SNTs are included under a catchall definition as "[t]rusts that are not described in Section 50489.1 or Section 50489.5." 22 Cal Code Regs §50489.9(a)(1). If the trust is irrevocable, the trust assets are not available until distributed. 22 Cal Code Regs §50489.9(b)(2). Under the regulation, the only requirements for a third party SNT are that it be a trust not described in 22 Cal Code Regs §50489.1 or §50489.5 (which it is) and that the trust be irrevocable. Presumably, the beneficiary might have the power to direct the trustee regarding distribution of assets, and the assets would still be unavailable to the beneficiary. Prudent practitioners, however, ensure that any third party SNT conforms to the SSI first party SNT rules. See §26A.23.

NOTE: Title 22 Cal Code Regs §50489.9(d)(2) requires that DHCS be notified by the trustee upon the death of the trust beneficiary, termination of the trust, or change of trustee. It is unclear why the regulation requires notice on the change of a trustee, because the DHCS has no right of reimbursement at that time. Nevertheless, prudent practitioners include this requirement in the notice requirements of the trust instrument. The notice requirements on death of the beneficiary or termination of the trust duplicate the notice provisions of Prob C §3605(c).

Title 22 Cal Code Regs §50489.9(a)(3)(A) clarifies that the assets in an LSNT established for a person under age 65 will remain sheltered as long as the beneficiary continues to be disabled after attaining age 65.

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§26A.30 C. Medicaid Transfer Rules

Like the SSI transfer penalties, the purpose of the Medicaid transfer rules is to disqualify individuals who have made gifts of their assets so as to qualify for Medicaid benefits.

If a person disposes of resources for less than fair market value on or after a certain "look-back" date, the person is ineligible for Medicaid for a number of months determined by dividing the value of all gift transfers by the SSI benefit rate. The maximum period of ineligibility is 60 months (36 months for transfers not in trust made before February 8, 2006). 42 USC §1396p(c)(1)(B).

WARNING: The period of ineligibility for long-term care is calculated by dividing the value of the transferred assets by the statewide average private-pay rate for nursing facility services. An ineligibility period resulting from asset transfers made on or after February 8, 2006, apparently will begin when the applicant is institutionalized and already otherwise eligible. 42 USC §1396p(c)(1)(D)(ii). Therefore, any applicant who makes a transfer on or after that date and less than 5 years before otherwise eligible for benefits will confront a penalty period that begins when the applicant has virtually no remaining assets and is probably already receiving long-term care.

The Medicaid transfer rules are similar to the SSI transfer rules (see §26A.23), but with several differences. An important distinction is that the Medicaid rules apply to both "resources" and "income." The SSI rules apply to transfers of resources but not income.

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VI. STATUTORY "SPENDTHRIFT" PROTECTION

§26A.31 A. Liability of Trust for Reimbursement When Required by Statute

If a public benefits recipient is the beneficiary of a trust (even a trust with a "spendthrift" clause) and a California statute makes the beneficiary liable for reimbursement for services, then the appropriate state or county representative may bring a petition under CCP §709.010 for reimbursement from the trust. Prob C §15306(a). There is a big exception to this requirement: There is no liability for reimbursement if the trust is established for the benefit of an individual who has a disability that substantially impairs the individual's ability to provide for his or her own care or custody and constitutes a substantial handicap. Prob C §15306(b). See §26A.32.

Probate Code §15306(a) provides for reimbursement in three situations:

(1) If the beneficiary has the right to compel the trustee to make payments, then the court may order the trustee to make reimbursements from the trust "as [*the payments*] become due."

(2) If the beneficiary has no right to compel the trustee to make payments, then the court may order reimbursements out of any discretionary payments that the trustee does make.

(3) If the beneficiary is the spouse or minor child of the settlor (testator) and does not have the right to compel distributions from the trust, the court can compel the trustee to make reimbursements from trust funds to the extent that the trustee has the discretionary power to make payments to or for the beneficiary.

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§26A.32 B. Exemption From Reimbursement Liability of Most Special Needs Trusts for Disabled

Probate Code §15306(b) substantially limits the court's authority to order reimbursements under Prob C §15306(a) (discussed in §26A.31) when the trust beneficiary is disabled. Probate Code §15306(a) does not apply

> to any trust that is established for the benefit of an individual who has a disability that substantially impairs the individual's ability to provide for his or her own care or custody and constitutes a substantial handicap.

According to Cal L Rev'n Comm'n Comment to Prob C §15306, this limitation is intended to encourage potential settlors to provide in trust for the care or support of a disabled person without the risk that the property of the trust will be taken to reimburse a public agency for the support it provided.

The second sentence of Prob C §15306(b) provides that if a trust results in an individual's ineligibility for public social services under Welf & I C §§10000-18991, then the first sentence of Prob C §15306(b), which exempts trusts for disabled persons from reimbursement obligations, does not apply. The cited Welfare and Institutions Code sections provide for benefits under the State Supplementary Program (the state supplement to SSI) and Medi-Cal, among other programs.

Consequently, if the third party SNT accomplishes its intended purpose of maintaining the beneficiary's financial eligibility for public benefits, assets of the trust should not be subject to the claims of public agencies.

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VII. DRAFTING CONSIDERATIONS

§26A.33 A. Necessary and Recommended Clauses

The remainder of this chapter discusses drafting considerations for third party SNTs intended to receive donative transfers for the benefit of a public benefits recipient. These considerations apply to inter vivos revocable or irrevocable trusts and testamentary trusts. For further discussion and forms, see Special Needs Trusts: Planning, Drafting, and Administration (Cal CEB 2008); Drafting California Revocable Trusts §§7.95-7.110 (4th ed Cal CEB 2003); California Will Drafting, chap 23 (3d ed Cal CEB 1992).

The special needs trust provisions are usually contained in a separate trust document or in a separate division of the transferor's will or trust document. The document or division should be titled as a special needs trust because most SSI and Medi-Cal offices are familiar with the term. Like an LSNT, a third party SNT must be irrevocable and unamendable. However, it may be helpful to provide a limited power of amendment to comply with any changes in the public benefit laws affecting trusts.

The document usually contains a statement of purpose that tracks the language of Prob C §15306(b) (see §26A.32) to establish that the trust should be exempt from reimbursement claims under Prob C §15306(a). The statement of purpose should describe the disability of the special needs beneficiary. The special needs beneficiary may be the sole beneficiary of the trust, or the trustee may have the power to make distributions to or for any one of a number of trust beneficiaries, in which case the purpose of the trust as a special needs trust will be with regard to the identified disabled or aged beneficiary only and the distribution clause will be a "sprinkling" clause that does not require distributions to the disabled or aged (or any other) beneficiary.

To avoid having the trust assets counted as income or a resource to the beneficiary, or as a source of reimbursement to a government agency for benefits rendered, the trust document must explicitly direct the trustee to use the trust assets as a supplement to, rather than a replacement for, public benefits.

A "spendthrift" clause is necessary to protect trust assets against the claims of third parties, including government agencies. Unless otherwise provided by statute (see §26A.31), a restriction in a trust instrument on voluntary or involuntary transfers by the beneficiary is enforceable with respect to undistributed income (Prob C §15300) and principal (Prob C §15301).

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§26A.34 B. Distribution Standard

The distribution standard of an SNT is often the most important provision in the entire SNT. The distribution standard will affect whether the trust "works" for the disabled beneficiary, in two ways:

- Too broad a distribution standard will, in some jurisdictions, cause the trust to be considered an available resource for some needs-based public benefit programs, and disqualify the beneficiary simply by the trust's existence, whether or not distributions are actually made.
- Too narrow a distribution standard restricts the trustee from enhancing the dignity and quality of life of the disabled beneficiary in the most effective manner.

Typically, the main purpose of an SNT is to supplement needs-based government benefits, without supplanting them. Trust assets should not be used to provide food or shelter for the beneficiary, unless the practitioner is aware of the consequences of doing so: If the trustee pays for food or shelter, it will cause a reduction or even elimination of some needs-based public benefits. See §26A.14.

However, much greater flexibility (especially in the area of housing) makes a fully discretionary distribution standard desirable in most circumstances. There is some concern that a government agency (or new regulations) may, in the future, deem the more flexible discretionary distribution standard exercised and cause a reduction or elimination in benefits, even if the trust assets are not used for food or shelter. The SNT, however, at that point could be modified to comply with changes in the law to reduce the discretion available to the trustee. See *In re Riddell* (Wash App 2007) 157 P3d 888, in which the trial court denied a request to modify a trust to create a special needs trust. The trust allowed the trustee to make distributions for the health, education, support, and maintenance of the beneficiary, and the trial court reasoned that the proposed modification would not further the settlors' purpose because it would only "permit [the family] to immunize itself financially from reimbursing the State for the costs of [the beneficiary's medical] care." The appellate court remanded the case to the trial court to reconsider the issue of whether the proposed modification would satisfy the equitable deviation test on the basis of unanticipated circumstances. See Restatement (Third) of Trusts §66(1), Comment a (2001). The trial court stated in an oral ruling that there was a showing of changed circumstances because the settlors were unaware of the beneficiary's severe disabilities. The appellate court stated: "The law invites, rather than discourages, the creation of special needs trusts in just this sort of situation." 167 P3d at 893.

Distributions for medical expenses should not be permissible if the beneficiary is otherwise eligible for Medi-Cal unless they are to pay for items not covered by Medi-Cal. 20 CFR §416.1102.

Examples of special needs should illustrate specific needs of the beneficiary that are generally unavailable from public resources. These examples should be tailored to the anticipated supplemental needs of the beneficiary. The distribution provisions create some flexibility to allow the trustee to forgo public benefits if determined necessary by the trustee. However, some clients will prefer more direct language authorizing the trustee to make distributions to pay for specific needs of the beneficiary, if the public benefits available for such needs are inadequate to ensure the beneficiary's good health, safety, and welfare.

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§26A.35 C. Trust Advisory Committee

A trust advisory committee is often used in SNT planning. Because the trustee normally has such broad discretion on distributions, it is often a good idea to have a system of checks and balances of management for an SNT. Moreover, because of the highly complex area of SNT administration, a trustee of an SNT is often a corporate fiduciary or private professional fiduciary. A trust advisory committee can be a safeguard against any professional trustee failing to perform its duties.

The trust advisory committee also may assist the trustee with decisions on distributions for the disabled beneficiary. The members of a trust advisory committee are typically family and friends of the beneficiary and sometimes professional members. The family and friends on the advisory committee may assist the trustee in understanding the needs of the disabled beneficiary and provide a voice for him or her. The professional members can be licensed clinical social workers who can provide expert management for the care of a disabled beneficiary, consultants familiar with Social Security Administration and Department of Health Service regulations to make sure distributions do not run afoul of public benefit rules regarding income and resources, or financial professionals who can design an investment strategy for the disabled beneficiary.

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§26A.36 D. Requirement to Seek Public Benefits

In directing the trustee to consider the applicable resource and income limitations of the public benefit programs for which the beneficiary is eligible (see §26A.33), the trustee is alerted not to make distributions from the trust that may constitute unearned income to the beneficiary and cause a reduction in benefits or a loss of eligibility for SSI and other benefits. The trust document may expand the trustee's fiduciary duty by requiring the trustee to apply for public benefits on behalf of the beneficiary.

Traditionally, trustees have discharged their responsibility to conserve trust corpus and to produce reasonable growth in the value of trust assets through investments. The clause requiring the trustee to apply for public benefits indirectly accomplishes the goal of preserving trust assets by attempting to fund the beneficiary's needs with resources obtained outside the trust. If the outside resource is SSI, the savings may be even more significant because SSI benefits are not subject to income tax.

Requiring the trustee to seek public benefits on behalf of the beneficiary may place a greater responsibility on trustees than they are willing to bear. The trustee may lack standing to seek public benefits for the beneficiary, the beneficiary may be uncooperative in the application process, or required confidential financial and medical records may be unobtainable by the trustee.

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§26A.37 E. Termination on Death of Beneficiary

The provision for termination on the death of the beneficiary marks the principal difference between a third party SNT and an LSNT. When drafting a third party SNT, the attorney need not give the beneficiary a testamentary special power of appointment to avoid making a completed gift on the funding of the trust, as required for an LSNT. See IRS Letter Ruling 9437034. Such a power may be included, of course, if the settlors wish the beneficiary to have a power to appoint on death.

In addition, there is no requirement that on the death of the beneficiary or other termination of the trust, the trustee reimburse the California Department of Health Services for medical assistance paid on behalf of the beneficiary. Consequently, the LSNT clause regarding compliance with federal law should not be included in a third party SNT. Generally, the assets in a third party SNT are not liable for the beneficiary's debts after death, because they are not part of his or her estate against which a creditor can make claims.

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§26A.38 F. Backstop Termination Clause

If assets in the trust are determined to be an available resource to the beneficiary and cause the loss of public benefits, the trustee may be granted the discretion to terminate all or part of the trust. If the trust has multiple beneficiaries, the clause may not terminate the trust itself but only the trustee's power to distribute to the disabled or aged beneficiary.

On termination of the trust, the terminated portion is usually distributed in the same manner as directed in the termination on death provision. The termination and distribution to remainder beneficiaries may result in a taxable gift by the beneficiary. The trustee may therefore need to make provisions for payment of gift taxes. Furthermore, the "transfer" may be considered a transfer by the beneficiary and result in a disqualification period before the beneficiary is eligible for public benefits. This is much less likely with a third party SNT than with a first party SNT.

The persons who receive the funds may be requested to keep and conserve them for the disabled person but are under no legal obligation to do so. Because there is a risk of misappropriation, the backstop termination clause usually requires prior court approval for termination of any portion of the trust.

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Disclaimers: Predeath Planning

Jeffrey A. Dennis-Strathmeyer

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§27.1 I. BASIC DEFINITION; APPLICABLE LAW

In the estate planning context, a "disclaimer" is essentially an unqualified refusal to accept an interest in property. The California Probate Code uses the term "disclaimer" more narrowly to refer to the writing that declines, refuses, renounces, or disclaims the interest (Prob C §265), but as a practical matter this distinction is immaterial, because a writing is required for a disclaimer under both IRC §2518(b)(2) and Prob C §§265 and 278.

California laws concerning disclaimers are codified in Prob C §§260-295. For federal transfer tax purposes, the primary statute applicable to disclaimers of transfers occurring after 1976 is IRC §2518. In rare cases, it is still possible to disclaim an interest in a transfer that occurred before 1977. These cases usually involve a person who did not know he or she had future interest rights under an old trust until the recent death of another beneficiary. Disclaimers of such interests are governed by Treas Reg §25.2511-1(c). This chapter focuses on planning for future disclaimers under future estate plans and therefore does not discuss Treas Reg §25.2511-1(c).

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§27.2 II. CALIFORNIA LAW CONSEQUENCES OF DISCLAIMER

If a disclaimer satisfies the requirements of Prob C §§260-295, a "disclaimant" (*i.e.,* a beneficiary who executes a disclaimer for himself or herself or a person who executes a disclaimer on behalf of a beneficiary; see Prob C §264) will be treated as never having owned the transferred property for any state law purpose. The disclaimer is irrevocable and binding on the beneficiary and all persons claiming by, through, or under the beneficiary. Prob C §281. The statute expressly provides that the disclaimer is binding on creditors (Prob C §281) and does not constitute a fraudulent conveyance (Prob C §283). Despite this protection from creditors, a federal tax lien is nonetheless enforceable against disclaimed property. *Drye v U.S.* (1999) 528 US 49, 145 L Ed 2d 466, 120 S Ct 474.

If the property is disclaimed, the transfer either fails or the disclaimed property or interest passes to an alternate taker. Unless the creator of the interest provides for a specific disposition in the event of a disclaimer, the interest is distributed or continued to be held (Prob C §282(a)):

- With regard to a present interest, as if the disclaimant had predeceased the creator of the interest; or
- With regard to a future interest, as if the disclaimant had died before the event determining that the taker of the interest had become finally ascertained and the taker's interest indefeasibly vested.

A disclaimer generally relates back for all purposes to the date of the death of the creator of the disclaimed interest for a present interest, or to the determinative event for a future interest. Prob C §282(a). But see Prob C §282(b) for certain limitations.

The California statute fails to consider the consequences of a disclaimer that does not satisfy statutory requirements. If the purported disclaimant was not concerned about accepting ownership of the property, it would seem appropriate to treat the disclaimer as a conveyance to the holders of the other interests in the property, *e.g.,* the other trust beneficiaries. There may be other circumstances in which a attempted disclaimer that does not meet statutory requirements should be treated as a nullity on the ground of mistake.

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§27.3 III. FEDERAL TAX LAW CONSEQUENCES OF "QUALIFIED" DISCLAIMER

Under IRC §2518(a) (incorporated by reference for estate tax purposes by IRC §2046):

> For purposes of this subtitle [Subtitle B], if a person makes a qualified disclaimer with respect to any interest in property, this subtitle shall apply with respect to such interest as if the interest had never been transferred to such person.

This reference effectively applies the statute to estate, gift, and generation-skipping transfer taxes, but excludes income taxes (Subtitle A). The most significant consequence of the statute is the fact that a person who makes a "qualified" disclaimer is not only not treated as ever having received the property, but is also not treated as making a taxable transfer to the persons who receive the property instead. For requirements for a qualified disclaimer, see §§27.12-27.23.

EXAMPLE: Assume that Decedent's will devises Blackacre to Child if living and otherwise to Grandchild. The will contains no special provision for disposing of Blackacre in the event of a disclaimer by a child. Child disclaims the transfer. As a result of the application of Prob C §282(a) (see §27.2), Blackacre is distributed to Grandchild. As a result of the application of IRC §2518(a), Decedent is treated as making a transfer directly to Grandchild for all transfer tax purposes. Child is not treated as making a gift. Decedent is treated as making a direct skip generation-skipping transfer to Grandchild (a potentially favorable result if Decedent has enough GST exemption available to eliminate the GST tax).

Income tax consequences of disclaimers are less certain. As a general rule, income from property is normally taxed to the owner of the property. At least in cases involving disclaimers made within a short period of time, the IRS seems content to treat the transfer tax rule (that disclaimed property is never owned by the disclaimant) as determinative of ownership for income tax purposes. If a disclaimer were to be made after many years—a possibility if the disclaimant was a minor at the time of the transfer—the IRS might take a different view.

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IV. COMMON ESTATE PLANNING USES FOR DISCLAIMERS

§27.4 A. Solutions Available Without Pre-Transfer Planning

This chapter focuses on disclaimer uses that result from intentional pre-transfer planning. Nevertheless, it is important to note that imaginative planners have frequently found ways to make valuable use of disclaimers even in the absence of any pre-transfer considerations. Indeed, many an estate planning disaster has been repaired, or at least ameliorated, by using disclaimers.

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§27.5 1. Salvaging Marital Deduction

In some cases, a bequest fails to qualify for the estate tax marital deduction, either because interests in the property pass to persons other than the spouse during the lifetime of the spouse or because the spouse's interest is subject to a condition not permitted by IRC §2056. Sometimes these problems can be addressed by a relatively simple disclaimer. In extreme cases, it is sometimes possible to convert a disposition to a nonqualifying trust into a qualifying transfer to the spouse under the laws of intestate succession by obtaining disclaimers from all of the trust beneficiaries.

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§27.6 2. Using GST Exemption

Under many wills and under the law of intestate succession, a child of a decedent can effectively redirect a transfer from the child to grandchildren by making disclaimers. Assuming the decedent has unused GST exemption that can be applied to avoid incurring GST tax, the disclaimer provides the opportunity to avoid the estate or gift tax that would otherwise be imposed if the property passed to the child and was then retransferred from the child to the grandchild.

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§27.7 3. Accelerating Distributions to Remainder Beneficiaries

A combination of tax and personal motives creates situations in which the lead beneficiary of a trust will want to immediately pass all or a fractional share of the trust to remainder beneficiaries. This use of disclaimers is particularly common if a decedent's property is left in trust for the benefit of the decedent's elderly sibling for life with remainder to the sibling's children.

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§27.8 4. Fixing Unfair Distributions

In some cases, a decedent will leave assets in a manner viewed as unfair by a named beneficiary, but acceptance and retransfer by the beneficiary would have undesirable gift tax consequences. For example, an estate might pass to only one of several children. Or, perhaps, it is not altogether clear whether the beneficiary may actually be under a legal obligation to redistribute the estate. A disclaimer may provide the solution.

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§27.9 5. Dead or Dying Beneficiary

If the original beneficiary has a short life expectancy, transfer taxes can sometimes be lowered by a disclaimer. If necessary, the disclaimer can be made, with the court's permission, by the beneficiary's personal representative. Prob C §277(b).

EXAMPLE: Husband and Wife have $10 million of community property. For better or worse, the estate plan directed the IRC §2010 applicable credit amount to a bypass trust and the balance to the spouse or a trust revocable by the spouse. Husband dies and Wife is terminally ill. Without a disclaimer by Wife or a representative of Wife or her estate, Wife's taxable estate will be much larger than Husband's. Because the estate tax has progressive rates, the total tax bill for both estates can be lowered by having Wife disclaim enough property to enlarge Husband's estate to an approximately equal size. Property that would otherwise be taxed at the maximum rate in the Wife's estate is taxed instead in lower brackets in the Husband's estate.

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§27.10 6. Unexpected Creditor Problems

Occasionally, property passes at death to a person who has serious creditor problems. California law expressly provides that the disclaimer is binding on creditors and does not constitute a fraudulent conveyance. Prob C §§281, 283. Further, a disclaimer relates back for all purposes to the death of the creator (or other date of transfer). Prob C §282(a). These rules not only allay fraudulent conveyance concerns, but presumably prevent attachment of liens other than federal tax liens. The latter are enforceable against disclaimed property. *Drye v U.S.* (1999) 528 US 49, 145 L Ed 2d 466, 120 S Ct 474.

Accordingly, there may be occasions when a beneficiary with creditor problems may choose to disclaim an inheritance if the disclaimer results in property passing to the beneficiary's children or other objects of the beneficiary's affection. The disclaimer may be ineffective, however, when a beneficiary becomes entitled to an inheritance within 180 days after petitioning for bankruptcy and the inheritance would otherwise become part of the bankruptcy estate. 11 USC §541(a)(5)(A). See §26.13.

It is important to note that disclaimer by a debtor may raise the possibility that the debtor and the person taking as a result of the disclaimer have made an agreement concerning the future use of the inheritance. Any such agreement will invalidate the disclaimer because it constitutes a voluntary assignment that is a prohibited "acceptance" of an interest in the property. See Prob C §285(b)(1); IRC §2518(b)(3). For federal tax purposes, the agreement also violates the rule that the property pass "without any direction on the part of the person making the disclaimer." IRC §2518(b)(4). See further discussion of disclaimers for creditor avoidance in §§26.9-26.13.

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§27.11 B. Solutions Available by Design

Opportunities to use postdeath disclaimers are extremely limited in the absence of predeath planning. When the predeath plan fails to expressly address the distribution and tax apportionment consequences of a disclaimer, the federal rule that disclaimed property must pass without the direction of the person making the disclaimer will often present insurmountable problems. IRC §2518(b)(4). Consider, for example, a situation in which a decedent's children would like to disclaim a small interest in a defective trust so that the transfer qualifies for the marital deduction. Unless the instrument expressly provides for disposition in event of a disclaimer, the disclaimed interest will pass as if the disclaimant predeceased the decedent. Commonly, the interest then passes to grandchildren, who may be minors or uncooperative. Even if they cooperate or a guardian ad litem makes the disclaimer for a minor, the result may be to pass the interest to a more distant relative. In many cases, disclaimers are precluded by the fact that those who would take in the event of a disclaimer are not the objects of the disclaimant's bounty. Surviving spouses, for instance, rarely make disclaimers that transfer property to the decedent's issue by prior marriage.

Predeath planning for disclaimers involves drafting distribution and tax apportionment provisions that apply only in the event of a disclaimer and allow favorable changes in distribution arrangements that otherwise would not be available. Frequently, such provisions are designed to facilitate the same kinds of solutions described in §§27.4-27.10.

In other cases, the objectives may be more exotic. For example, the uncertainties of life, the ever-changing applicable credit amounts (IRC §2010), and the possibility that income tax basis rules will be supplanted if the estate tax ends (IRC §§1014, 1022) have placed a premium on estate plan flexibility. In appropriate cases, planners are using "disclaimer trusts" to provide that flexibility. Such trusts allow a surviving spouse to convert an outright devise from the decedent into a trust that benefits the spouse but will not result in inclusion in the spouse's estate. See §§27.25-27.27.

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Source: Estate Planning/California Estate Planning/27 Disclaimers: Predeath Planning/§27.12 V. ANTICIPATING DISCLAIMER REQUIREMENTS

§27.12 V. ANTICIPATING DISCLAIMER REQUIREMENTS

Superficially, the requirements for making a "qualified" disclaimer for federal transfer tax purposes are straightforward. There must be a written irrevocable and unqualified refusal to accept an interest in the property. IRC §2518(b). Usually, the writing must be delivered to the executor or other appropriate persons within 9 months of the date of the transfer. IRC §2518(b)(2); Treas Reg §25.2518-2(b). See §27.13. No disclaimer can be made after the potential disclaimant has accepted an interest in the transfer. IRC §2518(b)(3). See §27.14. Special rules apply if the beneficiaries want to disclaim some interests in transferred property but not all of them. See §§27.15-27.19. Closer examination reveals that some of these rules are indeed simple, but others are complex. The discussion in §§27.13-27.23 focuses on issues relevant during predeath planning and does not significantly address such postdeath administration issues as contents of the disclaimer document and delivery and filing requirements for disclaimer documents.

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§27.13 A. Writing and Time Deadline

Disclaimers must be made in a writing signed by the disclaimant or a person authorized to act on behalf of the disclaimant under state law. See IRC §2518(b); Prob C §§277(b), 10519. An agent under a power of attorney can execute the disclaimer only if the instrument appointing the agent expressly confers this power or with court approval. Prob C §4264(d). A court order authorizing the disclaimer is required when a disclaimer is signed by a conservator, guardian, guardian ad litem, or the personal representative of the estate of a deceased beneficiary. Prob C §§276-277. The disclaimer must be delivered within 9 months of death (or other date of transfer) to "the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which it relates, or the person in possession of such property." Treas Reg §25.2518-2(b). California law provides for "filing" the disclaimer and provides the option of filing with the superior court. Prob C §280(a)(1). It is not clear that a filing with the superior court is always sufficient for federal tax purposes. In cases in which the disclaimant has title or possession, it is prudent to both execute a conveyance or deliver possession and also execute a document that meets the modest requirements of Prob C §278: identification of the creator of the interest; a description of the interest to be disclaimed; and a statement of the disclaimer and the extent of the disclaimer. In IRS Letter Ruling 200437032, the IRS ruled that a vow of poverty by a member of a religious order that was entitled to a residuary devise in the event of a disclaimer by the member was not a qualified disclaimer because the member did not transfer the property or otherwise make an effective disclaimer under state law. There is no filing issue in cases in which the disclaimant has title or possession because Prob C §280(a)(3) allows the disclaimer to be filed with "[a]ny other person having custody or possession of or legal title to the interest."

Except in the case of disclaimers by persons under age 21, the 9-month deadline cannot be extended. If the disclaimant is under age 21, the 9-month limitation is tolled until 9 months after that age is attained. IRC §2518(b)(2)(B). This extension applies only if the person does not accept the transfer in the meantime. The regular 9-month period begins on the date of the transfer—not on the date the particular beneficiary is entitled to enjoy the property. If, for example, the decedent's will creates a trust that pays income to *A* for life with remainder to *B*, *B* must disclaim within 9 months of the decedent's death—not 9 months after *A*'s death. See Treas Reg §25.2518-2(c)(3).

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§27.14 B. No Acceptance

One of the biggest dangers for estate planning strategies that rely on disclaimers is the risk that the potential disclaimant will "accept" the transferred interest "or any of its benefits." Any acceptance precludes a later disclaimer. IRC §2518(b)(3); Prob C §285. Treasury Regulation §25.2518-2(d)(1) provides in part:

> Acts indicative of acceptance include using the property or interest in property; accepting dividends, interest, or rents from the property; and directing others to act with respect to the property or interest in property. However, merely taking delivery of an instrument or title, without more, does not constitute acceptance.

Generally speaking, the IRS has made a reasonable effort to moderate the risk of an inadvertent acceptance of property—particularly in situations likely to arise with community property. For example, a surviving co-owner of a residence will not be deemed to accept a decedent's interest in the same residence just because the surviving co-owner occupies the residence and pays the taxes. Treas Reg §25.2518-2(d)(1), (d)(4), Examples 3, 8. Similarly, withdrawals from a co-owned financial institution account normally will not be treated as acceptance of the account if the withdrawals do not exceed the share that belonged to the survivor before death. See Treas Reg §25.2518-2(c)(4)(iii).

Actions taken in a fiduciary capacity generally do not constitute an acceptance even when the fiduciary is the disclaimant or the legal representative of the disclaimant. For example, actions taken by a guardian of a minor do not constitute acceptance by the minor. Treas Reg §25.2518-2(d)(2)-(3). It is also important to keep in mind that acceptance of one interest in a property generally is not the acceptance of a different interest *if,* under other rules regarding disclaimers, the disclaimant has a right to disclaim one interest while retaining the other. See §27.19.

Because of the risks created by the "acceptance" rules, estate planning strategies involving disclaimers are less appropriate if safer alternatives are available. Further, the planner must recognize that the risk of inadvertent acceptance is greatly increased if the planner cannot be reasonably sure that the survivors will immediately seek competent professional advice after the client's death.

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Source: Estate Planning/California Estate Planning/27 Disclaimers: Predeath Planning/§27.15 C. Separate Interests and Severable Property

§27.15 C. Separate Interests and Severable Property

In some cases, a beneficiary can disclaim one interest in property and retain another. IRC §2518(c); Treas Reg §25.2518-3. It is also important to determine for disclaimer purposes whether one is dealing with a single item of property or multiple items. A planner must understand these rules because the terms of the instrument creating the relevant interests will have a direct impact on the ability of the future beneficiary to make partial disclaimers.

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§27.16 1. Undivided Portions

Generally, the beneficiary can always disclaim an undivided portion of a separate interest in property on a fractional share basis. Treas Reg §25.2518-3(b). The disclaimer must be of a fraction of each and every substantial interest or right. The beneficiary cannot, for example, attempt to accept a life estate and disclaim a remainder interest if these interests were not separately created by the transfer instrument.

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§27.17 2. Severable Property

Severable property is property that can be divided into separate parts that each maintain a complete and independent existence after severance. Treas Reg §25.2518-3(a)(1)(ii). For example, a beneficiary of shares of corporate stock may accept some shares and make a qualified disclaimer of the remaining shares.

Presumably, this rule is applied based on the state of property at the time of death. For example, the surviving spouse may be able to disclaim the farm house and not the farm if the farm house is a separate legal parcel at the time of death, but not otherwise.

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§27.18 3. Trust Assets

Generally, a trust beneficiary only has an interest in the trust as a whole. The assets are not severable, and the beneficiary has no ability to disclaim some assets and not others. Treas Reg §25.2518-3(a)(2). The general rule can be circumvented in two ways. First, the trust instrument might provide that, in the event of a disclaimer of an undivided portion of the trust, the trust is to be divided into two trusts in order to reflect the disclaimer. In that event a friendly trustee might allocate a particular asset in a way that reflects the wishes of the beneficiaries. An alternative is provided by Treas Reg §25.2518-3(a)(2), which permits disclaimers of specific trust assets if the assets are thereby "removed from the trust and pass, without any direction on the part of the disclaimant, to persons other than the disclaimant or to the spouse of the decedent."

NOTE: Although the awkward construction at the end of the quote could be read to say that assets can pass "to persons other than… to the spouse of the decedent," it is intended to be consistent with the general rule (IRC §2518(c)(4)(A)) that property disclaimed by a spouse can pass back to the spouse. See §27.23.

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§27.19 4. Separate Interests

Generally, each separate interest created by the transfer is something that may be disclaimed without also disclaiming other interests or powers. Treas Reg §25.2518-3(a)(1)(i). For example, if an income interest in securities is given to *A* for life, then to *B* for life, with the remainder to *A*'s estate (and the remaining requirements of IRC §2518(b) are satisfied), *A* could make a qualified disclaimer of the income interest or the remainder, or an undivided portion of either interest. However, *A* could not disclaim the income interest for a certain number of years. Treas Reg §25.2518-3(a)(1)(i). In addition, when local law merges interests separately created by the transferor, a qualified disclaimer is allowed only if the entire merged interest or an undivided portion of the merged interest is disclaimed. Treas Reg §25.2518-3(a)(1)(i).

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§27.20 5. Disclaimers of Pecuniary Amounts

It is possible to disclaim a pecuniary amount out of a pecuniary or nonpecuniary bequest. The amount disclaimed and the income attributable to that amount must be segregated from the undisclaimed property. Treas Reg §25.2518-3(c). A disclaimer of a pecuniary amount may be easier to administer than a disclaimer of an undivided share in cases in which the disclaimer relates to a trust that owns difficult-to-value assets. Further, if the amount that can be disclaimed is limited by tax considerations (*e.g.,* the amount is to equal the IRC §2010 applicable credit amount or the IRC §2631 GST exemption amount), a pecuniary disclaimer may result in more property passing to the persons benefiting from the disclaimer if the value of trust assets has decreased.

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§27.21 6. Powers of Appointment

A power of appointment is treated as a separate interest in property. Treas Reg §25.2518-3(a)(1)(iii). The rule is straightforward if the disclaimant seeks to disclaim the power of appointment but retain other interests. If the disclaimant wants to disclaim other interests and retain the appointment power, however, the disclaimer may fail on the separate ground that the disclaimant controls disposition of the disclaimed interests in violation of the "passing without direction" rule discussed in §27.22. See IRC §2518(b)(4).

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§27.22 D. Passing Without Direction

A disclaimer is not qualified unless the property "passes without any direction on the part of the person making the disclaimer." IRC §2518(b)(4). The disclaimer fails if the disclaimant, either alone or in conjunction with others, directs the redistribution of the property, *or retains the power to do so.* The regulations provide an important exception to this rule that does not appear in the statute. The disclaimant can retain a fiduciary power to make distributions to designated beneficiaries "if the power is subject to an ascertainable standard." Treas Reg §25.2518-2(e)(1). The regulation does not expressly require that the "ascertainable standard" be related to health, education, maintenance, or support, but it appears that such a requirement was intended because the power used in the example that illustrates the rule is limited to health, maintenance, or support. Treas Reg §25.2518-2(e)(5), Example 12.

Under Treas Reg §20.2041-1(c)(2):

> *Powers limited by an ascertainable standard*. A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment. A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them). As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life. A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by the requisite standard. Examples of powers which are limited by the requisite standard are powers exercisable for the holder's "support," "support in reasonable comfort," "maintenance in health and reasonable comfort" "support in his accustomed manner of living," "education, including college and professional education," "health," and "medical, dental, hospital and nursing expenses and expenses in invalidism." In determining whether a power is limited by an ascertainable standard, it is immaterial whether the beneficiary is required to exhaust his other income before the power can be exercised.

The ascertainable standard rule results in a "good news-bad news" situation. The bad news is that a person making a disclaimer cannot retain a less restricted power of distribution. Most notably, the disclaimant cannot retain a power to appoint a trust remainder at death. On the other hand, considerable flexibility is provided by the fact that a disclaimant can disclaim an interest in a trust and still be the trustee of that trust and, in that capacity, exercise discretionary powers to make distributions for health, education, maintenance, and support. If the disclaimant is the spouse, the spouse can even retain the power to make such distributions to himself or herself. See §27.23.

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§27.23 E. To Spouse or Person Other Than Disclaimant

Generally, a disclaimer is not qualified unless it results in the property passing to someone other than the disclaimant. IRC §2518(b)(4)(B). However, this limitation does not apply to the decedent's spouse. IRC §2518(b)(4)(A). At first glance, it would seem to make little sense for a spouse (or any other beneficiary) to make a disclaimer in a way that results in the property not passing to a different person, but in fact this can be extremely useful if the disclaimer results in a change of property interests. The result can be an end run around the separate interest rules. As noted in §27.25, it is possible to provide in a plan document that a disclaimer of an outright transfer to a spouse will result in the property passing to a trust that names the spouse as trustee, and permits the spouse to distribute income and principal to himself or herself for health, education, and support. If the trust is properly drafted, the trust estate will not be included in the spouse's estate.

Note that when the trust instrument provides for the creation of such a trust, the "to the spouse of the decedent" rule is not only an exception to the "person other than the disclaimant" rule, but also, albeit implicitly, an exception to the "separate interest and severable property" rules described in §§27.15-27.17. The initial transfer may only provide the spouse with a single interest (*e.g.,* a fee simple interest in Blackacre), but the terms of the instrument can create the necessary separate interests.

A disclaimer made by a person other than the surviving spouse is not qualified if the disclaimant also has a right to receive a portion of the disclaimed interest as an heir at law or residuary beneficiary, or by any other means, unless the portion of the disclaimed interest that the disclaimant has the right to receive is an undivided portion of the property (see §27.16) or severable property (see §27.17). For example, a disclaimer of a specific bequest of a fee simple interest in property is not qualified if the property passes to a trust in which the disclaimant has a remainder interest. Treas Reg §25.2518-2(e)(3).

In IRS Letter Ruling 200846003, the IRS ruled that disclaimers of interests in an IRA by the designated beneficiaries were not qualified when the disclaimers resulted in the IRA passing to a QTIP trust in which the disclaimants were remainder beneficiaries, with the consequence that the IRA was not treated as transferred to the trust by the surviving spouse and therefore the trust did not qualify for the QTIP election and marital deduction under IRC §2056. The ruling did not consider the possibility that the income interest and remainder interest in the IRA were separate interests (see §27.19) in which case the disclaimers might have been treated as qualified disclaimers of the income interest.

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§27.24 VI. TAX APPORTIONMENT PROBLEMS

A disclaimer can have unintended tax apportionment consequences. Suppose, for example, that a trust provides that all estate and GST taxes are to be paid from the residue of the trust estate. The estate passes equally to three children. One of the children disclaims his share with the consequence that the share passes to grandchildren and triggers a large GST tax. Will the tax apportionment clause result in the two nondisclaiming children sharing the burden of the GST tax? Problems of this kind can normally be addressed by providing that additional taxes resulting from a disclaimer are to be paid from the disclaimed property. Such a clause is desirable even when the estate plan contains no other provision concerning disclaimers.

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VII. SPOUSE DISCLAIMER TRUST AS ALTERNATIVE TO BYPASS TRUST

§27.25 A. Purpose

Although any trust established as a result of a disclaimer might be referred to as a disclaimer trust, the term "disclaimer trust" as used by contemporary estate planners most commonly refers to a trust established when a surviving spouse disclaims a direct transfer of property from the deceased spouse. The transfer instrument, typically a will or revocable trust, must specify the terms of the trust and expressly provide that any property disclaimed by the spouse passes to the trust. In the absence of such a provision, the disclaimed property would pass as if the spouse had died. Prob C §282.

Normally, the disclaimer trust serves the common bypass trust objectives of benefiting the surviving spouse while preventing inclusion of the trust property in the surviving spouse's taxable estate. For a further discussion of bypass trust planning, see chap 17.

Disclaimer trusts have long been used as a standby device in circumstances in which the planner believes there is little possibility that any estate tax will be payable on the survivor's death even if all of a deceased spouse's property passes to the survivor. The inclusion of disclaimer trust provisions in the transfer document permits postdeath creation of a "bypass trust" if there is an unexpected increase in the value of the couple's assets by the disclaimer deadline—9 months after the death of the deceased spouse. See IRC §2518(b)(2). The possible utility of a disclaimer trust also depends on future congressional action concerning the applicable estate tax credit amount—not to mention the calendar year of death.

Disclaimer trusts have also been used to *enlarge* the bypass trust above the applicable exclusion amount if estate balancing or IRC §2013 previously taxed property credit considerations become important—as may occur when the surviving spouse has a short life expectancy at the death of the first spouse. Disclaimer trusts can also be useful for asset protection if the surviving spouse has creditor problems.

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§27.26 B. Problems With Disclaimer Trusts

Disclaimer trusts have several drawbacks. They are essentially useless unless their remainder beneficiaries are those desired by the surviving spouse. Further, the spouse cannot be given a power of appointment over a disclaimer trust, other than a power limited by an ascertainable standard, because of the qualified disclaimer requirement that the disclaimed property pass without the direction of the person making the disclaimer. IRC §2518(b)(4); Treas Reg §25.2518-2(e)(2). See §27.22.

More importantly, experience has shown that there is often a significant risk that the surviving spouse will not make a desirable disclaimer because of insecurity, failure to attend promptly to tax issues on the death of the deceased spouse, inadvertent "acceptance" of transfers from the deceased spouse (§27.14), or poor professional advice.

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§27.27 C. Illustration of Potential Flexibility

Assuming a disclaimer trust is otherwise appropriate, a trust drafter with a good understanding of IRC §2518 can provide a remarkable level of flexibility. Consider the following illustrative provisions that might appear in a jointly settled revocable trust of the type commonly used in California:

***Disclaimer Trust*. In the event the Surviving Settlor disclaims the right to receive any property otherwise passing from the Deceased Settlor to the Surviving Settlor, the disclaimed property shall be distributed to the Surviving Settlor as Trustee, in Trust, and held and administered as follows:** _ _[*Specify.*]_ _

***Periodic Distributions of Income*. During the life of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor all of the trust income at quarter-annual or more frequent intervals. In the event the Surviving Settlor disclaims this right to all income, the trustee shall instead pay to or apply for the benefit of the Surviving Settlor, at convenient intervals, as much of the net income of the trust as the trustee determines is appropriate for the Surviving Settlor's health, education, and support. Any income not distributed shall be added to principal. If the Surviving Settlor makes a disclaimer as to only a fractional share of a right to income, the fractional share of the trust subject to the disclaimer shall become a separate trust.**

***Distribution of Principal*. The trustee shall pay to or apply for the benefit of the Surviving Settlor, at convenient intervals, as much of the trust principal as the trustee determines is appropriate for the Surviving Settlor's health, education, and support. In the case of a trust that does not pay all income to the Surviving Settlor because of a qualified disclaimer of the right to all income made by the Surviving Settlor, the trustee may also pay to or apply for the benefit of the Surviving Settlor's descendants as much of the trust principal as the trustee determines is appropriate for their health, education, and support. In exercising its discretion with respect to Descendants, the trustee shall take into account that the primary objective of the trust is to provide for the support of the Surviving Settlor for life and all other objectives are secondary.**

***Disclaimer of All Rights in Principal and Income*. In the event the Surviving Settlor disclaims all rights in income and principal of the trust or a fractional share of the trust, the trust estate subject to such disclaimers shall be distributed as follows:** _ _[*Specify.*]_ _

***Distribution on the Surviving Settlor's Death*. On the death of the Surviving Settlor, the remaining trust estate shall be distributed to** _ _[*name(s)*]_ _**.**

Under these provisions, the surviving spouse (or the executor of the surviving spouse) has four basic options: (1) take an outright transfer; (2) take a mandatory income interest and a discretionary principal interest; (3) take discretionary interests in both income and principal; or (4) allow property to pass to the remainder beneficiaries immediately. The spouse may exercise these different options on different fractional shares of the trust. It is also possible to give the spouse a certain amount of indirect distribution discretion by providing for the initial creation of multiple trusts having different remainder beneficiaries—perhaps one trust for each child. The spouse could then make different choices with respect to the trusts for different children. (This strategy appears to be prohibited by Treas Reg §25.2518-2(e)(5), Example 9, but the Example deals with a single undivided estate residue rather than legally separate trusts.)

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§27.28 VIII. FACILITATING DISCLAIMERS BY MIDDLE-AGED CHILDREN

Estate planners frequently confront situations in which elderly clients desire to leave property to middle-aged children who have their own estate tax issues. An elegant solution to this problem is to establish a separate trust for each child that names the child as trustee, permits liberal withdrawals by the child for the child's health and support (without the child being required to take into account his or her own substantial income and assets in determining the appropriate amount), and gives the child the power to appoint trust property during life and at death among a broad class of potential appointees. Such a trust will not be included in the estate of the child at the child's death and an appropriately drafted trust may even provide some creditor protection benefits. If the trust is appropriately drafted, it is even possible to permit the child to include some or all of the trust in his or her taxable estate by triggering the so-called Delaware Trap under IRC §2041(a)(3) in order to avoid an IRC §2601 GST tax or to obtain a new income tax basis under IRC §1014.

A potential downside of this type of trust results from the possibility that estate tax repeal may become permanent. At least under current law, repeal of the estate tax also results in repeal of the "new basis on death" rule of IRC §1014, which will be replaced by IRC §1022. Section 1022 allows for liberal increases in the basis of assets owned by a decedent (up to $3 million for assets passing to a spouse plus another $1.3 million regardless of transferee), but property in a trust established by someone other than the decedent will not be treated as owned by the decedent. Therefore, if transfer taxes disappear, income tax rules may make it preferable to give the child outright ownership of property.

The ideal solution may be to leave property to the child, but give the child an option to disclaim to a trust for the child's intended beneficiaries. When this approach is used, it is important to remember that the trust will be worthless unless the trust terms provide a disposition desired by the *child*—this may be a disposition that is different than the *client.* Normally, the child should be named as trustee and given the power to make distributions to beneficiaries for their health, education, and support. The child cannot be a beneficiary and cannot be given any other distribution discretion without violating the "passing without direction" rule. IRC §2518(b)(4). See §27.22. Any additional discretionary distribution powers or powers of appointment must be given to someone other than the child. To avoid claims that the child can make distributions indirectly benefiting himself or herself, the trust instrument should prohibit the child from making distributions that discharge obligations of the child, including obligations of support.

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§27.29 IX. DISCLAIMERS IN FAVOR OF CHARITY

Sometimes a client wants to give a favored beneficiary the option to disclaim property in favor of charity. Provisions providing for the distribution of property to charity are particularly useful if it is uncertain whether the client's estate will be subject to estate tax. If the estate will not be taxed, the beneficiary usually will be better off accepting the transfer and then making his or her own contribution to the charity and claiming an income tax charitable deduction. Disclaimer provisions in favor of charities may also be particularly useful for individual retirement accounts due to the adverse income tax consequences of a withdrawal by a noncharitable beneficiary. Clients who have established a family foundation may be particularly interested in these options. For a case in which a family attempted to use a formula disclaimer to prevent increases in the value of an estate on audit, see *Estate of Helen Christiansen* (2008) 130 TC 1, aff'd (8th Cir 2008) 104 AFTR2d 7352. The strategy suggested by that decision, although not effectively executed by the family in that case, would involve a gift of the residue of an estate to a chosen beneficiary and a will or trust provision that provides that, in the event of a disclaimer by the beneficiary, the disclaimed property will pass to charity. Following the decedent's death, the chosen beneficiary then executes a disclaimer of a portion of the residue that is determined by the formula. The formula, operating similarly to a marital deduction formula gift that reduces estate tax to zero, results in a disclaimer of that amount of the estate that will cause the taxable estate to equal a selected amount. See also *Anne Y. Petter,* TC Memo 2009-280, in which a similar formula clause was used to determine the transfer tax value of a gift and sale of assets to a grantor trust with the residue passing to a private foundation. The IRS had contended that such formula value limitation clauses, like the formula disclaimer in *Chistiansen*, should be disallowed on public policy grounds because they fail to preserve an incentive for the IRS to audit the return as stated in *Commissioner v Procter* (4th Cir 1944) 142 F2d 824.

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28

Power of Attorney for Financial Matters

Alan Leigh Armstrong

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§28.1 I. INTRODUCTION

Planning for incapacity is an integral part of estate planning. Although there are numerous devices for handling incapacity—*e.g.*, a conservatorship, revocable living trust, joint tenancy, or community property management by a spouse—anyone who may, at some future time, need another to manage his or her financial affairs needs a financial power of attorney either as the primary tool for handling incapacity, or as a backup device for other methods. Essentially, everyone who becomes an estate planning client should have a power of attorney. The main purpose of the power of attorney is to ensure that a trusted nominee is ready to act if needed and thereby to avoid the expense and potential conflict of a conservatorship proceeding in the event of incapacity and the unavailability of suitable alternatives.

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§28.2 A. Incapacity Defined

Questions concerning the capacity of a client may arise in several contexts. Initially, a client must have capacity in order to execute a power of attorney. Later, a springing power of attorney (see §28.8) may not come into effect unless the principal is incapacitated. In either event, the capacity of the client will be measured under the Due Process in Competence Determinations Act (DPCDA) (Prob C §§810-813, 1801, 1881). Under DPCDA, a person lacks the capacity to make a decision unless the person has the ability to communicate verbally, or by any other means, the decision, and to understand and appreciate (Prob C §812):

- The rights, duties, and responsibilities created by or affected by the decision;
- The significant risks, benefits, and reasonable alternatives involved in the decision; and
- The probable consequences for the decision-maker and, when appropriate, for the persons affected by the decision.

The capacity to give informed consent for medical treatment is covered by Prob C §813. The rules regarding testamentary capacity are set forth in Prob C §§6100 and 6100.5.

The attorney is neither a psychiatrist nor a psychologist and can only make gross estimates of the capacity of the client. The attorney who has questions about the client's capacity will have to rely on opinions of the client's physician or another health care professional.

For a further discussion of incapacity issues, see California Powers of Attorney and Health Care Directives, chap 1 (Cal CEB 2008). See also Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide April 2010).

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§28.3 B. Terminology

Powers of attorney have their own words of art. See Prob C §§4010-4034. The "principal" is one who gives power to another. The "agent" or "attorney-in-fact" is the person given the power. The power of attorney can include successor agents who will act if agents listed before them are unable to act. Prob C §4203.

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§28.4 C. Ethical Considerations

When the client plans ahead and executes a power of attorney and other estate planning documents well before they are needed, questions of who the client is and the client's capacity seldom arise. Often, the only ethical concern in those circumstances may be to get a conflict waiver when the husband and the wife are jointly represented.

Even if the planning is being done well in advance of need, a client's child or another individual may bring the client to the attorney. In those situations, the attorney must determine what the *client* wants done, not merely what the child wants. At some point before the documents are executed, the attorney will need to meet alone with the client to make sure that the client's wishes are met.

NOTE: Because of the Sarbanes-Oxley Act of 2002 (Pub L 107-204, 116 Stat 745), California is reviewing the California Rules of Professional Conduct. This may result in the Rules being closer to the Model Rules of Professional Responsibility used in most other states. The Model Rules do allow an attorney, in certain circumstances, to act in the best interests of the client even if it is against the wishes of the client. That may include helping to start a conservatorship.

If the client speaks English with difficulty and neither the attorney nor staff are fluent in the client's primary language, a son or daughter may start out acting as translator. If the attorney feels that a discussion without the child present is needed, the attorney will have to arrange for a translator. For some of the more unusual languages, spoken only within small communities, the attorney may find that the translator and the client either know each other or have friends in common. In such cases, the attorney must address the client's privacy concerns.

More serious ethical problems arise when a child, often on short notice, wants the attorney to write a power of attorney for a parent who has suffered a health setback. During the interview, the attorney may decide that the potential client is incapacitated and a conservatorship is needed. In that case, as long as the attorney does not have an existing attorney-client relationship with the parent, the attorney can recommend a conservatorship and represent the child in the conservatorship. If there is an existing attorney-client relationship, or if the incapacity is not discovered until after an attorney-client relationship has begun, the attorney can only try to convince the client to do what the attorney feels is in the client's best interest. An attorney cannot start a conservatorship for a client without the client's permission. State Bar Ethics Opinion 1989-112. The attorney will have to advise the child to retain his or her own attorney to implement a conservatorship. For a discussion of ethical considerations in conservatorships, see California Conservatorship Practice, chap 1 (Cal CEB 2005).

Another ethical problem arises when the client wants to revoke an existing power of attorney but possibly lacks the capacity to do so. The client may feel that the agent is trying to take over the client's life. The attorney may be convinced that the client lacks capacity. If the attorney is convinced that the client lacks capacity, the attorney can only withdraw or attempt to convince the client to do what is best. Preparing a revocation of the power of attorney when the client is incapacitated may not be in the client's best interest and could damage the client.

PRACTICE TIP: When an attorney is uncertain regarding a client's capacity to revoke a power of attorney, the attorney can represent the client in a court action to revoke the power of attorney. Prob C §4541(a). Proceeding under judicial scrutiny protects both the attorney and the client. The near relatives of the client may either support or contest such a petition, and may also start a conservatorship proceeding, which can be consolidated with the action to revoke the power of attorney.

For additional discussion of ethical considerations in connection with financial powers of attorney, see California Powers of Attorney and Health Care Directives, chap 3 (Cal CEB 2008). See also chap 2.

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§28.5 D. Uses of Power of Attorney in Estate Planning

Powers of attorney have many purposes in estate planning. A power of attorney may be used to allow a trusted agent of the client to transfer property into a living trust that is the client's primary estate planning vehicle. Powers of attorney may also be used to facilitate gifts that take advantage of the annual exclusion available under IRC §2503. A power of attorney may be used to allow adjustments to a trust in response to changes in the tax law occurring after a settlor is incapacitated. A power of attorney may also allow a trusted agent to operate a partnership or a similar entity that is not put in a trust.

Multiple powers of attorney may be necessary to handle all the client's needs. The attorney should use as many documents as necessary to satisfy the client's requirements.

PRACTICE TIP: Certain powers, such as the power to make gifts or amend estate planning documents, must be granted with specificity in the power of attorney. Prob C §4264. See §§28.12, 28.27. Form language for such grants of authority can be found in California Powers of Attorney and Health Care Directives, chap 5 (Cal CEB 2008).

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II. POWERS OF ATTORNEY

A. Scope of Powers of Attorney

§28.6 1. General or Limited Power of Attorney

A power of attorney is general unless it is specifically limited in the instrument creating it. Prob C §4261. A general power of attorney gives the agent authority to transact any and all business for the principal and to manage the principal's property. There are, however, limits to the authority that can be delegated by general language. See §28.11 for powers that must be specifically granted.

Even if, technically, general language is sufficient to grant broad powers, it is good practice to delineate certain powers with particularity. Title companies, partnership transfer agents, and stock proxy rules may all require an agent to have specific authority to take certain actions. Thus, both a list of particular powers, as well as a general grant of authority, is most effective. See California Powers of Attorney and Health Care Directives, chap 5 (Cal CEB 2008) for form language.

There may be circumstances in which the principal wants to limit the agent's authority in some way. See Prob C §4262. Authority can be limited to a specific period of time, to a certain asset, or to particular, specified actions or conditions, and the limitations should be clearly specified in the instrument. See Durable Powers, chap 4.

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§28.7 2. Durable or Nondurable Power of Attorney

A durable power of attorney is one that remains in effect or comes into effect when the principal is incapacitated. Prob C §4124. If it is in effect from the time it is executed, it should contain the words: "This power of attorney shall not be affected by subsequent incapacity of the principal." Prob C §4124(a). If it is to come into effect when the principal is incapacitated, it should contain the words: "This power of attorney shall become effective upon the incapacity of the principal." Prob C §4124(b).

PRACTICE TIP: The language in Prob C §4124(a) and (b) should be used verbatim unless the attorney knows exactly why other words are being used.

The most common use for a nondurable power of attorney is when the principal anticipates being absent when an important document requires signature. For instance, a person may give a spouse, domestic partner, or a trusted friend a nondurable power of attorney to execute the documents to sell a house when moving. The principal may be at the new location and the requirements of the job may prevent the principal from traveling back to execute the documents. Such powers of attorney can also be used for business management, sale of other property, and other particular transactions. Although these "special" or "limited" powers of attorney can be durable, they seldom are. See §28.6. The principal generally does not contemplate the possibility of being incapacitated, only that he or she will be unavailable. The nondurable power of attorney is effective only if the principal is capable of signing the document, *i.e.*, retains capacity. It is a mere delegation of authority for convenience.

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§28.8 3. Immediately Effective or Springing?

A power of attorney can be drafted to be effective immediately or to be effective only if the principal becomes incapacitated: a "springing" power. See Prob C §4030. Sometimes this decision will be easy. If the client has cancer, Alzheimer's Disease, or another condition that will make the client incapacitated within a short time, the durable power of attorney needs to be immediately effective. Even if the disease or condition is not expected to affect the client's mental functioning, he or she may become too weak to effectively manage day-to-day affairs. An immediately effective power is most convenient, because incapacity need not be documented.

In most other circumstances, the decision of whether to use an immediately effective or a springing power is not an easy one. An immediately effective power of attorney is a powerful tool that can be used in a way that thwarts the principal's wishes. An agent can use an immediately effective power of attorney at any time, without the principal's knowledge. Some principals keep an immediately effective power of attorney in a safe place and away from the agent until it is needed. But in that case, the agent needs to find the power before it can be used in the event of real need. If an immediately effective power of attorney is placed in "escrow," the principal should give the agent a letter informing the agent who has the power of attorney and how to obtain it.

PRACTICE TIP: Because of the dangers inherent in the use of an immediately effective power of attorney, the author's preference is to draft a springing power of attorney unless the power of attorney will be needed within a short time.

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§28.9 4. Determining Incapacity

The springing power of attorney is not effective (turned on) until a person or persons, often two, declare that the principal is incapacitated. See Prob C §4129. Who should these people be? Usually the people are the principal's treating physician, the principal's spouse, and friends or relatives. The principal could be one of the people to turn on the power. This would be useful, for example, when the principal knows that he or she is going to be unable to handle financial matters, perhaps because of upcoming surgery. The incapacity deciders need to be people whom the client trusts to act in the client's best interests. They are often the same people who are the agent and successor agents.

A problem with making springing powers of attorney effective is obtaining the necessary certifications that the principal is incapacitated. Some powers of attorney require certification by two physicians. It can be very difficult to obtain these certifications unless the principal is so incapacitated that it is obvious to everyone. In the process of proving incapacity, the agent may find himself or herself at odds with the principal. It is easier to obtain certifications from two people on a list that includes the principal's physician, the agent, successor agents, and, perhaps, other people who would know the principal's condition. If obtaining the certification is problematic, the attorney should consider advising the use of an immediately effective power of attorney.

Some clients may want their attorney to be one of the people with the power to certify that the client is incapacitated. If the client is incapacitated, but thinks that he or she is not, the attorney, as part of the certification process, may be required to divulge privileged information in violation of Bus & P C §6068(e). See also California State Bar Formal Opinion No. 1989-112, dealing with an attorney's instituting a conservatorship proceeding contrary to the client's wishes.

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Source: Estate Planning/California Estate Planning/28 Power of Attorney for Financial Matters/§28.9A 5. Powers of Attorney for Members of the Military

§28.9A 5. Powers of Attorney for Members of the Military

People in the military need powers of attorney that are effective immediately or become effective when they leave the local area. It may be impossible to determine if they are injured; also, they could be prisoners of war or otherwise unable to act, but in good health, so that a springing power of attorney with the normal clauses to make it effective would not become effective. The power of attorney will need to give the agent additional and specialized powers, as the principal may be on active duty in an isolated place, a prisoner of war, or missing in action.

PRACTICE TIP: Missionaries, federal government employees, and private company employees who may be kidnapped may need many of these same clauses in their powers of attorney.

In addition to all of the powers in a normal power of attorney, the agent may need to start, stop, or change allotments, receive leave and earnings statements, obtain loans from service relief organizations, obtain military housing, certify the existence and number of dependents, terminate military housing, ship household goods when transferred, renew identification cards, and complete the forms necessary to obtain or continue dependent medical treatment. The agent may also have to deal with ServiceMembers Group Life Insurance (SGLI) and approving for the care of minor children.

NOTE: The power of attorney will be interpreted under federal law; therefore, it is recommended that the attorney contact the Judge Advocate General (JAG) that services the principal's unit for help in making sure the power of attorney contains all necessary provisions. In addition, the Army JAG web site has an Estate Planning Tool Kit available in PDF format.

Because pay, benefits, and promotions will continue when a member of the military is missing or a prisoner, the agent should not rush to have the principal declared dead.

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B. Uses and Limitations

§28.10 1. General Provisions

A power of attorney can give an agent the ability to handle a wide array of financial matters for the principal. Depending on the needs of clients and the types of assets held by them, some or all of the following powers may be granted in a power of attorney: the power to deal with real property, to obtain loans, to pay debts, to collect from creditors, to handle public benefits, to close charge accounts, to gain access to safe deposit boxes, and to deal with insurance, securities, and retirement accounts and benefits. In determining what clauses are needed, the attorney should determine what type of investments the client has, what businesses the client is involved in, and what the agent may need to do with those investments and business interests.

As the power of attorney becomes more specific in the actions to be taken, the agent loses the ability to react to changes in the principal's financial situation, business interests, and the financial world.

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§28.11 2. Powers That Must Be Specifically Granted

Under Prob C §4264, an agent can perform any of the following acts only if they are expressly authorized in the power of attorney:

- Create, modify, or revoke a trust;
- Fund with the principal's property a trust not created by the principal or a person authorized to create a trust on behalf of the principal;
- Make or revoke a gift of the principal's property;
- Exercise the right to make a disclaimer on behalf of the principal (an agent may still disclaim a detrimental transfer to the principal with court approval even without specific authorization);
- Create or change survivorship interests in the principal's property or in property in which the principal may have an interest;
- Designate or change the designation of beneficiaries to receive any property, benefit, or contract right on the principal's death; or
- Make a loan to the agent.

In addition, if the power to modify a trust is desired, the trust instrument itself must also refer to the power of attorney. Prob C §15401(c). See §28.27. A power of attorney cannot be used to execute, amend, or revoke a will. Prob C §4265.

PRACTICE TIP: For possible future tax or Medi-Cal planning, the power to make donative transfers or to fund trusts may be needed. If this power is granted, the principal may wish to specify that the principal's overall dispositive plan at death is not to be modified as a result of the actions of the agent. For a discussion of Medi-Cal planning, see chap 30.

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§28.12 3. Powers That Should Be Specifically Granted

The principal may want to authorize specifically certain acts that might otherwise give rise to the appearance of (or actually constitute) self-dealing on the part of the agent. For instance, if the agent is the principal's child, who will be managing the family business in which both agent and principal hold an interest, self-dealing may be necessary for the agent to manage the property. Or the principal may want to grant the agent a right of first refusal to purchase the family vacation home should it need to be sold to pay for the principal's care. Sometimes the principal's stockbroker or accountant is the nominated agent, and the principal may wish that such professionals continue to receive commissions or fees for handling the principal's financial affairs.

Probate Code §4232(b) protects the agent by providing that the agent's duty to act solely in the interests of the principal and to avoid conflicts of interest is not violated solely because the agent also benefits from the transaction or has conflicting interests relative to the transaction. It is nevertheless advisable, particularly in conflicted family situations, to be explicit about the agent's authority to perform certain acts that might otherwise be questionable or constitute outright self-dealing.

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Source: Estate Planning/California Estate Planning/28 Power of Attorney for Financial Matters/§28.13 4. Nomination of Conservator

§28.13 4. Nomination of Conservator

Under Prob C §4126, a nomination of a conservator may be made in a durable power of attorney. As a rule, the use of powers of attorney is designed to avoid the need for a conservatorship proceeding. It is generally wise, however, for clients to make such a nomination to ensure that their trusted nominee is appointed in the event that conservatorship proceedings are necessary.

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§28.14 5. Attorney-in-Fact Is Not Attorney at Law

A person cannot represent another in a court using a power of attorney as the authority. *People v Malone* (1965) 232 CA2d 531, 42 CR 888 (court nullified settlement obtained by principal's brother while principal was out of country). On the other hand, the agent, using the power of attorney, can hire an attorney to handle a lawsuit. Prob C §§4450(f), 4459. It is theoretically possible for the attorney to be the agent under the power of attorney and, in effect, retain himself or herself for a lawsuit. Such a course of action is rife with the potential for conflicts and is not advised.

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§28.15 6. Jurisdictional Requirements

A power of attorney is governed by the laws of the state of its execution. An agent who attempts to use a California power to deal with property in another state or to do business in another state may encounter both legal and practical problems. Although the Uniform Durable Power of Attorney Act has been adopted in some form by most United States jurisdictions, each legislature has the opportunity to customize the act to its own state. If the power of attorney is to be used outside California, the attorney should make sure that it meets the requirements of the other state.

To be effective in California, the power of attorney must be acknowledged before a notary or signed by at least two witnesses. Prob C §4121. The witnesses signing the power of attorney may witness the signing of the power or the principal's acknowledgment of the signature or the power. Prob C §4122. In *Estate of Rabinowitz* (2003) 114 CA4th 635, 7 CR3d 722, the court held that the decedent's power of attorney was valid even though the witnesses signed the power after his death and did not see the document at the time the decedent acknowledged its existence. Accordingly, the revocable trust established by the attorney-in-fact was valid. However, as a matter of advocacy, it may be difficult to persuade a court that *Rabinowitz* should be followed in the future—at least in cases involving a power that is not signed by the witnesses until after the decedent's death—in light of the decision in *Estate of Saueressig* (2006) 38 C4th 1045, 44 CR3d 672, in which the court held that a will must be signed by the witnesses no later than the testator's death. In *Kaneko v Yager* (2004) 120 CA4th 970, 16 CR3d 183, the court held that a third party dealing with an attorney-in-fact was not protected from possible liability under Prob C §4303 because the power of attorney was neither notarized nor witnessed. (In an unpublished portion of the opinion, the court determined that the third party was nevertheless protected from liability because the attorney-in-fact had ostensible authority under the law of agency.) The better practice is to have the power itself either notarized or witnessed. In *Torres v Torres* (2006) 135 CA4th 870, 37 CR3d 754, the court held that a defective statutory form durable power of attorney under Prob C §4401 (the principal had indicated desired powers using an "X" rather than her initials) was sufficient to appoint an attorney-in-fact because the document met the general requirements of Prob C §4121.

A valid power of attorney executed in California should be accepted in other jurisdictions under the well established legal principle that the form of jurisdictional acts is governed by the law of the place of execution. See Restatement (Second) of Conflict of Laws §199 (1971). Many states now have a law similar to Prob C §4053, which provides that a power of attorney validly executed in another state or jurisdiction is valid and enforceable in California, regardless of whether the principal is a domiciliary of California. The conditions under which a power of attorney will be governed by California's power of attorney law are set forth in Prob C §4052. Under some circumstances, California law applies to acts and transactions of the agent both inside and outside California. Prob C §4052(a).

In practice, however, a power of attorney may not be accepted in another jurisdiction, particularly if its form would not be valid if executed in that jurisdiction. Even if the power of attorney is accepted as a valid document in another jurisdiction, local laws governing the general agency relationship cannot be ignored. In view of potential conflicts of laws, an attorney should avoid drafting a power of attorney for use in another state. If it is necessary to do so, the attorney should take great care in drafting to ensure that the instrument complies with the relevant power of attorney law in the other state.

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Source: Estate Planning/California Estate Planning/28 Power of Attorney for Financial Matters/§28.16 7. Court Proceedings Concerning Powers of Attorney

§28.16 7. Court Proceedings Concerning Powers of Attorney

Powers of attorney are generally exercisable without judicial oversight or authorization. Prob C §4500. Court proceedings, however, are available for the following determinations concerning powers of attorney (Prob C §4541):

- Whether the power of attorney is in effect or has terminated;
- Passing on the acts or proposed acts of the agent, including granting authority to disobey the principal's instructions;
- Compelling the agent to submit an accounting, if the agent has failed to do so on the demand of the principal, the principal's spouse, the principal's conservator, or "any other person required by the court in its discretion";
- Revoking the authority of the agent on the court's determination of all of the following: (1) the agent is unfit or has violated his or her fiduciary duties; (2) the principal presently lacks capacity to revoke the power; and (3) the revocation of the power is in the best interests of the principal's estate;
- Approving the resignation of the agent; and
- Compelling a third party to honor the power of attorney.

Permissible petitioners for such judicial determinations are the agent, the principal, the principal's spouse, any relative of the principal, the principal's conservator, a local court investigator or public guardian, the personal representative or trustee of the principal's estate, the principal's "successor in interest," a person requested in writing to take action, and "any other interested person or friend" of the principal. Prob C §4540.

DRAFTING CONSIDERATIONS: The instrument may limit the right of a person, other than the principal himself or herself, the agent, the principal's conservator, or the public guardian, to bring the judicial proceedings described above. Prob C §4503. Such a limitation may be wise when the family is in conflict and the client believes that some individuals may seek to harass the agent or to interfere with the agent's activities.

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8. Termination of Power of Attorney

§28.17 a. Revocation

A power of attorney is revocable by the principal in accordance with the terms of the power of attorney or by another writing. Prob C §4151(a). The ability of the principal to revoke a power of attorney by a writing is not subject to limitation in the power of attorney. Prob C §4151(a)(2). The agent's authority is also revoked when the principal informs the agent orally or in writing that the authority is revoked or informs the agent of when and under what circumstances the power is revoked. This provision is also not subject to limitation in the power of attorney. Prob C §4153(a)(2). The power is revocable as long as the principal has capacity. See CC §2356(a)(3). See discussion of capacity at §28.2.

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§28.18 b. Death of Principal

The authority of an attorney-in-fact under a power of attorney is terminated when the principal dies, except as to specific authority permitted by statute to be exercised after the principal's death. Prob C §4152(a)(4). If the agent does not know and had no reason to know of the principal's death, a transaction undertaken by the agent will be effective even if it is later discovered that the principal died before the transaction took place. Prob C §4304(a). The agent may need to provide an affidavit as to his or her knowledge on the date the action was taken. Prob C §4305. In some foreign countries, the power of attorney continues in effect for a short period after the principal dies.

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§28.19 c. Death, Resignation, or Incapacity of Agent

The authority of an agent under a power of attorney is terminated by the agent's death, resignation, incapacity, or failure to act. Prob C §§4152, 4207. The agent serves at will, and may resign by submission of a written resignation to the principal. Prob C §4207. The agent should also provide notice to other interested parties.

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§28.20 d. Dissolution or Annulment

If, after executing a power of attorney, the principal's marriage to the agent is dissolved or annulled, the principal's designation of the former spouse as agent is revoked. Prob C §4154(a). This automatic revocation is subject to limitation by the power of attorney. Comment to Prob C §4154 (24 Cal L Rev'n Comm'n Reports 323, 393 (1994)). There is no reference in Prob C §4154 to revocation based on legal separation of spouses.

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§28.21 C. Transacting Business as Agent

When transacting business as an agent under a power of attorney, the agent should first sign the name of the principal and then his or her own name, followed by such words as "under power of attorney dated Jan. 1, 2006." The inclusion of both names is required by law for transactions affecting real estate. CC §1095. The agent should never use his or her name alone, or the principal's name alone, when doing business on the principal's behalf, in order to avoid any later charge of fraud or inadvertent acceptance of personal responsibility for the transaction.

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§28.22 1. Working With Financial Institutions

The bank, stock brokerage, or other financial institution that the client uses may have its own power of attorney form. If a different form of power of attorney is presented, the company may have to send a copy to its legal department for analysis. Some attorneys suggest that their clients separately complete the institution's form even if the client already has a comprehensive power of attorney.

PRACTICE TIP: Another option is to let the institution know about the power of attorney in advance. With the client's permission, the attorney can supply the institution with a copy of the power of attorney and request that the institution confirm that it will accept it. The institution may be able to note the existence of the power of attorney in its database. If the agent tries to use an attorney-drafted power of attorney without first notifying the institution, the institution will need time to verify who the agent is; that the power of attorney is genuine; and that the power of attorney is now active. These bureaucratic roadblocks can delay the agent in acting under the power of attorney, possibly to the detriment of the client when prompt action is needed. The attorney also may enlist the help of the institution in drafting an "irrevocable" power of attorney with the client's spouse as agent that will prevent the principal from withdrawing funds from a community property account in cases where the principal may be subject to undue influence.

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§28.23 2. Dealing With the Internal Revenue Service

An agent under a power of attorney should be granted authority to deal with the Internal Revenue Service, although the policies of that agency do not make such dealings easy. The Internal Revenue Service wants the client to use Form 2848 (Power of Attorney and Declaration of Representative). The IRS Deskguide (Publication 1514 (Rev 4-92)) states that a power of attorney cannot be effective for an indefinite period and limits its effectiveness to 3 years from the date of signature, notwithstanding Prob C §4127 (power of attorney effective "notwithstanding any lapse of time since execution"). The regulations specify what the power of attorney must contain. Treas Reg §601.503. The requirements include the "specific year(s)/period(s) involved." Treas Reg §601.503(a)(5)(iii).

There is no requirement to use the IRS form; if any of the required information (*e.g.*, social security number) is missing, the principal can provide the additional information by executing and attaching Form 2848. Treas Reg §601.503(b)(3).

If the principal is incapacitated, an explanation from the physician may be of great help in persuading the IRS to honor an attorney-drafted durable power of attorney.

Because the Uniform Statutory Form Power of Attorney (Prob C §4401) includes a check-the-box entry for "Tax Matters," with the proper authorization, there should be no trouble in using an attorney-prepared power of attorney to deal with the Franchise Tax Board or the Board of Equalization.

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§28.24 3. Multiple Powers of Attorney

If the client needs multiple powers of attorney, a problem can arise in coordinating these documents. Overlaps will happen when both attorney-prepared powers of attorney and institutional forms are used. There will be less chance of overlap when the attorney prepares separate powers of attorney for general financial purposes and for partnerships or operations of businesses.

The attorney must review all powers of attorney and be involved in their execution. The power of attorney for general financial purposes should refer to any institutional or other powers of attorney, and should declare which one governs in case of conflict.

PRACTICE TIP: This is an area in which an attorney can make a major error. The attorney should create a document detailing what each power of attorney does. This document may include diagrams as well as explanations, and should ensure that only one power of attorney deals with each action that the agent is to take, and that one power of attorney does not inadvertently revoke another. See Prob C §4130. The attorney should review all documents with the client so that the client is comfortable with how the powers of attorney will interact and how one or more agents will handle his or her financial affairs.

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D. The Agent

§28.25 1. Selecting the Agent

Choosing the correct agent or agents can be difficult. The agent is a fiduciary, so the main criteria are that the agent be trustworthy and responsible. If the client has a trust, the agent and successor agents will usually be the successor individual trustees, so as to streamline and coordinate estate management. There will likely be different nominees if a corporate trustee will serve.

Often the husband is the agent for the wife and vice versa, or domestic partners are agents for each other. This arrangement is fine, as long as both are trustworthy and capable of making the necessary decisions. The exact qualifications will differ from client to client. The client with simple financial affairs will not need someone with as much financial expertise as will a client with partnerships, closely held corporations, or otherwise complicated financial affairs.

If a client names only one of several children as the agent, the attorney and client must determine the likelihood that the agent will be sued by the other children if problems arise. The attorney and client must consider the family's dynamics and the relations among the parents and children. An agent who is placed in a sensitive family situation should keep detailed books and notes to defend any actions taken. See §28.16 regarding granting the agent protection from some court challenges.

PRACTICE TIP: A client sometimes asks the drafting attorney to serve as agent. This arrangement may be appropriate in a limited situation such as closing escrow on a property sale for a temporarily absent property owner. The attorney should, however, be cautious about agreeing to act as an agent under any power of attorney. Before agreeing to serve as agent, even under a limited power, the attorney should review his or her malpractice insurance. Acts under a power of attorney may be specifically excluded from coverage. Even when not specifically excluded, the carrier may later take the position that such acts are not included within the definition of an attorney's practice of law. Note also that under Prob C §4237, to the extent that agents possess "special skills," they are obligated to apply them to their "full extent" in discharging their duties as agent. This requirement may engage the attorney more deeply than expected in the task of analyzing the underlying fairness of a transaction, or gauging its long-term ramifications for the client.

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§28.26 2. Compensating the Agent

Under Prob C §4204, an agent is entitled to reasonable compensation for services as agent and to reimbursement for reasonable expenses incurred as a result of acting as agent. In practice, an agent rarely receives compensation, usually because family members and close friends waive this right. However, unless the document specifically prohibits compensation, the agent will have the authority to use the principal's assets for payment of "reasonable" compensation. If the agent is expected to be compensated, the client may prefer to specify either an hourly rate or a percentage of net assets as a guide for compensation. See California Powers of Attorney and Health Care Directives, chap 4 (Cal CEB 2008) for form language.

NOTE: Receiving compensation increases the standard of care under which the agent must act. See Prob C §4231(b).

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§28.26A 3. Monitoring the Agent

Because an agent is not required by law to provide an accounting while the principal is alive, many agents are sued to provide an accounting after the principal dies. To minimize the probability of the agent's misusing the principal's money, the agent can be required by the document to provide periodic accountings to other relatives or a trusted third party. In addition, multiple agents could be named with each as a check on the activities of the others. However, multiple agents may limit the banks that can be used. The use of multiple agents also does not eliminate the possibility that the agents could work together to misuse the principal's money.

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§28.27 E. Power to Amend Trust

It may be useful to give the agent the power to amend a revocable living trust in order to respond to changes in the estate tax law. This is especially true in light of legislation such as the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), under which estate and generation-skipping transfer taxes would disappear in 2010 and then return in 2011. As discussed in chap 10, it is generally believed that EGTRRA-2001 will be subject to significant amendment.

The power of attorney can give the agent the power to revoke or amend the trust. Prob C §4264(a). Such a revocation or modification, however, is effective only if permitted by the trust instrument. Prob C §15401(c). Therefore, two clauses are needed, one in the power of attorney and a second in the trust.

NOTE: Conferring a power to create or amend a revocable trust does not confer a power to change the disposition of property at the principal's death unless the document expressly confers that additional power. See *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285.

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Source: Estate Planning/California Estate Planning/28 Power of Attorney for Financial Matters/§28.28 1. Form: Power to Amend Trust (For Inclusion in Power of Attorney)

§28.28 1. Form: Power to Amend Trust (For Inclusion in Power of Attorney)

28.28-1 Power to amend trust (power of attorney)

The principal and the principal's spouse have executed a trust known as the CLIENT FAMILY TRUST, established January 1, 2008. A major purpose of the trust was to transfer property for the benefit of the trust beneficiaries in a manner that minimizes gift taxes, estate taxes, income taxes, and the costs of transfer. Because it is not possible to know what changes will be made in the tax laws and what effect those changes will have on the principal's estate, the principal's agent under this Power of Attorney, acting alone or with the principal's spouse, may amend or revoke the above trust, or any other trust established in the future. These powers will be used only to reduce the costs and taxes to be paid by the estate and the beneficiaries. Notwithstanding the above, the agent is not authorized by this power of attorney to:

(1) Remove or otherwise change the trustee or amend the provision concerning the rights to serve as a trustee or successor trustee;

(2) Directly or indirectly deprive the trustee of the ability to determine trust investments;

(3) Eliminate or reduce any obligations of the trustee to report matters concerning the trust to beneficiaries or to render accounts;

(4) Modify a provision concerning trustee compensation;

(5) Modify a provision concerning trustee liability for breach of trust; or

(6) Remove property from the control of the trustee (except to the extent necessary to fund gifts allowed under this power of attorney).

Comment: This provision is designed to be included in a power of attorney. For a corresponding form to be included in a living trust, see §28.29. For further discussion of authorizing an agent to amend a trust, see Dennis-Strathmeyer, *A Power of Attorney for Estate Planning: Thoughts to Consider*, 23 CEB Est Plan Rep 62 (Dec. 2001).

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Source: Estate Planning/California Estate Planning/28 Power of Attorney for Financial Matters/§28.29 2. Form: Power to Amend Trust (For Inclusion in Living Trust)

§28.29 2. Form: Power to Amend Trust (For Inclusion in Living Trust)

28.29-1 Power to amend trust (living trust)

Any power of either Settlor of this trust to revoke or amend the trust (including any trust to be established in the future under the provisions of this trust), alone or jointly with the other Settlor, may be exercised by the power holder's attorney-in-fact if the document appointing the attorney-in-fact expressly so authorizes with an express reference to this trust.

Comment: This provision is designed to be included in a living trust. For a corresponding form to be included in a power of attorney, see §28.28.

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§28.30 III. CHECKLIST: ESTATE PLANNING-RELATED PROVISIONS IN FINANCIAL POWERS OF ATTORNEY

The checklist below sets forth the provisions that should especially be considered for inclusion in a power of attorney that is used as part of a comprehensive estate plan. Extensive discussion of forms, layout, and language for powers of attorney can be found in California Powers of Attorney and Health Care Directives, chaps 4-5 (Cal CEB 2008).

- Power to create a trust.
- Power to add property to a trust.
- Power to amend a trust.
- Power to make gifts.
- Power to revoke gifts.
- Power to make a disclaimer.
- Power to deal with real property.
- Power to deal with partnerships and other business interests.
- Power to deal with IRAs and retirement plans.
- Power to deal with the IRS.
- Power to access a safe deposit box.
- Nomination of conservator.

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29

Health Care Decision Planning

Leah V. Granof

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§29.1 I. FACILITATING ADVANCE HEALTH CARE DECISION PLANNING

"I'm not afraid of dying," said Woody Allen, "I just don't want to be there when it happens." But a client will be there when it happens, and so may the client's attorney. Some of the most important decisions a client will make, or that will be made for the client, will be made at the end of his or her life. A knowledgeable attorney can help clients give careful advance consideration to how, and by whom, those decisions are made.

It is not enough for a lawyer to know the legal mechanisms for making advance health care decisions. The attorney should facilitate reflection by the client, in consultation with family and friends, and aid in formulating and memorializing wishes and desires. Good communication underlies all health care decision planning. It is necessary to elicit the client's values, which are the distillation of religious, familial, cultural, social, and medical elements.

This chapter provides a broad overview of the legal mechanisms for making health care decisions. A checklist and worksheets are provided to guide the practitioner and the client through the steps in the planning process.

For more detailed discussion of this subject, see California Powers of Attorney and Health Care Directives (Cal CEB 2008); California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 4 (Cal CEB 2003).

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II. HEALTH CARE DECISION LAW

§29.2 A. Authority for Advance Health Care Decisions

The legal authority for advance health care decisions is set forth in the Health Care Decisions Law (Prob C §§4600-4805), which became effective July 1, 2000. This law attempted to unify and simplify prior law in order to encourage individuals to make advance health care directives and to make it easier for individuals to express their health care concerns.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.3 B. Definition of Health Care Decisions

§29.3 B. Definition of Health Care Decisions

A "health care decision" is any decision made by a patient or the patient's agent, conservator, or surrogate, regarding the patient's health care, including the following (Prob C §4617):

- Selection and discharge of health care providers and institutions;
- Approval or disapproval of diagnostic tests, surgical procedures, and programs of medication; and
- Directions to provide, withhold, or withdraw artificial nutrition and hydration and all other forms of health care, including cardiopulmonary resuscitation.

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§29.4 C. Definition of Advance Health Care Directive

An "Advance Health Care Directive" (AHCD) or "advance directive" includes both an "individual health care instruction" and a power of attorney for health care (PAHC). Prob C §4605. A PAHC is a written document designating an agent for health care decision-making. Prob C §4629. It is what was formerly known as a "durable power of attorney for health care." The term "durable" was dropped by the 2000 revision of the law in order to streamline the name and because there is no longer technical preoccupation with the issue of durability or continuing effectiveness through incapacity. Such continuing effectiveness is now presumed.

An "individual health care instruction" or "health care instruction" is a new concept under the Health Care Decisions Law. It describes a patient's ability to make written or oral directions for his or her own health care without necessarily naming an agent. See Prob C §4623. It addresses the planning needs of the client who does not have family or friends able or willing to serve as agent, as well as allowing directions to be provided to a designated health care agent. This is particularly useful for many seniors who outlive family or friends or who are geographically separated from family.

In practice, the two functions are often joined together—a single document usually contains both health care instructions and nomination of an agent.

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§29.5 D. Directions for Future Health Care Decisions

The PAHC is the most effective document by which the well-advised and careful client can make sensible arrangements in the event of incapacity. For this reason, the PAHC is the best way to accomplish "incapacity planning" and to effectuate the client's intent, particularly in handling the delicate and controversial subject of withholding or withdrawing of life-support treatment. It also allows the client to give very specific or very general directions to an agent in making a broad range of future health care decisions. The document may also include instructions for personal care, and grant an agent authority to determine where the principal will live and to provide meals, hire household employees, provide transportation, handle mail, arrange for entertainment, and control visitation.

Properly designed, the PAHC can avoid the need for a conservatorship and ensure that the client's preferred decision-maker is in charge of these most personal matters.

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§29.6 E. Powers and Limitations of Agent

Unless otherwise specified in the document, the authority of an agent becomes effective only on a determination that the principal lacks capacity, and ceases to be effective on a determination that the principal has regained capacity. Prob C §4682. The agent has the power to make health care decisions, as defined in Prob C §4617, and to have access to the principal's medical records. Prob C §4678. See §29.3. In *Hogan v Country Villa Health Services* (2007) 148 CA4th 259, 55 CR3d 450, the court held that the power to make health care decisions includes the power to execute arbitration agreements with a nursing home, relying heavily on the decision in *Garrison v Superior Court* (2005) 132 CA4th 253, 33 CR3d 350, in which the court held that an agent under a PAHC had authority to execute agreements requiring arbitration of disputes. See also *Warfield v Summerville Senior Living, Inc.* (2007) 158 CA4th 443, 69 CR3d 783; *Flores v Evergreen at San Diego, LLC* (2007) 148 CA4th 581, 55 CR3d 823 (spouse of nursing home resident had no authority as agent to execute arbitration agreement).

The agent's power to have access to the principal's medical records under Prob C §4678 is affected by the privacy rules of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (42 USC §§1320d-1320d-8) and regulations issued under the Act (45 CFR §§160.500-160.534). Access to the principal's medical records has been problematic under the uneven enforcement of the HIPAA privacy rules. Therefore, certification of authority to act upon the incapacity of a trustee or holder of a power under an AHCD or a durable power of attorney for financial management (DPAF) may be difficult or impossible to obtain without a "HIPAA Release."

PRACTICE TIP: Draft a "HIPAA Release" document citing the statute and the regulations directed to all health care providers subject to the HIPAA privacy rules, drawn heavily from the language of the Act. Attach it to and reference the advance health care directive and have the release separately executed and witnessed or notarized. The "Release" may reference a trust and power of attorney for financial management (DPAF) as well. For a sample form of authorization of release of protected health information for certification of authority for a trustee or an agent under a DPAF, see §29.11A. For further discussion, see California Powers of Attorney and Health Care Directives §§7.76-7.84 (Cal CEB 2008). See also Soskin, *How to Be a HIPAA Lawyer*, 26 CEB Est Plan Rep 125 (Apr. 2005).

The agent under a PAHC does not have the power to commit the principal to a mental treatment facility or to authorize convulsive treatment, psychosurgery, sterilization, or abortion. Prob C §4652.

The agent's authority also does not extend to placement in mental facilities or secured perimeter facilities for dementia patients. Such placement requires a conservatorship under the Lanterman-Petris-Short Act (Welf & I C §§5000-5550) or probate conservatorship of the person with special powers (Prob C §2356.5).

Unlike general agency law, under which the powers of the agent die with the principal, an agent under a PAHC retains particular postdeath powers. These include the power to authorize an autopsy, make organ donations, and direct the disposition of the decedent's remains, as well as the power to authorize release of the principal's medical records to the extent necessary to fulfill the agent's duties. Prob C §4683.

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F. Duration of Health Care Power

§29.7 1. Execution Before January 1, 1992

An attorney may occasionally see durable powers of attorney for health care (DPAHC) executed before January 1, 1992. These had a 7-year validity limitation. If the principal became incapacitated after execution but before the expiration of the limit, the DPAHC continued to be valid until the principal regained capacity. Former Prob C §4654(a)(1)-(2), (b). Appointments under such documents are no longer effective for clients with capacity. In reviewing a client's estate planning documents, the attorney should be alert for expired DPAHCs and urge the client to execute current documents.

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§29.8 2. Execution On or After January 1, 1992

Advance directives executed on or after January 1, 1992, have no time limitation on validity unless the principal specifies a limit. Prob C §4686. The practitioner should caution clients that imposing a time limit creates a risk that the client might become incapacitated and need medical treatment without having a valid document. An expired document may nevertheless be useful to an attending physician as evidence of a patient's wishes.

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§29.9 G. Importance of Documentation for Particular Clients

In the absence of a PAHC, the physician will usually turn to next of kin to make health care decisions for incapacitated persons, unless there is family disagreement. See, *e.g.*, *Barber v Superior Court* (1983) 147 CA3d 1006, 195 CR 484 (consultation by physicians with immediate family was reasonable, and no law required instituting a conservatorship proceeding). This default practice may be particularly ill suited to certain clients. Gays, lesbians, and other unmarried domestic partners, as well as singles, may be estranged from their family, as well as geographically and philosophically remote. Because the PAHC gives the agent access to medical records affected by the privacy rules of the Health Insurance Portability and Accountability Act of 1996 (HIPAA) (see §29.6), clients who are HIV positive, or suffer from AIDS or other communicable or sexually transmitted diseases that carry a social stigma, may not want to reveal this to their family of origin. It is critical for such clients to have a PAHC that appoints their partner or a close friend as agent, and that contains custom-drafted provisions reflecting their unique circumstances. For instance, a document may direct the agent with respect to approved and unwelcome visitors to the ailing client. Such directions may help avoid angry family conflicts in the hospital hallways. Similarly, a clause may be included restricting the right of particular relatives to mount a judicial challenge to the acts of an agent, particularly if the client knows that certain individuals have opposing belief systems or hostility toward the designated agent. See Prob C §4753. If the client lacks capacity to make a health care decision and a designation of a surrogate is necessary, the client's domestic partner has the same authority as a spouse has to make a health care decision for his or her incapacitated spouse. Prob C §4716 (second of two).

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§29.10 H. Out-of-State Documents

California recognizes and enforces a written health directive or PAHC that meets the requirements of the law of California or of the state of origin. Prob C §4676(a). Not all states recognize California's PAHC.

Thus, if clients winter or summer outside California or plan an extended stay in another state, it is advisable for them to execute an advance directive on the approved out-of-state form, observing the laws of execution of that state. This document should be distributed to all health care providers at the out-of-state site, and the original should be made accessible to the designated agent. For such drafting, it is advisable for the client to consult with a practitioner in the out-of-state locale.

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§29.11 I. Revocation of Health Care Power

A patient with capacity may revoke the designation of an agent by a signed writing or by personally informing the supervising health care provider. Prob C §4695(a). Any portion or portions of a health care directive other than appointment of the agent can be revoked at any time and in any manner that communicates an intent to revoke. Prob C §4695(b). The authority of an agent is revoked by the appointment of a conservator for the principal. The conservator, however, is still obliged to follow any health care instructions in the document. Prob C §2355(a).

The higher standard for revocation of an agency designation protects against miscommunication or misinterpretation by a third party, or the false revocation of an agent, such as when unscrupulous friends or relatives try to replace the name of the former agent with an abuser's name.

A health care provider or agent who is informed of the revocation has a duty to communicate that fact to any health care institution at which the patient is receiving care. The communication triggers the obligation of the health care provider to record the revocation in the patient's health care record in order to reduce the risk of reliance on an invalid directive. Prob C §4731(a).

If, after executing a PAHC, the principal's marriage to the agent is dissolved or annulled, the designation is revoked. Prob C §4697(a). On remarriage to the agent, the designation is revived. Prob C §4697(b). The revocation rule does not apply to legal separation.

In case of conflict of a directive with an earlier advance directive, the later one revokes the earlier advance directive. Prob C §4698.

PRACTICE TIP: A successor document that *expressly* revokes its predecessor and is copied and distributed to the principal's medical caretakers avoids the potential conflict of partial revocations.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.11A J. Form: Authorization for Release of Protected Health Information

§29.11A J. Form: Authorization for Release of Protected Health Information

Authorization for Release of Protected Health Information

I, _ _[*name of principal*]_ _, hereby appoint _ _[*name*]_ _ as my Personal Representative for health care disclosure under the Standards for Privacy of Individually Identifiable Health Care Information (45 CFR Parts 160 and 164) under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) and under the California Confidentiality of Medical Information Act (CMIA). (In the event that the aforementioned person cannot act, for any reason, I hereby appoint _ _[*name*]_ _ as my Personal Representative.)

My Personal Representative shall have the same access to my health and medical information as I would.

The authority granted to my Personal Representative herein shall be effective immediately and shall not be dependent on a determination of whether or not I lack capacity.

I authorize the disclosure of all of my health and medical information, whether now existing or hereafter created, related to my physical or mental ability to (a) perform the duties of a trustee of a trust or administer a trust, (b) understand or be able to make or communicate decisions about my property or financial or business affairs or the financial or business affairs of any other person for whom I am an agent under a durable power of attorney, or (c) make informed health care decisions regarding myself or any other person for whom I am an agent under an advance health care directive or similar instrument.

This authorization shall apply to any health care providers, including physicians, nurses, and all other persons, entities, who may have provided, or are providing at the time such health or medical information is sought by my Personal Representative, any type of health or medical care to me.

Such health and medical information shall be provided to: (1) my _ _[*spouse/domestic partner*]_ _ ; (2) my lineal ancestors and descendants; (3) my Personal Representative; (4) my and my Personal Representative's respective attorneys; and (5) any court or other governmental agency which may require such information in connection with any proceeding before such court or governmental agency.

My Personal Representative may disclose my health and medical information to such other persons or entities, such as trustees of trusts of which I am or have been a trustee, or agents under durable powers of attorney or advance health care directives executed by me, as my Personal Representative may determine in my Personal Representative's sole and absolute discretion.

Although information disclosed by a health care provider pursuant to this authorization is subject to redisclosure and may no longer be protected by the privacy rules of HIPAA (45 CFR §164), California law prohibits the further disclosure of this information without a "new authorization". It is my intention that this authorization form be construed to be a "new authorization" that meets the requirements of California Civil Code §56.11 for purposes of California Civil Code §56.13 to permit further authorization by recipients of information initially received under this authorization.

The authority given to my Personal Representative herein shall supersede any prior agreement that I may have made with any health care provider to restrict access to, or the disclosure of, my health and medical information.

I understand that I have the right to revoke this authorization and that any such revocation must be in writing and delivered to my Personal Representative (and to my alternative Personal Representative) to be effective.

This authorization shall remain in full force and effect until the earlier of (1) my written revocation hereof or (2) my death.

Any person or entity may rely upon a copy or facsimile of this document.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT

STATE OF CALIFORNIA)
COUNTY OF _ _[*name*]_ _)
_____)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

__[*Signature of officer*]__ [*Officer's seal*]

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III. THE PLANNING PROCESS

§29.12 A. Attorney Checklist for Planning

A checklist based on the following discussion is provided in §29.38.

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B. Threshold Concerns for Attorney

§29.13 1. Capacity of Client

Capacity is the threshold issue in determining whether an individual can execute a health care directive. A patient is presumed to have the capacity to make a health care decision, give or revoke an advance health care directive, and designate or disqualify a surrogate. Prob C §4657.

When capacity is questionable, the practitioner should refer to the legal standards for determining incapacity in the Due Process in Competence Determinations Act (DPCDA) (Prob C §§810-813, 1801, 1881, 3201, 3204). A physician's simple diagnosis of "dementia" or "senile dementia" is not sufficient to establish incapacity. DPCDA lists certain mental functions and requires explicit finding of deficits in those functions and analysis of how those deficits affect specific acts or decisions. From this detailed analysis is drawn a conclusion that an individual has or does not have capacity to perform a particular act.

As a guide to making a competency determination, the practitioner will find useful the Capacity Declaration—Conservatorship (Judicial Council Form GC-335), which was designed to be completed by the attending physician in a petition for probate conservatorship. The form lists the DPCDA criteria and can be helpful as a checklist when capacity is uncertain or may be challenged. This review can become part of the practitioner's file, in case his or her assessment of the client's capacity is later challenged.

If the attorney has questions about the capacity of a client or believes that there is an existing or potential conflict, the client should be referred to a geriatric-psychiatrist, neurologist, psychologist, or other professional skilled in evaluating capacity, for an assessment and report. The professional's report can be reassuring during the planning process, as well as potent evidence in any later litigation.

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§29.14 2. Ethics of Attorney

It is unethical for an attorney to prepare an advance directive for someone he or she has not seen or evaluated. The practitioner should be wary when a family member or friend gives him or her the information for an elderly or frail person who is described as weak or unable to come into the office. The attorney cannot know whether the directive and the appointment of the agent truly reflect the person's desire or if, in fact, that person has capacity. The attorney runs the risk that the go-between has a hidden agenda or ulterior motive.

It is important that the practitioner, as counselor, meet with the client, examine whether any conflicts exist, explain the scope of the document and the powers and limitations of the agent, make the threshold determination of capacity, and instruct the client with regard to the correct distribution of the executed document and copies.

For more detailed information on ethics in this context, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 2 (Cal CEB 2003).

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.15 C. Facilitating Client Decision-Making

§29.15 C. Facilitating Client Decision-Making

The attorney can play an important role in helping a client think about goals for medical treatment and what he or she would want in various situations. The client should be encouraged to consider his or her wishes and desires in different circumstances and scenarios. The worksheet in §29.39 can be provided to the client in advance of the initial planning meeting to facilitate formulation of wishes and desires, or can be used as a guide to conversation at the initial meeting.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.16 D. Selecting the Agent

§29.16 D. Selecting the Agent

The most important decision the client will make is the selection of an agent. The following individuals are prohibited from serving as agent in order to avoid what could be dangerous or even life-threatening conflicts of interest (Prob C §4659(a)):

- A supervising health care provider;
- An employee of the health care institution where the patient is receiving care; and
- A community care facility or residential care facility operator or employee.

The worksheet in §29.40 is designed to help the client choose the most appropriate agent.

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§29.17 1. Co-Agents

The author counsels strongly against the appointment of co-agents because of the risk of conflicts and disagreements and the resultant delay or indecision. In addition, co-agents can create more complexity in dealing with medical care providers. Generally, parents want to treat all their children equally and, in order not to offend a particular child or children, want them all to participate in health care decisions. Issues of sibling rivalry, guilt, and differences in philosophy, however, can impede and sometimes halt the decision-making process. It is preferable to name the most capable and appropriate child first, and the others as alternates, and deal with wounded feelings later.

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§29.18 2. Alternate Agents

Alternate agents act when there has been death, resignation, or inability to act by the primary agent. The designation of alternate agents is important to ensure that individuals approved by the client continue to make health care decisions.

The succession of an alternate agent may, however, present problems of acceptance by a third party. To avoid these issues, if a competent client changes his or her mind about the designation of an agent, a newly executed directive revoking the former one and naming the alternate as agent is advised.

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§29.19 3. No Agent

The practitioner will encounter clients who have no living relatives, whose contemporaries are either too old or unwilling to accept the agency or who, for a host of other reasons, have no person they trust to appoint as a health care agent.

The advance directive under the Health Care Decisions Law allows an individual to make health care desires known without naming an agent. Under previous law this opportunity was restricted. This new development can be helpful in some circumstances. If there is no named agent, however, incapacity may still trigger a need for a conservatorship to have someone empowered to act on behalf of the principal. In addition, as a practical matter, instructions are less likely to be heeded by health care practitioners without an advocate to oversee health care.

Some social and religious-based agencies and private fiduciaries will become the agent for a fee. This may provide a better alternative to the bare wishes of an advance directive that specifies no one to make the delicate and important decisions necessary to carry out the principal's desires.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.20 4. Nomination of Conservator

§29.20 4. Nomination of Conservator

A properly designed PAHC will eliminate the need for a conservatorship of the person in many circumstances. To cover the possibility that a conservator may be necessary, it is advisable to make a nomination in the PAHC, as authorized by Prob C §4672. Such a nomination is valid under Prob C §1810 (governing priority to serve as a conservator), and a court is bound to give it deference. *Conservatorship of Ramirez* (2001) 90 CA4th 390, 108 CR2d 581.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.21 IV. CHOICE OF FORMS AND DRAFTING CONSIDERATIONS

§29.21 IV. CHOICE OF FORMS AND DRAFTING CONSIDERATIONS

There are three options for the drafting of documents for health care decision planning: (1) a statutory form set forth in Prob C §4701; (2) the California Medical Association form, or a form provided by another commercial publisher; and (3) an attorney-drafted custom form, complying with statutory requirements.

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§29.22 A. Statutory Form

The statutory form in Prob C §4701 can be used as an individual health care instruction, without appointment of an agent, or as a PAHC, appointing an agent. The form provides spaces for nomination of a conservator, end-of-life decisions, relief from pain, "other wishes" regarding end-of-life decisions, and organ donation, and allows for exceptions to the agent's postdeath authority to authorize an autopsy and direct disposition of remains. It does not mention the right of the agent to access medical records. Part 4 provides an optional and questionably useful place to designate one's primary physician. In the present climate of HMOs, PPOs, and similar organizations, it may be difficult for a client to designate a primary physician of any permanence. If the client has a physician of some duration or to whom he or she has a particular connection, this part should be completed.

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§29.23 B. CMA Form

The California Medical Association (CMA) Advance Health Care Directive form is the most widely used. It is the form that hospitals, hospice, and skilled nursing facilities routinely offer to incoming patients to meet their requirements under the Patient Self-Determination Act of 1990 (PSDA) (42 USC §1395cc(f)). The purpose of the PSDA is to provide patients on admission with written information about their medical rights and to provide advance directive forms if patients wish to complete them. Because these forms are common in hospitals, they have the advantage of being readily recognized by medical care providers.

The revised CMA form comes in a folder entitled "My Health Care Wishes—The California Medical Association's Advance Health Care Directive Kit." Forms may be ordered for a fee by phone at (800) 882-1262; by fax at (916) 551-2035; online at http://www.cmanet.org, or by mail through CMA Publications, 1201 J Street, Suite 375, Sacramento, CA 95814-2906.

The inside of the front cover provides spaces in which to list people who have a copy of the directive. The back cover has a punch-out wallet ID card.

A clearly written introduction contains answers to commonly asked questions about advance directives. The advance directive allows a person to appoint an agent (PAHC) or provide health care instructions without an agent, and allows for nomination of concurrent and alternate agents. There is no place for nomination of a conservator, but this omission can be remedied by making the nomination in an attachment.

PRACTICE TIP: Section 2 of the CMA form (§1.3 of Part I of the statutory form, discussed above), if checked, allows the agent authority to make health decisions immediately. This option is curious, unexplained, and potentially risky. An agent's authority under a PAHC is triggered only by the principal's incapacity. Prob C §4682. By checking this section, agent and principal would have concurrent powers, giving rise to the potential for disagreements and confusion among medical care providers. The author recommends against checking this box.

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§29.24 C. Attorney-Drafted Forms

An attorney-drafted form may occasionally be appropriate for a client with an unusual health condition or specific health care wishes that can be effectively communicated only in a custom document. Unfortunately, a custom document may be questioned by the entry-level health care facility employee who is familiar only with the printed forms. Such questions could cause delays in treatment while the document is being approved. The CMA and statutory forms provide substantial opportunity for customization by attachment. To minimize confusion, they may be the better alternative to a custom document. For samples of attorney-drafted forms, see California Powers of Attorney and Health Care Directives, chap 7 (Cal CEB 2008).

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§29.25 V. EXECUTION REQUIREMENTS

The Health Care Decisions Law's main thrust was to simplify the execution of the various health care planning forms and thereby to encourage more people to have advance health care directives. All the forms may be either witnessed or notarized.

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§29.26 A. Witnessing Procedure

The PAHC must contain the date of its execution to satisfy one of the requirements of legal sufficiency. Prob C §4673(a)(1). Two adult witnesses are required. Prob C §4673(a)(3). One of the two witnesses cannot be related to the principal by blood, adoption, or marriage, or be entitled to part of the principal's estate. Prob C §4674(e). A declaration to that effect must be part of the document and signed by the appropriate witness. Prob C §4674(f). Both witnesses must execute a statement under penalty of perjury that they witnessed the principal signing the document, have knowledge of the identity of the principal or proof of identity, and believe the principal to have capacity. Prob C §4674(d).

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§29.27 B. Notarization

The PAHC may be notarized as an alternative to witnessing. Prob C §4673(a)(3). The witnessing requirements of Prob C §4674 do not apply to notarization. Prob C §4674(g). Notarization is required for an electronic advance health care directive that may be executed with a digital signature. Prob C §4673(b).

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§29.28 C. Execution in Skilled Nursing Facility

The execution of a PAHC in a skilled nursing facility (SNF) deserves the careful treatment the law provides because of the possible mischief that can occur surrounding the voluntariness of a decision made by patients of impaired capacity.

If the principal is a patient in an SNF when the PAHC is executed, a patient advocate or ombudsman designated by the Department of Aging must sign the document as one of two witnesses if the witnessing procedure is followed, or in addition to notarization. Prob C §4675(a). The patient advocate or ombudsman will usually want to speak with the principal in advance of the execution, to be sure that the document is understood and undertaken voluntarily. Contact information for the local ombudsman's office should be available on a large sign posted in the SNF, through the local Area Agency on Aging, or in the telephone book. The attorney should call in advance to arrange the details for the execution.

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§29.29 VI. SPECIAL PROVISIONS

The PAHC confers certain limited postdeath powers on the agent that can be the subject of strong religious, moral, and philosophical views of the client. It is important to advise the client about the scope of the agent's powers to dispose of remains, order an autopsy, continue to access or release medical records, and authorize organ donation. Prob C §§4678, 4683(b). See §29.6.

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§29.30 A. Autopsy

An agent under a PAHC can order an autopsy of the principal's remains. See Health & S C §7113. If the principal for any reason is opposed to or wishes to restrict the agent's exercise of this power, he or she must explicitly state this in the document. Even then, the principal's wishes may be overridden by laws that require autopsy under certain circumstances.

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§29.31 B. Disposition of Remains

Unless the principal states otherwise in the PAHC, the agent will have the power to order interment, cremation, and memorial services, and to claim the body from the coroner. See Prob C §4683(b)(3); Health & S C §7100.

Emotions run high in this area and are overlaid by religious tenets about interment, cremation, and related procedures. To ensure that the principal's wishes are heeded, the PAHC should clearly state any desires about the disposition of remains, funeral, burial, or cremation arrangements, plot and cemetery locations, and preferences regarding ash distribution, as necessary.

Of course, service providers must be made aware of these desires. In *Spates v Dameron Hosp. Ass'n* (2003) 114 CA4th 208, 7 CR3d 597, the daughter of a nursing home patient provided the nursing home with information regarding the decedent's burial insurance and instructions indicating that the decedent's remains were to be sent to a funeral home, but this information was not communicated to a hospital where the patient was moved and later died. The court held that the daughter did not have a negligent infliction of emotional distress claim against the hospital, which attempted unsuccessfully to notify the daughter of decedent's death and then turned over decedent's remains to the county coroner for cremation.

Many clients have purchased plots from religious and fraternal organizations and some have made pre-need funeral arrangements. Information about and location of documents describing the ownership and location of cemetery plots and receipts for paid funeral and/or cremation arrangements should be made available to the agent. In discussing these matters with the client, the attorney should ask the client to address the issue of paying for disposition costs. Either prepayment or a designated burial fund (*e.g.,* a bank account or insurance proceeds) will ease the burden of the agent and ensure that the principal's instructions are carried out. For further discussion of the law surrounding the disposition of remains, see chap 31.

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§29.32 C. Anatomical Gifts

An agent under a PAHC has the authority to make anatomical gifts under the Uniform Anatomical Gift Act (Health & S C §§7150-7151.40) unless the principal expressly prohibits it in the document. Another way for a client to indicate willingness to make such gifts is upon issuance of a new driver's license, renewal of a driver's license, or issuance of an identification card to complete a gift form provided by the Department of Motor Vehicles (DMV) to be attached to the person's driver's license to enroll in the California Organ and Tissue Donor Registry, which is mailed to the California Organ and Tissue Donor Registrar. The word "donor" will be printed on the face of the driver's license or identification card of each registered donor. Health & S C §7151.20; Veh C §§12811(b), 13005(b).

PRACTICE TIP: If there are privacy concerns, the client should be told that his or her name will be available to federal donor organizations and posted on the websites of the DMV and the California Health and Human Services Agency.

The form requires information identifying the donor, consent for organs and tissue to be donated, and describes how to remove, add, or delete gifts. The form remains binding on the client's death if members of the client's family are opposed to the donation.

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VII. DO NOT RESUSCITATE ORDERS AND ALTERNATIVE

§29.33 A. Request Regarding Resuscitative Measures

In an emergency situation of cardiac or pulmonary failure, absent other instructions, cardiopulmonary resuscitation (CPR) is performed by medical emergency response employees such as paramedics, fire fighters, and law enforcement officers. Because the PAHC encompasses all health care decisions, a decision to forego CPR may be expressed in the document. When the quality of life being sustained is perceived as substandard, a frail, terminal, vegetative, or comatose principal may not want to go through the rigorous CPR process, which can result in oxygen deprivation and permanent mental or physical compromise. The law contemplates that some patients will reach this conclusion, and provides for methods of communicating this decision to health care providers, especially emergency medical personnel who are often the first responders in critical situations. The law also contemplates that some patients may reach a different conclusion. Accordingly, the law provides for both the patient and physician to execute either a "do not resuscitate" (DNR) order (see §§29.34-29.36) or a "physician orders for life sustaining treatment" (POLST) form (see §29.37). Prob C §§4780-4785.

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§29.34 B. DNR Order in Home Care Setting

If emergency response employees are called to a person's home, they are mandated to resuscitate consistent with their mission to save lives. A client wishing to avoid CPR, or an agent acting on a principal's instructions, should be advised of the Emergency Medical Services Authority Prehospital "Do Not Resuscitate" (DNR) form issued by the California Medical Association. See Prob C §4780(a)(2)(A). This form must be signed by the physician and the patient client (Prob C §4780(a)(1)), and the client should obtain a Medic-Alert bracelet, which evidences the DNR form and which contains the patient's identification number and a 24-hour toll-free number (Prob C §4780(e)). Additional considerations apply to the use of DNR orders in a skilled nursing facility (see §29.35) or residential care facility (see §29.36).

A copy of the executed form must be supplied to the personnel in an emergency so that the patient's wishes will be followed and CPR will not be applied. Thus, family and friends should know where the DNR form is located. The attorney should instruct the client to have the DNR orders made part of his or her medical records.

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§29.35 C. DNR Order in Skilled Nursing Facility (SNF)

If the patient is elderly and in a skilled nursing facility (SNF) or similar institution, it is critically important that a DNR order be on the medical chart. Nonetheless, the SNF may call "911" in the event of a critical incident, and CPR may be commenced on the way to the hospital contrary to the patient's wishes. This happens frequently and may be the result of an attempt by the SNF to avoid liability for failure to resuscitate, sloppy medical recordkeeping, or failure of the agent to see that the DNR is duly recorded. To protect against this, the CMA's Emergency Medical Services DNR form should be completed and the Medic-Alert bracelet worn by the patient.

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§29.36 D. DNR Order in Assisted Living or Residential Care Facility

The operator of an assisted living or residential care facility will rarely have a licensed health care provider on duty at the time a life-threatening emergency occurs. Therefore, the facility is required to call "911." To ensure that the patient's wishes are followed, the CMA's DNR form should be completed and the Medic-Alert bracelet worn.

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§29.37 E. Physician Orders for Life Sustaining Treatment (POLST)

As an alternative to a "do not resuscitate" (DNR) form, a patient may execute a "physician orders for life sustaining treatment" (POLST) form, as approved by the Emergency Medical Services Authority. It is expected that the form will soon become available from the California Medical Association. See Prob C §4780(a)(2)(B). As with the DNR form, the POLST form must be signed by the physician and the patient client. Prob C §4780(a)(1). See §29.34.

The agent under a PAHC may execute the form only if the patient lacks capacity or has designated that the agent's authority is effective. Prob C §4780(b). The POLST form is to be completed by the health care provider based on patient preferences and medical indications and explained to the patient. Prob C §4780(c). A patient having capacity may revoke the POLST form at any time. Prob C §4780(d).

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VIII. CHECKLISTS AND WORKSHEETS

§29.38 A. Checklist: Health Care Decision Planning

___ 1. Encourage client discussion with family and physician about values and wishes and end-of-life decisions before office appointment.

___ 2. Conduct initial client meeting, giving information about scope, availability, and importance of health care directive, and guiding client through reflection about personal priorities and spiritual and other values important to medical decisions.

___ 3. Stress importance of choosing agent and use worksheet to facilitate choice.

___ 4. Analyze client circumstances and determine whether statutory, CMA, or attorney-drafted form is appropriate.

___ 5. Discuss Pre-Hospital Do Not Resuscitate form and its use.

___ 6. Have client execute document, observing witnessing and notarization requirements.

___ 7. Instruct client to keep original in a place where it can easily be found (e.g., glove compartment of car), not bank safety deposit box.

___ 8. Instruct client to give copies to agent, physician, and, on admission to hospital, health care facility, and before undergoing any major diagnostic tests. Retain copy in client file in case of loss by agent.

___ 9. Instruct client to re-examine health care documents:

- At start of every decade.
- On major life changes such as death of spouse, divorce, remarriage.
- On major medical change such as diagnosis with serious disease or terminal illness.
- On loss of ability to live independently.

___ 10. Keep current on new legislation, cases, and statutes that affect the substance and technicalities of health care decision-making. Inform clients of changes as necessary.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.39 B. Worksheet: Advance Health Care Planning

§29.39 B. Worksheet: Advance Health Care Planning

Consider your health care options, and what you would like your agent to know, if you:

___ 1. Can no longer walk and are confined to a wheelchair.

___ 2. Are in severe pain.

___ 3. Are in severe discomfort (nausea, diarrhea).

___ 4. Cannot get outside.

___ 5. Are on a feeding tube to keep you alive.

___ 6. Are on a kidney dialysis machine to keep you alive.

___ 7. Are on a breathing machine to keep you alive.

___ 8. Need a 24-hour caretaker.

___ 9. Cannot control your bowels.

___ 10. Cannot control your bladder.

___ 11. Live in a nursing home.

___ 12. Can no longer think clearly.

___ 13. Can no longer talk clearly.

___ 14. Can no longer recognize family or friends.

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Source: Estate Planning/California Estate Planning/29 Health Care Decision Planning/§29.40 C. Worksheet: Choosing a Health Care Agent

§29.40 C. Worksheet: Choosing a Health Care Agent

A good health care decision-maker is one who:

___ 1. Is willing to speak on your behalf.

___ 2. Is able to act on *your* wishes and separate his or her own feelings from yours.

___ 3. Lives close by or could travel to your side if needed.

___ 4. Knows you well and understands what you want.

___ 5. Can handle the responsibility.

___ 6. Is willing to talk with you now about sensitive issues and is open to hearing your wishes.

___ 7. Will likely be available into the future.

___ 8. Would be able to handle conflicts of opinion among family and friends.

___ 9. Is capable of being a strong advocate in the face of an unresponsive or uncooperative doctor or institution.

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30

Transfers in Medi-Cal Planning

John Milgate

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§30.1 I. INTRODUCTION TO MEDI-CAL PLANNING

Transfers of property may be appropriate if government assistance through the Medi-Cal program is desired or has already begun. This chapter is intended as a general discussion of the use of transfers to (1) establish eligibility for Medi-Cal, or (2) avoid or reduce the state's recovery claim for services provided through the Medi-Cal program. It will provide the general practitioner with a basic knowledge of the reasons for such transfers and the various transfer techniques that might be utilized. It is not intended as a transaction guide for making such transfers. Instead, reference is made to other materials that include details of the various transfer techniques.

Many of California's regulations governing the Medi-Cal program are out of date. Much of the program is administered based on draft regulations issued as an attachment to two All-County Welfare Directors (ACWD) Letters issued in 1990 (ACWD Letters 90-01 (Jan. 5, 1990), 90-03 (Jan. 8, 1990)). The Medi-Cal regulations also have not conformed to many requirements of the Deficit Reduction Act of 2005 (DRA-2005) (Pub L 109-171, 120 Stat 4). See 42 USC §1396p(c), (e).

PRACTICE TIP: The California Department of Health Care Services ACWD Letters are available online (search for ACWDL) at http://www.dhs.ca.gov.

Given the difficulty of remaining current in this field, the general practitioner or estate planning attorney may use this chapter to help clients anticipate the future need for long-term care, to evaluate proposed Medi-Cal related transfers, or to decide when it would be appropriate to refer the client to a qualified elder law attorney for further consultation or actual implementation of transfers.

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§30.2 A. Medi-Cal versus Medicare

Many people confuse Medicare with Medi-Cal. Medicare is a federal medical benefits program financed through Social Security. Being a recipient of Social Security benefits is the primary eligibility criterion for Medicare; benefits are available to all participants regardless of financial need. Many Medicare recipients mistakenly believe that all their health care needs will be met by the Medicare program. In reality, although Medicare provides substantial payments for hospitalization, benefits for care at home or in a nursing facility are quite limited. For example, Medicare generally pays for care in a nursing home only if the recipient first spent at least 3 days in an acute care hospital and requires "skilled nursing care" (often involving wound care, intubation, or rehabilitation) related to that same illness or episode. 42 CFR §§409.30-409.36. In such situations Medicare pays for only the first 20 days of skilled nursing care. Medicare pays a substantial co-payment for the 21st through 100th days, and nothing thereafter. See benefits chart in California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 8 (Cal CEB 2003).

In contrast, Medi-Cal (or Medicaid, as it is called in most other states) is a "needs based" (welfare) program, funded jointly by the federal and state governments. Strict asset guidelines govern eligibility. To establish eligibility for Medi-Cal, an individual must either receive benefits under a "linked" program (such as Transitional Aid for Needy Families, Cal-WORKS, or the Supplemental Security Income program (SSI)), or establish eligibility as an aged, blind, or disabled person. 42 USC §1396a(a)(10)(A).

NOTE: Although Medi-Cal is a "welfare" program, as discussed in this chapter, many otherwise "middle-class" people can (and do) receive benefits, particularly for long-term care in skilled nursing facilities.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.3 B. Transfers as Only One Form of Medi-Cal Planning

§30.3 B. Transfers as Only One Form of Medi-Cal Planning

Numerous techniques are available to help people bring their "resources," or assets, within the limits established by the Medi-Cal program. The use of transfers or gifts is only one technique for establishing eligibility. In many instances, it may not be the best technique available. Yet, lifetime transfers may be the most effective technique for "claims avoidance."

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II. GENERAL CONSIDERATIONS FOR MEDI-CAL TRANSFERS

§30.4 A. Level of Care

Obtaining Medi-Cal benefits is not appropriate for all clients. In some California counties, the number of nursing homes participating in the Medi-Cal program is limited. In some areas, the facilities that participate in Medi-Cal are viewed as inferior or otherwise unsuitable. A client should explore these issues before seeking Medi-Cal qualification, through transfers or otherwise. In addition, clients should be apprised of a fairly pervasive view that Medi-Cal patients receive inferior care. Although this view has not been borne out by the author's experience, the possibility should be considered by each client.

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§30.5 B. Client Expectations

As with transfers pursued for other reasons, clients who make transfers for Medi-Cal purposes have certain expectations that underlie the decision to effect the transfer. Transfers for Medi-Cal purposes should be pursued only if a transfer will achieve the client's expectations.

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§30.6 1. Providing for Family

Many clients wishing to make a present gift ("transfer") of their assets to establish eligibility or avoid a recovery claim under Medi-Cal do so out of the desire to provide for their immediate family. For example, a spouse or domestic partner often attempts to achieve Medi-Cal eligibility for nursing home benefits as a means of preserving more assets for the other spouse or domestic partner. Many clients also make lifetime gifts to protect the anticipated inheritance of their children. It is possible, under present law, to achieve both of these expectations through lifetime transfers.

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§30.7 2. Care Objectives

Few clients are willing to sacrifice their own care in order to achieve property preservation objectives. Most people prefer to receive care at home, if reasonably possible. Very few would identify a nursing home as their permanent residence of choice. To pay for home care, private insurance or private payment for care is usually necessary. The Medi-Cal program will not provide 24-hour care in the client's home. Of particular importance for married couples, resource limits for home care benefits are much more restrictive than those applied if one spouse is in a skilled nursing facility. Similar benefit criteria apply to registered domestic partners. See Fam C §297.5(a). In general terms, to be eligible for home-care benefits, the couple must limit their "nonexempt resources" to no more than $3000, while eligibility with one of them in a nursing home can be achieved while they still own over $100,000 in such resources. See §30.23.

CAVEAT: In jurisdictions where the Program of All-Inclusive Care for the Elderly (PACE) operates—currently Los Angeles, Oakland, San Francisco, and Sacramento—clients may receive additional at home services once they meet the nursing home eligibility standards.

If the attorney represents both spouses or domestic partners, it is important to acknowledge openly that these differing rules give the "well" spouse or domestic partner a strong economic incentive to pursue nursing home placement for the ailing spouse sooner rather than later.

PRACTICE TIP: If the practitioner will advise both partners in a marriage or domestic partnership, an express waiver of this actual conflict should be obtained. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 2 (Cal CEB 2003).

Not all nursing homes participate in the Medi-Cal program, and sometimes it can be difficult to locate a facility willing to accept a new patient who is receiving Medi-Cal benefits. A client currently residing in a facility that does not accept Medi-Cal should be told that a move to another facility will be necessary to obtain benefits. Depending on the facilities, such a move may alter the client's life considerably: the workers providing day-to-day care will be different, roommates and their visiting families will change, and the ease with which the client's own family can visit may change (depending on the proximity of the facility to the homes or places of employment of the family members, and, perhaps, on the availability of public transportation). Any of these changes may adversely affect the quality of care. It is generally believed that the frequency and unpredictability of family visits are important factors in determining the quality of care in a skilled nursing facility, although published studies focus more on staffing (particularly the ratio of registered nursing staff to patients).

PRACTICE TIP: The practitioner should contact the local Long-Term Care Ombudsman office to obtain a list of skilled nursing facilities in the county, in order to share with clients the names of those that participate in the Medi-Cal program and those that do not. For a discussion of Long-Term Care Ombudsman programs, see Elder Law Resources, chap 5. Such information is also available online from California Advocates for Nursing Home Reform at http://www.canhr.org.

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§30.8 3. Psychological Impacts

Whether accurately or not, the client with minimal cognitive impairment may perceive the decision to qualify for Medi-Cal as a lessening of the quality of care. Although many "middle-class" people receive Medi-Cal benefits, it remains a welfare program. The transfer of virtually all assets, even to a long-time spouse or domestic partner, may affect the client's perception of how he or she is treated by others, as well as his or her own sense of self-worth. American society places great emphasis on material wealth as a measure of status, and the sudden loss of wealth (even if undertaken voluntarily) can affect the client profoundly. This sense of loss may be heightened by an attorney's explicit explanation of the loss of rights that accompanies the transfer of title to property. Although family members and others may tell the client that all this is "just on paper," the attorney must insist that the transfer means actual and real impoverishment and loss of control over the assets transferred. The attorney should be sensitive to clients who react emotionally, understanding their concern for their future welfare.

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§30.9 4. Future Support for Giver

The practitioner representing the proposed Medi-Cal beneficiary should help evaluate whether the client's financial resources will remain adequate to meet future needs. A realistic evaluation of this issue will often preclude a client from making substantial gifts while still living in his or her own home. Although Medi-Cal does provide some benefits for care at home, those benefits alone are insufficient to allow a person needing 24-hour care to remain at home, even for the short term. However, when part-time care at home (possibly including some "day care" options) would be sufficient, achieving eligibility through gifts might allow the client to remain at home when such expenses would otherwise make at-home care impossible. If the client's condition deteriorates, however, and care needs increase, the client may be left without resources to continue home care, and may be forced by the lack of funds into a nursing home placement where Medi-Cal benefits can be obtained.

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§30.10 5. Will Medi-Cal Remain Appropriate?

Even for the client who is already placed outside the home, the attorney should consider whether Medi-Cal will remain the most appropriate mode of payment. The client should be reminded that Medi-Cal long-term-care benefits are available only for care in a skilled nursing facility. If a client's condition might improve to the point that a residential care facility, or even a return home, would be more appropriate, transfers for purposes of Medi-Cal may preclude such a future change in placement. Indeed, transfers for Medi-Cal purposes may preclude all other forms of care for the balance of the client's life. The attorney should help the client consider these care realities before effecting transfers.

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§30.11 6. Property Tax Impact

The outright gift of California real property can result in a reassessment of the property for property tax purposes. Rev & T C §§50, 60-60.9. Although the most common Medi-Cal motivated transfers (to a spouse, domestic partner, or children) can be structured to avoid reappraisal, the exemption on transfers to children is available only if timely requested through a Claim for Reassessment Exclusion for Transfer Between Parent and Child filed with the county assessor. Rev & T C §63.1(d)(1). An increase in the assessed value of real property could affect eligibility in addition to increasing taxes. See §30.29. For further discussion of property tax reassessment, see chap 15. Any property tax increase or reassessment should be considered before making a gift of real property.

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§30.12 7. Capital Gains Impact

The transfer of appreciated property can result in significant adverse capital gains tax consequences. In general, property passing at death receives a step-up or step-down in its cost basis to its fair market value as of the date of death. IRC §1014(a). See chap 12. Any subsequent sale of the property results in a capital gains tax only if the property increased in value after the date of the donor's death. In contrast, property transferred by gift during life carries over its existing basis in the hands of the donor. IRC §1015; Rev & T C §24914. If the property has appreciated in value, a subsequent sale will result in capital gains tax liability on the difference between the adjusted cost basis and the sale price of the property. Such a tax can greatly reduce the benefits to the recipient of the lifetime gift, and should be weighed by the client when considering a transfer.

PRACTICE TIP: The practitioner should discuss cost basis and capital gains tax issues with clients who arrive determined to make a present gift of their house for Medi-Cal purposes. See §30.40 for basis step-up options. For a discussion of carryover basis under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), see chap 12. For discussion of the possible use of an "intentionally defective irrevocable trust" to avoid this result, see Wilkinson & Wilkinson, *California Irrevocable Trust: A Preferred Strategy for Protecting the Family Residence From Medi-Cal Recovery Claims*, 8 Cal Tr & Est Q 18 (Spring 2002).

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§30.13 8. Estate and Gift Tax Impact

Perhaps the most common misconception among clients concerning transfers for Medi-Cal purposes is that they are absolutely limited to no more than $13,000 per person per year, the IRC §2503(b) gift tax annual exclusion amount. It is often necessary to explain the difference between gift and estate tax rules and those applicable to Medi-Cal. Issues of gift and estate taxation are addressed elsewhere in this volume (see chap 10). As a rule, those attempting to qualify for Medi-Cal will not pay taxes unless the value of the assets given away, in excess of the gift tax annual exclusion amount, is greater than $1 million. IRC §2505. (The author has never had a client who incurred a gift tax liability from a gift made in order to qualify for Medi-Cal). Even if total gifts are less than $1 million and no tax is payable, a gift tax return should be filed if total gifts in any year exceed the available annual exclusion amount. IRC §2503(b). For a discussion of estate and gift taxes under EGTRRA-2001, see chap 10.

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§30.14 C. Are Transfers for Medi-Cal Purposes Ethical?

Questions are sometimes raised concerning the "ethics" of making gifts to qualify for public benefits. Some commentators have condemned the practice. Arguably, the adoption by Congress of statutes seeking to impose criminal liability for those who counsel or assist a person to become eligible for Medi-Cal by transferring away assets evidences disapproval of the approach. Following legal action, however, the United States Attorney General has been enjoined throughout the nation from enforcing these penalties. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). In the author's view, the ethics of Medi-Cal transfers is substantially similar to lifetime gifts to avoid estate tax.

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§30.15 1. Parallels to Tax Planning

One common technique for reducing the impact of estate taxes has been the use of annual exclusion gifts permitted under IRC §2503(b)(1). Such lifetime gifts, which reduce estate tax liability by decreasing the value of the expected estate, also reduce the amount of money available to the government through the estate tax to provide for, among other things, those with medical needs. Gifts intended to reduce the amount of death tax revenue the government receives are virtually never challenged on ethical grounds. Similarly, transfers that avoid postdeath Medi-Cal claims reduce the value of an estate and thereby also reduce the revenue available to the government through the Medi-Cal estate recovery process to provide for those with medical needs. Transfers for purposes of obtaining Medi-Cal benefits, although not identical to transfers that reduce revenues, are similar in their effect.

EDITOR'S NOTE: The author's view may be open to question. Transfers for purposes of obtaining Medi-Cal benefits not only reduce the revenue available to the government but also increase its expenditures. The author's focus on the recovery process ignores the initial benefit to the transferor.

In general, transfers to establish Medi-Cal eligibility merely hasten the date someone becomes eligible; seldom are they used to obtain eligibility for those who would never qualify under any circumstances. The fact that a person with a $1 million estate could qualify for Medi-Cal does not mean that there are many such people who choose to qualify for benefits.

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§30.16 2. Public Policy and Medicare

The need for nursing home care is concentrated among Medicare recipients who are unfortunate enough to have contracted the "wrong" disease. If an elderly individual needs coronary bypass surgery, Medicare would pay 80 percent of the reasonable and customary charges for that procedure (often exceeding $100,000). However, if an individual suffers from Alzheimer's Disease, Parkinson's Disease, dementia, or numerous other ailments, there is little opportunity for acute medical intervention, and, therefore, Medicare provides virtually no assistance. People with these and similar degenerative conditions must meet care expenses in other ways. The substantial changes made to the federal Medicaid law in 1988 were inspired by a congressional study that found that a significant number of married couples were impoverished soon after one spouse entered a nursing home (hence the common reference to Medicaid qualification statutes as the "spousal impoverishment provisions").

PRACTICE TIP: The attorney should encourage estate planning clients to explore the benefits of long-term care insurance. Many policies support care at home and in assisted living facilities, as well as in nursing homes. Most policies are priced to reward the early purchase of coverage. Some offer an investment model, often coupled with term life insurance coverage, as a means of recouping premiums paid by those who never need long-term care.

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§30.17 D. Will Client Lose More Than Is Gained by Transfer?

Transfers of assets in the Medi-Cal context, whether to establish eligibility or to avoid a recovery claim, typically result in the client being at least cash poor, if not outright destitute. Because single individuals cannot qualify for benefits unless their "non-exempt" assets are worth less than $2000, many people erroneously conclude that all Medi-Cal recipients are impoverished. However, under California law, a recipient can own considerable "exempt" and "unavailable" assets. The recipient's principal residence is the primary example (Medi-Cal rules place no limits on the equity or value of the recipient's home). Nonetheless, several non-financial factors should be considered when assessing Medi-Cal transfers.

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§30.18 1. Independence and Autonomy

In this society, independence is highly valued. Elders with a lifetime of self-reliance may be uncomfortable parting with assets in a way that results in their becoming dependent on others, particularly on family members. Especially for clients who still live in their own homes, a gift of substantially all of their assets to another (even to a spouse) raises significant issues of their own autonomy. Many people ground their personal identity in the things that they own and the neighborhood in which they live. In some cases, the person's identity is challenged if what has long been "our" house suddenly becomes his or her spouse's house.

The loss of independence resulting from deliberate impoverishment should be considered in each case. Even an attorney's "good lawyering" can contribute to these fears when the attorney advises the client of the significance of a gift of virtually all property to a spouse or children, emphasizing the significance of an express transmutation of all community assets. Encouraging a consultation with independent counsel may shock a client whom the attorney has represented for many years, and may intensify fears of abandonment.

Clients may understand the practical benefits of a substantial asset transfer, but find themselves unable to cope with the emotional aspects of impoverishment. They may also feel pressured to make the transfers by those whom the transfers would benefit. Dealing with these issues is important in ensuring that the transfers are entered into voluntarily.

PRACTICE TIP: The attorney should be prepared to provide clients with names and phone numbers of social workers and mental health professionals who can help in "working through" the emotions of these decisions.

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§30.19 2. Freedom of Choice as to Care

Clients must understand the reality that, in medical care (as in most areas of American society), "money talks." Freedom to choose medical care providers is often conditioned on the ability to pay. Although careful eligibility planning can allow clients to retain a health plan, personal physician, acute hospital care, and (in many situations) a specific care facility, transfers can be dangerous for those not yet in out-of-home care. Nursing homes are not required to accept all potential residents. Many facilities limit admission to patients meeting the facility's financial criteria. A client who gave away assets while planning to move to "Sunny Acres" may be shocked when denied admission because he or she cannot demonstrate an ability to pay for care. Clients, particularly those still living at home, should not transfer substantial assets without understanding these risks.

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§30.20 E. Are Transfers "Elder Abuse?"

All practitioners advising about possible Medi-Cal transfers should be aware of the potential for abusive transfers. The client may already feel highly dependent on a spouse or other family members. If the client is still living at home (and sometimes if he or she is out of the home and wants to return), the client may be willing to transfer assets in return for care. Sometimes situations may have already deteriorated to the point that the client is subjected to express threats ("I will move out if you don't give me the house!"). In other cases, the threat may have merely been implied ("I'm not sure how much longer I will be able to cope with you here"). In still others, the client merely imagines that he or she may be forced to move, and decides to make the gift in order to "bribe" the caregiver. Often the proposed transfer may appear abusive in that there is no obvious benefit to the dependent donor. See Welf & I C §15610.30(a)(1).

If a client is making a gift, the practitioner should recognize that accusations of abuse may attach to the practitioner's own activities, not merely those of the donees. The Elder Abuse and Dependent Adult Civil Protection Act (EADACPA) (Welf & I C §§15600-15675) defines "financial abuse" to include activity by a person who "assists in taking, secreting, appropriating, obtaining, or retaining real or personal property of an elder or dependent adult for a wrongful use or with intent to defraud, or both." Welf & I C §15610.30(a)(2). The possibility of such an accusation is real and is particularly acute when the client has diminished capacity. The practitioner should carefully document efforts undertaken to establish the client's capacity, as well as the voluntary nature of the transaction. Note that contingent beneficiaries of the client's estate may have standing to bring an elder abuse action against the donee. See *Estate of Lowrie* (2004) 118 CA4th 220, 12 CR3d 828.

PRACTICE TIP: When someone other than the owner of the assets seeks advice about using transfers as a means of establishing eligibility, the civil and criminal risks from allegations of elder abuse should be discussed. Even a client with the best of motives should be advised that the transfers might be viewed by some as abusive, and could give rise to an investigation by the police or Adult Protective Services. If the attorney represents someone other than the prospective grantor, the attorney should explain to the client that the prospect for allegations of elder abuse might be avoided by hiring independent counsel for the donor. Most clients ("well" spouses in particular) would not in their wildest dreams imagine the possibility of a criminal investigation concerning their private financial affairs.

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§30.21 III. PURPOSE OF MEDI-CAL-RELATED TRANSFERS

Transfers for Medi-Cal purposes are generally undertaken for one of three reasons:

(1) To reduce assets in order to establish eligibility;

(2) To alter title to assets in order to maintain eligibility; or

(3) To avoid or reduce the probable future estate recovery claim.

Transfers between spouses may also alter the character of the property, changing the property from community to separate or from the separate property of one spouse to the separate property of the other. The purpose of the particular transaction will often determine the form of transfer.

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A. Transfers to Gain Eligibility

§30.22 1. Rationale Under Law

Because Medi-Cal is a "needs-based" program, transfers may be made to reduce the intended applicant's resources. Note that transfers are only one of many techniques available to achieve eligibility. Transfers are sometimes used in conjunction with one or more of the other techniques. See generally California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003) for an expanded discussion of Medi-Cal asset reduction strategies.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.23 2. Eligibility for Married Client

§30.23 2. Eligibility for Married Client

For the married client, transfers are often unnecessary to establish eligibility, although they may be necessary to maintain eligibility. Under the Medicare Catastrophic Coverage Act (MCCA) (Pub L 100-360, 102 Stat 683), all assets of either spouse, regardless of character, are considered when determining Medi-Cal eligibility for the spouse in a nursing home. 42 USC §§1382, 1396r-5; ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50490.3. Some of those assets (such as the residence, all household furniture and furnishings, one automobile, the Individual Retirement Accounts (IRAs) of the "community" (not in-care) spouse, and burial plots or crypts) are "exempt." ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50458 (IRAs); 22 Cal Code Regs §§50425 (residence), 50461 (automobile; the use requirement has been deleted in draft regulations attached to ACWD Letter 96-55 (Sept. 20, 1996)), 50465 (household furnishings and furniture), 50477 (burial plots and crypts), 50479 (burial funds). Other assets (such as the IRAs of the in-care spouse) can be made "unavailable" by beginning withdrawal of periodic payments of principal and interest. ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50402(e). Annuities can be used to render assets "unavailable" if the annuity is actuarially sound, *i.e.,* periodic distributions are structured to exhaust principal during the life expectancy of either spouse. 42 USC §1396p(c)(1)(G); 22 Cal Code Regs §§50489(b)(3), 50489.5(g)(2)(A). Assets that are nonexempt and available are generally limited (in 2009) to $109,560 ($107,560 Community Spouse Resource Allowance (CSRA) for the community spouse and $2000 for the spouse in care). ACWD Letter 08-49 (Nov. 10, 2008).

PRACTICE TIP: Some couples may keep substantially more by seeking an administrative or judicial enlargement of the CSRA. Alternatively, if the nonexempt and available assets exceed $109,560, the excess amount might be used by the community spouse to pay down a mortgage or other debt or make repairs to the residence. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003).

The spouse in the nursing home can become eligible for Medi-Cal while his or her name remains on all the assets. However, within 90 days of the date Medi-Cal first determines eligibility, all non-exempt and available assets must be transferred to the well spouse. 42 USC §1396r-5(f); ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50490.7(d). Changes in title, effected within 90 days of the eligibility determination, have no negative effect on eligibility. Assets in excess of the CSRA can be used to purchase an immediate annuity in the name of the community spouse. See ACWD Letter 90-03 (Jan. 8, 1990); Draft 22 Cal Code Regs §50512.

Although many couples hold assets in a joint form that allows either spouse full access to the accounts, few spouses are aware of the fiduciary duties they owe each other in the management of community assets. See Fam C §721. Caution is warranted even if the community spouse is merely following the instructions of the ill spouse. Withdrawal of funds from a joint account and purchase of an asset in one name is a "transfer," even if that particular transfer does not affect eligibility. Numerous transfers into the sole name of the community spouse may be a breach of fiduciary duty, especially when the capacity of the ill spouse is marginal. Even a spouse can be accused of financial elder abuse (potentially including criminal proceedings). The risk of such allegations increases when children, parents, or other relatives disagree over care options or other issues. Although these planning strategies are often implemented for the elderly, younger people can also suffer medical catastrophes, and disputes between children and parents or in-laws can occur in this context.

PRACTICE TIP: The community spouse should be advised of his or her fiduciary duties, and cautioned against unilateral actions with community assets. This is particularly true when the ill spouse lacks capacity, and in second marriage situations. Under Prob C §259, the community spouse can be deprived of his or her right to inherit if the unilateral actions are found to be abusive. If the spouse lacks capacity, or if capacity is questionable, and there is no durable power of attorney with express provisions authorizing the contemplated actions, a petition under Prob C §3100 should be used. See §30.49. A simple letter may be sufficient to keep the client advised in this regard. A sample form is provided in §30.24.

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§30.24 3. Form: Sample Letter Language Regarding Spouse's Fiduciary Duties

30.24-1 Sample letter language: spouse's fiduciary duties

Under California law, each spouse owes a "fiduciary duty" to the other spouse in the management of community property. This duty requires, among other things, that you exercise the highest good faith and fair dealing on all decisions related to property. You must not take unfair advantage of your wife as you implement a Medi-Cal plan. Because she is over age 65, your transfer of community assets into your name alone could be interpreted as evidence of fiduciary elder abuse. I remind you that all assets will remain the community property of you and your wife unless they are properly "transmuted" into your sole and separate property; merely changing the names on title does not deprive your wife of her rights in the property, or relieve you of your fiduciary responsibilities in your use of those assets.

Comment: If the Medi-Cal recipient or applicant remains competent but is not the attorney's client, independent legal representation may be appropriate. Through the use of separate counsel, the donor's capacity can be assessed and the advantages and disadvantages of the transfer reviewed without the need for informed consent to dual representation.

PRACTICE TIP: In the author's experience, dual representation of married couples with written consent continues to be fairly common in many estate planning contexts. However, the use of dual representation in property transfers when the grantor has diminished capacity appears to be less common, at least in geographic areas where several attorneys practice in the field. The difficulty posed in explaining not only actual but potential conflicts to a prospective client suffering diminished capacity can, in itself, interfere with the substance of the transaction. The client's interests will frequently be best served through a recommendation that independent counsel be employed by the prospective donor. The practitioner can then prepare documents and provide them to the other attorney for review, revision, and signing.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.24A 4. Eligibility for Client With Domestic Partner

§30.24A 4. Eligibility for Client With Domestic Partner

The rights and duties of married couples extend to registered domestic partners. See Fam C §297.5(a), (k). With respect to the Medi-Cal long-term care benefits, the resource allowance, income, transfer, and estate recovery rules currently applied to married couples also apply to registered domestic partners. Thus, the transfer strategies addressed in §§30.23-30.24 should be considered for these clients.

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§30.25 5. Eligibility for Single Client

The client without a spouse or domestic partner may be forced to divest more assets than the client with a spouse or domestic partner. Eligibility may still be established while owning a residence to which the client "intends to return," one vehicle, annuities that provide periodic payments of principal and interest designed to exhaust the asset within the actuarial life expectancy of the client, and retirement funds from which periodic payments of principal and interest are being received. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). Nonexempt and available assets are limited to $2000. 22 Cal Code Regs §50420.

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§30.26 6. Transfer Penalties: Effect on Long-Term Care Benefits

Transfers of assets without consideration prior to making a Medi-Cal application may result in a client becoming ineligible for Medi-Cal for a period of time. Many prospective clients incorrectly believe that they can make no transfers whatsoever within the ineligibility period before they apply for benefits. Although all transfers occurring within 30 months before application (60 months under federal rules not yet implemented in California) must be disclosed in the application, not all transfers will affect eligibility. See, *e.g.,* ACWD Letter 90-01 (Jan. 5, 1990), Question 1, Answers 7-8; Draft 22 Cal Code Regs §§50408.5(c), 50411.5. Loss of eligibility occurs when non-exempt and available assets (resources) are transferred without consideration and long-term care benefits are sought from the Medi-Cal program. 42 USC §1396p(c); ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50408.5. Although the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) (Pub L 103-66, 107 Stat 312) allows the state to also deny eligibility for certain "community-based" services related to long-term care, such as home health care and community-based institutional care, California's Department of Health Care Services has historically not restricted such benefits based on property transfers.

WARNING: The transfer penalty rules applicable to the Medi-Cal program are not the same as those applicable to the Supplemental Security Income program (SSI) through Social Security. Clients who are receiving SSI may be disqualified for those benefits by transfers of resources. 42 USC §1382b. In addition, it appears that California will soon implement transfer regulations based on the State's interpretation of OBRA 1993. The historical approach of California, particularly regarding the transfer of the principal residence, may change significantly.

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§30.27 a. Expressly Permitted Transfers

Many contemplated transfers, particularly to a spouse at home, are expressly allowed by federal statute. See, *e.g.*, 42 USC §1396r-5. Even under the restrictions imposed by OBRA 1993, there is no loss of eligibility for the transfer of assets to (42 USC §1396p(c)(2)):

- The applicant's spouse;
- Another person for the sole benefit of the applicant's spouse;
- The applicant's blind or disabled child, or a trust solely for the benefit of such child; or
- A trust established for the sole benefit of a disabled person under 65 years of age.

California has not yet implemented these provisions of OBRA 1993, although the Medi-Cal policy branch of DHCS has expressed the intent to adopt such regulations in the near future. As of this writing, California continues to base its transfer rules (including the still-current 1990 "draft" regulation) on MCCA. Under the Medicare Catastrophic Coverage Act (MCCA) (Pub L 100-360, 102 Stat 683), a transfer of assets does not result in loss of eligibility if the transfer is to (Draft 22 Cal Code Regs §50411(a)(3)):

- The community spouse;
- Another person for the sole benefit of the community spouse (as of the date of the transfer); or
- A blind or permanently or totally disabled son or daughter of the in-care individual.

Similarly, California does not currently impose any penalty for the transfer of a home, if it is an exempt asset. ACWD Letter 90-01 (Jan. 5, 1990), Questions/Answers 7-8. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). A home can be treated as exempt under the rules for a variety of reasons but, in most cases, the exemption will be based on the intent of the nursing home resident to return to the property to live. See Draft 22 Cal Code Regs §50425(c)(3). When California implements OBRA 1993, it is possible that most transfers of the home will result in a period of ineligibility. Exempt transfers to a "spouse" include transfers to a registered domestic partner. See Fam C §297.5(k).

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§30.28 b. Calculation of Period of Ineligibility

If the transfer of nonexempt or available assets is disclosed during the Medi-Cal application process, a calculation is made to determine whether the transfer resulted in a period of ineligibility—the "penalty period." In general, the value of the assets transferred is divided by the then-applicable average monthly private-pay rate for nursing home services (APPR). This average is computed annually by the state and published in an All-County Welfare Directors' Letter. For 2006, the monthly APPR was $5031. ACWD Letter 06-11 (Mar. 9, 2006). By dividing this figure into the value of the gift, the number of months the transferor will be ineligible for Medi-Cal long-term care benefits is determined. However, different rules for applying the ineligibility period are used under federal law and California's draft regulations.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.29 (1) California Rules

§30.29 (1) California Rules

For most transfers, California continues to base its draft regulations on the Medicare Catastrophic Coverage Act (MCCA) (Pub L 100-360, 102 Stat 683), as interpreted and applied in ACWD Letter 90-01 (Jan. 5, 1990) and Draft 22 Cal Code Regs §§50408, 50411, 50411.3, 50411.5. Under these rules, only transfers of "resources" trigger ineligibility; transfers of "income" are not penalized. Determination of what is a resource as opposed to income, however, is not always easy. Under current California regulations (22 Cal Code Regs §50507(a)(15)), an inheritance of liquid assets is "unearned income." Similarly, insurance proceeds are income, but personal injury awards are a resource (see 22 Cal Code Regs §§50073, 50507(a)(10)-(11)). Further, the author understands that California treats a disclaimer as a transfer of resources for which a period of ineligibility may be imposed. (The California Department of Health Care Services apparently has prepared but not released a formal legal opinion on this issue.) OBRA 1993 applies to transfers of "assets," which include both "resources" and "income." See discussion in §30.31.

WARNING: A transfer occurs whenever an applicant or recipient's control over an asset is relinquished or diminished. Thus, transfers into joint tenancy, or removal of assets from a joint account by the other joint tenant, can be treated as an impermissible transfer, resulting in a loss of eligibility.

California continues to apply the MCCA 30-month look-back period in making eligibility determinations. Thus, the Medi-Cal application seeks disclosure of transfers that occurred within the previous 30 months. Earlier transfers are not subject to disclosure and will not result in loss of eligibility, regardless of the size of the gift. An exception applies to transfers to trusts. In 1996 California began implementing portions of OBRA 1993 related to annuities, trusts, and "similar legal devices." See Medi-Cal Eligibility Procedures Manual Letter No. 179 (May 15, 1997). Effective January 28, 1998, the state published regulations on these issues. 22 Cal Code Regs §§50489, 50489.1, 50489.9. Under those regulations, transfers to an irrevocable trust are subject to disclosure for a period of 60 months. Nevertheless, the Medi-Cal application does not seek this information directly. Instead, it is discovered when the applicant discloses that he or she holds assets "in trust" and when, on disclosure of the trust documents, the Medi-Cal eligibility staff determines that the trust is irrevocable. For Medi-Cal trust rules, including possible effects of transfers to and from a revocable living trust, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003).

Transfers may result in a loss of eligibility if (1) they were not a permissible transfer, and (2) the transfer was without adequate consideration. ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §§50408.5, 50411.3(c). To determine if there was a loss of eligibility, the value of each gift is divided by the then applicable APPR to determine the period of ineligibility. Fractions are rounded down to the next whole number.

Under MCCA before amendment by OBRA 1993, the maximum period of ineligibility is 30 months. Former 42 USC §1396p(c)(1); Draft 22 Cal Code Regs §§50408.5(b), 50411.3(b)(1). This approach is followed as to *each* gift. Thus, under California's rules, each gift carries a separate period of ineligibility, and the periods run concurrently. The use of "stacked" or "consecutive" gifts allows substantial amounts to be given in a relatively short time frame. For example, a single gift of $90,000 would result in a loss of eligibility for a period of 18 months ($90,000/$5000 = 18 months), while the same total gift amount made in 6 consecutive monthly gifts, the first of $26,000 (5-month ineligibility period), then $22,000 (4-month ineligibility period), $18,000 (3-month ineligibility period), $12,000 (2-month ineligibility period), $8000 (1-month ineligibility period), and $4000 (no loss of eligibility) would result in an ineligibility period that ends after the fifth month following the first gift. The penalty for the gift begins to run at the time of the transfer, not at the time of application. Draft 22 Cal Code Regs §50411.3(a); ACWD Letter 98-08 (Feb. 16, 1998) with attached form, MC 176 PI. An even more aggressive strategy would give $5000 per day for 19 consecutive days ($95,000 total) with no loss of eligibility (because no one gift was more than $5,000). The availability of such aggressive gifting opportunities was advertised by vocal "Medi-Cal planners" and contributed to the adoption of the more restrictive transfer provisions of OBRA 1993. See §30.30.

NOTE: As with other types of transfers, Medi-Cal has its own forms of valuation discounts. For example, real property in California is valued at its assessed value on the most recent tax rolls, less encumbrances of record (22 Cal

Code Regs §§50412, 50415); promissory notes can be valued at face value or at a value established by a qualified loan broker (22 Cal Code Regs §50441(c)), including substantial discounts due to limited security, low rate of interest, and the like. Thus, gifts of assets with low value under the Medi-Cal rules results in a shorter period of loss of eligibility than the transfer of cash after sale.

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§30.30 (2) Federal Rules

OBRA 1993 effectively eliminated "consecutive gift, concurrent penalty" planning in all states except California. Even in California, consideration of the OBRA 1993 rules is important because implementation of the "new" rules could occur at any time, and these rules would be applied to transfers for which the OBRA 1993 penalty period has not yet expired. Under OBRA 1993, all gifts made within a 36-month (60 months for trusts) look-back period are cumulated to determine the period of ineligibility. 42 USC §1396p(c)(1). If the penalty period on one gift expires before the next gift is given, the new gift carries its own period of ineligibility. The look-back period was increased to 60 months for transfers on or after February 8, 2006, and there is no rounding down of ineligibility periods under the Deficit Reduction Act of 2005 (DRA-2005) (Pub L 109-171, 120 Stat 4). Thus, a transfer of $26,000 (as discussed in §30.29) within the previous 60 months will result in an ineligibility period of 5 months and 12 days (not 5 months), and even a transfer of less than the applicable APPR will result in some period of ineligibility.

Although this change is important because it reduces the amount that can be given shortly before application, an even larger trap lurks for the unwary and unadvised client. Under OBRA 1993, loss of eligibility is potentially unlimited. If an applicant, for example, discloses the transfer of a $500,000 rental property, eligibility would be blocked for over 8 years from the date of the gift ($500,000/$5000 = 100 months). 42 USC §1396p(c)(1)(E). Further, under DRA-2005, the ineligibility period begins on the date of application for benefits—not the date of the transfer. 42 USC §1396p(c)(1)(D)(ii). As a result of this change, any applicant who makes a transfer after the date of enactment and less than 5 years before the applicant would otherwise be eligible for benefits will confront an ineligibility period that begins when the applicant has virtually no remaining assets and is probably already receiving long-term care. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). This apparent endless penalty problem is resolved for those who receive *and follow* proper legal advice—they simply delay application until the 61st month (31st month in California) after the transfer and need not disclose the transfer at application.

PRACTICE TIP: Clients should be advised that California's generous rules related to transfers may soon be superseded by the long-awaited implementation of OBRA 1993. Because OBRA 1993 does not include a maximum period of ineligibility, clients who make transfers under a "consecutive gift, concurrent penalty" calculation should be strongly advised not to seek any Medi-Cal benefits until they have first reviewed the matter again with counsel (who can verify that the MCCA rules still apply). Otherwise, clients must be prepared to wait the full 60 months after the last gift before making their application.

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§30.31 7. Transfers of Income

In general, "income" for Medi-Cal purposes is money received and divested in the same calendar month. 22 Cal Code Regs §§50503, 50507. See also California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). There is currently no penalty for the transfer of income in California. However, because OBRA 1993 penalizes the transfer of "assets" (a term that includes both resources and income), implementation of OBRA 1993 will probably result in a loss of eligibility for transfers of income. Nevertheless, because there will be no loss of eligibility for a transfer below the Average Private Pay Rate ($6000 in 2007), monthly transfers of income may be viable for some who are not yet eligible.

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§30.32 B. Transfers to Maintain Eligibility

A married couple with one spouse in a nursing home can establish eligibility while all assets remain in joint title. In such cases, the community spouse is allowed 90 days from the date eligibility is determined to transfer the Community Spouse Resource Allowance (CSRA) ($101,640 in 2007) into his or her own name. 42 USC §1396r-5(f); ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50490.7(d). These transfers must be timely completed in order to maintain eligibility. ACWD Letter 90-01 (Jan. 5, 1990); Draft 22 Cal Code Regs §50490.3(c), (d). Loss of eligibility may be avoided when the couple is unable to make title changes within the 90 days but action has been started to make such changes (such as the filing of a Prob C §3100 petition; see §30.49).

Occasionally, particularly for the married client, there will be some need to sell an exempt asset, such as the residence. As a rule, there is no difficulty selling one residence and transferring its exempt status to its replacement. However, many at-home spouses prefer to move to a smaller, less expensive, property. This can be an effective way to increase the liquidity of the spouse who has spent most of the cash or cash equivalent assets to keep the other spouse at home for as long as possible. However, timing is important. Eligibility should be established before the sale in order to avoid disqualification because of the cash influx. Once eligibility is established, the sale should not proceed while the residence is in the name of the Medi-Cal recipient. More than $2000 in the hands of the in-care spouse will be disqualifying. Thus, one of the strong reasons for transferring after eligibility is established is to allow the at-home spouse (or other co-owner of property) to sell the property in a way that does not jeopardize eligibility.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.33 C. Transfers to Reduce or Avoid State Recovery Claims

§30.33 C. Transfers to Reduce or Avoid State Recovery Claims

Medi-Cal recipients who own assets at their death (particularly assets of substantial value, such as a residence) may have their estates subjected to claims for repayment of benefits received. Welf & I C §14009.5. The state refers to this process as "estate recovery." Significantly, the state's right to recover does not come into existence until after the death of the Medi-Cal recipient. The claim does not accrue during the recipient's life (although the amount of the potential future claim can be ascertained), and there is no lien on specific property. Significantly, California's claim statute (Welf & I C §14009.5) provides that the state's right to recover is limited to the amount actually paid for care, or the value of the property passing at the Medi-Cal recipient's death, whichever is less. Recovery can be had against the recipient's probate estate, living trust, surviving joint tenants, and beneficiaries of an annuity purchased after September 1, 2004. Welf & I C §14009.5; 22 Cal Code Regs §50960.12. "Estate" is broadly defined in 22 Cal Code Regs §50960.12(a). In *Bonta v Burke* (2002) 98 CA4th 788, 120 CR2d 72, the court held that a residence was part of the decedent's estate when the decedent conveyed the residence to the decedent's children, reserving both a life estate and the right to revoke the conveyance. However, a lien may not be imposed on a judgment in a wrongful death action for recovery of amounts paid for medical care of the decedent. *Fitch v Select Prods. Co.* (2005) 36 C4th 812, 31 CR3d 591.

No recovery is allowed during the lifetime of the surviving spouse or registered domestic partner, the minority of surviving children, or when the recipient is survived by a child who is blind or permanently and totally disabled. Welf & I C §14009.5(b)(2); Fam C §297.5(k). See *Shewry v Arnold* (2004) 125 CA4th 186, 22 CR3d 488 (no recovery if trust property passes to disabled person). Recovery also may be waived if it would result in substantial hardship to dependents, heirs, or survivors. Welf & I C §14009.5(c)(1). The definition of "estate" in the regulations has been augmented by Department of Health Care Services (DHCS) policies, including an informal policy of exempting annuities and a policy not to pursue collections against certain life estates, as well as policies concerning hardship waivers, voluntary liens imposed on property that secure installment payment obligations to pay the DHCS, interest rates charged in connection with those obligations, and recovery of payments for in-home health services, that have been successfully challenged in court. See *California Advocates for Nursing Home Reform v Bonta* (2003) 106 CA4th 498, 130 CR2d 823.

NOTE: In June 2006, DHCS sought to expand its recovery authority through Recovery Regulations (R-32-00). The regulations generally provide that DHCS must claim against the estate of a decedent, or against any recipient of the decedent's property, for all Medi-Cal payments made on behalf of the decedent. 22 Cal Code Regs §50961(a)-(b). As promulgated, the regulations provide that DHCS must claim against a variety of life estate interests. 22 Cal Code Regs §50961(i). A controversial provision of the regulations purports to permit a recovery if the decedent's only interest in an item of property (typically the residence) at the time of death was an estate for the life of the decedent. Fortunately, DHCS has since issued proposed regulations (R-14-04) that would eliminate this provision.

As promulgated, the life estate regulation would have precluded planning techniques involving the transfer of a residence with a retained right of occupancy that were designed to give the decedent a life estate or retained interest for estate tax purposes under IRC §2036 or §2038 and thereby give the transferee of the property a stepped-up basis on the decedent's death without exposing the home to estate recovery claims by DHCS. Some advocates had argued that the "life estate only" recovery regulation contradicted a provision that limits the amount of estate claims to the lesser of all payments made on behalf of the decedent or the decedent's "equity interest" in the property. 22 Cal Code Regs §50961(a). DHCS has not proposed amending other provisions of the life estate regulation. These provisions generally permit full recovery against life estate property if the decedent retained the power to revoke the conveyance of the remainder. An exception exists in the case of an irrevocable conveyance of a life estate to a third party combined with a revocable transfer of the remainder. In such a case, DHCS can recover only against the remainder interest. 22 Cal Code Regs §50961(i).

To avoid the Medi-Cal recovery claim, recipients and their spouses often gift assets during their lifetimes. If the

recipient or the spouse is in (or may enter) a nursing home, care must be taken to effect the transfer in such a way as to not jeopardize eligibility. The limitations period for a DHCS action to recover Medi-Cal expenditures for skilled nursing care is 3 years. The period begins to run when DHCS is given written notice under Prob C §215. The CCP §366.2 1-year period for actions on a claim against a decedent does not apply and DHCS is entitled to recover prejudgment interest. *Shewry v Begil* (2005) 128 CA4th 639, 27 CR3d 209.

PRACTICE TIP: Before making a transfer for claims avoidance purposes, the practitioner should consider the possible increase in eventual capital gains tax liability for the donee on sale, compared to the probable recovery claim amount. See §§30.12, 30.40 for further discussion of the basis issue and possible solutions.

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§30.34 1. Rationale in Social Context

Transfers to avoid a recovery claim may be of particular benefit to those in the lowest socioeconomic groups. Indeed, those least likely to consult legal counsel may be those whose families would most benefit from transfers. The accumulation and transfer of "wealth" (specifically in the form of a family home) may be very important for those struggling to be free from the grips of poverty. Failure to transfer the home as allowed by law results in further impoverishment of such families.

EDITOR'S NOTE: The author's view may be open to question. Homeowners in California—even those with modest homes—usually are not in the lowest socio-economic group. Further, only those who have wealth can benefit from transfers, and those who have more wealth can transfer more.

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§30.35 2. Exempt Versus Nonexempt Assets

The person who has already established eligibility has few nonexempt assets against which recovery could be had. Such assets are often limited to a bank account with a balance below $2000. Usually the most significant exempt asset will be the personal residence. If a recipient or prospective recipient continues to live at home at the time of the transfer, the house is clearly exempt. The residence of a person in long-term care remains exempt as long as the recipient intends to return to the home (or it is occupied by the recipient's spouse or registered domestic partner as his or her principal residence). Under California's current rules, the transfer of an exempt asset does not result in any loss of eligibility. ACWD Letter 90-01 (Jan. 5, 1990), Questions/Answers 7-8. See California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 10 (Cal CEB 2003). Exempt status for the residence must be preserved during the transfer process, or the client risks loss of benefits under both MCCA and OBRA 1993. 42 USC §1396p(c). This is an area of law in which form is regularly regarded more highly than is substance.

Those transferring a residence for claims-avoidance purposes should carefully document the Medi-Cal beneficiary's "intent" to return home at the time of the transfer. Documentation may be accomplished by an exchange of contemporaneous letters, asserting the intent to return and the continued availability of the home, or by an affidavit setting forth the facts necessary to establish the residence as exempt (ACWD Letter 90-01 (Jan. 5, 1990), Question/Answer 8). Documentation is particularly important when the transfer is to someone other than a spouse (and not to an otherwise permissible transferee). See §30.39 regarding the use of trusts and §30.40 regarding retained right of occupancy agreements.

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§30.36 3. Transferring Community Property

Transfers to a spouse are perhaps the most common transfers to avoid recovery claims. Because such transfers are expressly permissible under both MCCA and OBRA 1993, they usually pose little risk to continued eligibility. See 42 USC §§1396p(c)(2), 1396r-5. See §30.27 for expressly permitted transfers. When both spouses are competent, an interspousal quitclaim or grant deed will alter title to real property. A similar quitclaim or grant deed can be used to alter title to real property owned as community property by registered domestic partners. See Fam C §297.5. Bank and investment accounts can be placed into the name of the spouse or partner. However, a mere change of the names on title may be insufficient to avoid the Medi-Cal recovery claim. The state recognizes that a mere change in the form of title does not deprive the spouse or partner of his or her community property interests. An express, written "transmutation" of the property must be made. See Fam C §850. Without a transmutation, the Medi-Cal recipient continues to own a community property interest in the property, and the effort to avoid the recovery claim is incomplete.

PRACTICE TIP: If the attorney deeds property to a spouse or partner to avoid a future recovery claim, the deed should include a legend establishing that the transfer is also a transmutation of the property and is for the "sole benefit" of the spouse or partner. However, the client should also be advised, in writing, of the probable negative capital gains tax potential from such a change in title and character and possible negative gift tax consequences in the case of domestic partners, as well as the distribution or division of such property on death or dissolution.

If both spouses or partners are competent, they may transfer and transmute property by signed writings. Fam C §§297.5, 850. However, if one or both of the spouses or partners is not clearly competent, some other avenue should be sought for making the transfer. See §§30.46-30.51 for a discussion of transfers by incompetent donors.

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§30.37 IV. TYPES OF TRANSFERS

Depending on the goals of a particular client, a transfer may be outright, in trust, into some form of co-ownership, with reservation of a "life estate," or subject to contractual restrictions. More sophisticated approaches include the use of "defective" grantor trusts, testamentary trusts, and QTIP trusts. Extensive discussion of these topics is beyond the scope of this chapter.

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§30.38 A. Outright Transfer of Entire Asset

Often transfers are effected as classic completed gifts of the entire asset. Whether accomplished by payment of cash, delivery of the item or of evidence of its ownership (*e.g.*, stock certificates), or by a deed, the mode of an outright transfer for Medi-Cal purposes is no different from that of other outright transfers, although inclusion of a statement that the transfer is for the "sole benefit" of the spouse or domestic partner may become necessary upon implementation of OBRA 1993.

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§30.39 B. Transfers in Trust

Transfers to trusts have troubled Medi-Cal regulators for years. Gifts to an inter vivos trust, in particular, may result in the loss of eligibility. Under OBRA 1993, a penalty may be imposed even if the trust is created by someone other than the Medi-Cal recipient. On the whole, testamentary trusts are free from these adverse consequences. For explanations of these complexities, see California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003). For discussion of the use of an "intentionally defective irrevocable trust" in the Medi-Cal planning context, see Wilkinson & Wilkinson, *California Irrevocable Trust: A Preferred Strategy for Protecting the Family Residence From Medi-Cal Recovery Claims*, 8 Cal Tr & Est Q 18 (Spring 2002).

One option that remains viable is a testamentary trust. If large asset transfers have been made to facilitate eligibility, the donee's will may establish a discretionary trust for the benefit of the Medi-Cal recipient that will not impair continued eligibility. Creation of such a trust ensures that adequate resources remain available for the donor's care, either for needs not covered by Medi-Cal or as an alternate funding source should nursing home placement later become inappropriate. Although the OBRA 1993 rules (incorporated into California's Medi-Cal Policy Manual by Medi-Cal Eligibility Procedures Manual Letter No. 159 (May 15, 1997)) generally treat a trust established by the recipient's spouse—*e.g.*, a bypass trust—as if fully "available" to the recipient, federal law specifically excludes a trust created by a will from these provisions. 42 USC §1396p(d)(2)(A). This exception is also recognized in California. See Medi-Cal Eligibility Procedures Manual Letter No. 192 (Dec. 18, 1997); Medi-Cal Eligibility Procedures Manual Letter No. 179 (May 15, 1997).

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§30.40 C. Transfers Subject to Contractual Rights

To secure a step-up in basis for a transferred asset at the Medi-Cal recipient's death, while still avoiding the Medi-Cal estate recovery claim, some transfers are coupled with an express written right of occupancy. A discussion of this approach, along with a sample agreement and a chart of various tax rulings (helpful in addressing this step-up issue with the client's tax preparer), is included in California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003), as well as in many of the materials available through California Advocates for Nursing Home Reform (CANHR) and the National Academy of Elder Law Attorneys (NAELA) (see Practice Tip, below). See §30.12 for capital gains issues associated with transfers; see §30.35 regarding maintaining exempt status for transferred assets.

PRACTICE TIP: California Advocates for Nursing Home Reform (CANHR) makes available copies of numerous useful sources of law and information for Medi-Cal planning, including copies of the Medi-Cal procedures manual and relevant All-County Welfare Directors (ACWD) letters. Contact CANHR at (800) 474-1116 or at http://www.canhr.org. Contact the National Academy of Elder Law Attorneys (NAELA) at (520) 881-4005, or at http://www.naela.com.

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§30.41 D. Transfers of Less Than Entire Asset

Some Medi-Cal motivated transfers pass less than all of the grantor's interest in the property. For example, a gift with the reservation of a life estate may be used to gift highly appreciated real property while preserving the IRC §1014 basis step-up for income tax purposes. See §30.12. In other cases, the grantor may choose to add one or more other persons as joint tenants on the residence, thereby reducing Medi-Cal's claim to the proportionate interest retained by the Medi-Cal recipient. Discussion of these forms of transfer is found in California Elder Law Resources, Benefits, and Planning: An Advocate's Guide, chap 11 (Cal CEB 2003). See also Worthington, Barreira & Darling, *Analysis of the Tax Aspects of Various Types of Transfers of the Home*, NAELA Advanced Elder Law Institute (Nov. 2001).

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V. TRANSFERRING THE PROPERTY

§30.42 A. Who Is the Client?

If an initial analysis indicates that a property transfer may be appropriate, the attorney should again carefully consider the identity of the client. Whom does the attorney represent in this transaction? If the attorney has historically represented both spouses or domestic partners (in estate planning matters, for example), can he or she still represent them both in this context? Has the attorney documented in writing the potential conflict of interest in representing them both in this new environment? Have they signed a consent acknowledging these conflicts? If the wife or domestic partner came in alone to apprise the attorney of her husband or partner's recent stroke, does she understand and consent to the attorney's disclosure to her husband or partner of her concerns about her financial future? Does her husband or partner retain sufficient cognitive abilities to understand the nature of the conflict and consent to the attorney's joint representation? If not, can the attorney proceed with a Petition to Approve Community Property Transaction under Prob C §3100 (see §30.49) when his or her former client is the respondent? Or is this a form of adverse representation precluded by California's ethical rules? If the attorney drafted durable powers of attorney under which the transaction will be effected, does the attorney have a written consent from the now-incapacitated client to represent the agent? See §30.54.

PRACTICE TIP: A practitioner who engages in Medi-Cal planning should consider, when drafting durable powers of attorney or other documents, offering a further, optional, form, by which clients affirm their understanding that Medi-Cal planning often includes transfers of property to the other spouse or to third parties and by which clients grant their permission for the practitioner's future representation of their agent, and, as necessary, the transferee. See §30.62 for an example.

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§30.43 B. The Competent Giver

Part of the attorney's analysis must include an assessment of competence. If the prospective donor lacks the capacity to contract, he or she cannot contract for the attorney's services. The attorney's purported representation of the donor, and receipt of fees, might then be deemed financial elder abuse. In the author's experience, evaluation for competence in this context is seldom formal. Even use of the "mini-mental status exam" is uncommon. (The "mini-mental health exam" is an evaluation tool used by some medical, social work, and mental health professionals to assess mental function. Its usefulness, however, is subject to question. See, *e.g.*, Espinoza, *Limitations of MMSE When Screening for Dementia*, Geriatrics (Sept. 2001).) Nevertheless, if an attorney believes that a transfer may be subject to question, documentation of some form of competence evaluation may prove invaluable. The difficult task for the attorney is determining whether the transfer could be deemed "suspect."

PRACTICE TIP: In the author's experience, the vast majority of clients wish to pass their assets to their spouse, domestic partner, or children. This common thread may cause some bias that this preference is "normal." Anything "abnormal" becomes suspect. On the other hand, someone who works regularly with victims of financial abuse may find that *any* lifetime transfer of valuable assets is suspect, and may vigorously question the competence of the transferor, as well as the integrity of those assisting with and benefiting from the transfer. The following circumstances may raise red flags for the cautious practitioner: multiple marriages; children from prior marriages; transfers to those outside the "natural objects of bounty"; or a donor who is dependent on the donee for care. The practitioner should draft and document responses to some basic inquiries to establish that the client is not being subjected to entreaties, threats, or other inappropriate pressure. If the practitioner is not comfortable with the circumstances, he or she can refuse to proceed until the troublesome issues are adequately addressed.

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§30.44 1. Establishing Competence

All adults are presumed competent. Prob C §810(a). At the same time, attorneys are not required to provide services to everyone entitled to the benefits of this presumption. Particularly if the client has some mental limitations, the attorney should establish to his or her own satisfaction that the person understands the nature of the transaction and is acting voluntarily. Laws related to competence to make a will should apply to the making of gifts as well. Under Prob C §6100.5, a person is competent to make a will if, among other things, he or she understands the nature of the testamentary act, understands and recollects the nature and situation of his or her property, and remembers and understands his or her relations to living descendants, spouse, parents, and others whose interests are affected by the will. A person who is not competent to make a will most likely lacks competence to make a lifetime gift.

A more formal psychological evaluation may be warranted if the client's capacity is still uncertain. The attorney can explain to the client the importance of establishing competence to ensure that the client's desires are actually implemented. Most clients will respond to anecdotal stories about wishes being defeated by disgruntled relatives. They will appreciate the attorney's interest in establishing the validity of their decisions against potential challengers.

For a discussion of competence issues, see Capacity and Undue Influence: Assessing, Challenging, and Defending (Cal CEB Action Guide February 2008). See also Prob C §§810-813.

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§30.45 2. Independent Representation

An independent attorney for the person with questionable competence is one viable solution. Alternatively, if the practitioner represented both spouses in the past, it may be better to obtain written consent from the clearly competent spouse to continue working with the donor, and to allow the competent spouse to seek independent representation. The practitioner who previously prepared estate planning documents and reviewed issues of disposition of the estate in a somewhat theoretical environment is often well suited to evaluate the current level of competence. With proper consents from the (now former) client, the practitioner can counsel the remaining client and obtain direction and consent.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.46 C. Dealing With Lack of Capacity

§30.46 C. Dealing With Lack of Capacity

When the prospective transferor lacks capacity, or when his or her capacity cannot reasonably be established, and there is no durable power of attorney in place that expressly authorizes the transactions contemplated, a court proceeding is required to approve and effect the transaction. See, *e.g.*, Prob C §§2580, 3101. These proceedings can include a single-transaction proceeding under Prob C §3100, a substituted judgment petition under Prob C §2580 in a conservatorship, or a complaint or prayer for support under, respectively, Fam C §4303(a) and Prob C §3080. Even when a power of attorney is in place, court approval for a specific act may be obtained under Prob C §4541(b).

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§30.47 1. Powers of Attorney

A durable power of attorney that includes specific authority to make gifts to the spouse or descendants may prove sufficient authority to effect the transaction. Gifting powers in a power of attorney must be explicit. Prob C §4264(c). General provisions are not sufficient; explicit authority for gifting, transmutation, and, possibly, self-dealing should be included in the instrument. See Prob C §§4231, 4264. A power to make gifts or create a revocable trust does not necessarily confer a power to select the beneficiaries who will ultimately receive assets. *Schubert v Reynolds* (2002) 95 CA4th 100, 115 CR2d 285. The duties imposed by law on an agent under a power of attorney, the fiduciary duties owed between spouses, and the risks of accusations of financial elder abuse all argue for careful analysis of the documents and family circumstances. Clients may need to be educated about their exposure to both civil and criminal penalties for breach of such duties.

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§30.48 2. Court Approval of Acts Under Power of Attorney

When a power of attorney is in place, but its powers are ambiguous, or the possibility of later accusations of self-dealing exist, a proceeding can be initiated for the purpose of "[p]assing on the acts or proposed acts of the attorney-in-fact, including approval of authority to disobey the principal's instructions pursuant to [Prob C §4234]." Prob C §4541(b). Such a petition is commenced in the probate court in the county of residence of the principal under the power of attorney. Prob C §§4520-4523.

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§30.49 3. Community Property: Single Transaction

If a spouse or registered domestic partner lacks capacity to consent to a transaction, and the transaction involves at least some community property, a petition under Prob C §3100 may be appropriate. Although denominated a "Proceeding for a Particular Transaction," the attorney is not limited to one transaction per petition. All of the proposed transactions involving property of the incapacitated spouse may be addressed in a single proceeding. Such petitions may include transactions involving separate property, on showing of good cause; *e.g.*, judicial economy in addressing all issues in a single proceeding and avoiding a conservatorship. Prob C §3100(b). The right to seek approval for a single transaction involving community property extends to registered domestic partners. See Fam C §297.5(a). Thus, a registered domestic partner should not need to bring a conservatorship petition to address issues of property for an incompetent partner, provided that the partners have at least some community property.

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§30.50 4. Substituted Judgment Petition: Separate Property

If the property to be transferred is the separate property of a single individual, it may be necessary to initiate a conservatorship coupled with a Petition for Substituted Judgment under Prob C §2580. If the proposed conservatee will be divested of virtually all assets, it may be possible to file the general probate conservatorship petition, a petition for temporary conservatorship, and the petition for substituted judgment at one time. If the temporary conservator is authorized to make the requested transfers under the substituted judgment petition, the hearing on the general petition can be continued to a future date, and, eventually, dropped altogether once the transactions are completed. The proceeding can be closed after filing a first and final accounting.

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§30.51 5. Complaint for Support

Although the OBRA 1993 rules include income in the definition of "assets," a transfer of income occasionally remains appropriate. For example, if the at-home spouse requires support beyond the Minimum Monthly Maintenance Needs Allowance (MMMNA) ($2739 in 2009), it may be possible to obtain an order for support against the Medi-Cal recipient. Depending on local practice, an increase in the MMMNA is accomplished through either a Petition for Support under Fam C §4303(a) or a prayer for such relief as one of the transactions in a Prob C §3100 community property petition. This remedy is also available to registered domestic partners. See Fam C §297.5(a), (k).

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§30.52 VI. ADVANCE PLANNING FOR MEDI-CAL THROUGH POWERS OF ATTORNEY

Practitioners should anticipate the possibility of future incapacity. One excellent way of addressing this possibility is the use of explicit durable powers of attorney for finance and personal care decisions with explicit directions. See chaps 28-29.

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§30.53 A. Client Expectations

An estate planner can help clients anticipate future needs and propose reasoned approaches to addressing those needs. Clients expect their estate planner to present issues and possibilities they had not anticipated. As the cost of long-term care escalates, clients may well expect some effort to address the possibility of future incapacity, as well as some advice for meeting the costs of long-term care. It is seldom necessary to make Medi-Cal transfers at the time of estate planning. However, a power of attorney can provide a mechanism to later implement broadly accepted Medi-Cal planning strategies without the need or expense of court intervention.

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§30.54 B. Identifying and Documenting Client Desires

Clients are generally well able to express their views about the future on a theoretical or philosophical level, notably when discussing end-of-life issues in completing an Advance Health Care Directive. See chap 29. The high cost of out-of-home care should be addressed, and the types of transfers that may become appropriate to facilitate long-term care funding can be described, at least in general terms. During such a discussion, the practitioner can identify client values regarding protection of assets for a spouse, domestic partner, children, or others.

PRACTICE TIP: The author suggests that a statement of a client's views on this important issue be included in every Durable Power of Attorney for Financial Management. Clients can indicate whether they want to receive public benefits under the Medi-Cal program, or whether they prefer to use some or all of their assets to pay for care. This will help ensure that those involved in future planning will know the client's desires.

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§30.55 C. Power-of-Attorney Clauses

A very broad range of possibilities exists for meeting the costs of long-term care. Medi-Cal is only one option, and it is certainly not the best option for all clients. For some clients, charging the agent with preserving an inheritance will raise concerns about jeopardized independence and possibly inappropriate care. Various clauses can be used or modified to express the client's desires and plans in writing. For example, some clients may prefer to receive care at home even if such care exhausts all assets. Other clients may feel that qualification for Medi-Cal, and subsequent estate recovery avoidance, is the best course of action. Their documents may reflect a more complicated strategy. Additional provisions for married clients may also be included in the power of attorney.

A client may want to implement a plan to qualify for Medi-Cal only if the anticipated costs of care are so great that his or her estate is "threatened." In the author's experience, most clients who elect this approach are able to express their view of "threatened" as a loss of some percentage of the overall estate. In such situations, language can be crafted to address the issue.

The primary concern of some clients will be the location of care. Often, these clients will have sufficient assets, income, or insurance to allow them to receive care in the best of settings, or will expect that one or more of their children will provide them with care. In some of these cases, it would be inappropriate to allow the attorney-in-fact to place them in a skilled nursing facility and qualify them for Medi-Cal.

The foregoing sentiments can be expressed in the suggested forms of clauses for durable powers of attorney in §§30.56-30.60. The language suggested in these forms is only a small sample of the type of provisions that could be included in a durable power of attorney. They by no means exhaust the possibilities, but are offered to aid practitioners in consideration of the issues, and in implementation of some strategy that would allow their clients' desires to be expressly stated in planning documents.

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§30.56 1. Form: Desire to Remain at Home

30.56-1 Desire to remain at home

The principal desires to remain at home and receive care at home. If that is not feasible due to the severity of the condition, the agent is to use the principal's income and assets, up to the whole thereof, to pay for any required care.

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§30.57 2. Form: Authorization of Medi-Cal Planning

30.57-1 Authorization of Medi-Cal planning

In the event that it appears that the principal will be confined to a long-term care facility for a period likely to exceed 60 days, the agent should consult with legal counsel knowledgeable in the Medi-Cal program (or the Medicaid program of any state in which the principal or any child of the principal then resides) and if, in the view of the agent, the benefits available from such program should be sought, the agent is authorized to establish and implement a plan designed to qualify the principal for those benefits as quickly as possible while providing maximum financial benefit to the beneficiaries under the principal's then-existing estate plan.

In this event, the agent is authorized to make gifts not limited to the annual federal gift tax exclusion amount and may make gifts to himself or herself if necessary to maintain equitable distribution of the principal's assets among those named in the principal's then-existing estate plan, if, but only if:

(1) The principal is in out-of-home placement;

(2) Making such gifts would:

(a) Allow the principal to become eligible (or increase the likelihood that he or she could later become eligible) for support from California's Medi-Cal program, or the Medicaid program of another state; or

(b) Avoid recovery against the principal's estate by any such program, or reduce the amount in his or her estate available for such recovery; and

(3) The agent has obtained a written, signed opinion approving the plan for making the gifts, from an attorney licensed to practice in the state in which Medi-Cal or Medicaid benefits will be sought, and has attached this opinion to the original of this Durable Power of Attorney.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.58 3. Form: Transmutation of Property

§30.58 3. Form: Transmutation of Property

30.58-1 Transmutation of property

In effecting gifts to the principal's _ _[*spouse/domestic partner*]_ _, the agent will also have the power to transmute the principal's interest in the property from the principal's community or separate property to the separate property of the principal's _ _[*spouse/registered domestic partner*]_ _, or to the community property of both _ _[*spouses/partners*]_ _.

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§30.59 4. Form: Implementation of Medi-Cal Planning If Estate Is Threatened

30.59-1 Implementation of Medi-Cal planning if estate is threatened

In the event that the principal is confined to long-term care, and it appears likely that such care will continue for at least 60 days, and, most likely, much longer, the agent should consult with legal counsel knowledgeable in the Medi-Cal program and, if the agent believes that the cost of long-term care will result in significant diminution of the principal's estate in excess of _ _[*number*]_ _ percent of the whole estate, the agent is authorized to implement a plan designed to qualify the principal for benefits from such program as quickly as possible while providing maximum financial benefit to the beneficiaries under the principal's then-existing estate plan.

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§30.60 5. Form: Location of Care

30.60-1 Location of care

It is my express desire to remain at home and receive care at my home or in the home of one of my children. My agent is directed to compensate any caregiver, including without limitation any of my children (including the agent), in reasonable amounts for room, board, and care (taking into account the cost of such care if it had been obtained from other sources). My agent should use my income and assets, up to the whole of them, to pay for my care. If home care is not feasible due to the severity of my condition, I wish to be cared for in the least restrictive setting possible and to be discharged home if no further efforts will be effective in relieving the course of the illness, so as to permit my death in a familiar and comfortable setting.

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§30.61 D. Future Representation of Agent

If the attorney has prepared a durable power of attorney reflecting the client's desire to make transfers for Medi-Cal purposes, is future representation of the agent ethically permissible? Without directly answering that question, it is suggested that obtaining some form of written consent from the client to future representation of the agent is advisable. On the theory that any written consent to such future representation is better than no consent, the author offers the sample form in §30.62.

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Source: Estate Planning/California Estate Planning/30 Transfers in Medi-Cal Planning/§30.62 E. Form: Sample Consent to Representation of Attorney-in-Fact

§30.62 E. Form: Sample Consent to Representation of Attorney-in-Fact

30.62-1 Consent to representation of attorney-in-fact

I have signed a Durable Power of Attorney naming one or more of my _ _[*children/others*]_ _ as my attorney-in-fact. In recognition of the uncertainty of health and mental capacity, the Durable Power of Attorney includes authority to make gifts of assets, transmute assets, and undertake other activities that may enable me to qualify for Medi-Cal assistance or otherwise protect my property for my children or others, should I ever require long-term care. Nevertheless, I also understand that my attorney-in-fact should obtain legal advice before taking any of these actions and, thus, may contact _ _[*attorney name*]_ _ because of her experience in such matters. However, because _ _[*attorney name*]_ _ has been my lawyer, and in view of her duty to vigorously defend my rights to personally control my present use and ultimate disposition of my assets, she may be unwilling to undertake representation of my agent. Indeed, because of the potentially significant impact on my ownership rights and her duties not to undertake representations that are adverse to former clients (and the possibility that I might later recover and need those assets), _ _[*attorney name*]_ _ has told me that unless I personally authorize her to represent my attorney-in-fact, she will not facilitate such transactions for my attorney-in-fact.

Thus, I hereby expressly authorize _ _[*attorney name*]_ _ to assume representation of my attorney-in-fact during any such future transactions, if my attorney-in-fact requests such representation. Nothing herein shall be construed to require my attorney-in-fact to use _ _[*attorney name*]_ _'s services, or to require _ _[*attorney name*]_ _ to provide representation; I am consenting to such representation, not making it mandatory. I also expressly authorize the disclosure to any person serving as my attorney-in-fact any of my otherwise privileged attorney-client communications.

I understand that this consent can be withdrawn at any time by signing, dating, and returning to _ _[*attorney name*]_ _ the Revocation set out below. I hereby acknowledge receipt of a copy of this Consent.

Date: _ _ _ _ _ _ **__[*Signature*]__**

REVOCATION

I hereby revoke the authorization granted by the original of this Consent form.

Date: _ _ _ _ _ _ **__[*Signature*]__**

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31

Disposition of Human Remains

Ruth E. Ratzlaff

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§31.1 I. RIGHT TO CONTROL AND DUTY TO ARRANGE DISPOSITION OF REMAINS

Health and Safety Code §§7100-7117 provide the statutory scheme for the right to control disposition of the remains of a deceased person, including the location and conditions of interment and financial and practical arrangements for funeral goods and services.

Generally, the decedent's written preferences control if they are clear. See §§31.3-31.7.

If the decedent left no written preferences, the duty to arrange for disposition of remains and payment devolves upon the following individuals in the order named (Health & S C §7100(a)(1)-(6); see §31.15):

- The agent under a power of attorney for health care who has the right and duty of disposition, including an agent named under an advance health care directive (Prob C §4683(b)(3)). See §31.5; chap 29.
- The competent surviving spouse or registered domestic partner.
- The competent surviving adult child or children.
- The competent surviving parent or parents.
- The competent surviving adult relative or relatives in the next degree of kindred.
- The public administrator when the decedent has sufficient assets.

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II. EXPRESSING DECEDENT'S PREFERENCE

§31.2 A. Oral Expression

There is in California no legal authority requiring compliance with a decedent's orally expressed preferences for disposition of remains. But see Health & S C §7100(e) (statute controlling disposition of remains must be construed so as to implement expressed instructions of decedent). Courts consider a variety of factors in weighing evidence of the decedent's expressed preference, including distance in time from date of death, wishes of other family members, and decedent's mental capacity when expressing a preference. See Anno, *Enforcement of Preference Expressed by Decedent as to Disposition of His Body After Death*, 54 ALR 3d 1037 (2001).

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§31.3 B. Written Expression

Health and Safety Code §7100.1(a) provides that "decedent, prior to death, may direct, in writing, the disposition of his or her remains and specify funeral goods and services to be provided…." The written expressions control provided they are clear and complete and that arrangements have been made for payment by some binding means. Health & S C §7100.1(a). If arrangements have been made only for the cost of either the interment or the funeral, the remaining wishes of the decedent must be carried out only to the extent the decedent had assets to cover the costs, unless third parties who otherwise have the right to control the disposition of remains agree to assume the cost. Health & S C §7100.1(b).

There is no required format for the writing, though there are several obvious alternatives. See §§31.4-31.7.

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§31.4 1. Testamentary Expression

Although a will may appear to be the proper document in which to express preferences for disposition of remains and funeral or memorial services, this may not be effective because the will might not be examined before disposition of remains is accomplished. Reported cases on the topic provide little assurance that the directions of one who seeks by will to provide for the disposition of his or her remains will have those wishes carried out. Anno, *Validity and Effect of Testamentary Direction as to Disposition of Testator's Body*, 7 ALR 3d 747, 748 (2001).

Under California law, the expression contained in a will must be carried out regardless of the validity of the will in other respects or of the fact that the will may not be offered for or admitted to probate until a later date. Health & S C §7100.1(c). One salutary result of an expression of preference in a will is that the probate court is available as a venue to adjudicate disputes regarding disposition of remains. See *Estate of Jimenez* (1997) 56 CA4th 733, 65 CR2d 710 (dismissing probate court petition for lack of jurisdiction when conflicting written instructions were contained in funeral home contracts).

In *Cohen v Cohen* (Fla App 2005) 896 So2d 950, the appellate court affirmed the trial court's finding that clear and convincing evidence showed that the testator had changed his mind about a burial site. His will, written while he and his wife were residents of the state of New York, provided that he should be buried in "a traditional Jewish burial" in his family plot in a New York Jewish cemetery. The plot was in a section of the cemetery where burial of non-Jewish decedents was prohibited.

The testator's wife of 40 years, who was not Jewish, testified that she and her husband had decided to be buried together in Florida, where they had moved after the will was written. His brother argued that the provision in the will should control. The court found that ambiguity in the will was not an essential element for the court to admit extrinsic evidence to determine that the testator had changed his mind about disposition of his remains. The opinion contains a good discussion of the law on this subject from many jurisdictions.

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§31.5 2. Advance Health Care Directive

California's statutory form for an advance health care directive (Prob C §4701) includes language in Part 1 (paragraph 1.5) authorizing the agent to direct disposition of the principal's remains. The agent's authorization in the advance health care directive takes precedence over the wishes of surviving family members. Health & S C §7100(a)(1). The statutory form merely identifies the agent designated to make arrangements, but the form may be customized to specify the exact manner of disposition of remains.

Execution of an advance health care directive without stating any limitations gives the agent full power to dispose of the principal's remains, to authorize an autopsy, and to donate all or part of the principal's body for transplant, education, or research purposes. Prob C §4683(b). See California Powers of Attorney and Health Care Directives §7.59 (Cal CEB 2008). The agent is liable for the costs of disposition only if the agent makes a specific agreement to pay the costs of disposition (Health & S C §7100(a)(1)(A)), or if the agent makes decisions concerning disposition that incur costs, in which situation the agent is liable only for the reasonable costs incurred to the extent that decedent's estate or other appropriate fund is insufficient (Health & S C §7100(a)(1)(B)).

On advance health care directives as an estate planning tool, see chap 29.

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§31.6 3. Contract With Funeral Home or Memorial Society

Funeral homes and memorial societies provide forms on which potential customers and members can express their preferences about disposition of remains and related instructions regarding funerals or other memorial arrangements. The consumer perspective on this issue is contained on the website for the Funeral Consumers Alliance, a federation of nonprofit consumer information societies, including many in California. See http://www.funerals.org.

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§31.7 4. Other Written Expression

Other writings expressing preference for disposition of remains are not precluded, but would presumably be subject to challenge on all the grounds available to challenge any other document taking effect after the death of the author, *e.g.*, lack of capacity, undue influence, mistake, or lack of intent. See California Will Drafting §§10.16-10.18 (3d ed Cal CEB 1992).

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III. ASPECTS OF DISPOSITION OF REMAINS

§31.8 A. Method of Disposition of Physical Remains

The right to control disposition of human remains (see §31.1) includes the right to decide whether the remains are cremated or buried and, if buried, whether they should be embalmed and where they should be buried.

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§31.9 B. Funeral or Memorial Service

The right to control disposition of human remains (see §31.1) includes the right to decide whether there will be a funeral or memorial service and, if there is a service, whether it will be public or private. See *Ross v Forest Lawn Mem. Park* (1984) 153 CA3d 988, 203 CR 468.

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§31.10 C. Location of Remains After Disposition

The decision on the location of human remains is vested in the person who has control over other aspects of disposition of remains. Human remains may be disposed of either by interment (including burial or placement in a vault or mausoleum), or by cremation. See Health & S C §103055(a). A disposition by interment must specify the cemetery where the remains will be interred. Health & S C §103055(a)(1). A disposition by cremation must also specify the destination of the ashes (including burial at sea, the address or location of burial or scattering on land, or the location where the cremated remains will be kept). Health & S C §103055(a)(2)-(4).

Removal of human remains from a cemetery is governed by Health & S C §§7500-7502, and requires an order from the county health department or the superior court, as well as the consent of a family member of the deceased. See Health & S C §7525.

If consent cannot be obtained, or if there is disagreement among the persons needed to give consent (surviving spouse or registered domestic partner, surviving children, surviving parent, surviving siblings, in that order) permission may be granted by the court in the county where the cemetery is located. Health & S C §7526.

The court has broad discretion to consider the facts of a particular case in deciding whether to grant permission to disinter human remains. In *Maffei v Woodlawn Mem. Park* (2005) 130 CA4th 119, 29 CR3d 679, for example, decedent's surviving husband agreed in 1982 to have his wife's remains interred in her family's crypt. Twenty years later, as he was getting his own affairs in order, he requested that her remains be disinterred and cremated. He wanted her ashes placed in an urn in a vault, to be combined with his ashes when he died. Also in the vault were urns with the ashes of his second wife and two of his dogs. The trial court sided with the first wife's family that there was no compelling reason to disturb the repose of the dead, and the court of appeal affirmed.

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IV. ENFORCEMENT OF EXPRESSED PREFERENCES

§31.11 A. Between Decedent and Survivors

The deceased person's expressed preferences for place and manner of interment are valid and may be judicially enforced. See *Estate of Henderson* (1936) 13 CA2d 449, 57 P2d 212.

If the person or persons vested with the duty of interment fail to act or agree on disposition of the remains within a specified time after death (10 days for surviving spouse or registered domestic partner, 7 days after vesting of the duty for other classes of survivors), the duty is relinquished and passed on to the person or persons in the next degree of kinship. Health & S C §7105(a)-(b); Fam C §297.5(c).

If persons with equal rights cannot be located or fail to agree on disposition of remains, a funeral establishment or a cemetery authority with possession of the remains or any person with an equal right to control disposition of the remains may petition for an order determining who among those parties will have control of disposition and directing that person to carry out the interment. Health & S C §7105(c). A petition to determine control of disposition also may be filed in cases of homicide. Health & S C §7105(d). See §31.15A.

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§31.12 B. Against Service Providers

If the decedent executed an advance health care directive (see §31.5), the agent under the directive may petition the court for an order compelling third parties to comply with the instructions of the agent. Prob C §4766(e). A sample petition is set forth in §31.13; the accompanying order is set forth in §31.14. On general procedural considerations for probate petitions, see California Trust and Probate Litigation, chap 9 (Cal CEB 1999).

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Source: Estate Planning/California Estate Planning/31 Disposition of Human Remains/§31.13 1. Form: Sample Petition to Compel Crematory to Honor Authority of Agent to Arrange for Disposal of Remains of Principal

§31.13 1. Form: Sample Petition to Compel Crematory to Honor Authority of Agent to Arrange for Disposal of Remains of Principal

31.13-1 Petition to compel crematory to honor authority of agent

Janet Roe,	**)**	**No. 123456**
Petitioner	**)**	
	)	**PETITION TO COMPEL**
vs	**)**	**CREMATORY TO HONOR**
	)	**AUTHORITY OF AGENT TO**
Suburban Crematorium,	**)**	**ARRANGE FOR DISPOSAL OF**
Defendant	**)**	**REMAINS OF PRINCIPAL**
_____	**)**	**(PROBATE CODE §4766(e))**

PETITIONER alleges:

1. *Status of Petitioner*. Petitioner, Janet Roe, is named as the agent to act on behalf of Allison Johnson (PRINCIPAL), in an advance health care directive signed by PRINCIPAL on November 10, 2001. Since that date Petitioner has acted as such agent. A copy of the advance health care directive is attached as Exhibit A. Petitioner is related to PRINCIPAL by marriage.

2. *Petitioner's authority regarding disposition of PRINCIPAL'S remains*. Under Paragraph 1.5 of the advance health care directive signed by PRINCIPAL on November 10, 2001, Petitioner is given authority to arrange for disposition of PRINCIPAL'S remains.

3. *Death of PRINCIPAL.* PRINCIPAL died of natural causes on February 5, 2002.

4. *Arrangements for disposition of remains*. Before PRINCIPAL'S death, arrangements were made for disposition of PRINCIPAL'S remains by cremation as provided by Hometown Funeral Services.

5. *Refusal to allow arranged disposition of remains without conditions*. Hometown Funeral Services has attempted in good faith to have PRINCIPAL'S remains disposed of by cremation, but Suburban Crematorium has refused to do so without the signature and approval of the PRINCIPAL'S spouse.

6. *Impossibility of conditions*. PRINCIPAL'S spouse cannot be located. PRINCIPAL'S spouse is not physically present at the only residence address known to Petitioner and no other location or telephone number is known to reach the spouse.

WHEREFORE, Petitioner requests that the court order and direct Suburban Crematorium to dispose of the remains of PRINCIPAL forthwith, without the signature of PRINCIPAL'S spouse, through cremation.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ **__[*Signature*]__**
Petitioner

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Source: Estate Planning/California Estate Planning/31 Disposition of Human Remains/§31.14 2. Form: Sample Order Compelling Crematory to Honor Authority of Agent to Arrange for Disposal of Remains of Principal

§31.14 2. Form: Sample Order Compelling Crematory to Honor Authority of Agent to Arrange for Disposal of Remains of Principal

31.14-1 Order compelling crematory to honor authority of agent

Janet Roe,	**)**	**No. 123456**
Petitioner	**)**	
	)	**ORDER COMPELLING**
Vs	**)**	**CREMATORY TO HONOR**
	)	**AUTHORITY OF AGENT TO**
Suburban Crematorium,	**)**	**ARRANGE FOR DISPOSAL OF**
Defendant	**)**	**REMAINS OF PRINCIPAL**
_____	**)**	**(PROBATE CODE §4766(e))**

The Court, having read and considered the petition of Petitioner, and all notices having been given as required by law, grants the petition as follows:

Suburban Crematorium is ordered and directed to dispose of the remains of PRINCIPAL forthwith, without the signature of PRINCIPAL'S spouse, through cremation.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

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§31.15 C. If No Preference Expressed

If the decedent made no written provisions for disposition of remains and did not include authority for disposition of remains in an advance health care directive, the priority for authority to arrange for disposition of human remains is as follows (Health & S C §7100(a)(2)-(7); Fam C §297.5(c)):

- The competent surviving spouse or registered domestic partner.
- The competent surviving adult child or children.
- The competent surviving parent or parents.
- The competent surviving adult sibling or siblings.
- The competent surviving adult relative or relatives in the next degree of kindred.
- The public administrator when the decedent has sufficient assets.

If unanimity among relatives in a particular category cannot be achieved, or if competent relatives are absent, the statute includes methods by which the decision-maker can be identified. See Health & S C §7100(a)(3)-(5).

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§31.15A D. In Cases of Homicide

If the person to whom the right to control disposition of the remains is vested has been charged with murder or voluntary manslaughter in connection with the decedent's death, and the funeral director or cemetery authority knows about the charges, the right of control is relinquished and passed on to the next class of survivors. Health & S C §7100(b).

If murder or voluntary manslaughter charges are pending, the person with the next highest priority may petition the court for an order granting the petitioner, rather than the person against whom charges are pending, the right to control disposition of the decedent's remains. Health & S C §7105(d).

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V. FINANCIAL CONSIDERATIONS

§31.16 A. Deducting Funeral Expenses for Federal Estate Tax Purposes

Funeral expenses are allowed as a deduction from the gross estate for federal estate tax purposes. IRC §2053(a)(1). For allowed items of funeral expenses, see Treas Reg §20.2053-2. See also *Estate of Sarah M. Davenport,* TC Memo 2006-215, in which the court denied a deduction for a claimed $3639 expense for a "funeral luncheon."

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§31.17 B. Allowing Funeral Expenses as Claim of Probate Estate

Funeral expenses are allowed as priority claims against a California probate estate. Prob C §11420(a)(3). Allowable funeral expenses are limited to the reasonable cost of interment. Health & S C §7101. For a discussion of factors to consider in determining reasonableness of costs, see *Estate of Malgor* (1947) 77 CA2d 535, 176 P2d 66. Under California law, "the term 'funeral expenses' has reference to those necessary and, in fact, compulsory expenditures, the necessity for which arises immediately upon and after the death of the decedent and which embraces the coffining, embalmment, arraying, and sepulture or cremation of his body, together with those accustomed forms and ceremonies which attend upon the present disposition of his remains." *Estate of Silverstein* (1984) 159 CA3d 221, 226, 205 CR 294, quoting *Estate of Bauer* (1925) 196 C 757, 759-760, 239 P 49.

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§31.18 C. Medi-Cal Limits on Funeral Expense Allowance

An individual receiving benefits under the Medi-Cal program, whether in the community or in an institution, may have a prepaid burial plot, vault, or crypt for use by any member of the individual's immediate family. 22 Cal Code Regs §50477(a). The individual may also have an irrevocable burial trust or prepaid burial contract for funeral, cremation, or interment expenses, with no limitation on the amount, and an additional $1500 revocably set aside for such expenses. See 22 Cal Code Regs §50479. Any amount in the irrevocable or revocable fund not used for funeral, cremation, or interment expenses would be part of the individual's estate, subject to a claim from the State of California for estate recovery under Welf & I C §14009.5(a).

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