NEW YORK STATE BAR ASSOCIATION

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Natalia Murphy, Esq.
Citi Private Bank
New York City

Program Chair
Michael S. Schwartz, Esq.
Curtis, Mallet-Prevost,
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New York City

NYSBA

Trusts and Estates Law Section Spring Meeting

The Cloister
Sea Island, Georgia

May 3 – 6, 2018

Sophisticated Estate Planning Techniques Made Easy

Attendance at this program offers **8.0 MCLE** credit hours: **7.0** credits in Areas of Professional Practice and **1.0** credit in Ethics for experienced attorneys only. Attendance at the optional Surrogates' Panel is worth an additional 1.0 credit in Areas of Professional Practice for experienced attorneys.

Sophisticated Estate Planning Techniques Made Easy

Trusts and Estates Law
Section Spring Meeting 2018

May 3-6, 2018

The Cloister

Sea Island, Georgia

Thank You! This program is made possible by the generous donation of time and expertise by members and volunteers. Thank you to our volunteers—and to you, for choosing NYSBA Programs.

This program is offered for educational purposes. The views and opinions of the faculty expressed during this program are those of the presenters and authors of the materials, including all materials that may have been updated since the books were printed or distributed electronically. Further, the statements made by the faculty during this program do not constitute legal advice.

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New York State Bar Association

Accessing the Online Electronic Course Materials

Program materials will be distributed exclusively online in PDF format. It is strongly recommended that you save the course materials in advance, in the event that you will be bringing a computer or tablet with you to the program.

Printing the complete materials is not required for attending the program.

The course materials may be accessed online at:
<<www.nysba.org/TRUSSP18MATERIALS>>

A hard copy NotePad will be provided to attendees at the live program site, which contains lined pages for taking notes on each topic, speaker biographies, and presentation slides or outlines if available.

Please note:

- You must have Adobe Acrobat on your computer in order to view, save, and/or print the files. If you do not already have this software, you can download a free copy of Adobe Acrobat Reader at https://get.adobe.com/reader/
- If you are bringing a laptop, tablet or other mobile device with you to the program, please be sure that your batteries are fully charged in advance, as electrical outlets may not be available.
- NYSBA cannot guarantee that free or paid Wi-Fi access will be available for your use at the program location.

MCLE INFORMATION

Program Title: **Trusts and Estates Law Section Spring Meeting 2018**
Dates: May 3-6, 2018 Location: Sea Island, Georgia

Evaluation: https://nysba.co1.qualtrics.com/jfe/form/SV_cLSy1y0TtYo3Yxf
This evaluation survey link will be emailed to registrants following the program.

Total Credits: **8.0 New York CLE credit hours**

Credit Category:
7.0 Areas of Professional Practice
1.0 Ethics and Professionalism

This course is approved for credit for **experienced attorneys only**. This course is not transitional and therefore will not qualify for credit for newly admitted attorneys (admitted to the New York Bar for less than two years).

Attendance Verification for New York MCLE Credit

In order to receive MCLE credit, attendees must:

1) **Sign in** with registration staff

2) Complete and return a **Verification of Presence form** (included with course materials) at the end of the program or session. For multi-day programs, you will receive a separate form for each day of the program, to be returned each day.

Partial credit for program segments is not allowed. Under New York State Continuing Legal Education Regulations and Guidelines, credit shall be awarded only for attendance at an entire course or program, or for attendance at an entire session of a course or program. Persons who arrive late, depart early, or are absent for any portion of a segment will not receive credit for that segment. The Verification of Presence form certifies presence for the entire presentation. Any exceptions where full educational benefit of the presentation is not received should be indicated on the form and noted with registration personnel.

Program Evaluation

The New York State Bar Association is committed to providing high quality continuing legal education courses, and your feedback regarding speakers and program accommodations is important to us. Following the program, an email will be sent to registrants with a link to complete an online evaluation survey. The link is also listed above.

Additional Information and Policies

Recording of NYSBA seminars, meetings and events is not permitted.

Accredited Provider

The New York State Bar Association's **Section and Meeting Services Department** has been certified by the New York State Continuing Legal Education Board as an accredited provider of continuing legal education courses and programs.

Credit Application Outside of New York State

Attorneys who wish to apply for credit outside of New York State should contact the governing body for MCLE in the respective jurisdiction.

MCLE Certificates

MCLE Certificates will be emailed to attendees a few weeks after the program, or mailed to those without an email address on file. **To update your contact information with NYSBA**, visit www.nysba.org/MyProfile, or contact the Member Resource Center at (800) 582-2452 or MRC@nysba.org.

Newly Admitted Attorneys—Permitted Formats

In accordance with New York CLE Board Regulations and Guidelines (section 2, part C), newly admitted attorneys (admitted to the New York Bar for less than two years) must complete **Skills** credit in the traditional live classroom setting or by fully interactive videoconference. **Ethics and Professionalism** credit may be completed in the traditional live classroom setting; by fully interactive videoconference; or by simultaneous transmission with synchronous interactivity, such as a live-streamed webcast that allows questions during the program. **Law Practice Management** and **Areas of Professional Practice** credit may be completed in any approved format.

Tuition Assistance

New York State Bar Association members and non-members may apply for a discount or scholarship to attend MCLE programs, based on financial hardship. This discount applies to the educational portion of the program only. Application details can be found at www.nysba.org/SectionCLEAssistance.

Questions

For questions, contact the NYSBA Section and Meeting Services Department at SectionCLE@nysba.org, or (800) 582-2452 (or (518) 463-3724 in the Albany area).

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Sigma Valuation Consulting Inc.
South Dakota Trust Company
Sterling Foundation Management
Willamette Management Associates

Save-The-Date

Trusts & Estates Fall Meeting

Thursday, October 18 - Friday, October 19

The Sagamore Resort
Bolton Landing, NY

www.nysba.org/TRUSFA18

SCHEDULE OF EVENTS

All MCLE Sessions are located at The Cloister.
Shuttles run from 7 am to 11 pm on the hour & half hour between The Cloister, the Inn on Sea Island and The Lodge.

Thursday, May 3

11:00 a.m. – 6:00 p.m. **Registration – Cloister Foyer III**
Silver Giveaway Sponsor: RDM FINANCIAL GROUP AT HIGHTOWER

12:00 – 2:00 p.m. **Executive Officers' Meeting – Cumberland Room**

2:00 – 5:00 p.m. **Executive Committee Meeting – Spanish Lounge**

6:00 – 7:30 p.m. **Welcoming Cocktail Reception – Black Banks Terrace**
Enjoy a Taste of Southern Coastal Style!
Silver Reception Sponsor: NORTHERN TRUST
Specialty Cocktails & Whiskey Bar Sponsors: GRASSI & CO. and PHILLIPS AUCTION HOUSE

Friday, May 4

7:30 a.m. – 1:00 p.m. **Registration – Cloister Foyer III**

8:00 – 9:30 a.m. **Continental Breakfast and Exhibitors – Mizner Ballroom II**
Open to all registered attendees including spouses and guests. Grab a bite and visit with our exhibitors.

8:00 – 8:50 a.m. **Breakfast with the Surrogates' – Spanish Lounge**
On Second Thought… A Surrogate's Guide to Tax-Related Reformation of Tax Clauses in a Changing Tax Landscape
With so many recent revisions to NY's estate and fiduciary income tax laws, as well the recent Federal tax reform (none of which would have been anticipated by a settlor of an existing governing instrument), an increasing number of fiduciaries must grapple with the potential negative tax consequences that might follow, and what could be done to mitigate them. In some cases, trust decanting or other techniques might offer a practical, non-judicial solution. But sometimes the only available remedy is a judicial reformation of the governing instrument. The panel will review recent reformation cases and will provide practical pointers for practitioners seeking to reform a governing instrument in light of changes to the tax laws.

Panelists:

Hon. Stephen W. Cass
Chautauqua County Surrogate's Court
Mayville

Hon. John M. Czygier
Suffolk County Surrogate's Court
Riverhead

Hon. Peter J. Kelly
Queens County Surrogate's Court
Jamaica

Joseph La Ferlita, Esq. - ***Moderator***
Farrell Fritz, P.C.
New York CIty

8:55 a.m. – 12:45 p.m. **MCLE GENERAL SESSION – Mizner Ballroom I**

8:55 – 9:10 a.m.

Introductions
Natalia Murphy, Esq.
Section Chair

NYSBA Welcome
Sharon Stern Gerstman, Esq.
President, NYSBA

Program Introductions
Michael S. Schwartz, Esq.
Program Chair

Sponsor Acknowledgements
Ilene Cooper, Esq.
Sponsorship Co-Chair

9:10 – 10:00 a.m. **Recent Developments in Estate Planning**
A review of the most significant developments in estate planning strategies from the past year, including Federal tax reform, the Hoppenstein case and its impact on decanting New York trusts, and much more.

Panelists:

Sean R. Weissbart, Esq.
Morris & McVeigh LLP
New York City

Bradley A. Dillon, Esq.
Brown Brothers Harriman
New York CIty

10:00 – 11:30 a.m. **SPOUSE/GUEST EVENT: SALT MARSH DOLPHIN TOUR, DEPARTS FROM CLOISTER DOCK**
Cruise through the tidal marshes to see numerous shorebirds, dolphins, and aquatic species. You will also learn the rich history surrounding the area's salt marshes. Recommended attire: athletic, comfortable clothes, sunscreen, sunglasses. **Adults: $115.00; Children up to age 18: $57.50. Preregistration required.**

Friday, May 4 *continued*

10:00 – 10:50 a.m. **Deconstructing Different Flavored Freezes: A Comparison of Popular Estate Freeze Techniques**

"Freeze" planning comes in a dizzying array of forms (e.g., outright gifts, intra-family loans, GRATs, installment sales and preferred partnerships). The art of "freeze" planning is matching the technique to the client's goals and assets, risk profile and then deciding how and whether to "super charge" it in some way. This presentation will give an overview of different "freeze" techniques, comparing and contrasting them, and highlighting the opportunities today, especially in light of the temporary doubling of the Applicable Exemption Amounts under the post Federal tax reform.

Speaker: **Todd Angkatavanich, Esq.**
Ernst & Young LLP
New York City

10:50 – 11:05 a.m. **Refreshment Break with the Exhibitors – Mizner Ballroom II**

11:05 – 11:55 a.m. **The More Trustees the Merrier? All About Directed Trusts**

It is becoming increasingly popular for clients to want to separate the duties of a Trustee by use of directed trusts. However, for many practitioners in states such as New York which do not have directed trust legislation, there is often confusion about how these trusts work, including the duties and liabilities of directed trustees and trust directors. This session will canvass the new Uniform Directed Trust Act and the Directed Trust laws of other states (including Delaware, South Dakota and Nevada) and will highlight some of the most common and helpful uses of directed trusts in the current planning environment, as well as related drafting tips. This session will also review the proposed New York Directed Trust law, and will analyze how it compares with the laws of other jurisdictions.

Panelists:

Jocelyn Margolin Borowsky, Esq.
Duane Morris, LLP
Wilmington, DE

Jill Choate Beier, Esq.
Beier & Associates, PLLC
Lake Placid

11:55 a.m. – 12:45 p.m. **The Practice of Trusts and Estates in the Digital Age: Ethical Issues in Law Firm Technology and Data Security & Privacy**

Explore the ethical responsibility of trusts and estates practitioners to keep up with evolving technologies, and the many potential risks and pitfalls that accompany the use of these technologies, including data security and privacy concerns.

Speaker: **Jennifer A. Beckage, Esq.**
Phillips Lytle LLP
Buffalo

AFTERNOON AT YOUR LEISURE

2:00 – 4:00 p.m. **INTRO TO CLAY TARGET SHOOTING – THE SHOOTING SCHOOL**

Shuttle available to school from Cloister. Overview of gun safety, equipment and shooting techniques

Preregistration Required. Adults: $130.00; Children ages 12 to 18: $65.00. Must Weigh 100 lbs.

Friday, May 4 *continued*

1:30 – 3:30 p.m. ***and*** 3:30 – 5:30 p.m.
YACHT CRUISE – DEPARTS FROM DOCK AT CLOISTER
Join us on a Salt Marsh Yacht Cruise with Naturalist and learn about the local eco-system.
Preregistration Required. Adults: $75.00; Children up to age 18: $37.50.

6:00 – 10:00 p.m.
RECEPTION AND DINNER – OCEAN ROOM, COURTYARD & PATIO AT THE BEACH CLUB
Enjoy sweeping views of the Atlantic starting withcocktails on the Patio followed by dinner in the Ocean Room and Courtyard. **Children's Dinner** adjacent to Ocean Room in the **Mirimar Room**.

Platinum Dinner Sponsor:
CITI PRIVATE BANK

Dinner Wine Sponsor:
FARRELL FRITZ, P.C.

Entertainment Sponsor:
EMPIRE VALUATION CONSULTANTS

Saturday, May 5

7:45 a.m. – 12:45 p.m. **Registration – Cloister Foyer III**

8:00 – 9:00 a.m. **Committee Breakfast Meetings – Georgian Room Restaurant**

8:00 – 9:30 a.m. **Continental Breakfast and Exhibitors – Mizner Ballroom II**
Open to all registered attendees including spouses and guests.
Grab a bite and visit with our exhibitors.

9:00 a.m. – 12:45 p.m. **MCLE GENERAL SESSION – Mizner Ballroom I**

9:00 – 9:10 a.m.
Program Introductions
Michael S. Schwartz, Esq.
Program Chair

Sponsor Acknowledgements
Darcy M. Katris, Esq.
Sponsorship Co-Chair

9:10 – 10:00 a.m.
Shoo Creditors, Don't Bother Me - All You Need to Know About the Use of Self-Settled Asset Protection Trusts
This session will address the asset protection afforded settlors through the use of self-settled asset protection trusts. This session will also discuss the conflict of law issues associated with the effectiveness of these trusts, and the impact that the Uniform Voidable Transactions Act (which is proposed in New York) may have on these structures and provide practitioners with drafting pointers and common pitfalls when looking to establish these structures.

Speaker: **Daniel S. Rubin, Esq.**
Moses & Singer LLP
New York City

10:00 – 10:50 a.m.
Dynasty Trusts: Nothing Lasts for Ever
Although there has been an increased use of Dynasty Trusts in jurisdictions that have abolished (or effectively abolished) the rule against perpetuities, numerous problems can be expected to be encountered throughout the very long existence of such a trust. This begs the question as to how much flexibility to include in a dynasty trust while also balancing settlor intentions, beneficiary concerns, tax considerations, state law limitations and the goal of minimizing the prospects for fiduciary litigation. We will examine the options and include drafting pointers along the way.

Speaker: **Michael M. Gordon, Esq.**
Gordon, Fournaris & Mammarella, P.A.
Wilmington, DE

Saturday, May 5 *continued*

10:50 – 11:05 a.m. **Refreshment Break with the Exhibitors – Mizner Ballroom II**

11:05 – 11:55 a.m. **Pressing the Do Over Button: A Practitioners Perspective on Strategies for Modifying Wills and Trusts After Formation**

During these times where everything changes in unanticipated ways, what after-the-fact options exist to both fix mistakes and to change things that weren't mistakes when done but no longer work. We will review flexible strategies such as tax and state law elections, 9100 relief and private letter rulings, construction proceedings, qualified and nonqualified disclaimers, amendments and decantings, as well as creative exercises of powers of appointment.

Speaker: **Joshua S. Rubenstein, Esq.**
Katten Muchin Rosenman LLP
New York City

11:55 a.m. – 12:45 p.m. **The Art of Planning for the Collector: A Guide to Estate Planning Considerations for Art Collectors**

Common planning considerations applicable to collectors of art will be reviewed, including valuation considerations, gifts of art to trusts and related considerations about retained use, liquidity concerns, and much more.

Panelists:

Von E. Sanborn, Esq.
Day Pitney LLP
New York City

Darren M. Wallace, Esq.
Day Pitney LLP
Greenwich, CT

Rebecca A. Lockwood, Esq.
Sotheby's
New York City

AFTERNOON AT YOUR LEISURE

1:00 – 3:00 p.m. **BEACH HORSEBACK RIDE - DEPARTS FROM RAINBOW ISLAND STABLES**

An unforgettable equestrian experience. Transportation is provided upon request from The Cloister.
Preregistration required. Adults: $145.00; Children ages 10 to 18: $72.50.

1:30 p.m. **GOLF AT THE SEASIDE COURSE**

Complimentary shuttle transportation between The Cloister main entrance and The Lodge is available on the hour and half-hour, and is available for guests of The Inn upon advance request. **$370.00 per person** includes green and cart fees, range balls, forecaddie, and club cleaning. **Preregistration required.**
Club rentals available; call 912-638-5118 or ext. 5118 onsite.
Golf Chair: Magdalen Gaynor Esq., Law Offices of Magdalen Gaynor, White Plains

Saturday, May 5 *continued*

2:00 – 4:00 p.m. **HOBIE CAT SHELLING TOUR - DEPARTS FROM SAILING CENTER AT THE BEACH CLUB**
Jump aboard a Hobie Cat ® Getaway with a local naturalist for a custom expediiton which will include shelling, information on the history of the area and Georgia's coastal geography and its wildlife. Walking dstance of The Cloister. **Preregistration Required. Adults: $150.00; Children ages 5 to 18: $75.00. Must be able to swim on own.**

2:30 – 4:00 p.m. **SALT MARSH KAYAKING WITH GUIDE - DEPARTS FROM RAINBOW ISLAND WATER SPORTS**
Explore the vast tidal grasslands behind our barrier islands by sea kayak with a naturalist. **Preregistration Required. Adults: $138.00; Children ages 6 to 18: $69.00. Must be able to swim on own without life jacket.**

6:30 – 10:00 p.m. **SOUTHERN RECEPTION-STYLE DINNER – RAINBOW ISLAND**
Enjoy an informal evening of local cuisine, traditional southern refereshments and craft beers overlooking the scenic Black Bank River.
Gold Dinner Sponsor: SOTHEBY'S

Sunday, May 6

12 noon **Check out and departure**

Lawyer Assistance Program 800.255.0569

Q. What is LAP?

A. The Lawyer Assistance Program is a program of the New York State Bar Association established to help attorneys, judges, and law students in New York State (NYSBA members and non-members) who are affected by alcoholism, drug abuse, gambling, depression, other mental health issues, or debilitating stress.

Q. What services does LAP provide?

A. Services are **free** and include:

- Early identification of impairment
- Intervention and motivation to seek help
- Assessment, evaluation and development of an appropriate treatment plan
- Referral to community resources, self-help groups, inpatient treatment, outpatient counseling, and rehabilitation services
- Referral to a trained peer assistant – attorneys who have faced their own difficulties and volunteer to assist a struggling colleague by providing support, understanding, guidance, and good listening
- Information and consultation for those (family, firm, and judges) concerned about an attorney
- Training programs on recognizing, preventing, and dealing with addiction, stress, depression, and other mental health issues

Q. Are LAP services confidential?

A. Absolutely, this wouldn't work any other way. In fact your confidentiality is guaranteed and protected under Section 499 of the Judiciary Law. Confidentiality is the hallmark of the program and the reason it has remained viable for almost 20 years.

Judiciary Law Section 499 Lawyer Assistance Committees Chapter 327 of the Laws of 1993

Confidential information privileged. The confidential relations and communications between a member or authorized agent of a lawyer assistance committee sponsored by a state or local bar association and any person, firm or corporation communicating with such a committee, its members or authorized agents shall be deemed to be privileged on the same basis as those provided by law between attorney and client. Such privileges may be waived only by the person, firm or corporation who has furnished information to the committee.

Q. How do I access LAP services?

A. LAP services are accessed voluntarily by calling **800.255.0569** or connecting to our website **www.nysba.org/lap**

Q. What can I expect when I contact LAP?

A. You can expect to speak to a Lawyer Assistance professional who has extensive experience with the issues and with the lawyer population. You can expect the undivided attention you deserve to share what's on your mind and to explore options for addressing your concerns. You will receive referrals, suggestions, and support. The LAP professional will ask your permission to check in with you in the weeks following your initial call to the LAP office.

Q. Can I expect resolution of my problem?

A. The LAP instills hope through the peer assistant volunteers, many of whom have triumphed over their own significant personal problems. Also there is evidence that appropriate treatment and support is effective in most cases of mental health problems. For example, a combination of medication and therapy effectively treats depression in 85% of the cases.

Personal Inventory

Personal problems such as alcoholism, substance abuse, depression and stress affect one's ability to practice law. Take time to review the following questions and consider whether you or a colleague would benefit from the available Lawyer Assistance Program services. If you answer "yes" to any of these questions, you may need help.

1. **Are my associates, clients or family saying that my behavior has changed or that I don't seem myself?**
2. **Is it difficult for me to maintain a routine and stay on top of responsibilities?**
3. **Have I experienced memory problems or an inability to concentrate?**
4. **Am I having difficulty managing emotions such as anger and sadness?**
5. **Have I missed appointments or appearances or failed to return phone calls? Am I keeping up with correspondence?**
6. **Have my sleeping and eating habits changed?**
7. **Am I experiencing a pattern of relationship problems with significant people in my life (spouse/parent, children, partners/associates)?**
8. **Does my family have a history of alcoholism, substance abuse or depression?**
9. **Do I drink or take drugs to deal with my problems?**
10. **In the last few months, have I had more drinks or drugs than I intended, or felt that I should cut back or quit, but could not?**
11. **Is gambling making me careless of my financial responsibilities?**
12. **Do I feel so stressed, burned out and depressed that I have thoughts of suicide?**

There Is Hope

CONTACT LAP TODAY FOR FREE CONFIDENTIAL ASSISTANCE AND SUPPORT

The sooner the better!

1.800.255.0569

NEW YORK STATE BAR ASSOCIATION

JOIN OUR SECTION

☐ As a NYSBA member, **PLEASE BILL ME $40 for Trusts and Estates Law Section dues.** (law student rate is $5)

☐ I wish to become a member of the NYSBA (please see Association membership dues categories) and the Trusts and Estates Law Section. **PLEASE BILL ME for both.**

☐ I am a Section member — please consider me for appointment to committees marked.

Name ____________________

Address ____________________

____

City __________ State ____ Zip __________

The above address is my ☐ Home ☐ Office ☐ Both

Please supply us with an additional address.

Name ____________________

Address ____________________

City __________ State ____ Zip __________

Office phone (______) ____________________

Home phone (______) ____________________

Fax number (______) ____________________

E-mail address ____________________

Date of birth ______ /______ /______

Law school ____________________

Graduation date __________

States and dates of admission to Bar: __________

Please return this application to:

MEMBER RESOURCE CENTER,

New York State Bar Association, One Elk Street, Albany NY 12207

Phone 800.582.2452/518.463.3200 • FAX 518.463.5993

E-mail mrc@nysba.org • www.nysba.org

JOIN A TRUSTS AND ESTATES LAW SECTION COMMITTEE(S)

Please designate in order of choice (1, 2, 3) from the list below, a maximum of three committees in which you are interested. You are assured of at least one committee appointment, however, all appointments are made as space availability permits.

___ Charitable Planning (TRUS1100)
___ Continuing Legal Education (TRUS1020)
___ Diversity (TRUS2800)
___ Elderly and Disabled (TRUS1700)
___ Estate and Trust Administration (TRUS1400)
___ Estate Litigation (TRUS1200)
___ Estate Planning (TRUS1300)
___ International Estate Planning (TRUS1600)
___ Law Students and New Members (TRUS2700)
___ Legislation and Governmental Relations (TRUS1030)
___ Life Insurance and Employee Benefits (TRUS1800)
___ Membership and Relations with Local Bars (TRUS1040)
___ Multi-State Practice (TRUS2400)
___ Newsletter and Publications (TRUS1900)
___ New York Uniform Trust Code (TRUS2900)
___ Practice and Ethics (TRUS2100)
___ Surrogates Court (TRUS2200)
___ Taxation (TRUS2300)
___ Technology in Practice (TRUS2500)

2018 MEMBERSHIP DUES

Class based on first year of admission to bar of any state. Membership year runs January through December.

ACTIVE/ASSOCIATE IN-STATE ATTORNEY MEMBERSHIP	
Attorneys admitted 2010 and prior	$275
Attorneys admitted 2011-2012	185
Attorneys admitted 2013-2014	125
Attorneys admitted 2015 - 3.31.2017	60

ACTIVE/ASSOCIATE OUT-OF-STATE ATTORNEY MEMBERSHIP	
Attorneys admitted 2010 and prior	$180
Attorneys admitted 2011-2012	150
Attorneys admitted 2013-2014	120
Attorneys admitted 2015 - 3.31.2017	60

OTHER	
Sustaining Member	$400
Affiliate Member	185
Newly Admitted Member*	FREE

DEFINITIONS

Active In-State = Attorneys admitted in NYS, who work and/or reside in NYS
Associate In-State = Attorneys not admitted in NYS, who work and/or reside in NYS
Active Out-of-State = Attorneys admitted in NYS, who neither work nor reside in NYS
Associate Out-of-State = Attorneys not admitted in NYS, who neither work nor reside in NYS
Sustaining = Attorney members who voluntarily provide additional funds to further support the work of the Association
Affiliate = Person(s) holding a JD, not admitted to practice, who work for a law school or bar association
*Newly admitted = Attorneys admitted on or after April 1, 2016

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Breakfast with the Surrogates'

On Second Thought....
A Surrogate's Guide to Tax-Related Reformation of Tax Clauses in a Changing Tax Landscape

Hon. Stephen W. Cass
Chautauqua County Surrogate's Court, Mayville

Hon. Peter J. Kelly
Queens County Surrogate's Court, Jamaica

Hon. John M. Czygier
Suffolk County Surrogate's Court, Riverhead

Joseph La Ferlita, Esq. (Moderator)
Farrell Fritz, P.C., NYC

I. Definition: Reformation involves the elimination of words from, or addition of words to, a will or trust

II. Court Principles:
   A. "[T]he testator's intent is paramount and must be ascertained by a sympathetic reading of the entire instrument" (*In re Larkin*, 9 NY2d 88 [1961]; *In re Fabbri*, 2 NY2d 236 [1957]).
   B. It is assumed that the testator, or settlor, wanted to utilize all tax advantages
   C. In considering whether reformation would alter the testator's dispositive scheme, the court may consider the impact on commissions (*see In re Hughes*, 220 AD2d 418 [2d Dep't 1995])
   D. If language is unambiguous, extrinsic evidence is generally not admissible
   E. Note that the court's power to reform a will must be in conformity with New York's statute of wills.

III. Statutes
   A. SCPA 1420: gives surrogate power to determine the validity, construction, or effect of any provision in a will and to take such proof and make decrees as justice requires
   B. EPTL 8-1.1 was adopted in 1971 to conform New York law with restrictions imposed upon governing instruments by the Tax Reform Act of 1969
   C. EPTL 7-1.13 was enacted in 1995; it authorizes the splitting of trusts when created for one of several tax purposes
   D. EPTL 1-1.11: gives a fiduciary limited power to amend a trust for certain tax purposes

IV. Background Cases
   A. *In re Snide*, 52 NY2d 193 (1981): Surrogates courts have jurisdiction/power to reform
   B. *Matter of Gottfried*, NYLJ 6/15/04 at 24, col. 5 (Sur Ct, New York County): "applications to reform donative instruments to satisfy technical tax code requirements and avoid unintended tax consequences are received sympathetically by the courts"

<u>Charitable Deductions:</u>

I. Generally
   A. A charitable deduction is allowable for gifts and bequests to or for the use of the US, any State or political subdivision, or the District of Columbia, for exclusively public purposes. Charitable deductions for a foreign government are not allowed unless dedicated to a charitable purpose
   B. A charitable deduction must be ascertainable and no private individual or entity can have an interest

II. Qualified reformations of a trust to meet IRC Section 2055(e)(2) for charitable remainder annuity trusts or charitable remainder unitrusts or an interest in the form of a guaranteed

annuity or a fixed percentage is allowed by IRC Section 2055(e)(3). There are 5 conditions in order to constitute a qualified reformation:
A. Charitable interest prior to reformation must be eligible for a deduction under IRC Section 2055(a);
B. The reformation must be effective as of the decedent's date of death;
C. The nonremainder interest must terminate at the same time before and after the reformation;
D. The actuarial value of the charitable remainder after the reformation may not differ by more than 5% from the actuarial value of the charitable remainder before the reformation; and
E. If, before the reformation, the noncharitable interest is not expressed in terms of a specified dollar amount, or a fixed percentage of the property, the reformation must be commenced within the time limit prescribed by IRC Section 2055(e)(3)(C)(iii).

III. A trust may be reformed to preserve a charitable deduction by splitting the trust into two and separating individuals from charitable interests.
  A. *See generally In re Goldberg*, NYLJ 7/20/92 at 28 (Sur Ct, Nassau County)
  B. *In re Case*, 154 Misc2d 699 (Sur Ct, New York County 1992): Will created a pecuniary credit shelter trust and a residuary QTIP trust. Both provided income to the spouse for life and, upon her death, the remainder ½ to individuals and ½ to charities. The court reformed the credit shelter trust by splitting it into two trusts, one as a by-pass for the individuals to which the unified credit would apply, and the other having a charitable remainder that would qualify for the charitable deduction in the estate of the surviving spouse.

Reformation for the Generation-Skipping Transfer Tax and Reverse QTIP Election:

I. QTIP
  A. Marital deduction allowed for QTIP property.
  B. QTIP property is property passing from the decedent in which the surviving spouse has a qualifying income interest for life, no person has the power to appoint any part of the property to any person other than the surviving spouse, and the executor has made an irrevocable election to qualify the property for the marital deduction.
  C. Reformation may used to create two trusts, separating out a QTIP trust. (Note: splitting may also be achieved pursuant to EPTL 7-1.13 or pursuant to the authorizing language in the will.)

II. Reverse QTIP Election & GST Tax
  A. Reverse QTIP election: allows the decedent to remain the "transferor" for generation-skipping transfer (GST) tax purposes.
  B. A reverse QTIP election must be made as to an entire QTIP trust
  C. The personal representative can make a reverse QTIP election for a terminable trust only if a QTIP election has also been made for that trust on the estate tax

return, Form 706, of the first spouse to die.

C. Requirements for a trust to be divided for GST tax purposes:

1. The trust must be included in the individual's gross estate or established under his or her will
2. The trust must be severed pursuant to a direction in the governing instrument which provides that the trust is to be divided upon the transferor's death, or the governing instrument has no such requirement or direction but the trust is severed pursuant to discretionary authority under the governing instrument or local law, or the trust is severed pursuant to a judicial reformation proceeding
3. The severance must occur, or the reformation proceeding that results in the severance must be commenced, before the due date of the return, including extensions
4. Either the "new" trusts must be funded on a fractional share basis, or, if required by the governing instruments, on the basis of a pecuniary amount. If funded on a pecuniary basis, the trust must be funded either with the fair market value of the assets on the date of the funding or in a manner that reflects the net appreciation or depreciation in value of the assets measured from the date of death to the date of funding.

D. Typically, a reverse QTIP election is relevant only for spouses who both need to use their full GST exemption

III. Cases

A. *In re Estate of Choate*, 141 Misc2d 489 (Sur Ct, New York County 1988): Will created a single QTIP marital trust with assets of $7.5 million for benefit of spouse. Upon wife's death, one half of the principle was to be held in trust for decedent's son, Tim, and on his death was to continue in further trust for Tim's children. The other half was to be held in a direct skip trust for Tim's children. The court split the QTIP trust into three trusts: (1) half the residue would continue after the wife's death for Tim; (2) $1,000,000 in trust for the benefit of Tim's children after wife's death; (3) half the residue less $1,000,000 would continue after wife's death for Tim's issue.

<u>Additional Cases of Interest</u>:

I. Intent is Key

A. *In re Sukenik*, NYLJ 7/1/16 at 25, col. 4 (Sur Ct, New York County): denying reformation where the reformation was substantial and there was no evidence of an intent to minimize taxes

B. *Matter of Carcanagues*, 2016 NY Misc. LEXIS 3436 (Sur Ct, New York County): denying relief to form trust so that it would qualify as a QTIP trust because, at the time of the trust's creation, same-sex marriage had not yet been legalized; decedent should have amended trust upon marriage to partner.

II. Examples of Trust Splitting

A. *Estate of Catalina K. Meyer*, 2002 NYLJ LEXIS 859 (Sur Ct, New York County): Allegation that if trust beneficiary received any assets from the trust, it would have a negative tax consequence, did not state a cause of action. However, the court did allow separation of the trust into two trusts, one of which would be immune from the generation-skipping transfer tax, under ETPL 7-1.13.

III. Misc.

A. *In re Shapiro*, 10 Misc3d 1071A (Sur Ct, Nassau County 2006): Reformation pertained to the appointment of a successor trustee. The concern was that because the trust did not prohibit the settlor from appointing a successor trustee who was a related or subordinate person within the meaning of IRC Section 672, this may be construed as a power under IRC Section 2036(a)(1), resulting in the trust to be included in the settlor's estate for tax purposes. The court allowed reformation.

B. *In re Marino*, NYLJ 11/5/07 at 43 (Sur Ct, Suffolk County): at the time of decedent's death, the federal and state death tax credits were the same. By the time of death, the amount that could be sheltered under a credit shelter trust for federal tax purposes had increased to $1.5 million, but the New York State credit was $1 million. The will appeared to limit the amount that could be sheltered to $1 million. The court allowed reformation.

C. *Matter of Brecher*, 2017 NYLJ LEXIS 164 (Sur Ct, New York County): allowing reformation where law imposing a New York estate tax was not in effect when will was executed.

D. *Estate of Charles Stern*, 2017 NYLJ Lexis 46 (Sur.Ct. New York 2017)

i. Reformation due to "estate tax cliff" denied.

ii. Similar to In re Brecher, above, the Petitioners sought to reform the Decedent's will to avoid paying New York state estate tax. Decedent's Will was drafted with a formula clause designed to use all of the Decedent's federal estate tax credit in a credit shelter trust and have the balance pass to the Decedent's spouse in a marital trust and thus avoid all federal estate tax and preserve the Decedent's full federal exemption. However, upon Decedent's passing his estate was below the federal exemption amount, meaning his entire $3,303,000 estate would all pass to the credit shelter trust and none of his estate would pass to the marital trust. Decedent's estate avoided federal estate tax, but due to the estate tax cliff, because his estate exceeded the New York exemption amount by $178,000, his entire estate would be subject to New York estate tax of $210,300. Petitioners sought to add the words "or state" to the formula clause of the Decedent's estate, which would allow them to fund the marital trust with $180,000 and avoid all federal and New York estate tax.

iii. The court denied the Petitioner's request for reformation reasoning that,

"there can be no dispute that the formula provision decedent elected to use would have resulted in a New York estate tax under the law in effect at the time of the instrument's execution."

iv. The court further reasoned that, "To permit the reformation petitioners seek under these circumstances would be to permit decedent's estate to receive the tax benefits of a formula provision decedent could have used, but elected to forgo in order to obtain a potentially greater federal estate tax benefit for his children….courts reform instruments in order to carry out a decedent's intent as reflected in the instrument. Reformations, as a court-provided remedy, are not intended for use as a post-mortem estate planning tool to spare decedents' estates from the consequences of their decedents' calculated decisions."

E. *Matter of Offerman*, 145 Misc.2d 477 (Sur.Ct. Kings 1989)

i. Oft cited case for reformation to avoid New York estate tax.

ii. The decedent's will provided for the residuary estate to be divided into a Trust A and a Trust B. Trust A was to receive the maximum marital deduction allowable for federal estate tax purposes. Decedent's wife, who was also the executrix of the estate, as well as the decedent's three children and their spouses requested and/or consented to a reformation of the will which would allocate the entire residuary to trust A, thereby eliminating trust B. The court set out the issue as follows, "[b]y virtue of the unified credit under Internal Revenue Code (26 USC) § 2010 (c) the estate will be shielded from Federal estate tax liability, irrespective of whether the unlimited marital deduction is available. However, the comparatively lower New York unified credit equivalent of $108,333 will not exempt the estate from New York estate tax liability. Accordingly, reformation herein is sought for the purpose of avoiding New York estate taxes only."

iii. The court reasoned that, "Despite the fact that many provisions of a will are tax motivated, many persons fail to revise their wills to reflect these changes in the tax laws. Consequently, courts are repeatedly requested to reform wills so that an intention to minimize taxes will not be defeated. Where, as here, revision is sought for the purpose of receiving the benefit of the unlimited marital deduction not available at the time the will was executed, such relief has been held to be warranted where an intention to minimize taxes is coupled with a primary intention to benefit the spouse. Evidence of such intent has been found to exist where the will contains a maximum marital deduction formula provision and a provision directing the executor to compute the marital deduction in accordance with the laws in effect at the time of the decedent's death." The court then held that the entire residuary estate could be allocated to trust A.

F. Matter of Manville, 112 Misc.2d 355 (Sur.Ct. Westchester 1982)

i. Reformation denied.

ii. Petitioner sought to reform decedent's will in order to substitute its provisions for those of the decedent's trust executed 15 years prior to

decedent's will, in an effort to avoid the impact of Swedish gift taxes on the beneficiaries who were Swedish domiciliaries.

iii. The court reasoned that "the trust instruments…are not ambiguous and raise no question for construction. Each instrument is clear. The reformation requested is not with respect to the provisions of each instrument but only to effect a different distribution than that required by the literal sequence of testator's plan. It is fundamental that 'the intention of a will-maker is to be found in the words used in the will, and when these are clear and definite there is no power to change them.'"

POSSIBLE ALTERNATIVES TO REFORMATION

I. Decanting trusts pursuant to EPTL 10-6.6
   1. What is a decanting?
   2. What are the prerequisites?
   3. What aspects of the trust can be changed
      I. Absolute discretion to invade principal
      II. Ascertainable standard to invade principal
   4. When is decanting not an option?
   5. All decantings are subject to objection by persons interested in trust

II. Non-Statutory Decantings
   a. Advantages over decanting under EPTL 10-6.6
   b. Disadvantages over decanting under EPTL 10-6.6
   c. *Matter of Hoppenstein*, NYLJ (Sur. Ct. NY County), 4/24/17

III. EPTL 7-1.9 Reformation of an Irrevocable Trust
   a. What are the prerequisites?
   b. What if a minor has a beneficial interest in the trust?

IV. Trust Division Pursuant to EPTL 7-1.13
   a. What are the prerequisites?
   b. How can this help from a tax perspective?
      i. The marital deduction
      ii. The charitable deduction
      iii. GST exempt trusts

V. Termination of the trust.

RELATED ISSUES:

I. Attorney draftsman's duty, if any, to keep client abreast of tax law changes that occur after execution of estate planning documents (e.g., formula credit shelter bequests keyed to maximum available federal estate tax exemption, when the exemption has increased dramatically over the years).

II. Executor's duty, if any, to pursue a claim against the attorney draftsman for damages due to tax-related drafting error.

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LexisNexis® Expert Commentaries

Joseph T. La Ferlita on

Whether the Distinction Between Construction and Reformation Proceedings in New York Surrogate's Court Still Exists

Cite as: La Ferlita, Joseph T. "Whether the Distinction Between Construction and Reformation Proceedings in New York Surrogate's Court Still Exists." LexisNexis® Expert Commentary, *(Insert date you accessed the document online).*

Trusts and estates practitioners likely will, at some point, confront a testamentary provision that is either ambiguous or seemingly impossible to reconcile with the otherwise apparent intent of a testator. While the need for court intervention may be clear, the appropriate procedural mechanism to address the situation can be less clear. In New York, the question often centers on whether a proceeding for construction or reformation is appropriate and, more importantly, whether extrinsic evidence would be admissible. [*See* SCPA 1420.]

Construction Proceedings. Construction of a will occurs when a court ascertains the testator's intent as expressed in the words of the will. [*See, e.g., In* re Estate of Stahle, 225 N.Y.L.J. 15, Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County).] SCPA 1420 allows a court to construe a will in one of three procedural contexts: (1) an independent construction proceeding, (2) an accounting proceeding, and (3) a probate proceeding. [*See* New York Estate Administration § 3.11 (LexisNexis 2008 ed.).]

A court will construe when certain language of the will is ambiguous, making it impossible to carry out the testator's intent. The goal of every construction is "to ascertain [the] decedent's intent in order that it may be effectuated." [*In re* Estate of Richard, N.Y.L.J., July 7, 2003, at 20, col. 1 (Sur. Ct. New York County); *see In re* Scale, 38 A.D.3d 983, 830 N.Y.S.2d 618 (3d Dep't 2007).] "That intent is to be ascertained 'not from a single word or phrase but from a sympathetic reading of the will as an entirety and in view of all the facts and circumstances under which the provisions of the will were framed.'" [*In re* Bieley, 91 N.Y.2d 520, 525, 673 N.Y.S.2d 38, 695 N.E.2d 1119 (1998) (emphasis omitted) (*quoting In re* Fabbri, 2 N.Y.2d 236, 159 N.Y.S.2d 184, 140 N.E.2d 269 (1957)).] When the testator's intent as expressed in the entire will is clear and unambiguous, courts will not look further than the instrument itself to ascertain the meaning of that part of the will that is ambiguous. [*See In re* Manufacturers & Traders Trust, 42 A.D.3d 936, 839 N.Y.S.2d 642 (4th Dep't 2007). "[I]t is a fundamental principle of will and trust construction that[,] where the document in question … is clear, it must be enforced as written, without reference to parol evidence with respect to the original intent of the grantor" (quoting *Hemingway v. Hemingway Foundation,* 193 A.D.2d 559, 598

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N.Y.S.2d 221 1st Dep't 1993).] If such intent is not ascertainable from the four corners of the will, the courts sometimes utilize certain canons of construction [*see* Warren's Heaton on Surrogate's Court Practice Chapter 187 (LexisNexis 7th ed. 2007)] to discern the testator's probable intent. However, in its frequently-cited case, *In re Fabbri*, the New York Court of Appeals emphasized that "[t]he prime consideration [in all construction proceedings] is the intention of the testator as expressed in the will. All rules of interpretation are subordinated to the requirement that the actual purpose of the testator be sought and effectuated as far as is consonant with principles of law and public policy." [*In re* Fabbri, 2 N.Y.2d 236, 239, 159 N.Y.S.2d 184, 140 N.E.2d 269 (1957); s*ee also* Warren's Heaton on Surrogate's Court Practice § 187.01[3][a].]

Extrinsic evidence of the testator's intent "is admissible to clarify an ambiguity in a will's language for which the intent of the testator cannot be gleaned from the four corners of the will." [Warren's Heaton on Surrogate's Court Practice § 187.01[5][a].] However, "if the terms of the will are clear and unambiguous, extrinsic evidence will not be admitted to contradict those terms." [*In re* Cole, 18 Misc. 3d 1105A, 2007 N.Y. Misc. LEXIS 8400, 2007 NY Slip Op 52417U (Sur. Ct. Nassau County 2007).]

Reformation Proceedings. Reformation of a will involves the court changing the language of the will by the addition or deletion of words. [*See, e.g., In re* Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County).] Unlike construction, which is necessitated when the testator's intent is questionable and needs to be ascertained, reformation can be appropriate only when the testator's intent is determinable but the terms of the instrument do not comport with such intent [*see In re* Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County)] due to, for example, a mistake or change in the law. [*See, e.g. In re* Estate of Meyer, N.Y.L.J., Feb. 26, 2002, at 18, col. 5 (Sur. Ct. New York County) (allowing reformation due to drafting error).] Many of the principles and rules of construction may also apply in a reformation proceeding. [*See* Warren's Heaton on Surrogate's Court Practice § 188.02[2].]

"Courts are generally loathe to reform testamentary instruments and, as a rule, will not, unless reformation effectuates the testator's intent." [*In re* Estate of Hyman, 14 Misc. 3d 1232A, 836 N.Y.S.2d 493 (Sur. Ct. Nassau County 2007).] "Moreover, when the will itself is clear any alleged mistake must be evident on the face of the document itself." [*In re* Patrick, N.Y.L.J., July 9, 2001, at 28, col. 3 (Sur. Ct. Onondaga County 2001) (denying reformation of unambiguous will even though extrinsic evidence suggested that will contained a mistake); *compare In re* Estate of Herceg, 193 Misc. 2d 201, 747 N.Y.S.2d

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901 (Sur. Ct. Broome County 2002) (adopting Restatement (Third) approach and admitting extrinsic evidence of testator's intent when will is unambiguous). Surrogate Wells explained that the logic behind the traditional rules is that "testamentary intent is best found in the unambiguous language of the instrument itself … . In short, to reform a will that has not ambiguities results in a will that is against the decedent's wishes (*In* re Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County).] As discussed in the next section, some courts, in a departure from traditional notions, have reformed wills due to mistakes or ambiguities that come to light only through the use of extrinsic evidence.

The Blurring of the Line Between Construction and Reformation. Although the distinction between construction and reformation may at first seem clear, in recent years the line between them sometimes gets blurred. [*See In re* Estate of Schumer, N.Y.L.J., July 9, 2003, at 24, col. 5 (Sur. Ct. Suffolk County) (noting the trend of "the blurring of the distinctions between a will construction … and a will reformation … ."); Warren's Heaton on Surrogate's Court Practice § 188.02[2].] For example, one Surrogate noted that "[i]n many instances reformation to correct mistakes has been sought in proceedings initiated under the guise of 'construction and reformation'. [*In* re Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County).]

This blurring of the line, whether intentional or not, seems linked to calls by some to liberalize the reformation process with respect to the admission of extrinsic evidence. [*See* Marilyn G. Ordover and Charles F. Gibbs, "Correcting Mistakes in Wills and Trusts," N.Y.L.J., Aug. 6, 1998, at 3, col. 1; *see also* Restatement (Third) of Property (Wills & Don. Trans.) § 12.1 (2003) ("A donative document, though unambiguous, may be reformed to conform the text to the donor's intention if it is established by clear and convincing evidence (1) that a mistake of fact or law, whether in expression or inducement, affected specific terms of the document; and (2) what the donor's intention was. In determining whether these elements have been established by clear and convincing evidence, direct evidence of intention contradicting the plain meaning of the text as well as other evidence of intention may be considered.").] Such calls have been welcomed by some [*see, e.g.,* Warren's Heaton on Surrogate's Court Practice § 188.02[2]] and rejected by others [*see, e.g., In* re Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County)] and have sparked a debate among Surrogate's Court practitioners [*see, e.g., In re* Schumer, N.Y.L.J., July 9, 2003, at 24, col. 5 (Sur. Ct. Suffolk County) ("The construction and reformation of wills is presently the subject of debate among scholars in the field")] over the appropri-

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ate means by which a court attempts to ascertain a testator's intent. [*Compare, e.g., In re* Rubin, 4 Misc. 3d 634, 781 N.Y.S.2d 421 (Sur. Ct. New York County 2004) (rejecting reformation of unambiguous will) *with In re* Will of Kamp, 7 Misc. 3d 615, 790 N.Y.S.2d 852 (Sur. Ct. Broome County 2005) (allowing reformation of unambiguous will).] The debate comes into sharp focus when parties seek to use extrinsic evidence to reform an unambiguous will. [*See generally* Ordover & Gibbs, "Correcting Mistakes in Wills and Trusts," N.Y.L.J., Aug. 6, 1998, at 3, col. 1.]

On one side of the debate are those who adhere to the traditional view that "courts are without power to reform unambiguous wills even though there was a mistake of fact or law, whether in expression or inducement. When the words in a will are clear and definite, the court is powerless to change them." [*In re* Estate of Schumer, N.Y.L.J., July 9, 2003, at 4, col. 5 (Sur. Ct. Suffolk County); *see* Decision by Surrogate John Czygier (case name not given), N.Y.L.J., Dec. 26, 2007, at 39, col. 4 (Sur. Ct. Suffolk County), and *In re* Estate of Braverman, 18 Misc. 3d 1105A, 2007 N.Y. Misc. LEXIS 8400, 2007 NY Slip Op 52417U (Sur. Ct. Nassau County 2007).] The adherents of this view would argue that EPTL 3-2.1 mandates this result. [*See generally In re* Estate of Schumer, N.Y.L.J., July 9, 2003, at 24, col. 5 (Sur. Ct. Suffolk County).] The primary notion here is that "[t]he intention of a will maker is to be found in the words used in the will … ." [*In re* Watson's Will, 262 N.Y. 284, 293, 186 N.E. 787 (1933).] Therefore, it would be inappropriate to consider extrinsic evidence when the will is unambiguous on its face even though extrinsic evidence may suggest that the testator's intent is different than what is clearly expressed in the four corners of the will. [*See* Decision by Surrogate John Czygier (case name not given), N.Y.L.J., Dec. 26, 2007, at 39, col. 4 (Sur. Ct. Suffolk County) and *In* re Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County) ("The Court is not unaware of the current agitation to dilute the sanctity of wills and to ease the time honored standards with respect to reformation. It is respectfully suggested that courts should refuse to join the parade in this regard but rather continue [to adhere to the traditional view].")]

On the other side of the debate are those for whom, in certain cases, "[t]he existence of clear and unambiguous language … is not a bar to the reformation of a testamentary trust." [*In re* Estate of Longhine, 15 Misc. 3d 1106A, 836 N.Y.S.2d 500 (Sur. Ct. Wyoming County 2007). *See In re* Estate of McHugh, 12 Misc. 3d 219, 810 N.Y.S.2d 635 (Sur. Ct. Broome County 2006) (considering extrinsic evidence and granting reformation even when will is unambiguous); *In re* Will of Kamp, 7 Misc. 3d 615, 790 N.Y.S.2d 852 (Sur. Ct. Broome County 2005) (same); *In re* Estate of Herceg, 193 Misc. 2d 201, 747 N.Y.S.2d 901 (Sur. Ct. Broome County 2002) (same). For a concise statement of this

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more liberal rule, see Restatement (Third) of Property (Wills & Don. Trans.) § 12.1 (2003); *see also* Ordover & Gibbs, "Correcting Mistakes in Wills and Trusts," N.Y.L.J., Aug. 6, 1998, at 3, col. 1.] The primary notion here is that extrinsic evidence of the decedent's intent, when strong enough [Restatement (Third) of Property (Wills & Don. Trans.) § 12.1 (2003) requires such evidence to be clear and convincing], justifies a departure from the strict adherence to the four corners of the will. In order to avoid a conflict with EPTL 3-2.1, "[courts] have labored to identify ambiguities in a will in order to justify altering its terms." [*In re* Schumer, N.Y.L.J., July 9, 2003, at 24, col. 5 (Sur. Ct. Suffolk County).]

It is precisely this "laboring" to find an ambiguity or mistake in a facially unambiguous will through the use extrinsic evidence that blurs the line between construction and reformation, leaving some New York estate practitioners wondering if the traditional distinction between them is really one without a difference. [*See* Ilene Sherwyn Cooper, "Key Practice Issues: Will Construction, Paternity Determination," N.Y.L.J., Sept. 18, 2003, at 3, col. 1.]

Certain trends regarding the willingness of courts to reform unambiguous wills have emerged. It is widely known that reformation "is often available" for tax relief. [Ordover & Gibbs, "Correcting Mistakes in Wills and Trusts," N.Y.L.J., Aug. 6, 1998, at 3, col. 1; *see generally In re* Choate, 141 Misc. 2d 489, 533 N.Y.S.2d 272 (Sur. Ct. New York County 1988) (allowing reformation for tax reasons).] Even then, however, "the intention of the testator [must be] plain and unambiguous and the reformation [must] not in any way alter the testator's dispositive scheme." [*In re* Carucci, 2 Misc. 3d 632, 637, 769 N.Y.S.2d 866, 870 (Sur. Ct. Nassau 2003).] A much more recent trend, which has been the subject of several recent decisions, relates to the qualification a testamentary trust as a supplemental needs trust. [*See In re* Estate of Hyman, 14 Misc. 3d 1232A, 836 N.Y.S.2d 493 (Sur. Ct. Nassau County 2007) (allowing reformation of unambiguous instrument to qualify as a supplemental needs trust); *In re* Estate of Longhine, 15 Misc. 3d 1106A, 836 N.Y.S.2d 500 (Sur. Ct. Wyoming County 2007) (same); *In re* Will of Kamp, 7 Misc. 3d 615, 790 N.Y.S.2d 852 (Sur. Ct. Broome County 2005) (same); *compare In re* Rubin, 4 Misc. 3d 634, 781 N.Y.S.2d 421 (Sur. Ct. New York County 2004) (rejecting reformation of unambiguous will sought to qualify as supplemental needs trust).] The reasoning set forth in the latter type of cases comports more with that of the Restatement (Third) [Restatement (Third) of Property (Wills & Don. Trans.) § 12.1 (2003)], which relies on the more liberal approach to reformation, than with that of the traditional New York reformation cases. It remains to be seen whether such reasoning will further permeate New York law.

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Joseph T. La Ferlita on

Whether the Distinction Between Construction and Reformation Proceedings in New York Surrogate's Court Still Exists

Notwithstanding the existence of this policy debate over the use of extrinsic evidence [*see generally In* re Estate of Stahle, N.Y.L.J., Jan. 23, 2001, at 32, 2001 N.Y. Misc. LEXIS 1353, 225 N.Y.L.J. 15 (Sur. Ct. Onondaga County)], it seems that, in New York, the traditional view is still the norm, albeit with occasional exceptions, some of which are noted above. [*See, e.g., In re* Estate of Schumer, N.Y.L.J., July 9, 2003, at 4, col. 5 (Sur. Ct. Suffolk County) (referring to efforts to liberalize the construction and reformation process via legislation and the present state of New York statutory law, which still conforms with the traditional notions). Also, note that the provisions of Restatement (Third) of Property (Wills & Don. Trans.) § 12.1 (2003) have not been adopted by the New York State Legislature. Nevertheless, some Surrogates have relied on its precepts in certain situations (*see, e.g., In re* Estate of Herceg, 193 Misc. 2d 201, 747 N.Y.S.2d 901 (Sur. Ct. Broome County 2002) (admitting extrinsic evidence of testator's intent when will is unambiguous).] Accordingly, it is still important for the New York trusts and estates practitioner to appreciate the basic, traditional distinctions between construction and reformation proceedings. [*Accord* Cooper, "Key Practice Issues: Will Construction, Paternity Determination," N.Y.L.J., Sept. 18, 2003, at 3, col. 1.]

Conclusion. New York trusts and estates practitioners should be familiar with the traditional distinction between construction and reformation, which still applies in most situations. At the same time, however, in order to best serve their clients, practitioners should also be aware of recent attempts to liberalize the rules regarding reformation proceedings as they relate to the use of extrinsic evidence, as well as the existence of case law that coincides with such attempts.

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Recent Developments in Estate Planning

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NYSBA: Trusts and Estates Law Section Spring Meeting
Recent Developments
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FEDERAL DEVELOPMENTS

Section 2704 Regulations

Background. Section 2704 generally disregards certain restrictions on the ability to liquidate family controlled corporations, partnerships, and limited liability companies when valuing the entity for estate, gift, and GST tax purposes. Much of section 2704 has been eroded by changes in state law and developments in case law. To combat some of this erosion, the Treasury Department issued proposed regulations for section 2704 that addressed the perceived abuse of certain valuation discounts for family owned entities.

Withdrawal of Proposed Regulations. In April 2017, President Trump signed executive order 13789 directing the Treasury Department to examine certain regulatory projects that imposed an undue financial burden on taxpayers, added undue complexity to federal tax laws, or exceeded the statutory authority of the IRS. On October 4, 2017, Treasury released a final report recommending that the proposed regulations under section 2704 should be withdrawn because they "would have hurt family owned and operated businesses by limiting valuation discounts. The regulations would have made it difficult and costly for families to transfer their businesses to the next generation."[1]

Planning Consideration. Therefore, the rules and regulations regarding restrictions on liquidation for valuation purposes for estate, gift, and GST tax purposes remains as it did prior to the proposed regulations. As such, the valuation discounts associated with said restrictions remain unaffected. There does not appear to be another iteration of the proposed regulations on the horizon.

Tax Cuts and Jobs Act of 2017

Qualified Business Income from Pass-Through Entities

A new complex provision was added to the Code under section 199A, which provides for a deduction of up to 20% of business income from pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations). In years preceding 2018, income from those entities was taxed at the individual owners' highest marginal rate. The new section 199A allows for a deduction for certain business income in order to bring tax rates for these corporate-like entities more in line with the new, permanent corporate tax rate of 21%. The section is riddled with many exceptions,

[1] Federal Register, Vol. 82, No. 198 (October 16, 2017).

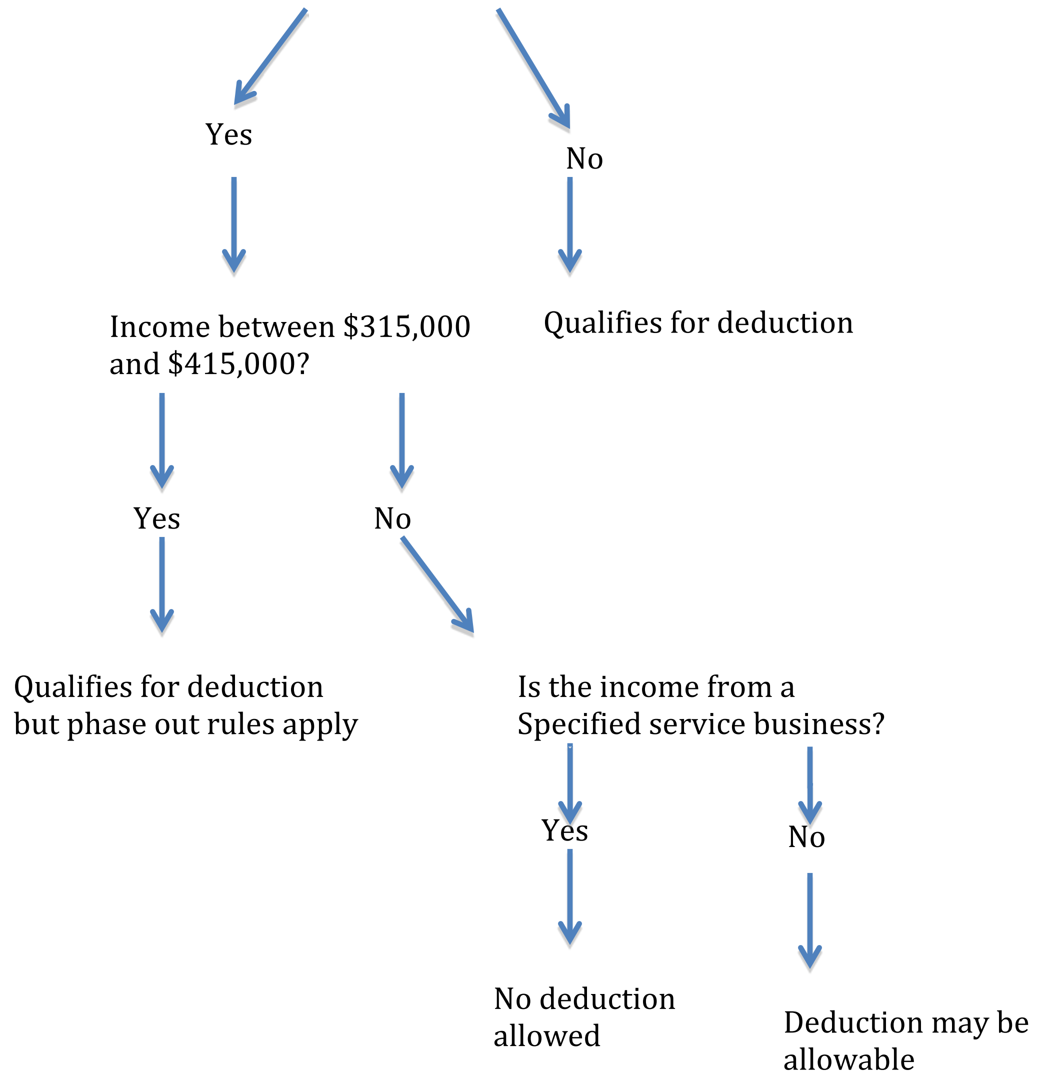
qualifications, and limitations, so any practitioner should be cautious when providing advice to clients about its applicability.

To "deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20-percent deduction,"[2] the deduction is capped at 50% of the taxpayer's pro rata share of the total W-2 wages paid by the business. For this reason, the top effective rate for pass-through entities that qualify for the deduction is 29.6%, far below the top individual marginal rate of 37% but well above the top corporate marginal rate of 21%.

The deduction is allowed only for qualified business income, which is generally the net amount of income, gain, deduction, and loss from an active trade or business within the United States; qualified business income does not include, among other items, capital gains, dividends, or interest generally.

Notably, the deduction does not apply to specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerages services, or any business where the principal asset is the reputation or skill of one or more of its employees. However, the wage and specified service business limitations do not apply if the taxpayer has taxable income below the specified threshold amounts ($315,000 for married individuals filing jointly), and the deduction is phased out for the next $100,000 of business income.

[2] The Joint Explanatory Statement.



The deduction is also available to trusts and estates. To determine the wage limitation, income is apportioned between beneficiaries and the fiduciary under section 199(d)(1)(B)(i).

Unlike the corporate tax rate, which was made permanent, section 199A expires at the end of 2025.

Increase to Basic Exclusion Amount under section 2010

The Tax Cuts and Jobs Act increases the basic exclusion amount under section 2010(c)(3) from $5 million to $10 million (indexed for inflation after 2011) for estates of decedents dying, generation-skipping transfers, and gifts made after 2017 and before 2026. The indexed amount for 2018 using the new chained CPI approach is $11,180,000.[3] Notably, aside from change to trusts' income tax brackets and the elimination of certain deductions, this is the only change made directly to transfer taxes. However, because the GST exemption is directly tied to section 2010, the GST exemption has also nearly doubled to $11,180,000 for individuals. This will similarly expire at the end of 2025. Previously created nonexempt trusts should be examined to determine whether it now makes sense to allocate GST exemption to the trust to shield it from this additional transfer tax in the future.

While many practitioners have returned to their similar concerns in 2012 about clawback, most commentators believe that clawback is unlikely, and Steve Akers has noted that Congressional staffers indicated that clawback was not intended in 2012.

Given the increased exemptions, it may be time to review existing formula clauses in existing documents or in template documents that practitioners and their firms use. A standard bequest of the maximum federal exclusion amount possible to a credit shelter trust may no longer make sense or align with the client's wishes, particularly if the surviving spouse is not a beneficiary of the credit shelter trust. Such a formula may also produce state estate taxes. There could also be potentially devastating consequences of an incorrect GST exemption formula clause, so these should be reviewed, as well.

Planning Opportunities in Light of Temporarily Increased Exemption

Given the temporary nature of the increased exemptions, the calculus involved in determining what kind of planning should be done for clients has become dramatically more complex. The client's level of wealth, the likelihood of appreciation of potentially gifted assets, and an assessment of the client's risk of death prior to 2026 will all play enhanced roles for the next several years as practitioners choose between income or estate tax savings and consider additional gifting strategies.

For example, a client whose wealth is substantially below the new exemption amount may forego typical estate tax planning strategies, such as making gifts, to qualify the assets for a step-up in basis under section 1014. Meanwhile, a client whose wealth is substantially over the new exemption amount may continue to use trust estate planning strategies such as sales to defective grantor trusts and discount planning. For most clients, however, flexibility will remain a crucial feature of any estate plans, so that the income tax/estate tax tradeoff decisions can be deferred until the client dies. Flexibility will also be crucial in allowing clients to avoid any buyer's remorse from making gifts to

[3] Rev. Proc. 2018-18.

utilize the increased exemptions while they exist without creating additional stress on the client. To create flexibility in our clients' planning documents, there are a number of strategies that may be useful to employ, such as QTIP planning, disclaimers, portability, powers of appointment, toggling of gross estate inclusion[4], and SLATs.

It may also be prudent for clients to consider specific gifting opportunities in light of the temporarily increased exemption amounts, such as gifts to dynasty trusts, forgiveness of intra-family loans, equalizing gifts between descendants, and decreasing the leverage in sale to a grantor trust.

Miscellaneous Itemized Deductions

Background. The Tax Cuts and Jobs Act added Section 67(g) to the Code, which provides that no taxpayer may deduct any expense defined as a "miscellaneous itemized deduction" for taxable years 2018-2025. This addition caused uncertainty regarding the ability for a trust or estate to deduct amounts paid to fiduciaries as commissions. Although fiduciary commissions constitute a miscellaneous itemized deduction, Section 67(e)(1) contains an exception that, at least previously, excepted it from the general limitation (discussed below) on deducting miscellaneous itemized deductions. Among other reasons, because Section 67(g) did not specifically address the exception for fiduciary commissions, Congress left practitioners wondering whether it intended to only eliminate the deductions subject to the prior limitation or all deductions considered miscellaneous itemized deductions, including a trust's or estate's ability to deduct commissions paid to its fiduciaries.

Overview of Miscellaneous Itemized Deductions. Section 67(a) provides that individual taxpayers may deduct miscellaneous itemized deductions only to the extent they exceed 2% of the taxpayer's adjusted gross income ("AGI"). Section 67(e) provides that trusts and estates should generally compute their adjusted gross income in the same manner as individuals. Accordingly, trusts and estates also faced the 2%-of-AGI limitation.

The Code does not actually list deductions considered miscellaneous itemized deductions. Instead, the Code defines miscellaneous itemized deductions as all itemized deductions other than the twelve deductions listed in Section 67(b).

Application of Rules to Fiduciary Commissions. This list of Section 67(b) does not include commissions paid by a trust or estate to its fiduciaries; thus, this expense constitutes a miscellaneous itemized deduction. However, as already noted above,

[4] For an excellent discussion of this strategy, which can help clients choose between estate and income tax benefits in their planning, see Bramwell & Madden, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning Journal*, Mar 2017.

Section 67(e)(1) contains an exception that has enabled trusts and estates to fully deduct[5] commissions paid to fiduciaries irrespective of the 2%-percent-of-AGI limitation.

Section 67(e)(1) provides, "the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred 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…shall be treated as allowable in arriving at adjusted gross income." The Regulations and case law are clear that fiduciary commissions meet the two-part analysis of being an expense (1) incurred in connection with the administration of an estate or trust and (2) that would not have been incurred unless the property was held in trust. Treas. Reg. § 1.67-4(c); *Mellon Bank v. U.S.,* 265 F.3d 1275 (Fed. Cir. 2001) ("It is undisputed that trustee fees are fully deductible").

No Resolution, but Indications Favor Continued Deductibility. As of March 2018, the IRS has not issued any regulations clarifying this issue. However, several factors indicate it is likely that trusts and estates will continue to be able to deduct fiduciary fees. First, the Joint Explanatory Statement on the Tax Cuts and Jobs Act provides that Congress added Section 67(g) to "suspend[] all miscellaneous itemized deductions *that are subject to the 2% floor under present law*." Joint Explanatory Statement 115-97, comments to Section 11045 (emphasis added). Section 67(e) excepted fiduciary fees from the so-called 2% floor. Thus, it appears that Congress did not intend to preclude trusts and estates from continuing to deduct these fees under new section 67(g).

Second, in addition to excepting fiduciary fees from the 2% floor, Section 67(e) also created another exception: despite being miscellaneous itemized deductions, trusts and estates can fully deduct their deduction in lieu of a personal exemption (642(b)) and distribution deduction (651 for simple trusts and 661 for complex trusts and estates). Section 67(e)(2). It is highly improbable that Congress intended to repeal these deductions. With respect to the personal exemption, the Tax Cuts and Jobs Act increased the personal exemption of disability trusts by the addition of Section 642(b)(2)(C)(iii). And if Congress eliminated the distribution deduction, trusts and estates would pay tax on amounts distributed and taxable to beneficiaries – a double taxation that contradicts the very purpose of the quasi-conduit regime of Subchapter J.

Although no certainty will exist until the IRS issues regulations, it seems likely that the Act did not eliminate a trust's or estate's deduction for fiduciary fees.

[5] If any portion of commissions is attributable to expenses that would be incurred irrespective of whether the property is held by a trust, such as investment management fees, that portion of the commission, is subject to the 2%-of-AGI limitation. The Regulations authorize using any reasonable method to make this allocation.

Investment Advisory Fees Not Deductible. The Act did suspend a trust's or estate's ability to deduct investment advisory or management fees. Such expenses are also miscellaneous itemized deductions that are not covered under the exception in Section 67(e). Accordingly, under the Act, these expenses cannot be deducted between 2018 and 2025. Finally, it's worth noting that, where a fiduciary fee is based in part on the fiduciary's investment management services, Treas. Reg. 1.67-4(c) requires the trust or estate to use a "reasonable method" to apportion the commission between the amount (hopefully) deductible in full under Section 67(e) and the amount temporarily not deductible.

Expanded Definition of U.S. Shareholder of Controlled Foreign Corporation

Background. The Tax Cuts and Jobs Act expanded the definition of who constitutes a "U.S. shareholder" of a controlled foreign corporation ("CFC"). Depending on certain factors, persons considered U.S. shareholders may be subject to a tax on the income of the foreign corporation irrespective of whether the corporation makes a distribution to its shareholders.[6]

The expanded definition may subject U.S. beneficiaries of foreign non-grantor trusts to U.S. shareholder status. Previously, the Code defined U.S. shareholder of a CFC as a U.S. person owning ten percent or more of its *voting* power. The definition of "U.S. person" includes individual citizens, resident aliens, and domestic partnerships, corporations, trusts and estates.[7] Although foreign trusts are not U.S. persons, indirect ownership rules[8] attributed ownership of foreign trust assets, including stock of a foreign corporation, to its U.S.-person beneficiaries. However, despite these indirect ownership rules,[9] U.S.-person beneficiaries of foreign non-grantor trusts had a strong argument to avoid U.S. shareholder status: trustees – not beneficiaries – hold the voting rights of stock owned by a trust.

New Definition of U.S. Shareholder. U.S. shareholder is now a U.S. person who owns at least 10% of the vote *or value* of the stock of the corporation.[10] Under the expanded vote-or-value definition, discretionary beneficiaries have increased susceptibility to U.S shareholder status. Although beneficiaries can no longer avoid U.S. shareholder status because they lack voting rights, trust beneficiaries – particularly wholly discretionary beneficiaries – may still be able to argue the value of their interest is beneath the 10% threshold for U.S. shareholder status.

[6] For more information on controlled foreign corporations, *see* Meltzer, Schwartz and Weissbart, *International Estate Planning for the Domestic Lawyer*, 43 ETPL 13 (April 2016).
[7] Section 7701(a)(30).
[8] Section 958(a)(2).
[9] Section 958(a)(2).
[10] Section 951(b).

Valuation of Discretionary Interests. The interest of a wholly discretionary trust beneficiary cannot be easily (if at all) valued because such a beneficiary has no mandatory economic rights at any given time. Compared to non-voting shareholders in a corporation and non-voting partners in a partnership, no similar uncertainty exists in determining the value of these interests, which have specific economic rights, including financial rights on liquidation. Indeed, the limited authority on valuing beneficial interests in trusts [11] does not even address the challenging valuation of wholly discretionary interests,[12] potentially leaving a narrow basis for U.S. beneficiaries of foreign trusts to continue to avoid U.S. shareholder status.

For more information on the subject, *see* Weissbart, *Impact of Expanded Definition of U.S. Shareholder on Trust Beneficiaries*, Estate Planning (anticipated May or June 2018).

Increased Deductibility for Cash Contributions to Public Charities

The Tax Cuts and Jobs Act added Section 170(b)(1)(G)(i) to the Code, which temporarily increases the limitation on tax deductions for cash contributions to public charities and certain private foundations. Previously, donors could deduct cash contributions provided the amount did not exceed 50% of the donor's adjusted gross income. For tax years 2018-2025, the limitation is increased to 60%. All other contribution limitations remain the same.

Estate of Powell v. Comm'r[13]

Background. Several commentators have suggested that *Powell* is the most important tax court case addressing FLPs and LLCs in at least a decade. The facts of the case involve aggressive deathbed tax planning, as the Tax Court called it, though the court's extension of section 2036(a)(2) to ownership of only limited partnership interests is surprising (prior cases, such as *Estate of Strangi v. Comm'r*[14], found estate inclusion when the decedent owned the LP interest and a portion of the GP interest). The case is an unfortunate example of bad facts producing bad law.

Facts and Reasoning of Tax Court. The decedent's son, acting through a power of attorney for his mother, contributed cash and marketable securities to a family limited partnership in return for a 99% limited partnership interest; two sons contributed unsecured promissory notes in return for the 1% general partnership interest. The partnership agreement gave the GP sole discretion to determine the amount and timing of

[11] Reg. 1.958-1(d)(3), Example 3 (addressing valuation of trusts with separate and distinct shares).
[12] PLR 8535020 (May 30, 1985) ("The fact that the trustee has discretion regarding distributions of income and principal to you is a factor that must be taken into account in determining the fair market value of your beneficial interest").
[13] 148 T.C. No. 18 (May 18, 2017) (reviewed by the Court).
[14] T.C. Memo. 2003-145, *aff'd* 417 F.3d 468 (5th Cir. 2005).

distributions, but importantly it also allowed for the dissolution of the partnership with the consent of all of the partners. Acting as attorney-in-fact, the son transferred the decedent's entire LP interest to a CLAT at a 25% discount for lack of control and marketability. Notably, the power of attorney did not authorize gifts greater than the annual exclusion amount. The decedent died unexpectedly one week later.

On audit of the estate tax return, the IRS claimed that the assets contributed to the FLP were includible in the decedent's estate under sections 2036(a)(1), 2036(a)(2), 2038 and 2035(a), though the Tax Court considered only the arguments for application of section 2036(a)(2),[15] which they considered to be persuasive. Reasoning that the decedent, in conjunction with the other partners, could dissolve the partnership pursuant to the partnership agreement, and that the decedent, through her son as GP and attorney-in-fact, could control the amount and timing of distributions, the Tax Court held that the assets contributed to the FLP were includible in her estate. Notably, the Tax Court also dismissed the "fiduciary duty" analysis at play in *United States v. Byrum*[16] as "illusory."

Observations. As Steve Akers has pointed out, Powell is the first case to apply section 2036(a)(2) "when the decedent owned merely a limited partnership interest."[17] Query whether the court would have come to a similar conclusion had the decedent owned a small limited partnership interest, though it made no distinction between a 99% or 1% limited partnership interest. In dicta, the majority opinion also analyzed whether there could potentially be "double inclusion" under section 2036 and section 2043 and decided that such double inclusion is illogical and not allowed.

It is not surprising that the taxpayer lost the case. Several bad facts were at play here, including the death bed transfer, the invalid transfer under the power of attorney, as well as the contribution by the sons of unsecured promissory notes in exchange for GP interest. However, the *Powell* case may not represent a significant practical change, since the section 2036 exception for bona fide sale for full consideration exception has been the primary defense in claims involving FLP or LLC interest under section 2036. Importantly, steps should be taken to ensure that a legitimate and significant business purpose exists to qualify for the bona fide sale exception to section 2036. Some commentators have also suggested considering a conservative valuation position to improve the optics of the transaction.[18]

<u>Notice 2017-15 – Retroactive Relief for Same-Sex Married Couples</u>

[15] The Court did consider the application of section 2035, but its application was denied because the gift tax deficiency associated with the transfer to the CLAT was not effective, since the transfer to the CLAT was void.
[16] 408 U.S. 125 (1972).
[17] Heckerling Recent Updates, page 21.
[18] Angkatavanich, Dougherty & Fisher, Estate of Power: Stranger Than Strangi and Partially Fiction, Tr. & Ests. 30 (Sept. 2017).

Same-sex couples may now retroactively claim marital deductions and recalculate GST exemptions. Prior to U.S. v. Windsor, 111 AFTR 2d 2013-2285, 133 S. Ct. 2675 (2013), same-sex couples were not recognized for federal tax purposes, which did not allow them to claim marital deductions for gifts and bequests or use generational assignments for GST tax purposes. This IRS notice states that same-sex couples who were validly married under state law at the time of a gift between spouses may claim marital deductions for gift tax purposes, even if the statute of limitations has run on the return reporting a transfer. As a result, the applicable exclusion amount and the DSUE amount may be recalculated.

Taxpayers in these situations may file a new or amended return, or executors may amend or revise any estate tax return for a deceased same-sex spouse. The Notice provides instructions for how to proceed. Importantly, couples may not claim a refund of taxes paid if the statute of limitations has expired. In addition, any allocation of GST exemption made in the past that ignored the marital status of same-sex spouses may be voided, and the exemption may be recalculated. Notably, same-sex marriage became legal in New York State in 2010, so the notice will apply only to those gifts made between spouses after that time.

STATE DEVELOPMENTS

In re Hoppenstein

Background. Prior to *In re Hoppenstein*, no case had addressed either the common law right to decant or the right to decant pursuant to the terms of a trust's governing instrument, though several cases in other jurisdictions have analyzed the extent of a trustee's common law power to decant.[19] In *In re Hoppenstein*[20], the New York Surrogate's Court dealt a potentially devastating blow to the necessity and relevance of New York Estates, Powers and Trusts Law 10-6.6 for trust decantings.

Facts and Ruling. The trustees of an irrevocable trust relied on their broad discretionary distribution authority in the trust instrument itself, as opposed to the New York's decanting statute, to transfer trust assets from one trust to another. The trust instrument authorized the trustees "to pay such sums out of principal of the trust (even to the extent of the whole thereof) to the settlor's descendants, living from time to time, in equal or unequal amounts, and to any one or more of them to the exclusion of the others, as the Trustees, in their absolute discretion, shall determine." The only administrative requirement provided within the instrument was one requiring the trustees to give the settlor's descendants 45 days notice prior to the distribution.

[19] See *Phipps v. Palm Beach Trust Co.*, 142 Fla. 782 (1940); *In re Spencer's Estate*, 232 N.W.2d. 491 (Iowa 1975); and *Wiedenmayer v. Johnson*, 106 N.J. Super. 161 (App. Div. 1969), *judgment aff'd* 55 N.J. 81 (1969).
[20] 2015-2918/A,NYLJ 1202784244139, at *1 (Sur. Ct., N.Y. Co., decided on March 31, 2017).

The daughter of the Settlor and her four children sought to void the trustee's distribution of an insurance policy from the trust to a new trust that eliminated the daughter and four children as beneficiaries. The plaintiffs claimed, inter alia, that the transfer did not comply with EPTL 10-6.6. In granting summary judgment in favor of the trustees, the court summarily dismissed the daughter's argument, noting that the trustees did not reply on the EPTL but rather on their power to make such distributions within the trust instrument itself. The court cited EPTL 10-6.6(k), which allows trustees to decant based on the provisions of the trust instrument or common law, in affirming the trustees' rights to decant under the terms of the trust instrument rather than the EPTL.

Practical Planning Outcome. By confirming the validity of the transfer to the new trust, the court allowed the trustees to effectively remove a trust beneficiary without having to follow the specific statutory requirements of EPTL 10-6.6. Notably absent from the language allowing the trustee's discretion over principal in this case was the language "to or for the benefit of" the beneficiaries. Therefore, it appears that mere discretion over principal distributions alone engenders the power to decant. It may now be possible to decant under the trust's governing instrument in ways that the EPTL did not allow. For example, a trust instrument might provide that a trustee has the ability to decant to a new trust with additional beneficiaries. Other non-statutory objectives could be achieved, such as elevating remainderpersons to present beneficiaries, prolonging the perpetuities period, altering the provisions regarding trustee compensation, or providing for other substantially different dispositive terms. Burdensome administrative requirements that the EPTL requires could be eliminated.[21]

In any event, *Hoppenstein* should provide comfort to practitioners who may have previously been hesitant to rely on this statutory exception.

<u>Allocation of Capital Gain to Trust Income</u>

Background. On February 27, 2018, the New York State Assembly unanimously passed (with several members absent) a bill that would permit trustees to allocate capital gain to income. *See* Bill Number A09765. The bill has been delivered to the State Senate, but as of March 2018, no vote has yet been taken. As explained below, the ability for a trustee to allocate capital gain to income effectively gives the trustee power to determine whether tax on the capital gain income will be paid by the trust or its beneficiaries. In certain instances, whether the trust or beneficiary pays the tax can yield dramatically different results because of different (1) tax brackets for trusts and individuals and (2) state income tax obligations (i.e., beneficiary in Florida, which has no income tax; trust pays New York state income tax).

Overview of the Proposed Legislation. The bill would amend sections 11-2.3(b)(5)(A) and 11-A-4.4(2) of the Estates, Powers and Trusts Law to provide that,

[21] For a detailed discussion of the non-statutory decanting options, see Dillon & Schwartz, "Who Needs a Decanting Statute," Trusts and Estates Law Section Newsletter, Vol. 60, No. 3 (Fall 2017).

unless a trust instrument otherwise provides, a trustee may make a reasonable and impartial allocation of realized capital gains to income.

The purpose of the new law is not to provide trustees with the ability to increase the dollar amounts distributed to income beneficiaries; this can already be accomplished under New York's power-to-adjust statute. EPTL 11-2.3(b)(5). Most importantly, granting the trustee discretion to allocate capital gain to income effectively, based on provisions of the Treasury Regulations, gives the trustee the power to determine whether capital gain is included in the distributable net income (DNI) of the trust. Treas. Reg. 1.643(a)-3(b). Although DNI could be a presentation unto itself, generally, tax on amounts included in DNI are paid by the trust's beneficiaries; tax on amounts not included in DNI are paid by the trust. Thus, a trustee's discretionary power to allocate capital gain to income effectively gives the trustee power to determine tax consequences.

Reasons the Legislation is Necessary. Under the Treasury Regulations, a trustee's allocation of capital gain to income will only result in its inclusion in DNI if the trustee exercises the power (1) " in accordance with a power granted to the fiduciary by applicable local law" or (2) "by [authority in] the governing instrument if not prohibited by applicable local law." Currently, New York law does not grant this power to trustees; thus, trustees may only allocate capital gain to income (and facilitate its inclusion in distributable net income) if the power to do so exists in the governing instrument.

The new law is necessary because many existing trusts do not contain a power granting the trustee discretionary authority to allocate capital gain to income. Additionally, draftspersons may neglect to include this power in future trusts. Thus, the new law will enable all trustees to make this allocation that can yield favorable tax consequences. If the law passes, clients who do not want trustees to have this power would need to include restrictive language in the governing instrument.

Planning Tip. As noted above, until the law passes, trustees of New York trusts can only allocate capital gain to income (and facilitate its inclusion in distributable net income) if the power to do so exists in the governing instrument. Thus, practitioners should be sure to include the power to allocate capital gain to income in all relevant documents.

In re Brecher – Will modification allowed to avoid estate tax

Background. A New York Surrogate's Court allowed a modification to a 27-year old will to eliminate over $500,000 of New York state estate tax. The modification was a reformation to a marital deduction formula provision to reflect changes to federal and state law since the execution of the will 27 years prior. The Surrogate's court noted that the movement of assets from the nonmarital to the marital trust would "protect the

testator's intent from being thwarted by a change in the tax law."[22] None of the beneficiaries opposed the modification.

Considerations. Query whether the beneficiaries' failure to oppose the modification constitutes a gift by them to the surviving spouse. Query also why a disclaimer by those same beneficiaries would not have been sufficient. While the decedent was not likely subject to federal estate tax, query whether this state court's opinion would be binding for federal estate tax marital deduction purposes.

[22] In re Brecher, 2017 N.Y. Misc. LEXIS 38 (Surr. Ct).

Deconstructing Different Flavored Freezes: A Comparison of Popular Estate Freeze Techniques

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I. INTRODUCTION

This outline is intended to provide an overview of some of the most popular types of "estate freeze" transactions, and provide some historical context, technical discussions, practical applications and relative pros and cons of the different techniques. As a general proposition, all estate freeze transactions do share some common characteristics in that these transactions generally involve a senior generation family member (sometimes referred to as "Senior Family Member") making some form of a transfer of an asset and receiving back a type of cash-flow interest (e.g., a promissory note, a fixed annuity interest, or a preferred payment).

There are different "flavors" of freeze transactions that are employed to achieve this trade-off of interests in different ways, and there are relative pros and cons that are associated with different types of freezes. These transactions can be very advantageous from an estate planning standpoint in that they can provide a means to provide a more stable priority cash-flow interest to the Senior Family Member while shifting potential future growth above that cash-flow interest to or for the benefit of junior generation family members (sometimes referred to as "Junior Family Member(s)"), or perhaps trusts for their benefit. Thus, all of these freeze transactions involve some balancing of risk versus reward, which may fit nicely with the relative risk appetite and investment horizon of different family members.

These transactions are broadly referred to as "estate freezes" because the Senior Family Member's "cash-flow" interest will be limited to the specific type of interest received; but those interests will not participate in future growth potential above a fixed hurdle. The other interests, typically held by the Junior Family Members, will participate in the upside growth potential of the transferred asset. Thus, the Senior Family Member's interest is "frozen" for estate tax valuation purposes. Beyond this broad theme, the different techniques often implemented by planners will vary and will have relative pros and cons. It is the opinion of the author that there is not necessarily a superior freeze technique, but rather, the most appropriate technique in a certain client situation will be dependent upon a balancing of a number of factors, including cash-flow needs, investment horizon, appetite for certainty versus uncertainty and complexity, desired rate of return, and multigenerational considerations.

This outline will discuss some of the most popular freeze techniques: Grantor Retained Annuity Trusts (or "GRATs"), Sales to Intentionally Defective Grantor Trusts ("IDGTs"), and Preferred Partnerships. Finally, this outline will discuss some of the relative pros and cons that practitioners should consider when evaluating these different techniques in different client situations as well as practical applications.

II. GRANTOR RETAINED ANNUITY TRUSTS (GRATs)

A. GRATs Generally

A GRAT is a statutorily blessed vehicle under Section 2702, which can provide a means to essentially make a gift tax-free transfer of the future appreciation (above

the Section 7520 interest rate) of a gifted asset without triggering any gift tax.[2] This is accomplished by the transfer of assets by a Senior Family Member into an irrevocable trust, called a Grantor Retained Annuity Trust, or GRAT, which provides a mandatory stream of annuity payments to him or her for a selected term of years, with any remaining balance passing typically to or for the benefit of Junior Family Members. If the grantor survives the selected term of years, upon the termination of the annuity stream, the remaining assets pass to the remainder beneficiaries, typically Junior Family Members, either outright or perhaps in further trust.[3]

Properly structured, the Senior Family Member, as the grantor of the GRAT, will subtract from the value of the transferred asset the present value of the annuity stream, in order to determine the value of the taxable gift. In most cases, GRATs will be structured so that the present value of the annuity stream will equal nearly the entire value of the transferred assets, thereby resulting in a gift of nearly zero (typically less than one dollar). If however, the assets transferred into the GRAT appreciate above the amounts necessary to pay the annuity stream, as may very likely be the case if assets with appreciation potential are transferred (e.g., pre-IPO stock), the balance passing to or for the Junior Family Members will pass gift tax-free.

GRAT Example:

Senior Family Member transfers $10,000,000 of closely-held stock into a "zeroed out" GRAT that provides an annuity of 51.80810% each year for 2 years, with the remainder passing to children after the 2-year GRAT term. Assuming a September 2017 transfer and a Section 7520 interest rate of 2.4%, the present value of Senior Family Member's retained annuity is $9,999,999.46, thus resulting in a taxable gift of $0.54. If the GRAT is invested in highly appreciating assets, such that the average rate of return is 15%, then at the end of the 2-year GRAT term, assuming that Senior Family Member has survived that period, the remaining balance in the trust of $2,086,258.50 will pass to the children without imposition of additional gift taxes and will be excluded from Senior Family Member's gross estate.

Some of the features of GRATs are as follows:

1. <u>Gift Value</u>

The value the gift is determined upon the GRAT's creation by calculating the present value of the remainder interest gift: the present value of the annuity stream payable to the grantor using the Section 7520 interest rate

[2] The Internal Revenue Code of 1986, as amended, is hereafter referred to as the "Code." Unless otherwise indicated, each reference to a "section" is a reference to a section of the Internal Revenue Code of 1986; and each reference to "Treas. Reg. §" is a reference to a regulations section. The "IRS" or the "Service" means either or both the US Department of the Treasury and Internal Revenue Service, as the context may require.

[3] For purposes of this outline, references to the terms "Senior Family Member" and "Junior Family Member" shall mean those persons individually and/or a trust for their benefit.

applicable for the month of the funding of the GRAT.[4] If the GRAT is "Zeroed-out" (a "Zeroed-out GRAT"), which is typical, the present value of the annuity stream is structured to roughly equal the value of the assets transferred into the GRAT. This results in a gift of "zero" or, more accurately, near zero for gift tax purposes. However, if the assets in the GRAT are invested to grow in excess of the annuity stream required to be paid to the grantor/annuitant, and if the grantor outlives the selected trust term the GRAT's assets are removed from the grantor's estate, and the excess assets pass to the remainder beneficiaries (typically the grantor's children or trusts for their benefit) free of additional gift taxes; essentially providing for a gift-tax-free transfer of the future appreciation (if any) in the assets. Of course, the annuity payments paid to the Senior Family Member are included in his or her estate, but any upside growth passes to the remainder beneficiaries, assuming that Senior Family Member outlives the stated GRAT term.

2. *Walton* case and Example 5

Initially, some controversy existed with respect to the originally issued "Example 5" of the Treasury Regulations. Essentially, the original Example 5 provided that if a grantor attempted to create a GRAT in which the annuity was paid for a set term of years, such could not be "Zeroed-out" (so as to result in a gift of zero). This is because the value of the retained annuity interest was calculated as if the annuity would be received for the shorter of the grantor/annuitant's life or the fixed term. Thus, the value of the annuity was calculated to be worth less than the value of the annuity interest for the fixed term (as the value of the grantor's retained annuity interest was reduced to account for the fact that if he/she died before the end of the annuity term, he/she would not actually receive all of these payments) and, therefore, a GRAT could not be "Zeroed-out."

This issue was resolved in *Walton*[5] in which it was held that the original Example 5 was invalid. The *Walton* court determined that in calculating the present value of the grantor's retained annuity interest (and, thus, the resulting taxable gift), value will be given for both the value of the annuity payable to the grantor and to the grantor's estate if he/she dies during the annuity term, as both would constitute Qualified Interests under Section 2702. Thus, following *Walton*, it became possible to "zero out" a GRAT. After an initial period of uncertainty, the IRS acquiesced to this rationale

[4] I.R.C § 7520 Rate is equal to 120% of the Applicable Federal Rate ("AFR"). Accordingly, there is potential that the GRAT will underperform the Gift/Sale Transaction.

[5] *Walton v. Commissioner*, 115 T.C. 589 (2000), *acq. in result*, I.R.S. Notice 2003-72, 2003-2 C.B. 964.

in Notice 2003-72. Example 5 was revised to conform to *Walton* in 2005.[6]

3. Adjustment Feature

Some practitioners consider GRATs to be more conservative planning vehicles (as compared to a Sale to an IDGT, etc.) because this technique is specifically authorized under Section 2702. Additionally, the Treasury Regulations specifically provide for a valuation adjustment feature to ensure that no unanticipated additional gift will occur as a result of the creation of a GRAT.[7] Thus, if the value of the asset contributed into a GRAT is increased on a gift tax audit, the amount of the annuity payment due will be automatically recalculated accordingly so as to result in a larger annuity payment due, but will still result in the same amount of gift (in the case of a Zeroed-out GRAT, will still result in a gift of roughly zero).

- Practice Point: This self-adjustment feature is one of the relative advantages of a GRAT that can be quite advantageous when planning to transfer hard-to-value assets, particularly when the potential value of those assets exceed the federal gift tax exemption. In contrast, as will be discussed in the section on Sales to Intentionally Defective Grantor Trusts, such self-adjustment features are generally not looked upon favorably by the IRS, as they are considered to be contrary to public policy (the rationale being that such a feature would disincentivize the IRS from pursuing gift tax audits since the consequence of any change in valuation of a transferred asset would still result in zero additional gift taxes).

4. Mortality Risk

While GRATs may in one sense be considered to be more conservative, there are relative pros and cons that should be considered. Inherent with a GRAT is the potential for some or possibly all of the transferred assets to be included in the grantor's estate in the event of his or her death before the end of the GRAT term. Mortality risk is perhaps the most significant downside to a GRAT: the grantor must outlive the trust term to remove all of the gifted assets from his or her estate under Section 2036(a)(1). If the grantor dies during the trust term, then a portion (or possibly all) of the assets necessary to produce the remaining annuity payments will be included in the grantor's gross estate. The Treasury Regulations under

[6] Treas. Reg. § 25.2702-3(e), *Ex*. 5 now provides as follows: "A transfers property in an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. The interest of A (and A's estate) to receive the unitrust amount for the specified term of 10 years in all events is a qualified unitrust interest for a term of 10 years."

[7] Treas. Reg. § 25.2702-3(b)(2).

Section 2036 were finalized effective November 8, 2011[8] to clarify that the amount included in the grantor's estate in the event of death prior to the end of the GRAT term will be calculated based upon a formula, which calculates the amount of principal required to generate the remaining annual annuity payments, without reducing or invading principal, based upon the Section 7520 interest rate existing at the date of death. Prior to the finalization of these Treasury Regulations, the IRS took the view that the entire value of the GRAT's assets were included in the grantor's estate under Sections 2036 and 2039 in the event of such a premature death.[9]

5. Grantor Trust

During the term of the GRAT, it will be considered a "grantor trust" as to Senior Family Member for income tax purposes under Section 677(a)(1). Thus, Senior Family Member will be legally obligated to pay the income tax liability associated with the GRAT's income, which will reduce his or her otherwise estate taxable assets while at the same time allowing the GRAT to grow unencumbered by income tax liability. Thus, while not an actual gift, this functionally has the effect of being a tax-free gift each year in the form of the income taxes paid on behalf of the GRAT.

6. Carryover Basis

The remainder beneficiaries receive a carryover tax basis in the assets remaining at the end of the GRAT term under Section 1015(a).

7. Rolling GRATs

Many GRATs are structured as short-term (e.g., two or three year) GRATs, or as a series of "rolling" short-term GRATs in which annuity payments received from existing GRATs are used to fund additional short-term GRATs. This results in a reduction of the potential mortality risk by increasing the chance that the grantor will survive the term of each GRAT. In addition, the short-term nature of each of the GRATs allows for an opportunity to "lock-in" the upside of the volatile market, while reducing the potential negative effects of a volatile market's downside.

8. Greenbook Proposals

In the past, various proposals have been made to place some limitations on the use of GRATs, reflecting the Treasury Department and former Obama Administration's shared sentiment that the use of short-term GRATs to achieve a gift-tax-free shift of future appreciation provided too much of an opportunity for taxpayers to shift wealth free of gift tax.[10] Former

[8] 76 Fed. Reg. 69126-69131 (11/8/11).
[9] Treas. Reg. § 20.2036-1(c)(2)(i).

[10] *See* GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS, DEPT. OF THE TREASURY (Feb. 2015) (referred to as the "Greenbook").

President Obama's Greenbook proposal would have required GRATs to have: (a) a minimum annuity term of ten years, (b) a maximum annuity term of the annuitant's life plus ten years, and (c) would have also required any GRAT's remainder interest to have a minimum value of the greater of 25% of the value of the contributed assets or $500,000 (but not more than the value of the assets contributed), thus eliminating the Zeroed-out GRAT technique. Had these changes become law, the new minimum gift concept would have effectively eliminated the use of the Rolling GRAT technique, which relies upon the ability to "zero out" a GRAT.[11]

To date, the Trump Administration has not adopted any of these proposals and has been silent with respect to its views with respect to GRATs.

B. Section 2702 – The Statutory Basis for GRATs as an Exception to the Zero Valuation Rule

While many practitioners view Section 2702 as being the statutory authorization for the creation of GRATs, which is true, GRATs are merely one of the statutory exceptions to the general application of Section 2702, which was designed to be a punitive deemed gift tax provision. In other words, GRATs are a statutory carve-out that is permitted as an exception to the potentially draconian zero-value gift tax rules under Section 2702.[12]

Section 2702 is a deemed gift provision that generally provides that when an individual makes a transfer of an interest in trust to a family member in which such individual (or certain other Senior Family Members) retains an interest in the trust, in determining the amount of any resulting gift the value of the retained interest is valued at zero, unless the retained interest satisfies the definition of a "Qualified Interest." In the event that the retained interest is a "Qualified Interest" its value shall be determined actuarially under Section 7520, and not at zero.

1. The Perceived Abuse

The rationale behind the enactment of Section 2702 and the "zero valuation" rule was to prohibit certain perceived abuses in connection with common law grantor retained income trusts (GRITs) that were being created before the enactment of Chapter 14 of the Code, which took effect with respect to transfers after October 8, 1990. Before the enactment of Section 2702, a Senior Family Member would make an irrevocable

[11] *Id.* at 198.

[12] I.R.C. § 2702 and its definition of a "Qualified Interest" provides the statutory basis for many estate planning vehicles involving transfers to trusts, such as Grantor Retained Annuity Trusts ("GRATs") and Qualified Personal Residence Trusts ("QPRTs"). Additionally, I.R.C. § 2702(c) contains provisions with respect to certain joint purchases of property and other property interests being treated as transfers held in trust, which are likewise subject to the zero valuation rule. This Section may have important implications in the case of joint purchases between family members, when term interests are acquired, and should be considered whenever contemplating such a transaction.

transfer of assets into a GRIT and retain the right to receive any and all income generated by the trust for a term of years, with the remaining balance at the end of the GRIT term passing to younger family members. While the actual amount of income that would be generated could, of course, not be determined at the time of the gift, for gift tax calculation purposes, the Senior Family Member/grantor would approximate the present value of that income interest based upon the then prevailing interest rate, which, when subtracted from the value of the transferred asset, would result in the amount of the taxable gift under a "subtraction method" of valuation. Particularly in a high interest rate environment, this would enable the Senior Family Member to reduce the amount of the taxable gift significantly, therefore resulting in a relatively small taxable gift of the remainder interest, because it was assumed that Senior Family Member would receive back an income interest calculated based upon the then higher prevailing interest rate. If, however, following the funding of the GRIT, the trust was invested so as to produce more growth and less actual income, then Senior Family Member would receive less income (perhaps significantly less income) than Senior Family Member would have gotten "credit" for gift tax purposes, thus leaving less assets in his/her estate and more assets in the GRIT to ultimately pass to the remainder beneficiaries.

2. General Definitions

a) General Rule

Section 2702 applies the "zero valuation" rule to determine the amount of a retained interest and, thus, the resulting gift, when an individual makes a transfer in trust to or for the benefit of a "Member of the Family" and such individual or an "Applicable Family Member" retains an interest in the trust.[13]

If Section 2702 applies to a transfer and the retained interest is not a "Qualified Interest," or some other exception does not apply, the retained interest is valued at zero and, under the subtraction method of valuation, the amount of the gift is equal to the entire value of the transferred property. If the retained interest is a "Qualified Interest," its value is determined actuarially and subtracted from the value of the transferred interest to determine the amount of the taxable gift.[14]

b) Member of the Family

The term "Member of the Family" means with respect to an individual Transferor, such Transferor's spouse, any ancestor or lineal descendant of

[13] Treas. Reg. § 25.2702-1(a).

[14] Treas. Reg. § 25.2702-1(b).

the Transferor or the Transferor's spouse, any brother or sister of the Transferor, and any spouse of the foregoing.[15]

c) Applicable Family Member

The term "Applicable Family Member" means with respect to the individual Transferor, the Transferor's spouse, and any ancestor of the Transferor or the Transferor's spouse, and the spouse of any such ancestor.[16]

d) Qualified Interest

Typically, a "Qualified Interest" is structured as a "Qualified Annuity Interest," which is an irrevocable right to receive a fixed amount, payable at least annually.[17] The value of a qualified annuity interest is determined under Section 7520.[18]

3. Section 2702 "Zero Valuation" Rule Hypothetical

Mom transfers a commercial building into an irrevocable trust in which she retains the right to receive all of the income (whatever income that may be) for 20 years with the remainder of the trust to pass to child at the end of the 20-year term. The building has a fair market value of $20 million (assume no debt) and produces rental income of $1 million per year. Because mom's retained income interest is not a "Qualified Interest," in determining the value of the gift, her interest is valued at zero under Section 2702. Thus, mom has made a gift of $20 million to the trust with no "credit" or reduction for the value of her retained income interest (despite the fact that there is some actual value attributable to her retained income interest).

If instead, mom had retained a right to receive a fixed annual annuity of $1 million for twenty years with the remainder to child, her retained interest would be a "Qualified Interest," that would be valued at zero under Section 2702. Thus, based on a Section 7520 interest rate of 2.4% as of September 2017, the value of her retained Qualified Interest would be $15,737,400 and the amount of the gift would be $4,262,600 (rather than the full $20 million). While the economics of these two deals would be quite similar, the gift tax consequences are dramatically different due to Section 2702.

[15] I.R.C. § 2704(c)(2); Treas. Reg. § 25.2702-2(a)(1).

[16] Treas. Reg. § 25.2701-1(d)(2).

[17] Treas. Reg. § 25.2702-3(b).

[18] Treas. Reg. § 25.2702-2(b)(2).

4. GRAT Technical Requirements

There are a number of technical requirements provided under Section 2702 and the Treasury Regulations thereunder that impose certain strict requirements or prohibitions when structuring a GRAT. It is critical when creating and administering a GRAT that none of these technical requirements are violated, as the consequences can be draconian, and can result in a significant deemed gift. Specifically, Treasury Regulation Section 25.2702(3)(b) provides that an interest is a Qualified Annuity Interest only if it meets a number of requirements, which primarily include the following:

a) Payment of Annuity Amount

A Qualified Annuity Interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually. A right of withdrawal, whether or not cumulative, is not a qualified annuity interest. Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.[19]

b) Fixed Amount

A "Fixed Amount" means either:

(1) A stated dollar amount, payable periodically (at least annually), but only to the extent the dollar amount does not exceed 120% of the stated dollar amount payable in the preceding year;[20] or

(2) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust, payable periodically (at least annually), but only to the extent the fractional percentage does not exceed 120% of the fixed fractional percentage payable in the preceding year.[21]

c) Income in Excess of the Annuity Amount

An annuity interest does not fail to be a Qualified Annuity Interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the Qualified Annuity Interest. Nevertheless, the right to receive the excess

[19] Treas. Reg. § 25.2702-3(b)(1).

[20] Treas. Reg. § 25.2702-3(b)(1)(ii)(A).

[21] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

income is not a qualified interest and is not taken into account in valuing the Qualified Annuity Interest.[22]

d) Incorrect Valuations of Trust Property

If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Section 1.664–2(a)(1)(iii) (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).[23]

e) Payment of the Annuity Amount Within Grace Period

An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date.[24]

f) Additional Contributions Prohibited

The governing instrument must prohibit additional contributions to the trust.[25]

g) Term of the Annuity Interest

The governing instrument must fix the term of the annuity and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods.[26]

h) Commutation

The governing instrument must prohibit commutation (prepayment) of the interest of the holder.[27]

i) No Use of Debt Obligations to Satisfy the Annuity Payment Obligation.

The trust instrument must prohibit the trustee from issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity payment obligation.[28]

[22] Treas. Reg. § 25.2702-3(b)(1)(iii).

[23] Treas. Reg. § 25.2702-3(b)(2).

[24] Treas. Reg. § 25.2702-3(b)(4).

[25] Treas. Reg. § 25.2702-3(b)(5).

[26] Treas. Reg. § 25.2702-3(d)(4).

[27] Treas. Reg. § 25.2702-3(d)(5).

C. Consequences of Violating GRAT Requirements

1. The numerous technical requirements for a GRAT must be strictly adhered to in order for it to be effective. The failure to satisfy any of these requirements, either at creation or in the subsequent administration of the GRAT, can have potentially harsh consequences. Arguably, the violation of any of these requirements will cause the initial transfer into the GRAT to fail the requirements of a Qualified Interest under Section 2702 and, accordingly, trigger the zero valuation rule with respect to the grantor's retained annuity interest. In such event, rather than the taxable gift equaling the actuarial value of the remainder interest (which, in the case of GRATs that are "zeroed out," is very close to zero), the taxable gift could instead be the entire value of the asset transferred into the GRAT from inception. While this issue has not been directly addressed in the context of a GRAT, in *Atkinson*,[29] the "operational failure" of a charitable remainder annuity trust (CRT) due to non-payment of annuity payments resulted in the CRT's disqualification.

2. Some practical issues to consider along these lines include the following:

a) As mentioned above, if the required annuity payment has not been paid on time, taking into consideration the 105 day grace period, the IRS could argue that this caused the annuity interest to not be a Qualified Interest in violation of Section 2702 and would be retroactive to the initial date of funding.

b) As mentioned above, GRATs are required to contain prohibitions against commutations (which are essentially early distributions), as well as additional contributions. Sometimes planners will recommend that a GRAT engage in a swap of assets between the grantor and the GRAT. While this can be achieved without recognition of gain due to the GRAT's grantor trust status, it is critical to be careful to not violate either of these prohibitions when swapping hard-to-value assets in or out of the GRAT. If a hard-to-value asset is determined by the IRS to be valued either higher or lower than the purported value used for purposes of the intended fair market value exchange via the swap, then it is possible that the IRS could argue that such constituted either an additional contribution or a commutation, as the case may be; in either case, in violation of Section 2702.[30]

[28] Treas. Reg. § 25.2702-3(d)(6)(i).

[29] *Estate of Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), *cert. denied*, 540 U.S. 946 (2003).

[30] *See, generally*, Carlyn S. McCaffrey, *Techniques for Improving GRAT Performance*, 51 Ann. Heckerling Inst. On Est. Plan. (2017), for an excellent discussion of various drafting techniques in order to provide some savings language to address these risks.

D. Generation Skipping Transfer Tax Limitations with GRATs and the Preferred Partnership GRAT

1. The Estate Tax Inclusion Period ("ETIP") Issue [31]

The general inability to allocate generation skipping transfer ("GST") tax exemption to a GRAT is another negative planning aspect, as it effectively prevents practitioners from structuring GRATs as Multigenerational, GST-Exempt trusts, in a tax-efficient manner. This is because of the "estate tax inclusion period" rule (the "ETIP Rule"), which basically provides that GST-Exemption cannot be allocated to a trust during its trust term if the assets would otherwise be included in the grantor's estate under Section 2036 if he or she died during that term.[32] If the grantor were to die during the annuity term, a portion of the GRAT assets would be included in his or her estate. As a result, the ETIP Rule would preclude the grantor from allocating GST-Exemption to a GRAT until the end of the ETIP (i.e., the end of the annuity term). Because of this limitation, there would be little if any ability to leverage the grantor's GST-Exemption with a GRAT. Allocation of the grantor's GST-Exemption to the trust at the end of the ETIP would have to be made based upon the then values of the trust's assets, and therefore would be an inefficient use of GST-Exemption. As a result, GST-Exemption is very often not allocated to a trust remaining at the expiration of a GRAT annuity term; as a consequence, such assets will typically be subject to estate tax at the death of the second generation beneficiaries or will be subject to a GST tax upon a GST event at the second generation's death.

2. Preferred Partnership GRAT to Address ETIP Issue

The creation of a "Preferred Partnership GRAT," which involves the combination of a statutorily compliant GRAT under Section 2702 with a statutorily compliant preferred partnership under Section 2701, may provide a way to obtain the statutory certainty of a GRAT while at the same time shifting appreciation into a GST-Exempt trust and, perhaps even containing the amount of potential estate tax inclusion if the grantor dies during the GRAT term. This technique dovetails the planning advantages of the preferred partnership with those of a GRAT by combining these two statutorily mandated techniques.

a) With this technique, Senior Family Member could create a preferred partnership, initially owning both common "growth" and preferred "frozen" interests. Thereafter, the Senior Family Member would make gift transfers of preferred interest to a long-term Zeroed-out GRAT, which would not trigger any gift taxes. Senior Family Member would also

[31] N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

[32] I.R.C. § 2632(c)(4).

create a GST-Exempt trust into which Senior Family Member would make taxable gifts of common interests, and would allocate GST-Exemption. The GRAT would be structured so that the preferred payments made annually to the GRAT would be sufficient to satisfy its annuity payments to the grantor. The GST-Exempt trust owning the common interests would receive all growth above the preferred coupon payable to the GRAT. At the end of the GRAT term, if the Senior Family Member is living, the GRAT remainder would be distributed to the remainder beneficiaries, however the preferred interest in the GRAT would have been "frozen" to the amount of the liquidation preference and the coupon; this is preferable since the GRAT remainder is GST non-exempt. Any appreciation above the coupon will exist in the common interests held by the GST-Exempt trust.

b) Perhaps an even more significant feature of the Preferred Partnership GRAT is the limitation on the mortality risk typically associated with a GRAT. If the grantor dies during the GRAT's annuity term, the estate tax inclusion would be limited to the frozen preferred interest gifted into the GRAT. However, because the common "growth" interest would never have been held in the GRAT, but, rather, it was obtained by the GST-Exempt trust via initial capital contribution, the grantor's death during the annuity term would become irrelevant with respect to the appreciated common interests held by the GST-Exempt trust.

III. SALE TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

A. Intentionally Defective Grantor Trusts Generally

1. Sale Rather Than a Gift

A Sale to Intentionally Defective Grantor Trust (IDGT) is another popular type of estate freeze transaction utilized by planners. This technique generally involves Senior Family Member selling an asset, such as an interest in a closely held business or perhaps a family limited partnership, to a grantor trust (typically for the benefit of Junior Family Members and, possibly, spouse) in exchange for a promissory note. Because this transaction involves a sale to the IDGT, presumably for fair market value, in exchange for a promissory note in the amount of the fair market value sale price, no taxable gift should result, as the transaction is presumably a fair market value exchange rather than a gift.[33]

[33] In *Frazee v. Commissioner,* 98 T.C. 554 (1992), it was determined that the receipt of a promissory note in connection with the sale of assets would constitute adequate and full consideration and, therefore, not a gift, provided that the face amount of the note reflected the fair market value of the assets and adequate interest was provided pursuant to I.R.C. § 7872, requiring interest imposed based upon the applicable federal rate under I.R.C. § 1274.

2. No Income Tax Recognition

Additionally, because the Senior Family Member is selling an asset to a trust that is a grantor trust to him or her, the transaction should not result in a gain recognition event for income tax purposes since grantor trusts are ignored for income tax purposes.[34] It should be noted, however, that a deemed sale will occur in the event that the grantor "turns off" grantor trust status while the promissory note has an unpaid balance. Thus, the amount of the gain incurred will be the difference between the outstanding note balance and the grantor's basis of the asset sold.[35]

3. Cash Flow versus Growth

The cash flow component of the IDGT transaction going back to the Senior Family Member consists of the promissory note plus interest imposed based upon the appropriate AFR in effect for the month and year of the sale. However, any growth in the assets held by the IDGT above the repayment of the note and AFR interest occurs in the trust and is outside of the Senior Family Member's taxable estate.

4. GST-Exempt IDGT

Unlike in the case of a GRAT (which, as discussed above, does not allow for leveraging of the grantor's GST-Exemption due to the ETIP Rule), it is possible for the IDGT transaction to be structured to be GST-Exempt by selling the asset into an IDGT that is a GST-Exempt trust. Thus, one of the advantages of an IDGT transaction over a GRAT is the ability to effectuate the sale transfer of assets into a multigenerational GST-Exempt structure, thereby achieving a longer term wealth transfer structure than a GRAT, which is generally considered to be only "two generation" in nature.

5. Benefits of Grantor Trust Status

The ability to shift post-sale appreciation out of the grantor's estate and into the IDGT can be quite powerful. Furthermore, because of the grantor trust status, the Senior Family Member is obligated to pay the income taxes associated with the assets in the trust, which enables the trust’s assets to essentially grow on an income tax-free basis. The Senior Family Member, as grantor, pays income taxes out of his or her own assets, which would otherwise be subject to estate or gift tax at some point in the future. In cases in which the assets in the trust have grown substantially, particularly where the trust has been leveraged by a sale or loan via a low interest rate note, it is quite possible for the payment of the annual income

[34] Rev. Rul. 85-13, 1985- 1 C.B. 184.

[35] Treas. Reg. § 1.1001-2(c), Ex. 5.

taxes on behalf of the trust to exceed the $11.18 million federal gift tax exemption (for 2018). Thus, in effect, the grantor trust status can be potentially even more valuable than the generous current gift tax exemption.

B. Rationale for IDGT Transaction

The rationale for the IDGT transaction is that, because the Senior Family Member is entering into a sale transaction with a trust that is considered to be a grantor trust as to him or her for income tax purposes within the meaning Sections 671-679, the sale will generally not be considered a recognition event for income tax purposes because it is treated as if the Senior Family Member is selling assets to himself or herself for income tax purposes.[36] The IDGT transaction is loosely based upon the IRS's rulings in PLRs 9436006 and 9535026, in which it was determined that sales of assets by grantors into a grantor trusts would not constitute deemed gifts under Section 2701 as "applicable retained interests" nor a "term interests" under Section 2702. It should be noted that in these rulings, the presumption is made that the notes involved were valid debt rather than some recharacterized form of disguised equity or disguised retained interest (see discussion below with respect to more recent arguments that have been made under these code sections).

The conventional wisdom with a sale to IDGT transaction is that the purchasing trust must have sufficient "seed equity" in order to support the debt service required under the promissory note that the trust will provide to the Senior Family Member as the seller. The working rule of thumb for many practitioners is that the trust must have a minimum of 10% in equity of the total value of the assets intended to be sold to the trust. Thus, seed equity of at least $1 million would be necessary in order to support a $9 million promissory note. This, however, is not at all a hard- and-fast rule, but rather is based upon the fact that 10% equity in the trust was involved in the above mentioned PLR 9535026. The rationale, however, for the 10% minimum seed is in order to counter an argument that the sale of assets in exchange for a promissory note was in essence some sort of retained interest in the sold assets, rather than debt.[37]

C. Estate Tax Considerations

The conventional wisdom is that estate tax exposure in the case of an IDGT transaction should be limited to the value of the promissory note owned by the Senior Family Member at his or her death. Said another way, the assets sold to the grantor trust should not be included in the estate in the absence of some type of retained string that the Senior Family Member continues to hold; only the promissory note should be included in the gross estate. However, it is possible that the IRS may raise an argument that the promissory note itself constituted a

[36] Rev. Rul. 85-13, 1985-1 C.B. 184.
[37] It should be noted that there is a 10% de minimis common equity requirement with respect to equity interests under I.R.C. § 2701(a)(4), which also presumably provides some additional indication of the origin of this working rule.

retained interest in the sold assets causing those assets to be included in the Senior Family Member's estate under Section 2036. In *Estate of Donald Woelbing,*[38] the IRS raised the argument that the sold stock was included in the grantor's gross estate under Section 2036(a)(1) under the theory that the promissory note was a retained income interest in the sold stock. It would seem that such an argument would be highly facts-and circumstances-based. Under the holding of the *Fidelity-Philadelphia Trust Co. v. Smith*[39] case, practitioners should be sure to structure the transaction so that the payments due under the note do not match the projected income generated by the sold assets. Practitioners are well advised to resist the urge to simply back into the amount of the note payments based upon the anticipated income generated off of the sold assets.

D. IDGT Does Not Self-Adjust

As mentioned above, one of the disadvantages of the IDGT transaction versus a GRAT is the lack of a self-adjusting feature enjoyed by the GRAT in the case of an adjustment to the reported gift tax value of the transferred asset. Thus, for instance, if a sale of an interest in a hard-to-value asset, such as a minority interest in a closely held business, is sold to an IDGT for an $8 million promissory note, based upon an independent valuation appraisal, and the value of the sold interest is adjusted to $10 million in connection with the gift tax audit, the seller will have made a taxable gift in the amount of the $2 million overage (in contrast, if the $8 million gift had been made to a GRAT and the value had been adjusted to $10 million on a gift tax audit, the consequence would be a corresponding increase in the amount of the annuity payments from the GRAT, but would not result in an additional taxable gift).

There are various ways that the valuation uncertainty of hard-to-value assets and the risk of a potential taxable gift tax in connection with an IDGT transaction can be addressed. However, each of these have their relative pros and cons so the practitioner must carefully consider these implications when advising the Senior Family Member on entering into a transaction. Determining the best approach for a particular transaction will require a nuanced discussion with the client in order to evaluate the relative risks and rewards associated with each approach. These approaches are discussed in paragraph F below, entitled "Planning Approaches for Hard-to-Value Assets."

E. Critical for Debt to Be Respected

1. Debt Challenges Generally

Critical to the IDGT transaction being successful is the promissory note being respected as valid debt because the rationale for the transaction not

[38] *Estate of Donald Woelbing v. Commissioner,* T.C. Docket No. 30261-13 (2013); *Estate of Marion Woelbing v. Commissioner*, T.C. Docket No. 30260-13 (2013)

[39] *Fidelity.-Philadelphia Trust. Co. v. Smith*, 356 U.S. 274 (1958).

resulting in a taxable gift is that Senior Family Member has sold the transferred property in exchange for the note in a fair market value exchange. If, however, the note is not respected as a valid debt and is instead disregarded as being illusory, then the transaction could result in a gift rather than a sale of the sold asset. There are different theories that the IRS has raised in an attempt to cause an IDGT transaction to constitute a gift. While there are different technical arguments raised by the IRS, they all involve in some form or another recharacterizing the promissory note as something other than true debt, such as a second class of equity or a transfer with retained interest.

Perhaps the most straightforward argument that the IRS has raised in connection with intra-family loans is that the parties did not actually intend to treat the note as true debt from inception. This has generally been heavily a facts and circumstances kind of inquiry based upon the post-loan conduct of the parties as an indication of the intention of the parties. Factors that have been taken into consideration generally include whether the payments required under the note were actually paid on time, whether the lender took appropriate actions to demand payments required under the loan in the case of late or nonpayment, whether interest payments required under the note were properly reported on the lender's income tax return, as well as other factors.[40]

Additional, more technical arguments have been made that the sale in exchange for a note should be recharacterized as a transfer in trust with a retained interest that does not constitute a qualified interest in violation of Section 2702. Alternatively, the IRS has attempted to recharacterize a note as a disguised second class of equity in the transferred entity interest, which would constitute a "distribution right" resulting in a deemed gift under Section 2701.

2. Debt Recharacterization Under Section 2702

a) *Karmazin v. Commissioner*[41]

In *Karmazin*, the IRS raised the argument that Section 2702 applied to an IDGT sale transaction. The IRS essentially argued that the sale of the limited partnership (LP) interest in a family limited partnership (FLP) by the taxpayer in exchange for a promissory note constituted a "transfer in trust" within the meaning of Section 2702. Under Section 2702, the value of a retained interest is zero unless it is a "qualified interest." Accordingly, the IRS argued that a sale of LP interests in exchange for a promissory note was actually a deemed transfer in trust with a retained income interest that did not qualify as a "qualified interest" under

[40] *Miller v. Commissioner*, 71 T.C.M. (CCH) 1674 (1996).
[41] *Karmazin v. Commissioner*, T.C. Docket No. 2127-03 (2003).

Section 2702 and, therefore, the value of the Senior Family Member's retained interest was zero under the subtraction method. Thus, the IRS took the position that the value of the sold LP interests should be recharacterized as a gift to the IDGT, in exchange for an interest that was valued at zero; thus resulting in a taxable gift of all the LP interests sold (with no reduction for the promissory note received in exchange).

b) *Estate of Donald Woelbing; Estate of Marion Woelbing*

More recently, the IRS challenged a sale transaction in *Estate of Donald Woelbing* and *Estate of Marion Woelbing,* companion Tax Court cases that were ultimately settled, as subject to zero valuation under Section 2702 reminiscent of *Karmazin*. In *Woelbing*, Donald Woelbing sold stock in the family business, Carma Laboratories, Inc. (Carmex lip balm company) to a grantor trust in exchange for a promissory note with a face value of $59 million with interest imposed at the AFR. The trust had assets of over $12 million before the transfer, some of which were available to service the note in addition to the company shares, and two trust beneficiaries had signed personal guarantees for 10% of the purchase price. In addition to the Section 2702 argument, discussed above, the IRS also challenged the valuation of the sold stock, arguing that the stock's value was actually $117 million, not the stated sale price of $59 million – so, in any case, the excess was a gift.

It seems that the pivotal issue is whether or not the sale of the stock to the trust in exchange for a promissory note could be considered a transfer in trust with a retained interest within the meaning of Section 2702. Prior to *Karmazin*, it was generally assumed that a debt was not considered a "term interest" under Section 2702, so that Section 2702 should not be applicable to a sale to an IDGT.

3. Debt Recharacterization Under Section 2701

In *Karmazin,* the IRS also argued that Section 2701 applied to a sale of FLP interests to an IDGT. In the transaction, the taxpayer created an FLP and sold LP interests to an IDGT in exchange for a promissory note. The IDGT financed the entire purchase price with the promissory note.

a) The IRS argued that the promissory note was not debt, but rather disguised equity and recited the following factors in support of its position:

(1) the trust's debt-to-equity ratio was too high;

(2) there was insufficient security for the note to be considered debt;

(3) it was unlikely that the LP interests would generate sufficient income to make the note payments; and

(4) no commercial lender would make a loan under such conditions.

b) By treating the promissory note as equity and not debt, the IRS sought to apply the provisions of Section 2701 which would result in the amount of the taxable gift being the value transferred minus the value of any "qualified payment rights" under the subtraction method. The IRS' argument was that the taxpayer made a transfer of subordinate interests (the LP interests) to the IDGT and retained a senior interest (in the form of the recharacterized promissory note). It reasoned that, because the retained interest included a "distribution right" for Section 2701 purposes and because the note payments would not be considered a "qualified payment right," the taxpayer would be treated as having made a gift of the LP units while retaining an interest in the FLP (the disguised equity, in the form of the promissory note) worth zero. Thus, a gift of the entire FLP interest would result with no offset for the promissory note. In this matter, the note payments made to the Senior Family Member were not "fixed" and did not make payments at least annually, and thus, were not "qualified payment rights."

c) Note, that had the promissory note been structured with fixed, cumulative, annual payments, such that it was a "qualified payment right," this would have avoided the application of the zero valuation rule under Section 2701, but still would not have completely saved the transaction. The required return for a preferred equity interest would still likely be higher than the AFR provided under the promissory note, under the rationale set forth in Revenue Ruling 83-120, so the value of the taxable gift would be less than the full value, but still more than zero – thus, a partial gift.

d) Ultimately, the matter was settled. However, the Section 2701 argument remains an issue that needs to be considered when structuring Sales to Intentionally Defective Grantor Trusts. If the IRS is able to successfully argue that a promissory note received in connection with such a transaction is, in fact, disguised equity, and if LP interests transferred to younger generational family members (or trusts for their benefit) are considered as subordinate to the retained promissory note recharacterized as equity, then potentially Section 2701 could result in a deemed gift.

F. Planning Approaches for Hard-to-Value Assets

When planning for the lifetime transfer of hard-to-value assets, there is uncertainty as to the value that will be ultimately determined for gift tax purposes. Consequently, there is inherent risk that a transfer of assets that is intended to fall

within the Senior Family Member's available gift tax exemption may ultimately be determined for gift tax purposes to exceed that available exemption and may cause gift tax liability with respect to the overage. Additionally, in the case of a sale to an IDGT, there is also the risk that the sale price may ultimately be determined to be for less than fair market value (as the IRS argued in *Woelbing)*, which could lead to additional gift tax exposure to the extent of the shortfall in the purchase price.

Of course, this is not an issue that is new, and is one that estate planning practitioners have been grappling with for over 70 years, going all the way back to the *Procter* decision.[42]

Due to the inherent valuation uncertainty with respect to closely-held businesses and other hard-to-value assets, and the desire to avoid unnecessary payment of gift tax liability in connection with gift and sales of these interests, estate planning practitioners have, for many years, attempted to craft different approaches to minimize or eliminate the gift tax exposure associated with making gifts and sales of hard-to-value assets.

Assuming Senior Family Member owns shares of stock in a closely-held company, and he or she has not previously utilized any of his or gift tax exemption, some of the different approaches and the relative pros and cons are discussed below as follows:

1. "Cushion" Approach

One approach would be to make a gift of shares, calculated based upon the per share appraised value, to be less than the available gift tax exemption of $11,118,000 (for 2018); for example, a gift of $8,000,000 worth of shares. If the IRS subsequently challenges the appraised value and attempts to increase the per share value of the transferred shares, the Senior Family Member would have some gift tax "cushion," in this case, $3,118,000, to "absorb" some, if not all, of the increased value as determined for gift tax purposes. Of course, this approach provides a "cushion" but not a guarantee that there will be no additional gift tax imposed. For instance, if the gifted shares have an appraised value of $8,000,000 and that value is increased on a gift tax audit to $13,000,000, then there would still be an excess taxable gift of $1,882,000 above the Senior Family Member's 2018 exemption of $11,118,000.

2. Price Adjustment Approach

This approach would involve including a provision that if the gift of the shares is ultimately determined for federal gift tax purposes to exceed a certain amount (for instance, the Senior Family Member's available gift tax exemption), then he or she will be deemed to have sold such excess

[42] *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

amount to the donee in exchange for a promissory note, which the donee would deliver upon such determination being made. This approach, however, is not favored by the IRS which takes the position that such a provision is invalid and violates public policy as being a "condition subsequent."[43] There is, however, one case, *King vs. Commissioner*, in which this type of approach was upheld.[44]

3. Formula Allocation Provision

Another approach that has gained recent popularity following *Succession of McCord v. Commissioner*[45] and *Estate of Petter*[46] is a so-called value allocation provision.[47] Such a provision would involve the transfer by the Senior Family Member of asset number of shares of an entity (for instance shares in an FLP), with the shares to be allocated between a gift taxable donee (such as a trust for children) and a non-gift taxable donee (such as a charity, or perhaps a marital trust, GRAT or incomplete gift trust). Under this approach, Senior Family Member, as the donor, would make a gift of a determined number of units in the entity; the unknown would be how those shares would be allocated between the gift taxable and the non-gift taxable donees, since the allocation of those shares would be dependent upon the value of the shares as finally determined for federal gift tax purposes. Thus, the allocation would be determined conclusively once the final value of the shares is determined for gift tax purposes.

4. Formula Definition Approach

This type of approach has gained popularity and support over the past several years with the Tax Court's issuance of the *Wandry vs. Commissioner*[48] decision in 2012, in which the taxpayer successfully made a gift of a defined dollar amount worth of interests in an entity. At the time of the gift, the actual number of shares transferred would be unknown, as that number would be dependent upon the valuation of shares as finally determined for gift tax purposes. However, what would be known would be the dollar denominated value of the gift; for example, $11,118,000 worth of shares of an FLP. If the value per share of the FLP is increased, this would reduce the number of shares that would be determined to be transferred, but the value of the transferred shares will always equal $11,118,000. It should be noted that the IRS has indicated in a non-acquiescence pronouncement that it does not agree with *Wandry*.[49]

[43] See *Ward v. Commissioner*, 87 T.C. 78 (1986); *Estate of McLendon v. Commissioner*, 66 T.C.M. (CCH) 946 (1993).

[44] *King v. United States*, 545 F.2d 700 (10th Cir. 1976).

[45] *McCord v. Commissioner* 20 T.C. No. 13 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006).

[46] *Estate of Petter*, 98 T.C.M. (CCH) 534.

[47] For an excellent discussion on value-allocation clauses *see* McCaffrey, *Formulaic Planning to Reduce Transfer Tax Risks*, 45 Ann. Heckerling Inst. On Est. Plan. (2011).

[48] *Wandry v. Commissioner*, 103 T.C.M. (CCH) 1472 (2012).

[49] I.R.S. Announcement 2012-46 I.R.B. 3.

Thus, the planner who is going to proceed with this type of approach should be mindful of the fact and advise their client that the IRS may challenge this approach. If the IRS were to challenge this approach, it would likely argue that the original number of shares estimated to be transferred was actually transferred at the adjusted gift tax value. If the IRS was successful, a gift tax would be imposed to the extent the value of those transferred shares exceeds the donor's lifetime gift tax exemption.

5. Cash Funding with Subsequent Swap

This approach would involve the Senior Family Member initially making a gift of cash or other readily marketable assets into a grantor trust. A gift tax return would be filed reporting the gift of the cash or the readily marketable securities at their readily determinable value. Thereafter, the grantor could sell or swap interests in the hard-to-value asset (such as an FLP interest) to the trust in exchange for either cash or those marketable securities, based upon the appraised value of those shares. Query whether or not in such case, the Senior Family Member should file an additional gift tax return disclosing the swap of assets and taking the position that the swap was made for fair market value and that no gift tax liability resulted?

G. To Report or Not to Report the Sale to IDGT?

An important consideration with an IDGT transaction is whether or not the sale component of the transaction should be reported on the seller's timely filed gift tax return. While certainly any "seed gift" to the trust would need to be reported on a gift tax return, a sale component is not necessarily required to be filed because, presumably, the transaction is a fair market value exchange rather than a gift. Many practitioners are of the view that it is advisable for the sale to the IDGT to, nonetheless, be reported on the taxpayer's gift tax return as a non-gift transaction in order to adequately disclose the transaction and start the three-year statute of limitations running under Section 6501 for the IRS to challenge the sale for gift tax purposes.[50] An important distinction should also be noted, that, while the adequate disclosure of a sale transaction on a gift tax return will start the statute of limitations running on the sale for gift tax purposes, such will not provide any insulation for purposes of any potential estate tax challenges that could arise at the Senior Family Member's death, for instance, under Section 2036.

For many practitioners, it has been considered the more favored approach to disclose the sale transaction on a gift tax return, so as to "bite the bullet" and address any gift tax issues associated with the sale currently rather than risk having those issues raised down the line, for instance, upon the death of the taxpayer, perhaps several decades in the future. However, such may not always

[50] Treas. Reg. § 301.6501(c)-1(f)(5) provides that the statute of limitations does not begin to run until the transfer is adequately disclosed on the taxpayer's' gift tax return.

necessarily be the correct approach. Particularly in the case of very large sale transactions, in the absence of some other effective approach to limit or eliminate the gift tax exposure in the event of the revaluation of a sold asset, there may be meaningful gift tax liability exposure if the sale transaction is determined to be for less than adequate consideration. Thus, advising as to the "right" approach for a client will require consideration of a number of unique factors such as age, health, appreciation potential, desire for closure of the gift tax issue and risk tolerance. For instance, in the *Woelbing* case discussed above, an IDGT transaction was entered into whereby stock was sold for a price of $59 million in exchange for a promissory note based upon a defined value sale approach. The IRS issued a notice of deficiency upon reviewing the sale transaction as disclosed on the taxpayer's gift tax return and determined that the value of the transferred stock was not $59 million but, rather, $117 million resulting in a gift of the overage (as discussed above, the IRS also argued that the note itself constituted a retained interest in the trust that violated Section 2702 and, therefore, was valued at zero, which would have resulted in an even larger taxable gift).

Whether or not it would have been preferable to not report the sale transaction on a gift tax return and instead allow the statute of limitations for assessment of gift taxes to remain open, and ultimately be subject to further review in connection with the Senior Family Member's estate tax return is debatable, and is difficult to determine in retrospect. However, the Woelbing case is a good illustration of the point that careful consideration should be given and discussed with the client as to whether or not a sale transaction should be reported on a gift tax return and the relative pros and cons associated therewith.

IV. PROACTIVE PLANNING WITH SECTION 2701 AND PREFERRED "FREEZE" PARTNERSHIPS[51]

A. Introduction

In its most basic form, a preferred "freeze" partnership (referred to in this outline as a "Freeze Partnership") is a type of entity that provides one partner, typically a Senior Family Member, with an annual fixed stream of cash flow in the form of a preferred interest, while providing another partner with the future growth in the form of common interests in a transfer-tax-efficient manner. Preferred Partnerships[52] are often referred to as "Freeze Partnerships" because they effectively contain or "freeze" the future growth of the preferred interest to the fixed rate preferred return plus its right to receive back its preferred capital upon liquidation (known as the "liquidation preference") before the common partners are entitled to anything. The preferred interests do not, however, participate in the upside growth of the partnership in excess of the preferred coupon and liquidation

[51] For excellent comprehensive discussions of preferred partnership planning, *see generally* Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35 Heckerling Inst. On Est. Plan. (2001). *See also* Paul S. Lee & John W. Porter, *Family Investment Partnerships: Beyond the Valuation Discount* (Sept. 2009), *available at* https://www.americanbar.org/content/dam/aba/events/real_property_trust_estate/joint_fall/2009/lee_family_investment_partnerships_outline_september2009.authcheckdam.pdf.

[52] For purposes of this outline, the term Freeze Partnership shall also refer to preferred freeze limited liability companies, unless specifically indicated otherwise.

preference, and all that additional future appreciation inures to the benefit of the common "growth" class of partnership interests, typically held by the younger generation or trusts for their benefit. Over time, assuming that the Freeze Partnership's assets are invested in such a way so as to outperform the required coupon on the preferred interest, the common interest will appreciate in value, thereby enabling future growth of the partnership (above the preferred coupon) to be shifted to the Junior Family Members that hold the common interests.

A Freeze Partnership is quite different than a single or same economic class "family limited partnership," in that it divides the partnership into two or more distinct economic classes, based upon each partner's particular preferences for more secure preferred "cash-flow" interests or more risky common "growth" interests. In the family context, a Freeze Partnership can provide a very useful vehicle to match the respective needs of different generational family members, in much the same way as those family members might orient their investments more heavily into equities or fixed income based upon their respective ages, cash-flow needs, risk tolerance and investment horizon.

In a typical application, a Freeze Partnership is created as a new entity, or perhaps an existing single economic class entity is recapitalized, as a result of which a Senior Family Member receives preferred interests in the Freeze Partnership. A Junior Family Member either contributes assets to the partnership in exchange for common interests (in the case of a capital contribution into a newly formed partnership), receives common interests in exchange for recapitalized common interests (in the case of a recapitalization), or perhaps the Senior Family Member initially owns both the preferred and the common interests and subsequently transfers (either by gift, sale or both) the common interests to the Junior Family Member.

The Senior Family Member's preferred interest in the Freeze Partnership will typically (but not always) be structured as a "qualified payment right" under Section 2701 to avoid a deemed gift being triggered upon a capital contribution of assets to the Freeze Partnership, upon a recapitalization or upon the subsequent transfer of the common interest to a Junior Family Member under the application of the "zero valuation" rule of Section 2701. This qualified payment right generally will be structured to provide that the Senior Family Member receives a fixed-percentage payment return on the preferred capital, payable at least annually and on a cumulative basis.[53] In addition, the Senior Family Member would also have a liquidation preference, so that when the Freeze Partnership is liquidated, the Senior Family Member will receive a return of capital before any return to the common interest holders of their capital.

Although the most straightforward Freeze Partnership application will often involve individuals as the preferred and common partners, in some cases trusts and/or other entities may be partners in these entities. In such case, where

[53] I.R.C. § 2701(c)(3)(A).

individual Senior Family Members and/or Junior Family Members have actual or beneficial ownership interests in these trusts or entities, a general "look through" type of analysis is applied to determine the proper way to structure a Freeze Partnership under complex attribution rules that exist with respect to trusts, estates, corporations and partnerships under the Treasury Regulations promulgated under Section 2701.

B. Gift Tax Formation Issues

There are various issues that must be considered in connection with the formation of a newly created entity or the restructuring of an existing entity into a Freeze Partnership. The most notable issue is Section 2701, which generally can result in a deemed gift upon a "transfer" by a Senior Family Member's in connection with a Freeze Partnership in which he or she retains senior equity interests, unless very specific requirements are satisfied with respect to the Senior Family Member's preferred interest. A "transfer" that can potentially trigger a deemed gift under Section 2701 is broadly defined and includes not only traditional gift transfers, but also capital contributions to new or existing entities, redemptions, recapitalizations or other changes in the capital structure of an entity.[54]

C. Structuring the Preferred Interest.

1. Qualified Payment Right

A Senior Family Member's preferred partnership interest is most typically, but not always, structured as a "qualified payment right" under Section 2701 to safeguard against the Senior Family Member's contribution of assets to the Freeze Partnership being considered a deemed gift under the Section 2701 "zero valuation" rule. The use of this "qualified payment right" structure will result in the Senior Family Member's retained preferred interest being valued under traditional valuation principles for gift tax purposes, and not under the unfavorable "zero valuation rule" of Section 2701.

This generally requires that the Senior Family Member's preferred interest be structured as a fixed percentage return on capital, that is payable at least annually and on a cumulative basis.[55] When a Senior Family Member retains a preferred interest that satisfies the requirements of a "qualified payment right," the Senior Family Member's preferred interest, or more accurately, the "distribution right" component of the preferred interest (that is, the right to receive distributions with respect to such equity interest) will not be valued at "zero" for gift tax valuation purposes,

[54] Treas. Reg. § 25.2701-1(b)(2)(i).
[55] I.R.C. § 2701(c)(3)(A).

determined under a subtraction method of valuation, but, rather, such distribution right will be valued under traditional valuation principles.[56]

In case the cash-flow is not sufficient to make the preferred payment in a given year, the Code provides that each preferred coupon payment can be made up to four years after its original due date and the payment will still be considered to be made on a timely basis.[57] The interest rate compounds should a payment go unpaid for an extended period, so the accrued interest amount can become substantial, but the deferral ability does nevertheless provide some flexibility.[58]

2. Liquidation Preference

In addition to being entitled to a preferred coupon payment, typically, the preferred interest would provide the Senior Family Member with a priority liquidation right, meaning that upon liquidation, Senior Family Member will receive a return of his or her capital before the common interest holders receive a return of their capital. Senior Family Member, however, will not receive any of the potential upside growth in the Preferred Partnership based on his, her or its preferred interest.[59] Anything in excess of the amount needed to pay the preferred coupon and liquidation preference will accrue to the benefit of the common interest holders (*i.e.*, child, or a trust for the child's benefit).

D. Subtraction Method of Valuation

If Section 2701 applies to a transfer, the value of an interest transferred to a Junior Family Member will be determined by subtracting from the value of all family held interests the value of the interest retained by the Senior Family Member. A deemed gift will occur from the Senior Family Member to the Junior Family Member to the extent of the value of all family held interests, less the value of any interests retained by the Senior Family Member, as determined under the Subtraction Method of valuation.[60]

E. Valuation of the Preferred Coupon

Even if the Senior Family Member's preferred interest is properly structured to avoid the "zero value" deemed gift rule under Section 2701, there are still other gift tax issues to consider under traditional gift tax principals. Properly structuring the frozen preferred interest merely avoids the distribution right component of the

[56] Treas. Reg. § 25.2701-2(a)(2).

[57] I.R.C. § 2701(d)(2)(C).

[58] I.R.C. § 2701(d)(2)(A)(i).

[59] Typically, the Senior Family Member will also retain at least a 1% common interest to ensure that his or her preferred interest is not recharacterized as debt. Such common interest would participate by its terms in any upside experienced by the Freeze Partnership.

[60] Treas. Reg. § 25.2701-1(a)(2).

Senior Family Member's preferred interest being valued at zero, under the Subtraction Method of valuation, for purposes of determining whether and to what extent a deemed gift has been made to Junior Family Members in connection with the transfer. However, there may still be a partial gift under traditional valuation principals if the Senior Family Member's retained preferred coupon is less than what it should be when measured against an arm's-length transaction. For example, if the Senior Family Member's retained coupon under the partnership agreement is a 5% coupon but a 7% return is determined to be required to equal par, then a deemed gift has still been made by the Senior Family Member to the extent of the shortfall in value, despite the fact that the preferred interest is structured to not violate Section 2701; albeit such would not be as dramatic a gift as would occur if Section 2701 is violated and the "zero value" deemed gift rule is triggered.

Vital to arriving at the proper coupon rate is the retention of a qualified appraiser to prepare a valuation appraisal to determine the preferred coupon required for the Senior Family Member to receive value equal to par for his or her capital contribution. In preparation of the appraisal, the appraiser will typically take into account the factors set forth by the IRS in Revenue Ruling 83-120.[61] The primary factors indicated are:

1. Comparable preferred interest returns on high-grade publicly-traded securities.

2. The Freeze Partnership's "coverage" of the preferred coupon, which is the ability to pay the required coupon when due, and its coverage of the liquidation preference, which is its ability to pay the liquidation preference upon liquidation of the Freeze Partnership, will impact the required coupon.

    a) Generally, a higher percentage of the Freeze Partnership interests being preferred interests, and correspondingly less common interests, puts greater financial pressure on the Freeze Partnership's ability to pay the coupon on time; this translates to weaker coverage of the coupon, and thus greater risk, and ultimately a higher required coupon to account for this greater risk.

    b) Conversely, a Freeze Partnership that has a higher percentage of common interests relative to preferred would provide stronger coverage which would result in lower risk and consequently a lower required coupon. A lower coupon may be more desirable from a wealth transfer standpoint as growth above the lower coupon will shift to the younger generation owning the common interest.

3. Valuation discounts and other relevant factors.

[61] Rev. Rul. 83-120, 1983-2 C.B. 170.

F. Lower of Rule

Even if the preferred interest is structured as a qualified payment right, it is critical that no “extraordinary payment rights” be retained by the Senior Family Member, in order to avoid the “lower of” rule. These include discretionary rights, such as puts, calls, conversion rights and rights to compel liquidation, the exercise or non-exercise of which affects the value of the transferred interest.[62] Inadvertently retaining an extraordinary payment right along with a qualified payment right could still result in a deemed gift upon the Senior Family Member’s capital contribution under the “lower of” rule, which essentially requires that the preferred interest be valued not at the determined value of the qualified payment right, but based upon the “lower of” the qualified payment right and any extraordinary payment rights, which could potentially be lower, perhaps significantly lower (for instance if the preferred interest contained a put right at a value that is lower than the value of the qualified payment right).[63]

G. Avoiding the Preferred Equity Interest Being Recharacterized as Debt

One issue to be considered is whether the IRS could assert that preferred interests should be recharacterized as debt, rather than as equity in the Freeze Partnership. This is largely a facts and circumstances determination that has been developed through a large body of case law and which takes into account a number of factors (not necessarily related to preferred equity specifically, but rather, equity interests in general), such as:

"(i) the denomination of the interests as debt or equity,

(ii) the presence or absence of a fixed maturity date,

(iii) the provision of a fixed interest rate or a specified market interest rate,

(iv) the unconditional or contingent nature of any payment obligation,

(v) the source of the payments,

(vi) the right to enforce the payment,

(vii) participation in management,

(viii) voting rights, if any,

(ix) subordination to the rights of general creditors,

[62] Treas. Reg. § 25.2701-1(a)(2)(i).

[63] Treas. Reg. § 25.2701-2(a)(3).

(x) any securitization arrangements or the equivalent, such as the provision for a sinking fund,

(xi) thin or inadequate capitalization,

(xii) the extent to which the identity of the preferred interest holders overlaps with the identity of the non-preferred interest holders,

(xiii) the general creditworthiness of the partnership,

(xiv) the degree of risk that payments or distributions will not be made, and

(xv) the intent of the parties." [64]

Unfortunately, there is no black and white test as to what will constitute sufficient evidence that a preferred interest in a partnership is an equity interest. In order to help bolster the argument that the preferred interest is equity rather than debt, the preferred structure should take into consideration as many of the above factors as possible. In addition to considering the various factors above, the planner might consider "stapling" a participation feature to the preferred interest, thereby creating a hybrid interest to further support the position that the preferred interest is an equity interest in the Freeze Partnership.

H. Section 2036 Considerations with Preferred Partnerships

Given the Section 2036(a)(2) issues that currently exist with family limited partnership structures, it may be advisable for the Senior Family Member to own limited partnership or non-voting interests in the Freeze Partnership, rather than general partner or voting interests in order to address the Section 2036(a)(2) "retained control" issue.[65]

Additionally, from a "bad facts" or "implied understanding" Section 2036(a)(1) perspective, it is important to respect the formalities of the Freeze Partnership arrangement.[66] To bolster the legitimacy of the partnership structure, it is advisable to consider the following in the administration of the vehicle, such as:

[64] A compilation of these factors was originally included in Milford B. Hatcher, Jr., *Preferred Partnerships: The Neglected Freeze Vehicle,* 35 Heckerling Inst. On Est. Plan. 3 (2001). *See also Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); I.R.S. Gen. Couns. Mem. 38275 (Feb. 7, 1980).

[65] *See generally*, DOUGLAS K. FREEMAN & STEPHANIE G. RAPKIN, PLANNING FOR LARGE ESTATES 3-71 (LexisNexis 2016) (1985) (noting that the IRS could argue for inclusion under I.R.C. § 2036(a)(1) to the extent that a partner also acts as the managing or general partner of the Freeze Partnership and retains control over, or the power to designate who may enjoy, the property of the Freeze Partnership).

[66] *Id. See also Estate of Liljestrand v. Commissioner*, 102 T.C.M. (CCH) 440 (2011). In addition to a litany of bad facts that lead to an unfavorable result in *Liljestrand*, the Tax Court specifically noted the following with respect to the preferred payment:

> "As part of the partnership agreement, Dr. Liljestrand was guaranteed a preferred return of 14 percent of the value of his class A limited partnership interest. Dr. Liljestrand's class A limited partnership interest was valued at $310,000,

1. Make sure that the preferred coupon is paid to the Senior Family Member on time, as scheduled, and if a payment is late, the Senior Family Member should take steps to enforce payment.

2. Avoid making the preferred coupon match the anticipated partnership annual income.[67]

3. Section 2701 does permit a four-year deferral for a qualified payment right preferred coupon payment.[68]

4. A preferred payment can be satisfied through the issuance of a promissory note with a term no longer than four years.[69]

A Freeze Partnership is, economically, very different than the typical so-called "FLP" involved in the various cases decided under Section 2036(a)(1) because the parties from inception are entering into this type of transaction based upon an affirmative decision to split their economic arrangement into guaranteed preferred cash-flow on the one hand and upside growth potential on the other. The decision to receive preferred or common interests will be guided by the relative needs of the Senior Family Member and the Junior Family Member, based upon a risk versus reward analysis, taking into consideration each partners' relative investment horizon, appetite for risk and need for liquidity, much the same as those individuals would allocate their investment portfolios between fixed income and equities.

Thus, a decision to invest in a Freeze Partnership should itself provide a good argument that the "bona fide sale exception" to Section 2036 should be satisfied, because the decision is made in furtherance of a legitimate and significant non-tax purpose. In the case of the creation of a new Freeze Partnership, the Junior Family Member will be making a significant and independent capital contribution of previously existing assets into the Freeze Partnership in exchange for common interests. This is supportive of an argument that the Senior Family Member's transfer to the Freeze Partnership was made for "adequate and full consideration" and, therefore, falls within the statutory exception to Section 2036(a). To the extent that separate counsel is retained to represent the parties in connection with the negotiation and formation of the Freeze Partnership, and an independent

thus Dr. Liljestrand was guaranteed annual payments equal to $43,400. Moss-Adam's appraisal estimated the partnership's annual income would equal $43,000. We find this guaranteed return indicative of an agreement to retain an interest or right in the contributed property. . . Dr. Liljestrand received a disproportionate share of the partnership distributions, engineered a guaranteed payment equal to the partnership expected annual income and benefited from the sale of partnership assets. The objective evidence points to the fact that Dr. Liljestrand continued to enjoy the economic benefits associated with the transferred property during his lifetime."

[67] *Id.; Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) (noting that to avoid the reach of I.R.C. § 2036(a), a payment obligation must, among other things, "not [be] determined by the size of the actual income from the transferred property at the time the payments are made").

[68] I.R.C. § 2701(d)(2)(C).

[69] Treas. Reg. § 25.2701-4(c)(5). A debt obligation issued to satisfy a qualified payment must also bear compound interest from the due date of the qualified payment at the appropriate discount rate.

appraisal is obtained to determine the adequacy of the preferred coupon, could also be further support that the "bona fide sale exception" requirement has been met.

There should be a strong argument in favor of the bona fide sale exception to Section 2036 applying with respect to the initial contribution by Senior Family Member into the partnership in exchange for a priority cash flow preferred interest. Indeed, the economic arrangement of a preferred partnership is such that a bargain is being struck between the preferred and common partners such that the preferred partners receive a priority return but surrender any upside growth potential in favor of the common interest holders. Additionally, in the absence of particularly bad fact scenarios in which the preferred return has been reversed engineered so as to equal the partnership's anticipated income, a good argument exists that the preferred return should not constitute a "retained interest" under Section 2036(a).

In *Estate of Boykin,*[70] the Tax Court determined that the retention of non-voting preferred stock did not constitute a retained interest in connection with decedent's transfer of voting common shares to a trust for his children. The IRS argued that the decedent's retention of the non-voting preferred shares constituted his retention of "nearly all of the income from the transferred property," which it argued "constituted a retention of the enjoyment of the transferred voting common stock or a right to income from the transferred stock." The Tax Court rejected the IRS's argument, indicating that such ignored the legal distinction between the two separate classes of shares and the respective economic rights associated therewith. It stated:

> When decedent gave his voting shares to the trust for the benefit of his children… he transferred with the voting shares the right to receive all dividends and liquidating distributions that were subsequently declared on them. The only rights decedent retained were those accorded to the [Corporation's] nonvoting shares he retained, which were separate and distinct rights from the rights enjoyed by the voting shares that he transferred.[71]

Thus, in most cases, there should exist a strong argument that the holding of a preferred partnership interest should not constitute a transfer with a retained interest under Section 2036(a)(1).

I. <u>The 2701 Attribution Rules</u>

Various attribution rules apply under Section 2701 with respect to equity interests indirectly owned by way of entities such as partnerships, corporations and limited liability companies (LLCs), as well as through trusts.[72] In addition, these rules

[70] *Estate of Boykin v. Commissioner*, 53 T.C.M. 345 (1987).
[71] *Id* at 12.
[72] Treas. Reg. § 25.2701-6.

are further complicated by the fact that it is possible to have "multiple attribution" in which the rules determine an equity interest to be owned by different people for purposes of Section 2701. In such case, certain "tie-breaker" rules apply, which set forth ordering rules as to whom will be attributed ownership of a particular interest depending upon the particular generational assignment of certain individuals as well as whether the equity interest in question is a senior interest or a subordinate interest. Given the complexity of these rules and how seemingly insignificant variations in the facts can lead to different conclusions, it is critical that a Section 2701 analysis include proper consideration of these rules.

1. <u>Entity Attribution Rules</u>

The attribution rules under Section 2701 applicable to entities such as corporations, partnerships and LLCs are relatively straightforward. The rules apply a proportionate ownership in the entity type of approach, which generally attributes ownership of an equity interest owned by an entity as owned by the owner of the entity to the extent of his or her percentage ownership in the entity.[73] In the case of entities that hold interests in other entities, the attribution rules have provisions to apply a "tiered" attribution approach.[74] An example is provided in the Treasury Regulations as follows:

> *A, an individual, holds 25% by value of each class of stock of Y Corporation. Persons unrelated to A hold the remaining stock. Y holds 50% of the stock of Corporation X .... Y's interests in X are attributable proportionately to the shareholders of Y. Accordingly, A is considered to hold a 12.5% (25% x 50%) interest in X.*[75]

2. <u>Corporations and Partnerships</u>

In the case of interests in corporations, the attribution rules refer to the fair market value of the stock as a percentage of the total fair market value of all stock in the corporation.[76] In the case of partnerships and other entities treated as partnerships for federal tax purposes, the rules attribute to a partner interests based upon the greater of a partner's profit percentage or capital percentage.[77] For example, if a partner X makes a capital contribution of 10% of the partnership's assets and receives a 25% profits interest, and partner Y contributes 90% of the capital and receives a 75% profits interest, the attribution rules will treat X as having a 25% interest

[73] Treas. Reg. § 25.2701-6(a)(1). If the individual holds directly and indirectly in multiple capacities, the rules are applied in a manner that results in the individual being treated as having the largest possible total ownership. *Id.*

[74] *Id.*

[75] Treas. Reg. § 25.2701-6(b), *Ex.* 1.

[76] Treas. Reg. § 25.2701-6(a)(2).

[77] Treas. Reg. § 25.2701-6(a)(3).

and B as having a 90% interest in the Partnership; in each case the greater of the profit or capital percentage for each partner.

3. Trust Attribution Rules

The attribution rules under Section 2701 with respect to trusts are not as straightforward as the entity attributions rules. This is because there are different sets of attribution rules that can apply and can result in multiple attribution, as well as a set of "tie-breaker" rules that can also apply.

A proper analysis of the trust attribution rules often involves a multi-step process. First, one must proceed through the so-called "basic" trust attribution rules. Then, if the trust at issue is recognized as a grantor trust under Section 671 *et seq.*, one must also consider the "grantor trust" attribution rules, followed by further analysis under the "tie-breaker" or "multiple attribution" ordering rules, which calls for an examination of both the grantor's and the beneficiaries' generational assignments and a determination regarding whether the trust's equity interest is subordinate or senior. When parsing through these rules it becomes apparent that seemingly negligible changes in any of the foregoing factors can produce quite different results under the trust attribution rules and, in turn, the Section 2701 analysis.

a) The "Basic" Trust Rules

It is often difficult to express a trust beneficiary's interest in a trust with any degree of certainty; especially if there are multiple beneficiaries or if its trustees have been given substantial discretion with respect to distributions or other decisions affecting the beneficiaries' interests in the trust. In this sense (and many others), trusts are unlike entities where ownership percentages are more often readily determinable. This distinction is one of the underlying policy rationales for the above-referenced "basic" trust attribution rules, which generally provide that a person has a beneficial interest in a trust whenever the person may receive distributions from the trust in exchange for less than full and adequate consideration.[78] The basic rules also attribute the trusts equity interests among its beneficial owners to the extent that they may each receive distributions from the trust, and based on a presumption that trustee discretion will be exercised in their favor to the maximum extent permitted.[79]

(1) There is one exception to this rule: the equity interest held by the trust will not be attributed to a beneficiary who cannot receive distributions with respect to such equity

[78] Treas. Reg. § 25.2701-6(a)(4)(ii)(B).

[79] Treas. Reg. § 25.2701-6(a)(4)(i). These rules generally apply to estates as well, but for ease of discussion, the analysis herein will refer only to trusts.

interest, including income therefrom or the proceeds from the disposition thereof, as would be the case, for example, if equity interests in the entity are earmarked for one or more beneficiaries to the exclusion of the other beneficiaries.[80]

(2) Ownership of the interest may be attributed to a beneficiary, even where the trust instrument states that he or she cannot own it or receive dividends or other current distributions from it, if he or she may receive a share of the proceeds received from its future disposition. Indeed, the Treasury Regulations provide that a trust's equity interest may be fully-attributed to its remainder beneficiaries.[81] A single equity interest owned by a discretionary trust could, therefore, be 100% attributable to *each* of its beneficiaries if only the "basic" trust attribution rule was considered. However, the above-mentioned grantor trust attribution and multiple-attribution ordering rules may very well modify this result in some cases, as is further discussed below.

b) The Grantor Trust Attribution Rules

The grantor trust attribution rules attribute the ownership of an equity interest held by or for a "grantor trust" to the substantial owner(s) (or "grantor(s)") of such grantor trust.[82] Thus, a grantor of a grantor trust will also be considered the owner of any equity interest held by such trust for purposes of the Section 2701 analysis. However, if a transfer occurs which results in such transferred interest no longer being treated as held by the grantor for purposes of the grantor trust rules, then such shall be considered a transfer of such interest for purposes of Section 2701.[83]

c) The Multiple Attribution Rules

If the "basic" and "grantor trust" attribution rules are both applied, ownership of an equity interest in an entity owned by a trust may often be attributable to the grantor *and* one or more beneficiaries of the same trust. To resolve such situations, one must look to the "tie-breaker" or "multiple attribution" rules. These rules resolve such situations by application of a rule that orders the interests held and thereby determines how ownership should be attributed between the grantor, other persons and/or different beneficiaries. However, the way in which this ordering rule is applied will vary depending on whether the equity interest at issue is senior or

[80] *Id.*

[81] *Id.*

[82] Treas. Reg. § 25.2701-6(a)(4)(ii)(C).

[83] Treas. Reg. § 25.2701-1(b)(2)(C)(1).

subordinate, and the status of particular persons in relation to the Transferor.

(1) More specifically, if the above rules would otherwise attribute an "Applicable Retained Interest" to more than one person in the group consisting of the Transferor and all "Applicable Family Members," the multiple-attribution ordering rules re-attribute such Applicable Retained Interest in the following order:[84]

(a) to the person whom the grantor trust attribution rules treat as the holder of the Applicable Retained Interest (if the trust is a grantor trust);

(b) to the Transferor of the Applicable Retained Interest;

(c) to the spouse of the Transferor of the Applicable Retained Interest; or

(d) pro rata among the Applicable Family Members.

(2) By contrast, if the above rules would otherwise attribute a "subordinate equity interest" to more than one person in the group consisting of the Transferor, all Applicable Family Members and "members of the Transferor's family," the multiple-attribution ordering rules attribute such subordinate equity interest in the following order:[85]

(a) to the transferee of the subordinate equity interest;

(b) pro rata among members of the Transferor's family;

(c) to the person whom the grantor trust attribution rules treat as the holder of the subordinate equity interest (if the trust is a grantor trust);

(d) to the Transferor of the subordinate equity interest;

(e) to the spouse of the Transferor of the subordinate equity interest; or

(f) pro rata among the "Applicable Family Members" of the Transferor of the subordinate equity interest.

[84] Treas. Reg. § 25.2701-6(a)(5)(i).
[85] Treas. Reg. § 25.2701-6(a)(5)(ii).

(3) The distinction between the two sets of ordering rules appears to be motivated by two goals: (1) maximizing the chance that ownership of an Applicable Retained Interest will be attributed to a Transferor (or related parties grouped with the Transferor for Section 2701 purposes); and (2) maximizing the chance that ownership of a subordinate equity interest will be attributed to a transferee (or younger generations of the Transferor's family). The net result in both cases is an increase in the likely applicability of Section 2701.

J. Selected Income Tax Issues

Structuring a Freeze Partnership requires balancing competing factors from an income tax and transfer tax perspective. In drafting the provisions relevant to the preferred coupon, it is necessary to balance the following income tax and transfer tax concepts, which do not necessarily overlap smoothly:

1. Generally

In addition to the Section 2701 gift tax issues, and the estate tax issues mentioned above, partnership income tax issues must be considered in connection with the formation of the partnership to protect against the recognition of gain as a result of the contribution of assets into the Freeze Partnership.

2. Diversification

In the case of partnership assets consisting of securities there should be no recognition of gain as a result of the capitalization of the partnership if no "diversification" occurs under Section 721(b) as a result of a partner's capital contribution.[86] Accordingly, if both partners already have diversified portfolios,[87] then the contribution by them of their portfolios into the Freeze Partnership should not result in gain under the Section 721(b) diversification rule.

[86] More specifically, I.R.C. § 721(b) provides that gain or loss will be recognized on the contribution of property to a partnership if the partnership would otherwise be considered an "investment company" within the meaning of I.R.C. § 351(e) if the partnership were a corporation. In such an event the inside basis of such securities is equal to their fair market value at the time of the contribution. I.R.C. § 723.

[87] A partner's portfolio generally will be considered to be diversified if (i) the securities of one issuer do not constitute more than 25% of the contribution, and (ii) the securities of five or fewer issuers do not constitute more than 50% of the contribution. I.R.C. § 368(a)(2)(F)(ii). While a complete analysis of the diversification rules is beyond the scope of this outline, the Treasury Regulations provide detailed mechanical rules that should if a concern regarding diversification is present.

3. Investment Company

Alternatively, if at least 20% of the partnership assets consist of real estate or other assets other than readily marketable securities, this too would avoid recognition of gain as a result of the capitalization.[88]

4. *De Minimis* Exception

Under the so-called *de minimis* exception, if one of the partners contributes assets that are "insignificant" in amount as compared to the total assets of the partnership, the contribution of those assets does not result in diversification.[89] Although an example in the Treasury Regulations indicates that a contribution of less than 1% would be insignificant, private letter rulings have determined that up to a 5% contribution could be considered insignificant.[90]

5. "Disguised Sale" Rules

The Treasury Regulations under Section 707 establish a presumption that a "disguised sale" exists any time a member contributes "built-in gain" property to an LLC or partnership and cash or other property is distributed to such contributing member within two years of the contribution.[91] If a disguised sale is considered to occur, the contributing member is deemed (for income tax purposes) to have sold all or part of the built-in gain property contributed (measured by the cash received versus the total value of the property contributed by the member).

A disguised sale generally occurs if, based on all of the facts and circumstances (i) the distribution would not have been made but for the contribution of property to the partnership, and (ii) the distribution is not dependent on the entrepreneurial risks of the partnership.[92] The Treasury Regulations, however, provide an exception to disguised sale treatment for preferred returns where payments to the contributing member are "reasonable" and the facts do not "clearly establish" that the distribution is part of a sale.[93] The Treasury Regulations further provide a safe harbor, deeming a preferred payment "reasonable" if the preferred payment does not exceed (i) the member's unreturned capital in the partnership at the beginning of the year multiplied by (ii) 150 percent of the highest applicable federal rate.[94] This safe harbor notwithstanding, in light of the

[88] Treas. Reg. § 1.351-1(c)(1)(ii); Treas. Reg. § 1.351-1(c)(2), (3).

[89] Treas. Reg. § 1.351-1(c)(5).

[90] *See, e.g.*, PLRs 9451035, 200006008.

[91] Treas. Reg. § 1.707-3(c)(1).

[92] Treas. Reg. § 1.707-3(b)(1)(i), (ii).

[93] Treas. Reg. § 1.707-4(a)(2).

[94] Treas. Reg. § 1.707-4(a)(3)(ii).

historically low interest rates and the valuation factors discussed above, it is extremely likely, in light of the factors set forth in Revenue Ruling 83-120, that the valuation of the preferred coupon will exceed the regulatory safe harbor. As such, structuring a preferred partnership where the contributing partners are different taxpayers requires reconciling these two seemingly incompatible sets of rules.

Granted, when the 150% safe harbor for "reasonable" preferred returns was introduced in 1992, the highest applicable federal rate was 7.89%, meaning a preferred coupon as high as 11.83% could fall within the regulatory safe harbor. The potential abuse the safe harbor was attempting to address was one in which the preferred payment was *too high* (and therefore, not reasonable as a preferred payment, but rather more resembling a disguised sale), rather than *too low*. The current interest rate environment is at an unprecedented and historic low. This is likely something that was simply not envisioned at the time of the introduction of the reasonable payment safe harbor, and the incompatibility between the Section 707 and Section 2701 rules is likely something that was never anticipated, and even today is not fully appreciated by many practitioners.

a) Safe Harbor Approach with Qualified Payment Right Election

One approach to mitigating the risk of a disguised sale could be to structure the preferred coupon so as to restrict the payment of the preferred return for the first two years to not exceed 150% of the highest applicable federal rate, followed by a make-up payment in the third year in order to "true up" the preferred partner to the preferred coupon amount required for the first two years.[95] However, while such a provision addresses the disguised sale rules, it is in direct conflict with the transfer tax requirement that the coupon be payable annually from the Freeze Partnership to the preferred interest holder (assuming the preferred coupon will be structured as a Qualified Payment Right under Section 2701). To address this issue, one could structure the preferred coupon to fall within the reasonable payment safe harbor, but intentionally not satisfy the requirements of a Qualified Payment Right, and instead make an election to treat the preferred interest as if it were a Qualified Payment Right on a timely filed gift tax return.[96]

b) Alternate Safe Harbor Approach

An alternative safe harbor to the reasonable payment is available for operating cash flow distributions, which are not presumed to be disguised

[95] Treas. Reg. § 1.707-4(c) specifically provides that a guaranteed payment or preferred return that is presumed not to be a disguised sale by reason of the safe harbor does not lose the benefits of such presumption merely because it is retained for distribution in a future year.

[96] I.R.C. § 2701(c)(3)(C); Treas. Reg. § 25.2701-2(c).

sales unless the facts and circumstances clearly suggest otherwise.[97] An operating cash flow distribution is a transfer of money by a partnership to a partner that does not exceed the partnership's net cash flow from operations, multiplied by the lesser of (i) the partner's percentage interest in partnership profits for the tax year in question, or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.[98] This approach may permit practitioners to more readily structure the preferred coupon in a manner that avoids classification as a guaranteed payment, which could provide certain advantages from an income tax perspective.[99] Care should be taken if adopting this approach to confirm that the partnership complies with the technical requirements of both the operating cash flow safe harbor and the Qualified Payment Right under Section 2701, including possibly making a protective Qualified Payment Right election.

c) Non-Safe Harbor Reasonable Payment Approach

Failure to satisfy the disguised sale regulatory safe harbor does not necessarily mean that a preferred payment is not "reasonable;" rather, it simply means that the safe harbor cannot be relied upon. Given that the rate of return is being determined by an independent appraisal to reflect a market rate of return, presumably based upon the IRS' articulated valuation factors, as set forth in Revenue Ruling 83-120, a good argument should exist that the preferred payment should be reasonable and, thus, the facts do not "clearly establish" that the payment of the preferred return is part of a disguised sale.

d) Factors to Consider

Based on the relative tax cost associated with failing to satisfy the Section 2701 valuation rules, as compared to the income tax consequences of triggering a disguised sale (which would be offset at least somewhat by an accompanying basis increase), a balancing of the relative risks will need to be undertaken to determine whether taking on the risk of disguised sale treatment is preferable to bearing the risk of a deemed gift under Section 2701. For instance, if the property to be contributed has significant appreciation such that triggering the disguised sale rules could have a larger income tax impact, perhaps relying upon the "safe harbor" approach coupled with a Qualified Payment Right election might be advisable. If instead, the contributed assets have a relatively high basis such that the consequence of triggering the disguised sale rules might be less, then the position that the preferred payment is a reasonable one, albeit outside of

[97] Steven B. Gorin, STRUCTURING OWNERSHIP OF PRIVATELY-OWNED BUSINESSES: TAX AND ESTATE PLANNING IMPLICATIONS 215 (July 5, 2016), available by email at sgorin@thompsoncoburn.com.

[98] Treas. Reg. § 1.707-4(b)(2).

[99] Gorin, *supra* note 100, at 215.

the safe harbor, might be an acceptable risk, and one that avoids needing to make a Qualified Payment Right election.

6. Guaranteed Payments

Qualified Payment Rights are sometimes structured as guaranteed payments under Section 707(c) to take advantage of an exception of such payments from the zero valuation rule of Section 2701.[100] Broadly speaking, a guaranteed payment is a payment made by a partnership to a partner for services or for the use of capital to the extent such payments are determined without regard to the income or profits of the partnership.[101] In some circumstances, the IRS might attempt to argue that the preferred coupon is debt, rather than equity, because the payment of the guaranteed payment is fixed in both time and amount and is not dependent on the entrepreneurial success of the partnership; however, unlike debt, guaranteed payments need not actually be made when earned. Indeed, in most cases, the payment of a guaranteed payment from a partnership is deferred until sufficient liquidity is available to make the payment.

Conversely, it may sometimes be preferable to avoid structuring the preferred coupon as a guaranteed payment, because guaranteed payments are generally taxable to the recipient of the partner as ordinary income, regardless of whether the partnership has sufficient liquidity to actually make the payment.[102] A partnership making guaranteed payments is eligible for an offsetting deduction under Section 162(a). However, the deduction for the payment of guaranteed payments is subject to various limitations that may result in income inclusion for the preferred interest holder without the ability of the partners to currently deduct the full value of the guaranteed payment.[103]

To structure the preferred coupon in a manner that avoids guaranteed payments status, it is typically necessary to condition the payment of the preferred coupon on partnership profits.[104] As this structuring decision can arguably remove the preferred coupon from the statutory definition of a Qualified Payment Right under Section 2701, structuring the preferred coupon in this manner is often done in tandem with a Qualified Payment Right election.

[100] Treas. Reg. § 25.2701-2(b)(4)(iii).

[101] I.R.C. § 707(c).

[102] *But see*, Andrew Kreisberg, *Guaranteed Payments for Capital: Interest or Distributive Share?*, TAX NOTES, July 4, 2011.

[103] Depending on the characterization of the guaranteed payment, the partnership may be entitled to either fully deduct the guaranteed payment under I.R.C. § 162(a), or may be required to capitalize the payment in accordance with I.R.C. § 263.

[104] Because qualification as a guaranteed payment requires that the amount be payable without regard to partnership profits or income, conditioning the payment of the preferred coupon on the partnership having sufficient profits would likely disqualify the payment under I.R.C. § 707(c).

K. REVERSE FREEZE PARTNERSHIP

1. General

A "Reverse Freeze Partnership" is conceptually similar to a Freeze Partnership in that the entity can provide an effective means of shifting assets between different partners, based upon relative needs and risk tolerance. However, the economics with this type of vehicle are "reversed." Thus, instead of the Senior Family Member holding the preferred interest, as in the Freeze Partnership, the Senior Family Member retains the common "growth" interest and transfers the preferred "frozen" interest to the Junior Family Member, or perhaps these interests are received in connection with the initial capitalization of the Reverse Freeze Partnership. This can have the potential to provide fixed cash flow to the Junior Family Members in the form of preferred interests.

2. Section 2701 Not Applicable

The use of a Reverse Freeze Partnership is attractive because, unlike a forward Freeze Partnership, it is generally not subject to Section 2701, which allows for greater flexibility in structuring the preferred payment. This is because in a Reverse Freeze Partnership, the Senior Family Member holds a "subordinate interest" in the form of the common interest, which is an exception to the Senior Family Member's interest from being a "distribution right" subject to the zero valuation rule under Section 2701.[105] In such case, however, it is critical that the Senior Family Member does not hold any Extraordinary Payment Rights in connection with the common interests, as such rights could still be valued at zero under Section 2701, even in the case of a Reverse Freeze Partnership.[106]

3. Valuation Considerations

As with the forward Freeze Partnership, it is necessary to obtain an appraisal of the preferred interest to confirm that an adequate coupon percentage is being paid to the preferred interest holders. If the ratio of preferred versus common used in structuring the Reverse Freeze Partnership is higher such that it effectively increases the entity's preferred payment obligations, and consequently diminishes the strength of the entity's coupon coverage (thereby making the preferred interest a much riskier investment), such would increase, perhaps significantly under the factors set forth in Revenue Ruling 83-120, the coupon required to be paid to the Junior Family Members as the preferred interest holders. In the Reverse Freeze Partnership scenario, the preferred interest payment would increase the value that would have to be paid to younger generations (in the form of a much higher preferred coupon) and, consequently, may contain the extent of the future growth in the value of the common interests held by the Senior Family Members. If the entity does not grow at least at the rate of the preferred coupon required to be paid

[105] Treas. Reg. § 25.2701-2(b)(3)(i).

[106] Treas. Reg. § 25.2701-2(b)(2).

to the younger generation, it is possible that the common interests will actually decrease in value over time, which would reduce the asset value of the Senior Family Member; if the entity grows above the preferred coupon then that growth will inure to the benefit of the common interests owned by the Senior Family Member, thereby increasing his or her estate.

Deconstructing Different Flavored Freezes – A Comparison of Popular Estate Freeze Techniques

N. Todd Angkatavanich

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Why Engage in Wealth Transfer "Freeze" Planning?

- Contain the value of assets in Grantor's taxable estate.
- Protect against possible future loss of valuation discounts.
- Shift future appreciation in asset to beneficiaries (perhaps in a multi-generational GST Exempt manner).
- Provide cash-flow to Grantor in the form of promissory note payments, annuity payments or "frozen" preferred coupon payments.

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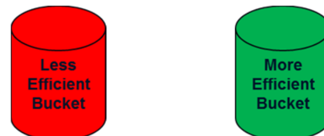
Freezes Generally

- "Freezes" contain asset growth in one less efficient "bucket" and shift growth into more efficient one



- Divide economics so as to match cash-flow, investment horizon and risk/reward profile of different parties
- Trade more secure cash flow (GRAT, Promissory Note, Preferred Coupon) vs. upside growth potential

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Types of Freezes

- Gifts
- GRATs
- Sales to "Defective" Grantor Trusts
- Preferred Partnerships

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Grantor Retained Annuity Trusts

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Grantor Retained Annuity Trust – The Basics

- A GRAT is a **trust planning technique** authorized under Code Section 2702.
- It involves making a **transfer of a future interest** in trust for the benefit of the beneficiaries (typically the Grantor's children or trusts for descendants), with the Grantor **retaining a specified annuity interest** for a fixed term of years.
- Grantor's/Parent's **taxable gift is reduced** by the present value of the annuity interest he/she retains in the transferred asset – so that under the "subtraction method" of valuation, only the value of the **remainder interest is subject to gift tax.**
- If Grantor/Parent outlives the selected annuity term, then the remaining assets (including appreciation) are removed from his/her taxable estate.

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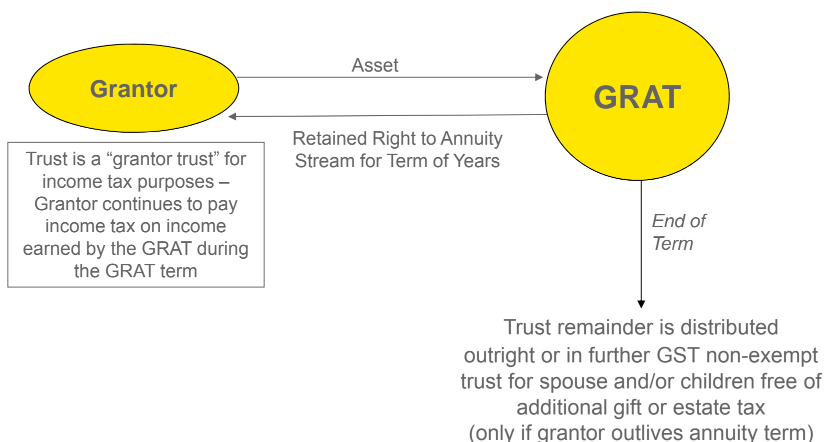
GRAT Basic Illustration



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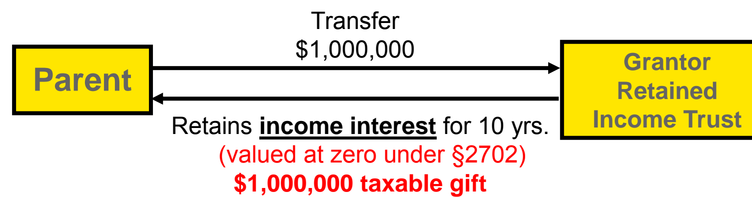
General "Zero Value" Rule under Section 2702

- A transfer into an irrevocable trust f/b/o a "member of the family" when the Grantor retains an interest will be fully subject to gift tax (unless an exception applies).
- No "credit" is given for the Grantor's retained interest (valued at "zero" for gift tax purposes under subtraction method).

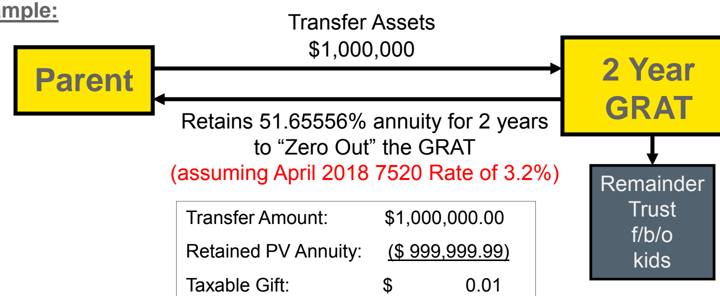
Example of Retained "Income Interest" Valued at Zero:



"Zeroed-Out" GRAT

- A GRAT is an exception to the zero valuation rule under Section 2702 when the Grantor's retained interest is a "Qualified Interest." Grantor gets "credit" for the PV of the annuity.
- If Parent's retained annuity is large enough for her retained interest to nearly equal the value of the transfer into the GRAT then parent's taxable gift will be close to zero.
- At end of annuity term, the value (if any) of the remaining GRAT assets above the annuity payments passes gift tax free to remainder beneficiaries.

Example:



Transfer Amount:	$1,000,000.00
Retained PV Annuity:	($ 999,999.99)
Taxable Gift:	$ 0.01

GRAT Technical Requirements

- Annuity must be a fixed amount (in dollars, percentage or fraction) paid at least annually to Parent/Grantor.
- Annuity amount (in percentage or dollar amount) may be increased up to 20% each year. This allows more assets to remain in the GRAT in the early years to allow trust's assets to grow.
- Annuity amount adjusts for incorrect valuations.
- Annuity payment cannot be satisfied by payment of a debt obligation option or similar financial arrangement issued by the GRAT to Parent/Grantor.
- No additional contributions to GRAT permitted.
- No commutation (pre-payment) of annuity interest permitted.
- Annuity payments must be paid within 105 days of due date.

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GRAT Characteristics

Advantages

- Remove appreciating assets from the estate
- Shift capital appreciation above the annuity payments to remainder beneficiaries
- Provide annuity stream for set term of years
- Reduce taxable gift by present value of retained annuity stream
- Can be structured to nearly "zero-out" the taxable gift of the remainder interest
- Statutorily blessed under Section 2702
- Valuation adjustment feature
- Grantor pays income tax on GRAT's income – equivalent of a tax-free gift

Other Factors

- Annuity payments are added to grantor's estate
- A portion or all of GRAT's assets are included in grantor's estate if grantor dies before annuity term ends
- Violation of strict rules can have harsh results
- Cannot receive additional contributions
- To be successful, asset needs to appreciate at a rate greater than the IRS discount rate (§7520 Rate) in effect for the month of the transfer (e.g., April 2018 = 3.2%)
- Beneficiaries receive a carryover basis in property if grantor survives the GRAT term
- Multigenerational planning is very difficult due to ETIP rule.

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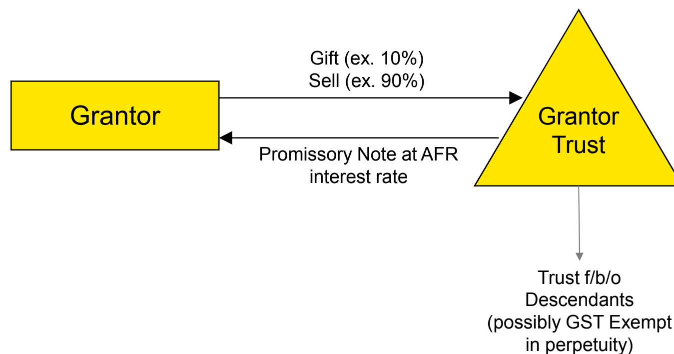
Sale to Intentionally Defective Grantor Trust (IDGT)

What is a Sale to an Intentionally "Defective" Grantor Trust?

Example:

- Parent/Grantor transfers assets (e.g. LP interests in an FLP) to a grantor trust
- Transfer consists of a gift of typically at least 10% of the total assets.
- Grantor makes a subsequent sale of the additional assets.
- Trust pays for the purchase component (ex. 90%) with a promissory note payable to the grantor.
- Transfers to grantor trust are "complete" for estate and gift tax purposes but disregarded for income tax purpose
  - Assets transferred to the grantor trust are not included in grantor's estate
  - Grantor pays trust's income tax – equivalent to tax-free gift
  - Grantor does not recognize gain on sale to trust and promissory note interest payments are not includible as income to grantor
- Planning Benefits:
  - Trust assets (and appreciation) excluded from Grantor's estate
  - Trust can be made GST exempt upon creation and therefore may provide "multi-generational" transfer tax protection

Gift/Sale to Grantor Trust Illustration



- Gift of up to $11.18M permitted by current unified credit
- Sale or loan of up to $100M @ AFR (April 2018 mid-term of 2.72%)

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Sale to an Intentionally Defective Grantor Trust

Advantages

- Leverage lifetime gift and generation-skipping transfer tax exemptions
- Freeze value of assets at value of unpaid note balance (if unpaid at death) for estate tax purposes
- GST-Exempt planning can be achieved
- Post-sale capital appreciation passes to heirs gift tax free (possibly GST exempt)
- No gain or loss is recognized by the seller at the time of sale to the trust
- Low Applicable Federal Rate to service the note:
  - Example: Loans made in April 2018 - Mid-term AFR of 2.72%
- Grantor pays income taxes for trust

Other Factors

- Irrevocable gift
- Any unpaid portion of note at seller's death included in the gross estate for estate tax purposes
- Income tax consequences at Grantor's death if an unpaid note?
- Valuation uncertainty risks on sale and gift
- Possibly vulnerable to challenge as gift with retained interest
- Risk of economic loss to purchasing trust

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Section 2701 and Karmazin

- TP created a partnership and sold LP interests to IDGT in exchange for promissory note. LP interests sold to trust were financed 100% by note.
- IRS argued that note was disguised equity, not debt.
- If promissory note is really equity and not debt, amount of taxable gift is value transferred minus value of qualified payment rights under the subtraction method of § 2701.

Karmazin v. Comm'r, T.C. Docket No. 2127-03 (settled).

Section 2701 and Karmazin

- While Karmazin was settled, the § 2701 argument remains a threat.
- If IRS can argue that promissory note received in connection with gift/sale transaction to grantor trust is disguised equity, and if common interests represented by LP interests are transferred to younger family members (or their trusts), then § 2701 could value note at zero and would cause gift of a deemed gift with respect to parent's retained interest.

Karmazin v. Comm'r, T.C. Docket No. 2127-03 (settled).

Section 2702 and Karmazin (and now Woebling)

- IRS argued - sale of the LP interest by the TP in exchange for note constituted a "transfer in trust" under §2702
- Under §2702, a retained interest has no value unless it is a "qualified interest"

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Section 2702 and Karmazin (and now Woelbing)

- The sold LP interest should be recharacterized as a gift to the IDGT, in exchange for a retained interest valued at zero, resulting in a taxable gift of all LP interests sold
- Estate of Woelbing - ultimately settled before trial.

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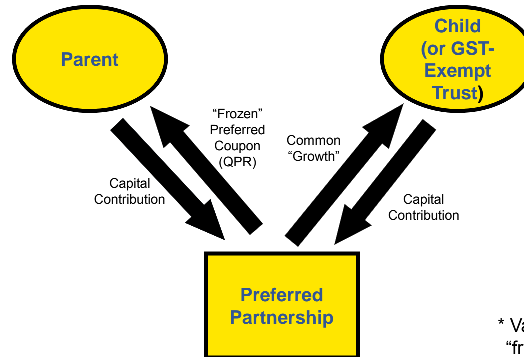
Planning Opportunities with Preferred "Freeze" Partnerships

Preferred Partnerships to Shift Value

- Division of partnership or LLC interests into preferred "Frozen" and common "Growth" interests
  - Preferred interests have priority to cash flow (in the form of a set percentage return) and liquidation proceeds, but a cap on upside potential
  - Common interests are subordinate to income and liquidation rights of preferred interests, but capture all residual growth of partnership or LLC
- If older generation/parent owns preferred interests and younger generation (or, better, GST exempt trust) owns common interests, there is a potential to contain or "freeze" the growth in value of parent's preferred partnership interests and shift growth (in excess of preferred coupon) to common interests.

Basic Preferred Partnership



* Value of Parent's interest "frozen" at value of initial contribution

* Parent retains predictable cash flow

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"Qualified Payment Right" ("QPR") – Statutory basis for most 2701 compliant preferred partnerships.

- Qualified Payment Right
  - Cumulative payment
  - Payable at least annually
  - At a fixed rate or at a rate bearing a fixed relationship to a specified market interest rate
- A preferred interest that is a QPR is valued under traditional valuation principals (not subject to "Zero Valuation").

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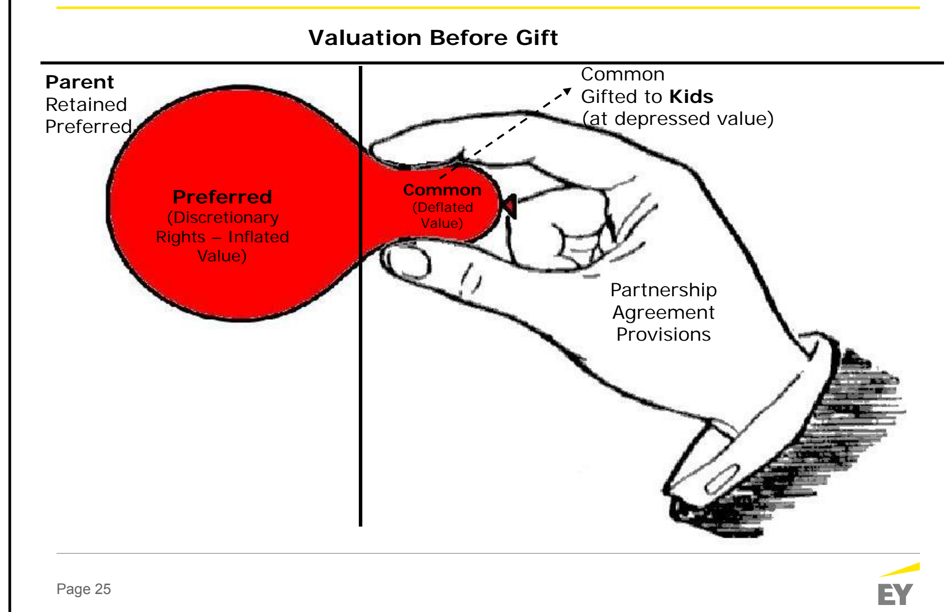
Pre-2701 Preferred Partnership Perceived Abuse



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IRC Section 2701 – Overview

- **Perceived Abuse** – Different generations work in concert to artificially minimize the value of assets transferred to younger generation.
- **Pre-2701 Transaction** – Older generation transfers interests in an entity (corporation or partnership) to members of younger generation while at the same time retaining certain types of interests in the same entity that soak up most of the value of the entity thus making the gifted interest worth very little.
- **What Section 2701 Can Do** – Cause the value of the gift to members of the younger generation to include the value of the interest retained by the older generation and in certain cases treat the value of the retained interest to be zero.
- **When Section 2701 Applies** – Any "transfer," which includes recapitalizations, capital contributions and changes in capital structure, if the older generation then has
  - senior distribution rights in a family controlled entity or
  - discretionary liquidation, put, call or conversion rights in any entity. (Retained rights that are mandatory and quantifiable typically are excluded.)

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Valuing The Preferred Interest

- QPR avoids "Zero Valuation" rule, but still must be valued
- Value of preferred interest should equal "par" to avoid partial deemed gift under traditional "indirect gift" theory.
- Rev. Rul. 83-120 factors:
  - Yield as compared to risk-adjusted market comparables
  - Coverage of coupon
  - Dissolution protection
  - Voting rights
  - Lack of Marketability
- De minimus Rule - junior equity interest (i.e., common interest) deemed to have a minimum value equal to at least 10% of the gross assets of the entity under the subtraction method of valuation.

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Section 2036 Considerations with Preferred Partnerships

- Preferred partnerships present similar risks as typical family limited partnerships
- Transferor should not retain control rights that might give rise to estate inclusion
  - Amend partnership agreement, control distributions, dissolve the partnership
- Special issues with respect to the preferred coupon
  - *Fidelity-Philadelphia Trust Co. v. Smith*
    - In the context of debt obligations, three-part test to avoid Section 2036: (i) promise must be a personal obligation of the transferee, (ii) obligation must not be specifically chargeable to transferred property, and (iii) size of payments must not be determined by the income generated by the transferred property
  - *Estate of Liljestrand v. Comm'r*
    - Decedent transferred almost all of his assets into a limited partnership, subsequently made gifts of limited partnership interests to trusts for his children
    - Among other bad facts, the preferred interest retained by the decedent was "engineered" such that it equalled the partnership's expected annual income
    - All assets of the partnership were included in the decedent's estate
  - But see *Estate of Boykin*
    - Preferred coupon is not necessarily a retained interest under Section 2036

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Section 2036 Considerations with Preferred Partnerships

- 2701 Compliant Preferred Partnership is "statutory" for gift tax purposes only
- Potential 2036(a)(1) retained interest argument for estate tax purposes
  - Bonafide Sale exception
  - Need proper valuation of preferred coupon at par. If less than par is it for "adequate and full consideration"?
  - Negotiation of separate and distinct economic interests.
- Potential 2036(a)(2) "control" – Strangi, Turner, Powell

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GRAT vs. Sale to Defective Grantor Trust vs. Partnership Freeze

GRAT	*Sale to Grantor Trust*	*Preferred Partnership Freeze*
Tax treatment most certain	Tax treatment less certain	Tax treatment more certain
Zero taxable gift possible	Some gift required	Possible gift
Annuity payment to grantor must be fixed (but may be structured to increase annually by up to 20%)	Note payments may be amortized or structured as interest-only with balloon (ex. 9 years, 15 years)	Preferred fixed and cumulative
Higher 7520 Rate (120% of AFR)	Lowest Rate: AFR Rate (mid-term)	Highest payout rate: Based off of Rev Ruling 83-120
Most mortality risk	Less mortality risk. But evolving 2036 argument as to Note	Less mortality risk Section 2036 considerations
GST Planning: No, generally due to ETIP	Multi-Generational Planning: Yes (Note: 90-year GST proposal)	Multi-Generational Planning: Yes (best with common interest)
Valuation Adjustment – If FMV of asset is adjusted	Valuation Risk – as to FMV of transferred asset	Valuation Risk – as to preferred coupon rate and as to value of capital contributions
Prior 2017 Greenbook (Obama Administration) proposed to limit the use of zeroed-out GRATs	Risk of sale recharacterization • Illusory debt • Section 2701 • Section 2702	Section 2701 considerations

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Tax Implications

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Grounded in commercial rather than statutory terms; not statutorily blessed • Based upon PLR 9535026 and 9436006 • Structured to be "complete" for transfer tax purposes but "defective" for income tax purposes • Initial sale does not trigger any capital gains tax consequences to the grantor • Consequences at death	• More certainty – Section 2701 compliant • To avoid a deemed gift, the preferred interest must be structured as a qualified payment or other 2701 compliant interest	• Section 2702 compliant GRAT allows the present value of grantor retained annuity to be subtracted from total value to determining value of the gift

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Gift required

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Generally requires a "seed" gift unless the trust has preexisting capital, so as to support the debt • The trust should have equity capital of at least 10% so as to support the debt (or guarantee instead)	• Parent typically sells or gifts the common "growth" interest to or f/b/o descendants while retaining the preferred "frozen" interest	• Zeroed-out GRAT: a gift of nearly zero can be achieved if the present value annuity equals the value of the transferred asset to determine the taxable gift • *Note, prior 2017 Greenbook (Obama Administration) proposed to limit the use of zeroed-out GRATs*

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Payments

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Payments set by the terms of the promissory note • Payable with interest at AFR rate for a period of time is either straight amortized or interest only payments with a balloon payment of principal (*i.e.* 9-year or 15-year) • No grace period for late payments. Failed payments may support argument that it is not true debt	• Section 2701(d)(2)(C) allows a 4 year grace period for "qualified payments" • Qualified payments can be made with a 4 year promissory note • Allows any payment made during the 4 year period to be treated as being made on the due date • Allows some cash flow flexibility	• Annuity payments must be fixed • But the annuity payments can be structured so that they increase by as much as 20% per year during the term of the GRAT • 105-day grace period

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Hurdle rate

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Interest at AFR rate (*i.e.,* 9-year, 15-year) • When interest rates are low, more attractive because any growth in the asset is more likely to out-perform the hurdle rate	• Appraisals determined by prevailing market rates and other factors and appraisal is required to determine the proper preferred coupon rate and other factors (See Rev. Ruling 83-120) • Tends to be a higher rate • If the client needs more cash this allows a higher payout	• Annuity payments to the Grantor is determined based upon 7520 rate • 120% of the midterm AFR (determined under section 1274) • Tends to be a higher rate than Sale to Grantor Trust

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Mortality Risk

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Conventional wisdom is that sold assets are not included in estate, however the unpaid note is included in estate • If the grantor dies during the term of the sale, the balance on the installment note not paid off at the time of death will be included in the grantor's estate • But the sold assets should not be included in the grantor's estate • If grantor dies before the note is paid in full then there may be adverse income tax implications • Some risk: Note the evolving 2036 argument that the promissory note itself constitutes a retained income interest in the assets	• Less mortality risk • Query, can Section 2036 apply? Best practice is to ensure capital contribution in exchange for preferred interest satisfies bona fide sale exception • When the preferred partner dies, the estate will receive a step-up in tax basis	• Grantor must outlive the trust term to remove the gifted assets from estate under Section 2036(a)(1) • If the grantor dies during the term of the trust then a portion or perhaps all of the remaining assets will be included in the grantor's gross estate • Series of short term "rolling" GRATs can be used • *Note, prior 2017 Greenbook proposals (Obama Administration) would have limited the usefulness of a GRAT including instituting a minimum 10 year annuity term and making the remainder interest have a value of greater then zero*

Risk Level

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Some risk • Valuation risk • If the investment return is not met then the gift tax exemption used to fund the trust will be lost • Argument that not true debt • Recharacterize note as a 2036 refund interest • Recharacterization of note argument 2701 2702	• Some risk • Section 2701 gift issues • Risk if the asset does not reach a growth rate in excess of the rate of return paid • 2036 Considerations • Income tax issue on formation	• No risk with a Zeroed-out GRAT if the investment return is not met (no loss of gift tax exemption) • If no growth, then most of of the assets will be return to the grantor in the annuity payment • Grantor is in the same Position

GST Implications

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• Is often structured to be GST Exempt • Grantor can allocate GST exemption on which the seed gift to the trust is reported • Sale portion also GST exempt	• Common "growth" interest can be held in a GST trust for the benefit of children, grandchildren and remote descendants • Possible because of the divided ownership between common and preferred ownership	• It is generally not possible to create GRATs with a multi-generational structure because of estate tax inclusion period (ETIP) rule • GRATs are excellent vehicles for transferring assets to the next generation but not so effective for multi-generational planning • Consider possible alternative approaches

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Valuation

Sale to Grantor Trust:	Preferred Partnership:	GRAT:
• If the value of the transferred assets exceed the note amount then the difference is a gift. Challenge with hard-to-value assets • Step transaction argument that seed gift and sold interest are a single transfer, so sale price cannot be full consideration • No regulatory safe harbor as there is with GRATs • Consider use of Defined Value Clause or Price Adjustment Clause to minimize risk	• Important to receive the proper valuation of the coupon rate to avoid a deemed gift • Revenue Ruling 83-120 provides guidance on the factors the IRS considers when relevant in determining the adequacy of the coupon.	• Section 7520 allows the annuity amount to be recalculated if the value of the initial trust is ever challenged. *See also* Regs. Sec. 25.2702-3(b)(2)

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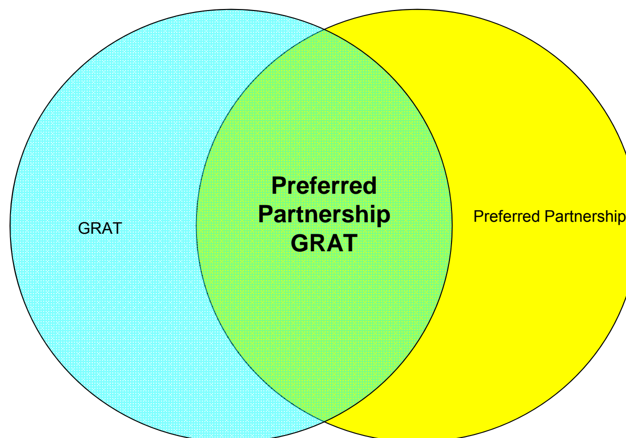
Combining Two Statutory Techniques GRAT and Preferred Partnership



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What the Preferred Partnership GRAT does?

- Permits GRAT planning with a way to allocate GST Exemption from inception (rather than at ETIP Termination).
- GST Exempt Growth (above the preferred coupon) occurs in GST Exempt Trust rather than in GRAT (GST Non-Exempt).
- Accumulation of assets in the GRAT (GST Non-Exempt) is contained to the "frozen" preferred coupon, which is used to fund GRAT annuity payments, and the preferred liquidation preference.
- Section 2036 inclusion of some or all of GRAT's assets is contained to preferred "frozen" interest.
- If Greenbook 10 year minimum becomes law, advantages are more pronounced.
- For a detailed discussion see: N. Todd Angkatavanich & Karen E. Yates, *The Preferred Partnership GRAT: A Way Around the ETIP Issue?*, 35 ACTEC J. 290 (2009).

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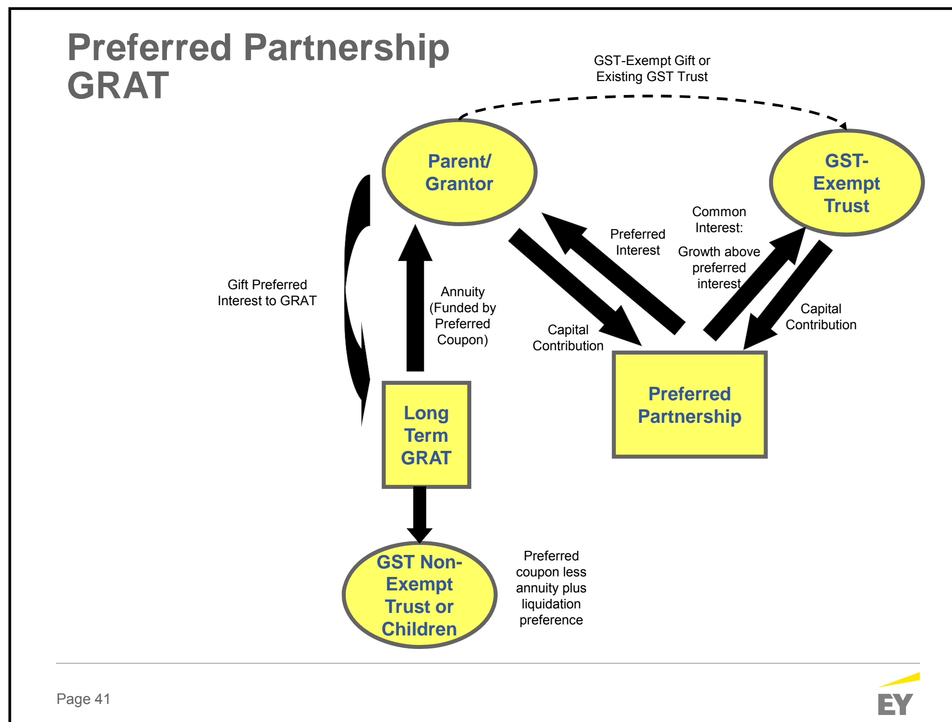

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The More Trustees the Merrier?
All About Directed Trusts

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THE MORE TRUSTEES THE MERRIER? ALL ABOUT DIRECTED TRUSTS

I. Introduction

A. Directed trusts are not new and, in fact, have become common place over the last decade.

B. In the early days of directed trusts, the purpose was to limit a trustee's power to sell specific trust assets without the consent or written direction of a person not serving as trustee. Today the limitations on a trustee's authority to deal with certain trust assets often affect all of the trustee's discretionary powers over the assets including voting decisions, management decisions, distribution decisions and other decisions previously solely within the realm of the trustee's discretion.

C. Directed trusts are popular because of the desire to structure specialized and complex objectives that may require a lack of diversification or investment in non-traditional or risky assets, including closely held businesses, limited liability company interests and oil and gas interests.[1]

D. These special and complex objectives require specialized knowledge and often conflict with the traditional fiduciary duties imposed on trustees. Many trustees are unwilling to subject themselves to the risk of potentially breaching these traditional limitations.[2]

E. One way to accomplish these objectives is through the use of a directed trust. In fact, trustees faced with the fiduciary duty to diversify trust assets and deal impartially with income beneficiaries and remainder beneficiaries welcome the ability to limit their liability through the use of directed trusts.[3]

F. The increased use of directed trusts has led to the enactment of directed trust statutes in some states while others rely on the UTC or Third Restatement of Trusts for implementation and administration of directed trusts.

G. There is no consistent vocabulary in practice to describe the person other than a trustee who holds a power in a directed trust. Common terms used include "trust protector", "trust adviser" and "trust director."

H. There is uncertainty in existing law about the fiduciary status of a nontrustee that has a power over a trust and about the fiduciary duty of a trustee with respect to actions taken or directed to be taken by the nontrustee.

[1] *See* Todd A. Flubacher, *Directed Trusts: Panacea or Plague*?, NAEPC Journal of Estate Tax Planning, September 2015.
[2] *See id*.
[3] *See* Michael M. Gordon, *Directed Trusts, Trust Protectors, Private Trust Companies and Other Bells and Whistles*, 10th Annual International Estate Planning Institutue, March 13, 2014.

II. Current New York Law

A. New York does not have a directed trust statute. Any attempt to create a directed trust in New York would be met with unpredictable results as evidenced by the case law.[4]

B. In a recent case, the court held that a directed trust was effective, but a later case held that it was not.

C. In *In re Estate of Rubin*, the decedent's Will named his son and daughter as co-executors but specified that, in the event of disagreement, they were to act as directed by two named individuals.

1. At the son's request, the two named individuals directed that he be given sole check-writing authority and management responsibility over five commercial properties.[5]

2. Rejecting the daughter's claim that the arrangement violated her rights as co-executor, the court held that "the designation of advisors…to make directives controlling the actions of the co-executors in any disputes is a valid limitation upon the powers of such executors."[6]

D. In *In re Rivas*, the corporate trustee objected to a direction by the Investment Advisory Committee formed under the governing instrument of a charitable trust to invest in the charitable donee's long-term investment pool.

1. The court held: [T]his Court cannot allow the proposed investment of the Helen Rivas Trust corpus, as such investment in the LTIP is contrary to the Agreement and the intent of the settlor, may give rise to an impermissible division of fiduciary loyalties among the majority of the Advisory Committee.[7]

2. The court held that this would also violate the Prudent Investor Act.

III. Directed Trust Laws in Other Jurisdictions

A. As discussed above, the primary issue raised by the use of a directed trust is the allocation of fiduciary duties to the various parties involved.

1. The duties imposed on a fiduciary require the fiduciary to act in good faith, trust, confidence and candor with respect to the beneficiaries of a trust.[8]

2. If the trust advisor/protector is not a fiduciary role, then what is it? If the beneficiaries become unhappy with the administration of a directed trust, who is

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[4] *See In re Estate of Rubin,* 143 Misc.2d 303, 540 N.Y.S.2d 944 (Sur. Ct., Nassau Co. 1989), *aff'd*, 172 A.D.2d 841, 570 N.Y.S.2d 996 (2d Dep't 1991); *In re Rivas*, 30 Misc.3d 1207(A), 958 N.Y.S.2d 648 (Sur. Ct., Monroe Co. 2011), *aff'd* 93 A.D.3d 1233, 939 N.Y.S.2d 918 (4th Dep't) 2012).

[5] 143 Misc. 2d at 303.

[6] *Id.* at 308.

[7] *In re Rubin*, 30 Misc.3d at 18.

[8] *See* Stephan R. Leimberg, Jonathan E. Gopman, Michael A. Sneeringer, *The Tools and Techniques of Trust Planning*, 1st Edition

responsible or liable? Does the directed trust structure provide enough recourse to the beneficiaries in the event of misconduct?

3. The clarification of the trust advisor/protector/trust director is critical for establishing the standard of care owed to the beneficiaries.[9]

B. In evaluating the laws in other states, four groups have emerged in the treatment of directed trusts.

1. States that have adopted UTC. Section 808(b) of the Uniform Trust Code either in whole or in part[10]:

a. Section 808(b) provides:

> If the terms of a trust confer upon a person other than the trustee of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power *unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty* that the person holding the power owes to the beneficiaries of the trust. [emphasis added]

b. Under the UTC, the directed trustee must act as directed. The trustee may only refuse to act as directed if the directed trustee believes that the directed action would contravene the trust terms or would cause a serious breach of fiduciary duty.

c. The comments to Section 808 further provides

> Powers to direct are most effective when the trustee is not deterred from exercising the power by fear of possible liability. On the other hand, the trustee does have overall responsibility for seeing that the terms of the trust are honored. For this reason, subsection (b) imposed only minimal oversight responsibility on the trustee. A trustee must generally act in accordance with the direction.[11]

d. Under this approach, the directed trustee still has a fiduciary responsibility and potential liability for deciding whether to follow the direction.

2. States that follow Section 185 of the Restatement (Second) of Trusts[12].

a. Section 185 of the Restatement (Second) of Trusts provides as follows[13]:

[9] *See id.*
[10] 20 states have adopted Section 808: Alabama, Arkansas, Florida, Kansas, Maine, Maryland, Massachusetts, Michigan, Mississippi, Montana, Nebraska, New Mexico, North Dakota, Oregon, Pennsylvania, South Carolina, Texas, Vermont, Virginia and West Virginia.
[11] Uniform Tr. Code, § 808 cmt.
[12] These states are Indiana and Iowa.
[13] Restatement (Second) of Trusts § 185 (1989); *see also* Restatement (Third) of Trusts §75 which provides:

If under the terms of the trust a person has power to control the action of the trustee in certain respects, the trustee is under a duty to act in accordance with the exercise of such power, unless the attempted exercise of the power violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power.

b. Under the Restatement, the trustee shall follow direction unless the exercise of the power "*violates the terms of the trust or is a violation of a fiduciary duty to which such person is subject in the exercise of the power*". [emphasis added]

c. Thus, the trustee continues to possess the fiduciary responsibility and liability for deciding whether to follow the direction.

3. States that have enacted directed trust statutes (or modified the UTC or Restatement) to provide stronger protection to the directed trustee.[14]

a. A subset of these states provide that a directed trustee has no duty or liability for complying with an exercise of a power of direction. These states include Alaska, New Hampshire, Nevada, and South Dakota.

1) The policy rationale for these "no duty" statutes is that duty should follow power. If a director has the exclusive authority to exercise a power of direction, then the director should be the exclusive bearer of fiduciary duty.

2) By placing the exclusive duty on a director, the duty owed to the beneficiary is not diminished.

3) A beneficiary's only recourse for misconduct by the trust director is an against the director for breach of the director's fiduciary duty to the beneficiary.

b. Other states that include Delaware, Illinois, Texas and Virginia, provide that a directed trustee is not liable for complying with a direction of a trust director unless by doing so the directed trustee would personally engage in willful misconduct.

1) Under this approach, the theory is that because the trustee is at the center of the trust, the trustee must bear at least some duty even if the trustee is acting under the direction of a director.

Except in cases covered by § 74 (involving powers of revocation and other ownership-equivalent powers), if the terms of a trust reserve to the settlor or confer upon another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, *unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty* that the power holder owes to the beneficiaries.

[14] Alaska, Arizona, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Kentucky, Missouri, Nevada, New Hampshire, North Carolina, Ohio, Oklahoma, South Dakota, Tennessee, Utah, Virginia, Washington, Wisconsin, Wyoming.

2) Under traditional notions of trust law, the trustee must be accountable to the beneficiary in some way.

3) A beneficiary's main recourse for misconduct by the trust director is an action against the director for breach of the fiduciary duty to the beneficiary.

4) Under this approach, the beneficiary also has recourse against the trustee, but only if the trustee's compliance with the direction amounted to willful misconduct by the trustee.

5) This has the effect of increasing the total fiduciary duties owed to a beneficiary.

4. States that have no statutory framework for third-party advisors.[15]

C. Delaware directed trust law was enacted in 1986.[16]

1. Delaware law recognizes a broad class of advisers including direction advisers, consent advisers and trust protectors. Where one or more persons are given authority by the terms of a governing instrument to direct, consent to or disapprove a fiduciary's actual or proposed investment decisions, distribution decisions or other decisions of the fiduciary, such persons shall be considered to be advisers and fiduciaries when exercising such authority unless the governing instrument otherwise provides.[17]

2. When a trustee acts in accordance with the directions of a trust direction adviser, the trustee will only be liable for its "willful misconduct".

3. If a governing instrument provides that a fiduciary is to follow the direction of an adviser, and the fiduciary acts in accordance with such a direction, then except in cases of willful misconduct on the part of the fiduciary so directed, the fiduciary shall not be liable for any loss resulting directly or indirectly from any such act.[18]

4. The term willful misconduct means intentional wrongdoing and not mere negligence, gross negligence or recklessness.[19]

5. The term wrongdoing means malicious conduct or conduct designed to defraud or seek an unconscionable advantage.[20]

6. If a governing instrument provides that a fiduciary is to make decisions with the consent of an adviser, then except in cases of willful misconduct or gross negligence on the part of the fiduciary, the fiduciary shall not be liable for any loss resulting directly or indirectly from any act taken or omitted as a result of

[15] California, Connecticut, Hawaii, Louisiana, Minnesota, New Jersey, New York and Rhode Island.
[16] Del. Code Ann. Title 12 §3313.
[17] 12 Del. C. § 3313(a)
[18] 12 Del. C. § 3313(b).
[19] 12 Del. C. § 3301(g) and 12 Del. C. § 3301(h)(4).
[20] 12 Del. C. § 3301(g).

such adviser's failure to provide such consent after having been requested to do so by the fiduciary.[21]

7. ... the term "advisor" shall include a "protector" who shall have all of the power and authority granted to the protector by the terms of the governing instrument, which may include but shall not be limited to:

   (i) The power to remove and appoint trustees, advisers, trust committee members, and other protectors;

   (ii) The power to modify or amend the governing instrument to achieve favorable tax status or to facilitate the efficient administration of the trust; and

   (iii) The power to modify, expand, or restrict the terms of a power of appointment granted to a beneficiary by the governing instrument.[22]

8. Whenever a governing instrument provides that a fiduciary is to follow the direction of an adviser with respect to investment decisions, distribution decisions, or other decisions of the fiduciary, then, except to the extent that the governing instrument provides otherwise, the fiduciary shall have no duty to:

   (i) monitor the conduct of the adviser;

   (ii) provide advice to the adviser or consult with the adviser; or

   (iii) communicate with or warn or apprise any beneficiary or third party concerning instances in which the fiduciary would or might have exercised the fiduciary's own discretion in a manner different from the manner directed by the adviser.[23]

9. Absent clear and convincing evidence to the contrary, the actions of the fiduciary pertaining to matters within the scope of the adviser's authority (such as confirming that the adviser's directions have been carried out and recording and reporting actions taken at the adviser's direction), shall be presumed to be administrative actions taken by the fiduciary solely to allow the fiduciary to perform those duties assigned to the fiduciary under the governing instrument and such administrative actions shall not be deemed to constitute an undertaking by the fiduciary to monitor the adviser or otherwise participate in actions within the scope of the adviser's authority.[24]

10. *Duemler v. Wilmington Trust Company*[25] - a Delaware Vice Chancellor ruled that a corporate trustee was not liable for the failure of a sophisticated (*i.e.*, securities lawyer) investment adviser to direct it on an investment decision where the trustee forwarded relevant information to the adviser.

[21] 12 Del. C. § 3313(c).
[22] 12 Del. C. § 3313(f).
[23] 12 Del. C. § 3313(e).
[24] *Id.*
[25] 2004 Del. Ch. LEXIS 206 (Del. Ch. 2004).

a. The Vice Chancellor held: The Court…finds that section 3313(b) of title 12 of the Delaware Code insulates fiduciaries of a Delaware trust from liability associated with any loss to the trust where a governing instrument provides that the fiduciary is to follow the direction of an advisor, the fiduciary acts in accordance with such direction and the fiduciary did not engage in willful misconduct.

b. The trust agreement involved in this case appointed Plaintiff as the investment advisor to the Trust and, at all times, Plaintiff made all of the investment decisions for the Trust, including not to tender the securities in the Exchange Offer.

c. In connection with Plaintiff’s decision not to tender the securities in the Exchange Offer, Wilmington Trust acted in accordance with Plaintiff’s instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer.

d. Accordingly, 12 Del. C. § 3313(b) insulates Wilmington Trust from all liability for any loss to the Trust resulting from plaintiff’s decision not to tender the securities in the Exchange Offer.

11. Delaware adopted 12 Del. C. § 3317 in 2010.

a. The statute states that, except as provided in the governing instrument, each trust fiduciary (including trustees, advisers, protectors, and other fiduciaries) has a duty to keep the other fiduciaries reasonably informed about the administration of the trust with respect to the specific duty or function being performed by that fiduciary.

b. The statute further provides that a fiduciary who requests and receives such information has no duty to monitor the conduct of the other fiduciary, provide advice or consult with the other fiduciary or provide information or communicate or warn any beneficiary or third party concerning instances in which the fiduciary receiving the information would or might have exercised the fiduciary’s own discretion in a different manner.

12. Under the Delaware statute, there is potential liability of the adviser appointed to direct the trustee with respect to investment decisions, distribution decisions or other decisions of the trustee.

a. Absent express language in the governing instrument such adviser is deemed to serve in a fiduciary capacity and will be held to the prudent person standard.

b. Delaware law permits a trust agreement to exculpate and indemnify a fiduciary (including an adviser) for all acts other than those committed with willful misconduct.[26]

D. Uniform Directed Trust Act (**See Exhibit A**)

1. The Act introduces several terms.

a. A power is called a "power of direction."[27] The definition is very broad and includes any power over a trust to the extent the power is exercisable at a time when the power holder is not serving as a trustee. UDTA Section 5 carves out powers that are not intended to be a "power of direction" under the Act.

b. The person that holds the power is called a "trust director."[28]

c. A trustee that is subject to the power is called a "directed trustee."[29] It refers only to a trustee that is subject to direction by a trust director. This does not include a trustee that is subject to a direction by a co-trustee.

d. And the trust is called a "directed trust."[30]

2. The Act applies to any arrangement that exhibits the functional features of a directed trust even if the terms of the trust use other terminology such as "trust protector, "trust advisor," or "administrative trustee."

3. The Act applies prospectively. All trusts that are administered in an enacting state are governed by the act but only with respect to a decision or action occurring on or after the effective date or, if the trust's principal place of administration was changed, then only with respect to a decision or action occurring after the change.

4. Section 5 describes five categories of powers that are not covered by the Act[31].

a. Power of Appointment

b. Power to appoint or remove a trustee or trust director

c. Power of grantor to revoke the trust

d. Power of beneficiary the exercise or nonexercised of which affects the beneficial interest of the beneficiary or another beneficiary represented by the beneficiary.

e. Any power for which the terms of the trust state that it is held in a nonfiduciary capacity solely to achieve the grantor's tax objectives.

5. Powers of the Trust Director[32]

[26] 12 Del. C. § 3303(a).
[27] Uniform Directed Trust Act § 2(5).
[28] UDTA § 2(9).
[29] UDTA § 2(3)
[30] UDTA § 2(2).
[31] UDTA § 5 *et. seq.*

a. The UDTA does not enumerate specific powers or define the scope of a trust director's powers. Instead, the powers must be specified by the terms of the trust.

b. The ULC drafting committee contemplated that this section would validate terms of a trust that grant a power to a trust director to direct investments; modify, reform, terminate or decant a trust; change the principal place of administration; determine the capacity of a trustee, grantor, director or beneficiary; determine trustee's compensation; release a trustee from liability, etc.[33]

c. Further "appropriate powers"[34]

(1) Prescribes a default rule under which a trust director may exercise further powers as appropriate to the director's exercise of the director's express powers.

(2) Appropriateness is judged in relation to the purpose for which the power was granted and the function being carried out by the director.

(3) Would include further powers such as: incurring reasonable costs; making a report or accounting to a beneficiary; prosecuting, defending or joining an action, claim or judicial proceeding relating to the trust; employing a profession for advice or assistance.[35]

d. Majority decision of trust directors. The Act provides a default rule of majority action for multiple trust directors with joint powers.[36]

6. The Act imposed all the same rules that would apply to a trustee in a like position such as where a state would require a trustee to give notice to a state Attorney General before taking certain actions with respect to a charitable trust or with respect to payback provisions meant to comply with Medicaid law.[37]

7. The trust director has the same duties and liabilities as a trustee in a like position would be subject to, including to act prudently, in the sole interest of the beneficiaries and with impartiality.[38]

a. The trust director functions much like a trustee in a non-directed trust so the trust director should have the same duties as a trustee.

b. The Act absorbs existing state trust fiduciary laws which avoids the need to replicate already existing laws and accommodates the diversity across

[32] UDTA §6.
[33] *See* UDTA § 6 cmt. pg. 14.
[34] UDTA § 6(b)(1).
[35] *See* UDTA § 6 cmt. pg. 15.
[36] UDTA § 6(b)(2).
[37] UDTA § 7.
[38] UDTA § 8 (a).

the states in the particulars of a trustee's default and mandatory fiduciary duties.

c. Trust director is subject to the same rules as a trustee with regard to an exoneration clause.

d. Section (b) contemplates the situation in which a health care professional is acting as a trust director and the terms of the trust require a health care professional to determine the capacity of a beneficiary or the grantor. In making this determination, the health care professional would not be subject to a fiduciary duty or liability under the Act.[39]

8. A directed trustee is required to take reasonable action to comply with a trust director's power of direction and the directed trustee is not liable for acting.[40]

a. The duty to take reasonable action depends on the context of the power of direction. The duty is to take reasonable action to comply with whatever the terms of the trust require of a trustee in connection with a trust director's exercise of a power of direction.

b. The trustee should not comply with a direction that is outside the scope of the director's power of direction. To do so would be a breach of fiduciary duty.

c. A trustee is not under a duty to ensure that the substance of the direction is reasonable. A trustee that takes reasonable action to comply with a direction is not liable even if the substance is unreasonable.

d. A trustee is only liable for its own breach of trust in executing a direction if to do so would constitute willful misconduct.[41]

e. The terms of a trust may not reduce the trustee's duty below the standard of willful misconduct. Such a provision would be unenforceable.

9. Trustee and trust director has duty to provide information to each other that is sufficient to fulfill their obligations. Information must be disclosed only if it is reasonable related both to the powers and duties of person making the disclosure and to the person receiving the disclosure.[42]

10. Trustee has no duty to monitor a trust director or inform or give advice to a grantor, beneficiary, trustee or trust director concerning instances in which the trustee might have acted differently than the director.[43]

11. <u>Co-Trusteeship</u>. Section 12 of UDTA allows a grantor to choose the traditional rules of co-trusteeship or the more permissive rules of a directed trusteeship. A

[39] UDTA § 8(b).
[40] UDTA § 9(a).
[41] UDTA § 9(b).
[42] UDTA § 10; *see also* cmt. pg. 27.
[43] UDTA § 11(a). Under the UDTA the outcome of *Rollins v. Branch Banking & Trust Company of Virginia* would have been different.

co-trustee may only have the duty requires by the reasonable action and willful misconduct standards if the grantor chooses and the terms of the trust dictate. The default rule is the rules of co-trusteeship.

12. The Act absorbs state law governing the statute of limitations for bringing an action against a trustee as well as defenses that are available to trustee.[44]

E. Proposed New York Uniform Directed Trust Act

1. The New York Uniform Directed Trust Act proposal is modeled after UDTA and contemplates the enactment of the proposed New York Trust Code (modeled after the UTC).

2. The NYUDTA uses the reasonable action and willful misconduct standard for directed trustees.

3. The definition of willful misconduct is added (modeled after the Delaware statute)

    a. "Willful misconduct" means intentional wrongdoing, not mere negligence, gross negligence or recklessness.

    b. "Wrongdoing" means malicious conduct or conduct designed to defraud or seek an unconscionable advantage.

4. Applies to trusts which have their principal place of administration in New York, subject to certain limitations. NYUDTA clarifies that the terms of a directed trust which designate its principal place of administration will be valid and controlling if such designation satisfies the requirements of the proposed New York Trust Code.

5. NYUDTA contains the same exclusions as Section 5 of the UDTA discussed above.

6. Major Differences from UDTA

    a. Powers of the Trust Director. The UDTA leaves the power of the trust director undefined and leaves it to the terms of the trust to enumerate those powers. NYUDTA includes a set of illustrative powers in the statute. A similar set of powers are discussed in the comments to the UDTA.

    b. NYUDTA provides a default definition of the power to direct investments.

    c. NYUDTA provides a set of illustrative further powers appropriate to the exercise or nonexercise of a power of direction.

    d. Application to co-Trustee. While the UDTA allows a grantor to choose whether to apply the rules of co-trusteeship or allow the rules of a directed trusteeship to apply, the NYUDTA instead follows the Delaware statute § 3313A which was just enacted in August 2017.

[44] *See* UDTA § 13 and § 14.

e. NYUDTA provides that a co-trustee who is to be directed by a co-trustee is relieved from liability to the same extent as a directed trustee. It also allows a co-trustee to have exclusive authority over one or more trust powers, with concomitant duties and liabilities and relieves any other excluded co-trustee from having any duties or liabilities.

IV. Reforming an Existing New York Trust to a Directed Trust

A. Changing the Situs of a New York Trust

1. The willingness of the New York courts to change the situs of a testamentary trust away from New York to the jurisdiction where the trustees are resident has not been evident.

a. *Matter of Bush*, 2 Misc.3d 744, 774, N.Y.S.2d 298 (Sur. Ct. New York Co., 2003).

1) Trustees of a testamentary trust sought to avoid New York State fiduciary income tax by requesting a resignation of the New York trustee and appointment of a Delaware trustee and requesting a transfer of two trusts to Delaware.

2) The court stated that modifications to a testamentary trust will be granted so long as they are the least disruptive to the grantor's or testator's scheme.

3) The change in trusteeship from a New York trustee to a Delaware trustee achieves the purpose of avoiding New York State income tax on the trust.

4) The testator made an explicit direction that the trust be administered in accordance with New York law which demonstrates an intent for the New York courts to supervise the trust's administration. The court, therefore, denied the application to change the situs of the trust.[45]

b. *Matter of Rockefeller*, 2 Misc.3d 554, 773 N.Y.S.2d 529 (Sur. Ct. New York Co., 2003).

1) Petitioners who were trustees of a New York testamentary trust requested to allow the corporate trustee to resign in favor of an affiliate in Delaware and to change the situs of the trust to Delaware.

2) The purpose of the requested changes was to eliminate the New York State fiduciary income tax payable by the trust.

3) The court allowed the resignation of the New York trustee and appointment of the Delaware trustee but did not allow the change of situs to Delaware.

[45] *Matter of Bush*, 774 N.Y.S.2d at 299.

4) The court stated that the income tax purpose was satisfied by the change in trustee and the continued supervision of the trust by New York courts and the application of New York law was not inconsistent with that purpose.[46]

5) Decedent's will was silent concerning the permissibility of a change of situs of the trust. Therefore, where the "desired tax savings can be achieved by a change of trustee, a change of situs will not be allowed unless it would result in some benefit to the trust apart from the tax considerations themselves."[47]

2. The New York Courts have allowed the change in situs in certain situations.

a. The court will permit transfer of the situs of the trust if the transfer is not prohibited by the instrument and would facilitate the administration of the trust.[48]

b. The courts will allow a transfer of situs where the language of the will or trust agreement does not prohibit the transfer, either explicitly or implicitly, and the transfer will simplify the administration of the trust or promote the beneficiary's interest.[49]

3. Presumably if the governing instrument gives the fiduciary the authority to change the situs of the trust, then the courts will allow it.

B. Decanting as a Tool to Reform an Existing New York Trust

1. It is possible for the trustee of a New York testamentary trust to decant to a trust with a situs in another state so that the law of that state governs the trust.

a. Decanting does not require court approval and there is nothing in EPTL 10-6.6 that prevents decanting to a trust with a situs in another state and trustees who are resident in that state.

b. The new appointed trust is created from the corpus of the invaded trust but is a new trust. In all likelihood, because the appointed trust is created by the trustee of the invaded trust, a testamentary trust becomes a lifetime trust.

2. There may be an argument that a trustee who decants to a trust with a situs in a state other than New York can have letters revoked under SCPA 711(7) because

[46] *Matter of Rockefeller*, 773 N.Y.S.2d at 530.
[47] *Id* at 531; *see also Matter of Flexner*, 166 N.Y.S.2d 469 (1957) (where the transfer of situs was denied where the trust instrument specifically provided that it be governed under New York law, even though the grantor herself requested the transfer.).
[48] *See Matter of Garver*, NYLJ, Jan. 18, 2003, at 20, col. 3).
[49] *Matter of LeoGrande*, 2009 N.Y. Slip Op 33140(U); *see also Matter of Weinberger*, 250 N.Y.S.2d 887 (1st Dept. 1964)(where the court found that a transfer of situs would facilitate the administration of the trust because the distance between the two trustees had made the administration difficult); *Matter of McComas*, 630 N.Y.S.2d 895 (Sur. Ct. New York Co, 1995) (where the court granted the application for change in situs finding that the interests of the beneficiaries would be promoted by a transfer to the beneficiaries' residence).

the trustee has moved property out of the state of New York without court approval.

3. However, a trustee may distribute assets from a New York trust to a beneficiary outside of New York without issues. Thus, because the trustee is using its principal invasion power to appoint the assets of the invaded trust to the appointed trust, this is a weak argument, at best.

EXHIBIT A

UNIFORM DIRECTED TRUST ACT

SECTION 1. SHORT TITLE. This [act] may be cited as the Uniform Directed Trust Act.

SECTION 2. DEFINITIONS. In this [act]:

(1) "Breach of trust" includes a violation by a trust director or trustee of a duty imposed on that director or trustee by the terms of the trust, this [act], or law of this state other than this [act] pertaining to trusts.

(2) "Directed trust" means a trust for which the terms of the trust grant a power of direction.

(3) "Directed trustee" means a trustee that is subject to a trust director's power of direction.

(4) "Person" means an individual, estate, business or nonprofit entity, public corporation, government or governmental subdivision, agency, or instrumentality, or other legal entity.

(5) "Power of direction" means a power over a trust granted to a person by the terms of the trust to the extent the power is exercisable while the person is not serving as a trustee. The term includes a power over the investment, management, or distribution of trust property or other matters of trust administration. The term excludes the powers described in Section 5(b).

(6) "Settlor" means a person, including a testator, that creates, or contributes property to, a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion.

(7) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any other territory or possession subject to the jurisdiction of the United States.

(8) "Terms of a trust" means:

(A) except as otherwise provided in subparagraph (B), the manifestation of the settlor's intent regarding a trust's provisions as:

(i) expressed in the trust instrument; or

(ii) established by other evidence that would be admissible in a judicial proceeding; or

(B) the trust's provisions as established, determined, or amended by:

(i) a trustee or trust director in accordance with applicable law; [or]

(ii) court order[; or

(iii) a nonjudicial settlement agreement under [Uniform Trust Code Section 111]].

(9) "Trust director" means a person that is granted a power of direction by the terms of a trust to the extent the power is exercisable while the person is not serving as a trustee. The person is a trust director whether or not the terms of the trust refer to the person as a trust director and whether or not the person is a beneficiary or settlor of the trust.

(10) "Trustee" includes an original, additional, and successor trustee, and a cotrustee.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 103(18), defining "terms of a trust," or Uniform Trust Decanting Act (2015) Section 2(28), defining "terms of the trust," should update those definitions to conform to paragraph (8). A state that has enacted Uniform Trust Code Section 103(15) and (20) could replace paragraphs (6) and (10) of this section with cross-references to those provisions. A state that has not enacted Uniform Trust Code Section 111 should replace the bracketed language of paragraph (8)(B)(iii) with a cross reference to the state's statute governing nonjudicial settlement or should omit paragraph (8)(B)(iii) if the state does not have such a statute.*

SECTION 3. APPLICATION; PRINCIPAL PLACE OF ADMINISTRATION.

(a) This [act] applies to a trust, whenever created, that has its principal place of administration in this state, subject to the following rules:

(1) If the trust was created before [the effective date of this [act]], this [act] applies only to a decision or action occurring on or after [the effective date of this [act]].

(2) If the principal place of administration of the trust is changed to this state on or after [the effective date of this [act]], this [act] applies only to a decision or action occurring on or after the date of the change.

(b) Without precluding other means to establish a sufficient connection with the designated jurisdiction in a directed trust, terms of the trust which designate the principal place of administration of the trust are valid and controlling if:

(1) a trustee's principal place of business is located in or a trustee is a resident of the designated jurisdiction;

(2) a trust director's principal place of business is located in or a trust director is a resident of the designated jurisdiction; or

(3) all or part of the administration occurs in the designated jurisdiction.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 108(a) could omit subsection (b) and instead add subsection (b)(2) to Section 108 if the state also adds to the state's Uniform Trust Code the definitions of power of direction and trust director from Section 2(5) and (9).*

SECTION 4. COMMON LAW AND PRINCIPLES OF EQUITY. The common law and principles of equity supplement this [act], except to the extent modified by this [act] or law of this state other than this [act].

SECTION 5. EXCLUSIONS.

(a) In this section, "power of appointment" means a power that enables a person acting in a nonfiduciary capacity to designate a recipient of an ownership interest in or another power of appointment over trust property.

(b) This [act] does not apply to a:

(1) power of appointment;

(2) power to appoint or remove a trustee or trust director;

(3) power of a settlor over a trust to the extent the settlor has a power to revoke the trust;

(4) power of a beneficiary over a trust to the extent the exercise or nonexercise of the power affects the beneficial interest of:

(A) the beneficiary; or

(B) another beneficiary represented by the beneficiary[under Uniform Trust Code Sections 301 through 305] with respect to the exercise or nonexercise of the power; or

(5) power over a trust if:

(A) the terms of the trust provide that the power is held in a nonfiduciary capacity; and

(B) the power must be held in a nonfiduciary capacity to achieve the settlor's tax objectives under the United States Internal Revenue Code of 1986[, as amended][, and regulations issued thereunder][, as amended].

(c) Unless the terms of a trust provide otherwise, a power granted to a person to designate a recipient of an ownership interest in or power of appointment over trust property which is exercisable while the person is not serving as a trustee is a power of appointment and not a power of direction.

Legislative Note: *A state that has not enacted Uniform Trust Code (Last Revised or Amended in 2010) Sections 301 through 305 should replace the bracketed language in subsection (b)(4)(B) with a cross reference to the state's statute governing virtual representation or should omit the bracketed language if the state does not have such a statute.*

A state that does not permit the phrase "as amended" when incorporating federal statutes or permit reference to "regulations issued thereunder" should delete the bracketed language in subsection (b)(5)(B).

SECTION 6. POWERS OF TRUST DIRECTOR.

(a) Subject to Section 7, the terms of a trust may grant a power of direction to a trust director.

(b) Unless the terms of a trust provide otherwise:

(1) a trust director may exercise any further power appropriate to the exercise or nonexercise of a power of direction granted to the director under subsection (a); and

(2) trust directors with joint powers must act by majority decision.

SECTION 7. LIMITATIONS ON TRUST DIRECTOR. A trust director is subject to the same rules as a trustee in a like position and under similar circumstances in the exercise or nonexercise of a power of direction or further power under Section 6(b)(1) regarding:

(1) a payback provision in the terms of a trust necessary to comply with the reimbursement requirements of Medicaid law in Section 1917 of the Social Security Act, 42 U.S.C. Section 1396p(d)(4)(A)[, as amended][, and regulations issued thereunder][, as amended]; and

(2) a charitable interest in the trust, including notice regarding the interest to [the Attorney General].

Legislative Note: *A state that does not permit the phrase "as amended" when incorporating federal statutes or that does not permit reference to "regulations issued thereunder" should delete the bracketed language in paragraph (1) accordingly.*

In paragraph (2), "Attorney General" is in brackets to accommodate a state that grants enforcement authority over a charitable interest in a trust to another public official.

SECTION 8. DUTY AND LIABILITY OF TRUST DIRECTOR.

(a) Subject to subsection (b), with respect to a power of direction or further power under Section 6(b)(1):

(1) a trust director has the same fiduciary duty and liability in the exercise or nonexercise of the power:

(A) if the power is held individually, as a sole trustee in a like position and under similar circumstances; or

(B) if the power is held jointly with a trustee or another trust director, as a cotrustee in a like position and under similar circumstances; and

(2) the terms of the trust may vary the director's duty or liability to the same extent the terms of the trust could vary the duty or liability of a trustee in a like position and under similar circumstances.

(b) Unless the terms of a trust provide otherwise, if a trust director is licensed, certified, or otherwise authorized or permitted by law other than this [act] to provide health care in the ordinary course of the director's business or practice of a profession, to the extent the director acts in that capacity, the director has no duty or liability under this [act].

(c) The terms of a trust may impose a duty or liability on a trust director in addition to the duties and liabilities under this section.

SECTION 9. DUTY AND LIABILITY OF DIRECTED TRUSTEE.

(a) Subject to subsection (b), a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action.

(b) A directed trustee must not comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1) to the extent that by complying the trustee would engage in willful misconduct.

(c) An exercise of a power of direction under which a trust director may release a trustee or another trust director from liability for breach of trust is not effective if:

(1) the breach involved the trustee's or other director's willful misconduct;

(2) the release was induced by improper conduct of the trustee or other director in procuring the release; or

(3) at the time of the release, the director did not know the material facts relating to the breach.

(d) A directed trustee that has reasonable doubt about its duty under this section may petition the [court] for instructions.

(e) The terms of a trust may impose a duty or liability on a directed trustee in addition to the duties and liabilities under this section.

Legislative Note: *A state that has enacted the Uniform Trust Code (Last Revised or Amended in 2010) should move Section 808(a) into Section 603, delete Section 808(b) through (d), and add "subject to [insert cite to Uniform Directed Trust Act Sections 9, 11, and 12]," to the beginning of subsection (b)(2) of Section 105. Section 105(b)(2) prescribes the mandatory minimum fiduciary duty of a trustee, which is superseded with respect to a directed trustee by the willful misconduct mandatory minimum of this section.*
The term "court" in subsection (d) of this section should be revised as needed to refer to the appropriate court having jurisdiction over trust matters.

SECTION 10. DUTY TO PROVIDE INFORMATION TO TRUST DIRECTOR OR TRUSTEE.

(a) Subject to Section 11, a trustee shall provide information to a trust director to the extent the information is reasonably related both to:

(1) the powers or duties of the trustee; and

(2) the powers or duties of the director.

(b) Subject to Section 11, a trust director shall provide information to a trustee or another trust director to the extent the information is reasonably related both to:

(1) the powers or duties of the director; and

(2) the powers or duties of the trustee or other director.

(c) A trustee that acts in reliance on information provided by a trust director is not liable for a breach of trust to the extent the breach resulted from the reliance, unless by so acting the trustee engages in willful misconduct.

(d) A trust director that acts in reliance on information provided by a trustee or another trust director is not liable for a breach of trust to the extent the breach resulted from the reliance, unless by so acting the trust director engages in willful misconduct.

SECTION 11. NO DUTY TO MONITOR, INFORM, OR ADVISE.

(a) Unless the terms of a trust provide otherwise:

(1) a trustee does not have a duty to:

(A) monitor a trust director; or

(B) inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director; and

(2) by taking an action described in paragraph (1), a trustee does not assume the duty excluded by paragraph (1).

(b) Unless the terms of a trust provide otherwise:

(1) a trust director does not have a duty to:

(A) monitor a trustee or another trust director; or

(B) inform or give advice to a settlor, beneficiary, trustee, or another trust director concerning an instance in which the director might have acted differently than a trustee or another trust director; and

(2) by taking an action described in paragraph (1), a trust director does not assume the duty excluded by paragraph (1).

SECTION 12. APPLICATION TO COTRUSTEE. The terms of a trust may relieve a cotrustee from duty and liability with respect to another cotrustee's exercise or nonexercise of a power of the other cotrustee to the same extent that in a directed trust a directed trustee is relieved from duty and liability with respect to a trust director's power of direction under Sections 9 through 11.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 703(c) or (g) should revise those sections to make them subject to this section. In the alternative, the state could insert this section as a new subsection in Section 703, and make subsections (c) and (g) subject to that new subsection if the state also adds to its Uniform Trust Code the definitions of "directed trustee," "power of direction," and "trust director" from Section 2(3), (5), and (9).*

SECTION 13. LIMITATION OF ACTION AGAINST TRUST DIRECTOR.

(a) An action against a trust director for breach of trust must be commenced within the same limitation period as[under Uniform Trust Code Section 1005] for an action for breach of trust against a trustee in a like position and under similar circumstances.

(b) A report or accounting has the same effect on the limitation period for an action against a trust director for breach of trust that the report or accounting would have[under Uniform Trust Code Section 1005] in an action for breach of trust against a trustee in a like position and under similar circumstances.

Legislative Note: *A state that has enacted Uniform Trust Code (Last Revised or Amended in 2010) Section 1005 should update the bracketed language to refer to that enactment. A state that has enacted a statute other than Uniform Trust Code Section 1005 to govern limitation of an action against a trustee should replace the bracketed language with a cross reference to that statute. A state that has not enacted a statutory limitation should delete the bracketed language.*

SECTION 14. DEFENSES IN ACTION AGAINST TRUST DIRECTOR. In an action against a trust director for breach of trust, the director may assert the same defenses a trustee in a like position and under similar circumstances could assert in an action for breach of trust against the trustee.

SECTION 15. JURISDICTION OVER TRUST DIRECTOR.

(a) By accepting appointment as a trust director of a trust subject to this [act], the director submits to personal jurisdiction of the courts of this state regarding any matter related to a power or duty of the director.

(b) This section does not preclude other methods of obtaining jurisdiction over a trust director.

SECTION 16. OFFICE OF TRUST DIRECTOR. Unless the terms of a trust provide otherwise, the rules applicable to a trustee apply to a trust director regarding the following matters:

(1) acceptance[under Uniform Trust Code Section 701];

(2) giving of bond to secure performance[under Uniform Trust Code Section 702];

(3) reasonable compensation[under Uniform Trust Code Section 708];

(4) resignation[under Uniform Trust Code Section 705];

(5) removal[under Uniform Trust Code Section 706]; and

(6) vacancy and appointment of successor[under Uniform Trust Code Section 704].

Legislative Note: *A state that has enacted the Uniform Trust Code (Last Revised or Amended in 2010) provisions cited in this section should update the bracketed language to refer to the appropriate provisions of that enactment. A state that has enacted relevant statutory provisions other than the provisions of the Uniform Trust Code cited in this section should replace the bracketed language with cross references to those provisions, except that a state that allows statutory commissions rather than reasonable compensation for a trustee is advised for the reasons given in the comments below to apply a rule of reasonable compensation to a trust director. A state that has not enacted relevant statutory provisions should delete the bracketed language.*

SECTION 17. UNIFORMITY OF APPLICATION AND CONSTRUCTION. In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

SECTION 18. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT. This [act] modifies, limits, or supersedes the Electronic Signatures in Global and National Commerce Act, 15 U.S.C. Section 7001 et seq., but does not modify, limit, or supersede Section 101(c) of that act, 15 U.S.C. Section 7001(c), or authorize electronic delivery of any of the notices described in Section 103(b) of that act, 15 U.S.C. Section 7003(b).

SECTION 19. REPEALS; CONFORMING AMENDMENTS.

(a) . . . .

(b) . . . .

(c) . . . .

SECTION 20. EFFECTIVE DATE. This [act] takes effect . . . .

I. <u>Why Use A Directed Trust</u>?

A. <u>Control over investments, distributions and other decisions</u>. Many clients prefer to vest control over key decisions in the hands of trusted family or advisors while leaving all other decisions in the hands of a professional trustee. The following are common situations:

1. A client seeking to hold some or all of a family business in trust may prefer to confer on a close friend, relative or trusted advisor, the power to vote the shares held in trust or otherwise exercise managerial control over the company.

2. Similarly, if the client wishes to hold special assets in trust, a corporate trustee may insist that it be directed as to those special holdings because otherwise the trustee may be liable for failure to diversify or failure to meet its duty of prudence and care with respect to such investment.

3. Another common situation is where the client prefers a corporate trustee to manage the record keeping and accounting but wants someone closer to the family to make decisions about distributions.

4. A corporate trustee may provide nexus to a particular trust jurisdiction but the client has a long standing relationship with other advisors who the client prefers to make key decisions rather than the unfamiliar corporate trustee.

B. <u>Lower trustee fees</u>. In Delaware and other states with directed trust statutes, trust companies have lowered their fees where they are directed. Many charge annual flat fees ranging from $5,000 to $10,000. When compared to basis point fees, this can translate into large savings.

II. <u>Trust Modification</u>. In order to convert a fully managed trust to a directed trust, the trust will need to be modified to authorize an advisor to direct the trustee on specified trustee powers, exonerate the directed trustee for loss on account of following directions, and compensate the advisors, among other things. A trust can easily be amended if so provided in the trust agreement. In the absence of any trust provisions authorizing trust amendment, a trust, nevertheless, may be able to be amended under state law. If the existing jurisdiction governing the trust does not readily permit trust amendments, it is often possible to move the situs of the trust and change the law governing the administration of the trust. This may be accomplished by removing and replacing the existing trustee with a resident trustee in a state with flexible amendment laws. Under Delaware law, for example, once a Delaware-based trustee is in office and the trust is being administered in Delaware, the laws of Delaware govern matters of trust

administration, including the four main non-judicial methods of modifying a trust.[1] Once the trust administration is governed by the laws of a state which permits trust amendments, the trust can then be amended in accordance with such state laws. Four non-judicial methods of modifying a trust are summarized below.

A. Non-Judicial Settlement. UTC § 111 provides in pertinent part that interested persons may enter into a binding non-judicial settlement agreement with respect to any matter involving a trust, to the extent it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court or other applicable law.[2] UTC § 111(d) provides a non-exclusive list of matters that may be resolved by the non-judicial settlement, including, among others, matters related to: the direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power; the resignation or appointment of a trustee and the determination of a trustee's compensation; and liability of a trustee for an action relating to the trust.[3] These types of changes would be required to convert a trust into a directed trust. Nevertheless, some practitioners may feel hesitant to modify a trust in a manner not identified in UTC § 111(d) or where there is no dispute or disagreement among the parties.

1. All of the states that have adopted UTC § 111 (except Kansas), and several additional states that have not adopted the UTC, permit non-judicial settlement agreements to change the extent of trustee powers, liability and compensation.[4] The states which have not adopted UTC § 111 (or a similar statute) are: Alaska, California, Colorado, Connecticut, Georgia, Hawaii, Indiana, Louisiana, Nevada, New York, Oklahoma, Rhode Island, South Dakota, Texas.[5] Kansas adopted UTC § 111 in a limited form that does not permit interpretation or construction of the

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[1] 12 *Del. C.* § 3332(b) ("Except as otherwise provided by the terms of a court order and notwithstanding a general choice of law provision in the governing instrument of a trust, such as a provision to the effect that the laws of a jurisdiction other than this State shall govern the trust or the administration of the trust, the laws of this State shall govern the administration of the trust while the trust is administered in this State unless the governing instrument expressly provides that the laws of another jurisdiction govern the administration of the trust and further provides that the laws governing the administration of the trust shall not change on account of a change in the place of administration of the trust.")

[2] UTC § 111(b), (c) (2010).

[3] UTC § 111(d) (2010).

[4] Todd A. Flubacher and Thomas R. Pulsifer, *The Delaware Advantage* (2017) (on file with author) Overview of State Statutes Permitting Modification of Irrevocable Trusts chart at pp. 1-5, identifying such matters as a "wrapper."

[5] Todd A. Flubacher and Thomas R. Pulsifer, *The Delaware Advantage* (2017) (on file with author) Overview of State Statutes Permitting Modification of Irrevocable Trusts chart at pp. 1-5.

terms of the trust, direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power.[6]

2. Delaware Non-Judicial Settlement Agreement Requirements

a. Under Delaware law, which is based on UTC § 111, the non-judicial settlement agreement may not violate a "material purpose" of the trust.[7] The non-judicial settlement statute does not define the term "material purpose." There seems to be a consensus in Delaware among practitioners that a material change to the dispositive provisions or tax provisions of a trust could violate a material purpose of the trust, whereas a change to the administrative provisions generally would not violate a material purpose of the trust. No Delaware cases address this issue, to date.

b. All "interested persons" must sign the agreement.[8] Interested persons are, generally, those whose interest in the trust would be affected by the proposed non-judicial settlement agreement, including:

i. Trustees and other fiduciaries;

ii. Trust beneficiaries, who will generally be those with a present interest in the trust and those whose interest in the trust would vest, without regard to the exercise or nonexercise of any power of appointment, if the present interests in the trust terminated on the date of the non-judicial settlement agreement;

iii. The trustor of the trust, if living; and

iv. All other persons having an interest in the trust according to the express terms of the governing instrument (such as, but not limited to, holders of powers and persons having other rights, held in a nonfiduciary capacity, relating to trust property).

v. Contingent interests may be represented in compliance with the virtual representation statute.[9]

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[6] Todd A. Flubacher and Thomas R. Pulsifer, *The Delaware Advantage* (2017) (on file with author) Overview of State Nonjudicial Settlement Agreement (NJSA) Statutes chart at pp. 23-32.

[7] 12 *Del. C.* § 3338(c).

[8] 12 *Del. C.* § 3338(a).

[9] 12 *Del. C.* § 3547.

c. The agreement may resolve any of the following matters, which include, but are not limited to the following:[10]

i. The interpretation or construction of the terms of the trust;

ii. The approval of a trustee's report or accounting;

iii. The direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;

iv. The resignation or appointment of a trustee and the determination of a trustee's compensation;

v. The transfer of a trust's principal place of administration; and

vi. The liability of a trustee for an action relating to the trust.

d. The court's approval is not required but any interested person may "bring a proceeding in the Court of Chancery to interpret, apply, enforce, or determine the validity of a non-judicial settlement agreement" including whether any virtual representation was adequate.[11]

B. <u>Non-Judicial Modification</u>

1. UTC § 411(a) provides, in part, that a noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.[12] Some states allow such modification or termination without approval of the court, and others require court approval.

a. The jurisdictions which have adopted UTC § 411(a) (or a similar statute) which do not require court approval for modification are: Arkansas, California, Delaware, District of Columbia, Florida, Iowa, Kansas, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Montana, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, South Dakota, Tennessee (only allows

[10] 12 *Del. C.* § 3338(d).

[11] 12 *Del. C.* § 3338(e).

[12] UTC § 411(a) (2010).

modification during settlor's lifetime), Utah, Vermont, Wisconsin and Wyoming.[13]

2. Delaware Non-Judicial Modification Requirements. Non-judicial modification is available under Delaware law even if it may violate a material purpose of the trust.[14] The agreement must be made with the written consent or written nonobjection of the trustor, all then serving fiduciaries and all beneficiaries.

   a. The term "beneficiaries" is undefined but, under common law principles, includes contingent and remote beneficiaries.[15] Contingent interests may be represented in compliance with the virtual representation statute.[16]

   b. If there is more than one settlor, all settlors must consent or provide a written nonobjection.[17] If a settlor is incapacitated an agent under a power of attorney may consent or provide a written nonobjection on behalf of the settlor, if expressly authorized to do so under the power of attorney or under the terms of the trust agreement.[18] A court appointed guardian may also sign on behalf of an incapacitated settlor with court approval.

   c. The modification may include any provision that could have been included in the governing instrument of the trust were such trust created upon the date of the modification.

   d. The court's approval is not required but any interested person, including the trustor, may "bring a proceeding in the Court of Chancery to interpret, apply, enforce, or determine the validity of a modification" including determining whether any virtual representation was adequate.[19]

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[13] Todd A. Flubacher and Thomas R. Pulsifer, *The Delaware Advantage* (2017) (on file with author) Summary of State Statutes That Generally Permit Modification By Consent of Parties To Noncharitable Irrevocable Trusts chart at pp. 18-22.

[14] 12 *Del. C*. § 3342.

[15] *Restatement (Third) of Trusts*, § 48.

[16] 12 *Del. C*. § 3547.

[17] 12 *Del. C*. § 3342(a).

[18] 12 *Del. C*. § 3342(a).

[19] 12 *Del. C*. § 3342(c).

e. An interested person may waive the right to contest the modification.[20]

C. Decanting

1. Decanting involves an exercise of the trustee's discretion to distribute trust principal to the trustee of another trust for the benefit of one or more of the beneficiaries of the first trust. Twenty-five jurisdictions have enacted decanting statutes, which vary considerably. Some are more restrictive than others. Some require consent of, or notice to, beneficiaries or court approval. Others do not.

2. Delaware Decanting Requirements.

a. Generally, under Delaware law, the trustee must have discretionary authority to distribute trust principal or trust income; the decanting power is limited to the property over which the trustee has authority to distribute.[21] It cannot be used, for example, to decant trust principal if the trustee is authorized to make discretionary distributions of only trust income.[22]

b. Trust must be decanted in favor of one or more current beneficiaries.

c. Notice to beneficiaries is not required.

d. The decanted trust should include any ascertainable standards set forth in the first trust.

e. The decanted trust may include a new general or limited power of appointment exercisable by any of the current permissible beneficiaries of the first trust.

f. The decanted trust cannot accelerate distributions to or among members of an open class of beneficiaries (e.g., a person's living descendants) or permit distributions which exceed amounts permitted under the governing instrument for the first trust.

g. The trustee can create a new trust to receive the existing trust fund. Additionally, a trustee may decant under the same trust instrument,

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[20] *Id.*

[21] 12 *Del. C.* § 3528.

[22] 12 *Del. C.* § 3528.

as modified by the decanting, rather than decanting to an entirely new trust instrument.[23]

h. Limitations apply to minor's trusts, marital trusts, trusts with certain powers of withdrawal so that tax benefits are not invalidated under the decanted trust:

i. A decanted minor's trust must vest and become distributable no later than the date upon which such interest would have vested and become distributable under the terms of the governing instrument of the first trust.

ii. The income or unitrust interest of a trust for which a marital deduction was taken cannot be reduced as a result of the decanting.

iii. Decanting is not allowed with respect to trust property subject to a presently exercisable power of withdrawal held by a sole current beneficiary.

i. The original trust agreement must not expressly prohibit decanting.

D. Merger

1. Merger can be used as a means to modify a trust by merging the assets of one trust into another trust having different terms. Most merger statutes require that the merger not impair the rights of a beneficiary or adversely affect the achievement of trust purposes.[24] Some states impose additional or different standards for merger.

2. Delaware Merger Requirements.[25]

a. Under the Delaware merger statute, merger cannot result in a "material change in the dispositive terms of the trust defining the nature and extent of any trust beneficiary's interest in the principal or income of the trust."[26] This provision is intended to clarify that while some changes may impact a beneficiary's interest, the ones which are prohibited under the merger statute are limited to those that materially change the dispositive provisions relating to the

[23] 12 *Del. C.* § 3528(a).

[24] Todd A. Flubacher and Thomas R. Pulsifer, *The Delaware Advantage* (2017) (on file with author) Overview of State Statutes Permitting the Merger, Combination, or Consolidation of Trusts chart at pp. 13-17.

[25] 12 *Del. C.* § 3325(29).

[26] 12 *Del. C.* § 3325(29).

beneficiary's interest in principal or income, such as when and to what extent a beneficiary can receive distributions from the trust.

b. Trustee may declare a new trust for the purpose of merging all or a portion of an existing trust with and into the new trust or merge existing trusts.

c. Merged trusts do not have to be created by the same trustor.

d. Merged trusts need not be funded prior to the merger.

e. The merger power is exercised by the trustee without consent of or notice to beneficiaries or court approval. Notwithstanding, Delaware trustees will likely require that beneficiaries be notified of the merger and consent to it in advance.

III. Drafting and Management of Directed Trusts

A. Establish clear intent of settlor. Include clear statements about settlor's intent that the trust be directed and manage the trust accordingly.

1. A properly managed directed trust will require the advisor to direct the trustee with respect to specified powers. FORM 1 is a form of direction letter that can be used to direct the trustee.

2. The trustee should follow directions and should not engage in second guessing the advisor, with certain exceptions. The trustee should not violate the terms of the trust agreement or engage in acts of willful misconduct.

3. For ambiguous situations, the advisor should obtain consent of beneficiaries.

B. Identify directed powers. A drafting attorney should pay careful attention to which powers are directed to avoid gaps in advisor's authority. A best practice is to identify which of the trustee powers are to be directed rather than referring generally to "investment decisions" or "distribution decisions" as being directed.

1. Some powers have elements of distribution powers and investment powers, such as a loan to a beneficiary or guarantee on behalf of a beneficiary.

2. If the trust will hold or acquire non-marketable assets, the trust agreement should authorize the trustee to rely on informal valuations for non-marketable assets. The trust agreement should establish the procedure for directing the trustee to make any representations or warranties in connection with acquiring certain assets and signing documents without substantive review. See FORM 2.

3. Some powers do not fit neatly within distribution powers or investment powers and might best be held by a separate "trust protector." Such powers could include the power to amend, change situs and governing law or grant a general power of appointment.

C. Who Should Not Serve As Advisor.

1. The advisor, whether an investment or distribution advisor, should not have a conflict of interest with other beneficiaries.

2. If the settlor wishes to serve as investment advisor for a directed trust where the trust is to hold a closely held company, consider vesting the voting power with respect to such company in someone other than the settlor, or name someone else as the investment advisor. There is a concern that the settlor's retention of the power to vote with respect to such company could be a retained interest.[27]

3. The settlor should not serve as the distribution advisor or as trust protector holding specified powers. This could be a retained interest to the extent that the settlor is deemed to hold dispositive powers of a trustee.

D. Fiduciary Capacity. Under Delaware law, an advisor is presumed to act in a fiduciary capacity unless the governing instrument provides otherwise.[28] It is generally considered a best practice to have an advisor serve in a fiduciary capacity. A concern is that if an advisor holds most of the trust powers without any fiduciary responsibility, then the trust may not be a trust, and perhaps may be an outright gift or an agency arrangement.

E. Exculpation. Under Delaware law, a directed trustee is not liable for loss resulting from following the advisor's direction unless the trustee engages in an act of willful misconduct.[29] Further, a directed trustee has no duty to monitor the advisor, provide advice to the advisor or warn beneficiaries about instances in which the trustee would have taken a different course of action.[30] Accordingly, most Delaware trust companies expect the trust agreement to exculpate the directed trustee for all liability except for its own willful misconduct and waive the duty to monitor and warn.

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[27] *Mirowski v. Comm'r*, T.C. Memo 2008-74. See also, Mitchell M. Gans and Jonathan G. Blattmachr, "Family Limited Partnerships and Section 2036: Not Such a Good Fit," *ACTEC Law Journal*, Vol. 42:253 (Winter 2017), *citing Estate of Powell v. Comm'r*, 148 T.C. No. 18 (T.C. May 18, 2017).

[28] 12 *Del. C*. § 3313(a).

[29] 12 *Del. C*. § 3313(b).

[30] 12 *Del. C*. § 3313(e).

1. Some statutes can exculpate a co-trustee for all liability if the co-trustee is an "excluded trustee."[31]

2. The trustee should disclose to the settlor and beneficiaries the nature of trust both initially and on account statements.[32]

F. Compensation. The trust agreement should provide compensation for all fiduciaries serving.

IV. Coordination Among Trustee and Advisors. Consider the following scenarios when drafting a directed trust.

A. Tax Matters

1. Who Is In Charge of Tax Matters

a. Under 12 Del. C. § 3325(16), (17), the trustee.

b. Under federal law, the trustee. See Instructions for Form 1041.

2. E.g. Due to an IRS audit, the GST trust is overfunded and does not have an exclusion ratio of zero. Who is responsible for handling this situation if the trust is silent? It may make sense to assign tax matters to the professional trustee, and include precatory language with respect to distributions from a GST exempt trust. See FORM 3.

3. E.g. Trust acquires stock in S corporation. Who is in charge of making the S election if the trust is silent?

B. Cash Matters - what is trustee's duty or authority in the following situations

1. E.g. Tax payment or other administrative expenses are due but trust holds only an interest in a family LLC. See FORM 4.

2. E.g. Trustee is being sued but holds only an interest in a family LLC. See FORM 5.

3. E.g. Trust holds only an interest in an operating LLC and the manager issues a capital call.

C. Coordinating Distribution Language

1. E.g. Trust agreement provides for a mandatory distribution at a certain time, but gives advisor discretion to override mandatory distribution under

[31] 12 *Del. C.* § 3313A.

[32] 12 *Del. C.* § 3585 (2 year laches following a report).

certain circumstances. Should trustee contact the advisor to determine whether advisor wishes to override each mandatory distribution?

2. E.g. Advisor has authority to direct distributions but trust is silent as to whether distributions can be made in cash or in kind. Who decides?

D. Exercise of Power of Substitution

1. E.g. The settlor serves as investment advisor and has made a completed gift of shares of stock in closely held company to the trust in 2012. The settlor now wishes to substitute marketable securities with the trust property.

2. Under Rev. Rul. 2008-22,[33] a settlor will not be treated as having a retained interest by virtue of holding the power of substitution provided that the trustee has a fiduciary obligation (under local law) to ensure that properties acquired and substituted by settlor are of equivalent value and further provided that substitution power cannot be exercised in manner that can shift benefits among trust beneficiaries.

a. If the trust is drafted under Delaware law, the default law is that the fiduciary responsible for investment decisions has a fiduciary duty to determine that the substituted property is of equivalent value. If there is an investment advisor, the default law would make the investment advisor responsible for this determination. If the settlor is exercising the swap power and is also the investment advisor, the settlor may fail to satisfy the terms of the revenue ruling. Therefore, it is important to override the default law under the terms of the trust agreement, as is permitted by statute, and provide that the trustee, not the investment advisor, is responsible for determining whether the swapped property is of equivalent value.

b. See FORM 6.

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[33] Rev. Rul. 2008-22, 2008-1 CB 796 (4/17/2008) (power by itself will not cause estate tax inclusion for grantor provided trustee has fiduciary obligation (under local law) to ensure grantor's compliance with terms of this power by satisfying itself that properties acquired and substituted by grantor are of equivalent value and further provided that substitution power cannot be exercised in manner that can shift benefits among trust beneficiaries).

FORM 1

DIRECTION LETTER WITH RESPECT TO SIGNING REPRESENTATIONS/WARRANTIES

Dear Administrative Trustee:

Under Article ___ of ______________________Trust (the "Trust"), I am named as the Investment Adviser. _________________________ serves as Administrative Trustee of the Trust (the "Administrative Trustee"). Under the terms of the Trust, the Investment Adviser has full power to make all investment decisions with respect to the investment of trust property.

I hereby direct the Administrative Trustee to sign the attached ___________Agreement and to accept and retain the interest in ________________ LP as described in the ___________Agreement.

I have reviewed the attached documents and, in my capacity as Investment Adviser under the Trust, approve of the terms contained in the documents. I acknowledge that the document listed above includes certain representations, warrantees and covenants made by the Trust, and I agree (a) that this direction includes my representation and warrantee that the same are true and correct [based upon my actual knowledge], (b) that my responsibility as Investment Adviser of the Trust includes the responsibility to monitor the Trust's investments and the actions of the Trust, and to direct and instruct the Administrative Trustee on the future actions to be taken with respect to such representations, warrantees and covenants. The Administrative Trustee shall not be obligated to monitor the Trust's investments or the actions of the Trust with respect to any such representations, warrantees and covenants.

These directions are intended by me to be directions described in section 3313(b) of Title 12 of the Delaware Code. This states, in relevant part, that if a declaration of trust provides that a trustee is to make investment decisions upon the direction of an adviser, including a trustee, and the trustee acts in accordance with such a direction, then except in cases of willful misconduct, the trustee shall not be liable for any loss resulting from any such act.

Sincerely,

FORM 2

DIRECTION TO SIGN AGREEMENTS AND OTHER DOCUMENTS

Additionally, the Investment Adviser shall have the power to [i] manage or participate in the management of any entity owned by the trust, to the extent such entity's governing instruments or applicable law require the trust to manage the same, [ii] direct the Trustee to make any representation, warranty or covenant required in order to make or maintain any investment of the trust, [iii] direct the Trustee to take any future action with respect to any such representation, warranty or covenant; and [iv] to direct the Trustee to sign agreements and any other documentation required in connection with the purchase of any investment and the maintenance of any such investment. The Investment Adviser shall have sole responsibility (and the Trustee shall have no responsibility) for the exercise of the foregoing powers. The Trustee shall not be required to sign any document that purports to be based on the Trustee's actual knowledge if not true, that is impossible for the Trustee to carry out, or that violates any law or regulation applicable to banks, trust companies or sophisticated investors.

FORM 3

GENERATION-SKIPPING TRANSFER TAXATION PROVISIONS

It is the Grantor's intention that the Trustee consult with the executor of the Grantor's estate to determine whether the trusts hereunder shall be entirely exempt from generation-skipping transfer tax. In furtherance of the Grantor's intention:

A. Power To Act The Trustee is authorized: (1) to hold any property immediately upon receipt in a separate trust, pending allocation of the transferor's GST exemption; or (2) to divide any property held in trust (including any terminating trust) or directed to be held in trust (whether or not immediately upon receipt) into two or more separate trusts of equal or unequal value, each of which shall be held as a separate trust.

B. Division of Trust If, upon the death of any beneficiary of a trust hereunder, the assets of the trust are includible in the beneficiary's gross estate for federal estate tax purposes, the Trustee may divide such trust into separate trusts so that one such trust is equal in value to the amount of GST exemption the legal representatives of the beneficiary's estate intend to allocate thereto. The Trustee is further authorized, to the extent permitted by law, sever any trust hereunder in a "qualified severance" within the meaning of Section 2642(a)(3) of the Code. Any division of property into shares pursuant to this Agreement, whether pro rata or non-pro rata, shall be made in such manner as to comply with all Treasury Regulations promulgated under the Code, so that appreciation and depreciation in the property prior to actual division are fairly represented in each share.

C. Combination of Trusts The Trustee is authorized to combine (1) separate trusts hereunder with the same dispositive provisions for the same beneficiaries into a single trust, or (2) the assets of any trust hereunder with those of any substantially similar trust, as the Trustee, in its sole and absolute discretion, shall determine, for the same beneficiaries under another instrument, either by transferring such assets to the trustees of such other trust to be held as part of such other trust, or by accepting from the trustees of such other trust assets thereof to hold as part of a trust under this trust agreement; provided, in each case, that an exempt trust and a non-exempt trust may not be combined. If two or more trusts (each an "original trust") are combined pursuant to the provisions of this paragraph and one or more of such original trusts were subject to any rule against perpetuities or similar rule in any jurisdiction, the earliest termination date applicable to such original trusts shall govern the termination of the resulting combined trust.

D. Distribution Adviser Any provision to the contrary notwithstanding, the Grantor requests but does not require that the Distribution Adviser refrain from directing discretionary distributions of income and principal from an exempt trust that could instead be made to the same person from a non-exempt trust without incurring any generation-skipping transfer tax on the distribution.

E. Liability of Trustee and Distribution Adviser Any action taken by the Trustee or Distribution Adviser pursuant to the provisions of this Article with respect to any trust shall be conclusive on all persons then or thereafter interested in such trust, and the Trustee or

Distribution Adviser, as the case may be, shall have no liability if, in light of or as a result of subsequent events, a different action would have caused a better tax result.

FORM 4

TAX MATTERS INVOLVING CUSTODIANS

The Trustee shall provide all information with respect to a trust necessary to enable each trust beneficiary to prepare his or her federal and state income tax returns. During any time that a bank, broker, custodian, investment counsel, money manager or others holding trust assets retained hereunder ("custodians") has custodial responsibility for all or any portion of the assets of a trust created hereunder, the periodic statements of account provided to the Trustee by such custodians shall be considered the records of the Trust and the Trustee may rely upon them without independent examination. The duty of the Trustee to provide tax reporting information to beneficiaries shall be limited, with respect to the trust property for which such custodians have responsibility, to the extent that the Trustee does not receive the necessary information in a timely fashion from such custodians. The duty of the Trustee to prepare and file or cause to be prepared and filed any required federal or state income tax returns or any other required tax returns and to pay any taxes due (including, but not limited to estimated taxes) shall be limited, with respect to the trust property for which such custodians have responsibility, to the extent the Trustee does not receive the necessary information in a timely fashion from such custodians or it is not provided with the necessary funds required to pay any taxes due (including, but not limited to estimated taxes) from such custodians.

FORM 5

INSUFFICIENT FUNDS FOR LEGAL PROCEEDING

In the event that the Trustee reasonably believes that the marketable assets of the trust will not be sufficient to fully indemnify the Trustee with respect to its obligation to defend or to continue to defend the trust or its assets in an action in which the claimant seeks, through the exercise of judicial process or otherwise to reach the assets of the trust (including, but not limited to, situations where the action or litigation was initiated by the Trustee, and/or where such claimant is a defendant in such a litigation and raises a counterclaim against the Trustee or the assets of the trust, and/or where such claimant is a third party in such a litigation and raises a cross claim against the Trustee or the assets of the trust), the Trustee shall promptly give written notice thereof to each beneficiary and Investment Adviser of such trust whereupon the Investment Adviser shall use reasonable best efforts to obtain the funds necessary to make such payments through other means, such as borrowing the funds and/or securing the loan with trust assets. If the Investment Adviser notifies the Trustee that other means of obtaining such funds are not reasonably available, the Trustee shall request the beneficiaries, jointly and severally, to pay in full for all liabilities and expenses of such defense (including without limitation the professional fees and expenses of counsel, accountants and expert witnesses) with such security for their obligation to make such payments as the Trustee may reasonably require in its sole discretion. The beneficiaries shall have no duty or obligation to pay for such liabilities and expenses or provide security therefor. For purposes of this Declaration, "defend or continue to defend" includes without limitation participating in, intervening in, or defending a lawsuit, action in equity or administrative, arbitration or mediation proceeding, including any counterclaim brought by a defendant in a litigation initiated by Trustee or any cross-claim brought by a third party in any litigation (collectively, a "proceeding"), or taking any other action to resist such claim. In the event that the beneficiaries refuse to agree to undertake to pay, or having so agreed, in the event the beneficiaries fail to perform their obligations to pay, for such liabilities and expenses or provide security therefor, the Trustee shall be entitled to withdraw from the proceeding involved without liability, including without limitation even if such withdrawal may result in the granting or award of relief against the trust or its assets (including without limitation a distribution of trust assets) in satisfaction of the claims being made therefor.

Notwithstanding the foregoing in the subparagraph above, if the Trustee initiates litigation on behalf of the trust and if one or more defendants in such litigation raise a counterclaim against the Trustee or the assets of the trust or one or more third parties raise a cross claim against the Trustee or the assets of the trust, the Trustee shall not have the right to withdraw from such proceeding if the amount of the counterclaim and/or such cross claim, as the case may be, is or are less than the amount claimed against the defendant by the Trustee. Nor shall the Trustee shall have the right to withdraw from such proceeding if the amount of the counterclaim and/or cross claim exceed(s) such amount claimed by the Trustee, unless the Trustee reasonably believes that all the assets of the trust, whether readily marketable or not, are insufficient to satisfy any such excess.

FORM 6

POWER OF SUBSTITUTION IN DIRECTED TRUST

At any time and from time to time, without the consent of any Trustee or other fiduciary serving hereunder, the Grantor, acting in a non-fiduciary capacity, may acquire or reacquire any part or all of the property of any trust under this Agreement by substituting therefor other property of equivalent value, valued on the date of substitution. The Trustee has a duty to satisfy itself that the property acquired and substituted by the Grantor is in fact of equivalent value, and accordingly has a duty of impartiality with respect to the beneficiaries that supersedes any other provision of this Agreement. Therefore, if the Trustee believes that the property the Grantor seeks to substitute for trust property is not in fact of equivalent value, or, if the Trustee believes that the power authorized by this paragraph may be exercised to shift benefits among the beneficiaries, then the Trustee shall seek a determination by a court of competent jurisdiction to assure that the property which the Grantor seeks to substitute is of equivalent value and/or that the power is not exercised to shift benefits among the beneficiaries. The Grantor may release this power at any time by written notice to the Trustee. Any such release shall be irrevocable and shall be binding upon such Grantor, the Trustee and Adviser serving at the time of such release, and all successor trustees and advisers.

The Practice of Trusts and Estates in the Digital Age: Ethical Issues in Law Firm Technology and Data Security & Privacy

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The Practice of Trusts and Estates in the Digital Age:

Ethical Issues in Law Firm Technology and Data Security & Privacy

Presenter: Jennifer A. Beckage, CIPP/US, Partner and Leader, Data Security & Privacy Team, Phillips Lytle LLP

Summary: This session will address the ethical responsibility of trusts and estates attorneys to keep up with evolving technologies, and the potential risks and pitfalls that accompany the use of these technologies, plus data security and privacy concerns.

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I. INTRODUCTION

Jennifer A. Beckage, Partner and Leader of the Data Security & Privacy and Crisis Response Teams (Phillips Lytle LLP).

A previous technology business owner, who had a successful exit to a publically-traded company where she was retained in a VP position overseeing "e-services" products and operations.

Jennifer has significant experience responding to numerous data breaches, cyberattacks, ransomware and malware incidents and other thefts of data: from the IT response to customer reporting, litigation, and government interactions. While she is a seasoned attorney, her technology and business expertise uniquely positions her to solve complex and significant problems for her global clients. She becomes an extension of an IT department's team — mining the information necessary to solve the issue and prevent further crises.

Jennifer has appeared on behalf of clients in large and contentious matters in New York Surrogate's Court. She is a regular speaker on data security topics, including a speaker for the Erie County Bar Association's 2017 presentation of Surrogate Court Practice in the Digital Age, with speakers including Honorable Barbara Howe, Erie County Surrogate Judge.

Attached is Jennifer's profile.

II. ETHICAL RULES

Attorneys practicing trusts and estates law undoubtedly handle digital information on a daily basis, whether in electronic court filings, electronic drafts of wills and other testamentary documents, e-discovery, emails with clients and opposing counsel, and transfer of files through file transfer systems and programs.

Guided by the ethical rules, attorneys are to take reasonable care in taking steps to protect client confidences, and as explained in point III, may have other legal obligations to take steps to protect certain data. Below is a summary of the New York Rules of Professional Conduct and ethical decisions as it relates to data security and privacy.

A. Reasonableness Standard

1. Rule 1.6: Confidentiality of Information.
   - Rule 1.6(a): "A lawyer shall not **knowingly** reveal confidential information," unless there is consent or authorization to do so as set forth in the rule. (Emphasis added).
   - Rule 1.6(c): "A lawyer shall make **reasonable efforts** to prevent the inadvertent or unauthorized disclosure or use of, or unauthorized access to [confidential information]." (Emphasis added).

- Rule 1.6, comment [16] Duty to Preserve Confidentiality. "Paragraph (c) imposes three related obligations. It requires a lawyer to make reasonable efforts to safeguard confidential information against unauthorized access by third parties and against inadvertent or unauthorized disclosure by the lawyer or other persons who are participating in the representation of the client or who are otherwise subject to the lawyer's supervision. See Rules 1.1, 5.1 and 5.3."
- Rule 1.6, comment [16] Duty to Preserve Confidentiality. "Factors to be considered in determining the reasonableness of the lawyer's efforts include, but are not limited to: (i) the sensitivity of the information; (ii) the likelihood of disclosure if additional safeguards are not employed; (iii) the cost of employing additional safeguards; (iv) the difficulty of implementing the safeguards; and (v) the extent to which the safeguards adversely affect the lawyer's ability to represent clients (*e.g.*, by making a device or software excessively difficult to use). A client may require the lawyer to implement special security measures not required by this

Rule, or may give informed consent to forgo security measures that would otherwise be required by this Rule."

B. Ethics Decisions Addressing Five Questions Around Data Security & Privacy

1. What Data Do You Have And Is It Protected Data?

a. Rule 1.6(a)(3) defines confidential information.

- "'Confidential information' consists of information gained during or relating to the representation of a client, whatever its source, that is (a) protected by the attorney-client privilege, (b) likely to be embarrassing or detrimental to the client if disclosed, or (c) information that the client has requested be kept confidential. 'Confidential information' does not ordinarily include (i) a lawyer's legal knowledge or legal research, or (ii) information that is generally known in the local community or in the trade, field or profession to which the information relates." (Exceptions, see Rule 1.6(b)).
- Comment [2], "A fundamental principle in the client-lawyer relationship is that, in the absence of the client's informed consent, or except as permitted or required by these Rules, the lawyer must not knowingly reveal

information gained during and related to the representation, whatever its source."

b. Sensitive data may also be protected by other laws and regulations.

2. How Is Data Transferred?

a. Secure means to transfer data.

- Rule 1.6, Comment [17]: "When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients. Paragraph (c) does not ordinarily require that the lawyer use special security measures if the method of communication affords a reasonable expectation of confidentiality. However, a lawyer may be required to take specific steps to safeguard a client's information to comply with various laws.

b. Inadvertent disclosure.

- Rule 4.4(b): "A lawyer who receives a document, electronically stored information, or other writing relating to the representation of the lawyer's client and knows or

reasonably should know that it was inadvertently sent shall promptly notify the sender."

- Rule 4.4., Comment [2]: "A document, electronically stored information, or other writing is 'inadvertently sent' within the meaning of paragraph (b) when it is accidentally transmitted, such as when an email or letter is misaddressed or a document or other writing is accidentally included with information that was intentionally transmitted."
- For purposes of [Rule 4.4], a "document, electronically stored information or other writing" includes not only paper documents, but also email and other forms of electronically stored information — including embedded data (commonly referred to as "metadata") — that is subject to being read or put into readable form. Rule 4.4, Comment [2].

c. Do not track electronic communications.

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 749 (2001). A lawyer may not ethically use available technology to surreptitiously examine and trace email and other electronic documents. A lawyer may not place a "bug"

in an email that the lawyer sends to determine the subsequent route of the email. The Rules of Professional Conduct prohibit a lawyer from engaging in conduct involving dishonesty, fraud, or deceit and there is a strong public policy benefit to preserving confidential communications.

d. Border crossing and keeping data confidential.

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 2017-5 (2017). During border searches, confidential information may be on the attorney's electronic devices, which may be searched.

3. How/Where Is Data Stored?

a. Backups and record retention.

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 940 (2012). "A lawyer may use off-site backup tapes to store confidential client information if the lawyer takes reasonable care to ensure that the storage system, and the arrangements for its use, adequately protect the confidentiality of such information." See also N.Y. St. Bar Assn. Comm. on Prof. Ethics 842 (2010) (same

principles addressed in determining reasonableness and use of cloud storage).

b. Paper or electronic form.

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 1142 (2018). Except where documents need to be maintained in original form, a lawyer is not required to maintain a file in any particular form.
- N.Y. St. Bar Assn. Comm. on Prof. Ethics 1077 (2015). Lawyers can destroy an original retainer agreement after scanning the original executed copy and maintaining that electronic copy for the requisite period (at least seven years).
- N.Y. St. Bar Assn. Comm. on Prof. Ethics 950 (2012). There should be a reliable method to determine if a record is an original when making decisions about destruction of paper and saving only electronic copies.

c. Cloud storage.

- Jurisdictions have generally approved lawyers' use of off-site third-party providers' cloud and software as a service ("SaaS") services for creating, backing up and storing electronic versions of client files if there are

reasonable assurances that the accessibility and disclosure of information are protected.

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 842 (2010). Addresses Rule 1.6 and reiterates that an attorney must take reasonable steps to protect confidential information. Reasonable care may include consideration of the following: (1) that there is a way to ensure that the provider has enforceable obligations to preserve confidential information; (2) that there is a method by which to investigate providers security measures; (3) that the provider employs technology to guard against access to data; and (4) that the provider has the ability to wipe data/move it. See, N.Y. St. Bar Assn. Comm. on Prof. Ethics 1020 (2014).

4. Who Has Access?

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 1019 (2014). In providing lawyers remote access to client files, a law firm must take reasonable steps to protect information, but: "Because of the fact-specific and evolving nature of both technology and cyber risks, [this Committee] cannot recommend particular steps that would

constitute reasonable precautions to prevent confidential information from coming into the hands of unintended recipients."

- N.Y. St. Bar Assn. Comm. on Prof. Ethics 1020 (2014). Authorized persons should have access to cloud storage containing confidential information.
- N.Y. St. Bar Assn. Comm. on Prof. Ethics 939 (2012). Discusses the sufficiency of passwords where two lawyers are sharing a computer.

5. Who Is Responsible?

- Rule 5.3(b): Responsibility Over Non-Lawyers (*i.e.*, Choosing and Supervising Vendors). A lawyer is responsible for certain conduct of a non-lawyer employed/retained by or associated with the lawyer.
- Rule 5.3, Comment [3]: "A lawyer may use nonlawyers outside the firm to assist the lawyer in rendering legal services to the client." One such example is using an Internet-based service to store client information. When using such outside services, the lawyer "must make reasonable efforts to ensure that the services are provided in a manner that is compatible

> with the professional obligations of the lawyer and law firm. The extent of the reasonable efforts required under this Rule will depend upon the circumstances, including: (a) the education, experience and reputation of the non-lawyer; (b) the nature of the services involved; (c) the terms of any arrangements concerning the protection of client information; (d) the legal and ethical environments of the jurisdictions in which the services will be performed, particularly with regard to confidentiality; (e) the sensitivity of the particular kind of confidential information at issue; (f) whether the client will be supervising all or part of the non-lawyer's work . . . ." When retaining or directing a non-lawyer outside the firm, a lawyer should appropriately communicate directions to give reasonable assurance that the non-lawyer's conduct is compatible with the lawyer's professional obligations.

III. LEGAL LANDSCAPE

In addition to ethical rules, there are other laws and regulations that guide the protection of data that may be in the hands of attorneys.

A. Patchwork of Laws

1. International. Lawyers in trusts and estates may be impacted by international data security laws based upon the individual's residence and other factors (*e.g.*, see GDPR below).
2. Federal. Trust and estate lawyers may be subject to federal requirements, such as HIPAA.
3. State. If a trust and estate lawyer's practice suffers a data security incident, there may be state law reporting obligations, which are primarily driven by where the potentially-impacted persons reside. So, even if the lawyer's practice is primarily in New York, its contacts may reside out of the state, and those state laws would apply for notification purposes.
4. Not all laws are the same: privacy laws, security laws, breach notification laws, and more.
5. Guidance is not uniform, and much is driven by industry and the types of data that are held by the law firm or organization.

B. New Regulations Having Impact On Legal Services

1. General Data Protection Regulation ("GDPR").
   a. Lawyers practicing in trusts and estates may be practicing in a manner and holding onto data concerning persons located in the European Union ("EU"), which would trigger

GDPR. Such personal EU data may appear in wills or in client files, or as a result of the law firm operating in or soliciting work from persons in the EU, and would require attention to GDPR.

b. Overview.

   i. The GDPR was approved and adopted by the EU Parliament in April 2016. The regulation will take effect after a two-year transition period and will be in force May 25, 2018.

   ii. The GDPR applies to all companies located in the EU and members of the European Economic Area (Liechtenstein, Iceland and Norway), as well as companies that control or process the personal data of data subjects located in the EU, regardless of the company's location or citizenship of the individuals.

   iii. Organizations that violate GDPR can be fined the greater of up to 4% of annual global sales or €20M.

   iv. Personal data includes any information related to a natural person that can be used to directly or indirectly identify the person, including a name, a photograph, an

email address, location tracking information, an identification number, biometric data, or an IP address.

v. Some key provisions.

- Breach Notification: Data controllers are required to notify the relevant supervisory authority within 72 hours of having first become aware of a breach. Data processors are required to notify the relevant controllers "without undue delay."
- Right to be Forgotten: Also known as Data Erasure, individuals have the right to require a data controller to erase his/her personal data, cease further dissemination of the data, and potentially have third parties halt processing of the data, if having the data is no longer required for the original purposes for processing, if an individual withdraws consent, or if the use falls into one of the other enumerated exceptions.
- Right to Access: Data subjects have the right to obtain confirmation as to whether or not their personal data is being processed, including where, by whom, and for what purpose.

- Right to Portability: Individuals can request that their data be provided in a commonly used and machine readable format and transmitted to another controller, if certain conditions are met.
- Lawful basis for processing data. These bases are set out in Article 6 of the GDPR. At least one of these must apply, many will use Consent (Art. 6(1)(a)). Other bases include: Contract (Art. 6(1)(b)); Legal Obligation (Art. 6 (1)(c)); Vital Interests (Art. 6(1)(d)); Public Task (Art. 6(1)(e)); and Legitimate Interests (Art. 6(1)(f)).

c. Lawyers impacted by GDPR should develop internal policies for compliance, including, *e.g.*, privacy policies, privacy notices, incident response plan, and contract negotiation strategy.

2. New York State Department of Financial Services ("NYSDFS") Cybersecurity Regulation.

a. Law firms, including those practicing in trusts and estates, may be subject to the NYSDFS Cybersecurity Regulation, which requires certain data security and privacy safeguards.

b. Overview.

i. Became effective March 1, 2017.

ii. Applies to those regulated by New York banking, financial, and insurance laws.

iii. Focus on protecting non-public information (“NPI”), i.e., business-sensitive information, personal identifiable information (“PII”), and personal health information (“PHI”).

iv. Based upon an organization’s risk management.

v. 72 hour reporting requirement for qualified cybersecurity events after a determination is made, inter alia, that there is a reportable incident.

vi. Requires certain cybersecurity practices be put in place, including data security policies, with oversight of third-party vendors.

vii. First set of compliance measures was to be satisfied by August 28, 2017, with first compliance certificate due February 15, 2018.

viii. “Covered Entity” is “any Person operating under or required to operate under a license, registration, charter, certificate, permit, accreditation or similar authorization

under the Banking Law, the Insurance Law or the Financial Services Law" (§ 500.01).

ix. Ripple effect to third-party vendors. Covered Entities must evaluate third-party providers. Note, a business can be a Covered Entity and Third-Party Vendor.

x. Regulation contemplates cybersecurity events.

xi. Any act or attempt, successful or unsuccessful, to gain unauthorized access to, disrupt or misuse an information system or information stored on such information systems.

xii. There is an enhanced role of risk management and how it affects cybersecurity practices.

xiii. Timeline for compliance.

- August 28, 2017:
  - Cybersecurity program (§ 500.02).
  - Cybersecurity policy (§ 500.03).
  - Chief Information Security Officer ("CISO") (§ 500.04).
  - Access privileges (§ 500.07).
  - Cybersecurity personnel and intelligence (§ 500.10).

  - Incident response plan (§ 500.16).
  - Notice of cybersecurity event (§ 500.17(a)).
- February 15, 2018:
  - Annual certification.
- March 1, 2018:
  - CISO report (§ 500.04(b)).
  - Risk assessment (§ 500.09).
  - Annual penetration testing and bi-annual vulnerability assessments or continuous monitoring (§ 500.05).
  - Multi-factor authentication (§ 500.12).
  - Training and monitoring (§ 500.14(b)).
- September 1, 2018:
  - Audit trail (§ 500.06).
  - Application security (§ 500.08).
  - Limitations on data retention (§ 500.13).
  - Training and monitoring (§ 500.14(a)).
  - Encryption of non-public information (§ 500.15).
- March 1, 2019:

  - Third-party service provider security policy requirements (§ 500.11).
- February 15, 2019:
  - Annual certification (§ 500.17(b)). And continue to provide annual certifications thereafter.

xiv. Exemptions.

- Limited and non-limited exemptions.
- The DFS has been sending email notices to those who did not file an exemption or certification.

IV. TECHNOLOGY LANDSCAPE

There are new, emerging, and disruptive technologies that are changing how trust and estate lawyers, and their clients do business.

- Digital assets in estate planning.
- The transfer of digital assets — systems still available to support them.
- Passwords/access to social media and other online accounts.
- Online/electronic wills.
- Smart contracts.
- Blockchain technology.
- Bitcoin and other crypto currencies in estate planning.
- Internet of Things (IOT).

- Artificial intelligence.

V. DATA SECURITY & PRIVACY PRACTICES

Knowing the ethical rules, what laws and regulations apply, and technology available to the attorney, what is the next step to develop a practical and defensible practice to address ethics and data security and privacy? Typical lawyer answer: "It depends." There is no "one-size-fits all" cybersecurity program. Also, there is no prescriptive rule for technical controls. It is a case-by-case analysis. However, no matter what the size of the organization, the approach is the same and can be approached by addressing five key questions (which were addressed in section II):

A. What Data Do You Have and Is It Protected Data?

1. Privileged.
2. Personal Identifiable Information (PII).
3. Personal Health Information (PHI).
4. Non-Public Information (NPI).
5. Sensitive.
6. Such data may appear in wills, trust drafts, estate tax filings, communications, and other files.

B. How Is Data Transferred?

1. Avoid where possible using unencrypted methods to transfer sensitive data, such as web-based email or document share programs to transfer protected data.
2. Emails.
3. Document share programs.
4. Portable devices.
5. Discovery/exchange with opposing counsel.
6. Internally (using web or unsecured mail).
7. Court (efiling and communications).

C. Where Is It Stored?

1. Internally.
    a. Software.
    b. Scanning trust and estate file documents.
2. Externally with vendors.
    a. Cloud.
    b. Contracts.
    c. NDAs.
3. Portable devices.
    a. Monitoring mobile device use.
    b. Home computing.
4. For how long is it stored?

a. De-duplicate.

b. Record retention periods.

D. Who Has Access?

1. Access controls.

2. Strong passwords.

3. Multi-factor authentication.

E. Who is Responsible?

1. Who is monitoring/testing?

2. Staff.

3. Vendors.

4. What does incident response look like?

5. Are there policies and procedures in place?

VI. DEFINITIONS

A. Audit Trail: Listing of activity, information that is used to monitor or validate activity concerning data and systems.

B. Big Data: Large data sets.

C. Biometrics: Data concerning the physical characteristics of an individual (*e.g.*, retina scan).

D. Caching: Saving information about content downloaded so the next time a website is visited, the same information does not need to be downloaded again, which provides for faster page display.

E. **Cloud**: Storing information on a network of locations instead of on your business's network.

F. **Cookie**: A file stored on a user's device that allows another web server to track user activity on the internet and can be used to remember the user to prevent the user from having to log into and authenticate every time the user visits a website.

G. **Encryption**: Converting data using an algorithm into ciphertext, which can only be deciphered (converted back into a readable message) with a "key."

H. **Metadata**: Data that is often hidden from plain view but provides additional information about data. For example, for emails there is hidden metadata that provides the date and time the email was sent and received.

I. **Spam**: Unsolicited emails sent to many addresses.

1. Email Spoofing: Registered domain names may closely resemble a company's legitimate domain name; for instance, with the difference being a single altered letter or character, to target the legitimate domain. Cybercriminals then send a fraudulent or "spoofed" email to employees or customers of the target company, hoping to acquire inadvertently sent out financial information.

2. Phishing: A type of "social engineering" used to trick people into sharing information through, for example, emails using personal information learned from social media in an attempt to give the hacker credibility. Phisher obtains information from the individual in their response to the email, or the individual may unknowingly, by opening the email, open an application that sends the phisher data.

J. **Malware**: Software inadvertently downloaded that can negatively affect your network and systems.

1. Computer Virus: A computer program that can copy itself and cause harm in various ways, such as stealing private information or destroying data.
2. Keylogger: A program that records every keystroke on a keyboard and sends that information to an attacker.
3. Ransomware: A type of malware that usually holds victims' computer files hostage by locking access to them or encrypting them.
4. Trojan Horse: Malware that appears to be a valid, and not malicious, software.

K. **Multi-factor Authentication**: Process for individuals to validate their identities that requires more than one level of identification

(*e.g.*, a password plus a biometric scan or a message to another device linked to the individual).

L. **Internet of Things**: Internetworking of multiple physical devices, each having network connectivity that enables these devices to collect and exchange data.

M. **Worm**: A malicious program that replicates over a network.

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This presentation is an overview of some of the potentially applicable laws and rules and possible exposures and risks and best practices, of which Phillips Lytle strives to achieve and which must be evaluated on a case-by case basis by each firm/business.

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If you would like further information or believe you have a data security incident that requires response and evaluation of notification and reporting requirements, please contact Jennifer A. Beckage, Team Leader of the Data Security & Privacy Team. 716-847-7093.

Doc #01-3108440

The Practice of Trusts and Estates in the Digital Age: Ethical Issues in Law Firm Technology and Data Security and Privacy

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Partner and Leader of the
Data Security & Privacy Team

May 4, 2018

I. INTRODUCTION

Phillips Lytle LLP

II. ETHICAL RULES

A. Reasonableness Standard
B. Ethics Decisions Addressing Five Questions Around Data Security and Privacy
   1. What Data Do You Have And Is It Protected Data?
   2. How Is Data Transferred?
   3. How/Where Is Data Stored?
   4. Who Has Access?
   5. Who Is Responsible?

Phillips Lytle LLP

III. LEGAL LANDSCAPE

A. Patchwork of Laws
B. New Regulations Having An Impact On Legal Services
   1. General Data Protection Regulation ("GDPR")
   2. New York State Department of Financial Services ("NYSDFS") Cybersecurity Regulation

Phillips Lytle LLP

IV. TECHNOLOGY LANDSCAPE

- Digital Assets In Estate Planning
- The Transfer of Digital Assets – Systems Still Available to Support Them
- Passwords/Access to Social Media and Other Online Accounts
- Online/Electronic Wills
- Smart Contracts

Phillips Lytle LLP

IV. TECHNOLOGY LANDSCAPE *(cont'd)*

- Blockchain Technology
- Bitcoin and Other Crypto Currencies in Estate Planning
- Internet of Things (IOT)
- Artificial Intelligence

Phillips Lytle LLP

V. DATA SECURITY & PRIVACY PRACTICES

A. What Data Do You Have And Is It Protected Data?
B. How Is Data Transferred?
C. Where Is It Stored?
D. Who Has Access?
E. Who Is Responsible?

Phillips Lytle LLP

VI. DEFINITIONS

Thank You

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Shoo Creditors, Don't Bother Me -
All You Need to Know About the Use of Self-Settled Asset Protection Trusts

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I. INTRODUCTION

A. It's no secret that the United States is a litigious society, and there's no indication that the trend line with respect to lawsuits goes anywhere from here but up. And, although some claims have merit, far too many do not. In such an atmosphere, one's clients are subject to an unacceptable level of risk.

B. Today, self-settled spendthrift trusts, more commonly called "asset protection trusts," are a common planning tool to protect clients against the claims of potential future creditors. A number of states within the United States, as well as certain foreign jurisdictions, now permit such trusts and, as time goes by, more jurisdictions (including, perhaps, New York), will enact self-settled spendthrift trust legislation.

II. BACKGROUND

A. A Brief (and Selective) History of Creditor-Proof Trusts

1. Spendthrift Trusts

a. "Trusts in which a beneficiary cannot assign the interest, or that provide that creditors cannot reach it, are known as 'spendthrift trusts.'" SCOTT AND ASCHER ON TRUSTS § 15.2, Vol. 3 at 898 (5th ed. 2007).

b. "The term 'spendthrift trust' refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests." RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

c. In New York, § 7-1.5(a)(1) of the Estates, Powers and Trusts Law provides, in general, and in pertinent part, that "…[t]he right of a beneficiary of an express trust to receive the income from property and apply it to the use of or pay it to any person may not be transferred by assignment or otherwise unless a power to transfer such right, or any part thereof, is conferred upon such beneficiary by the instrument creating or declaring the trust."

2. Discretionary Trusts

a. A "discretionary" trust is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard. RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

3. Combined Discretionary and Spendthrift Trusts

a. "A spendthrift trust is to be distinguished from a discretionary trust but may or may not also contain discretionary interests…" RESTATEMENT (THIRD) OF TRUSTS § 58, Vol. 2 at 355 (2003).

b. A discretionary spendthrift trust has the potential to afford a beneficiary a significant amount of creditor protection. A series of cases is instructive in this regard; they are (i) *Nichols v. Eaton*, 91 U.S. 716 (1875), (ii) *Sligh v. First National Bank of Holmes County*, 704 So. 2d 1020 (Miss. 1997), (iii) *Scheffel v. Krueger,* 782 A.2d 410 (N.H. 2001), and (iv) *Gibson v. Speegle*, 1984 Del. Ch. LEXIS 475 (DE Ct. of Chancery, Sussex County, May 30, 1984).

(i) *Nichols v. Eaton*

(a) It was not until 1875, with the United States Supreme Court decision in *Nichols v. Eaton*, that a break with the English common law on spendthrift trusts was effected, and their validity became generally accepted throughout the United States.

(b) The theoretical basis underlying the general acceptance of the validity of spendthrift trusts in the United States, as demonstrated by the Supreme Court in *Nichols*, is the idea that an individual should be able to transfer property subject to certain limiting conditions upon which the property will be available to the beneficiary.

(1) In this regard, the maxim "*cujus est dare, ejus est disponere*," or "[w]hose it is to give, his it is to dispose" is frequently cited in connection with references to the validity of spendthrift trust restrictions.

(c) In *Nichols*, the trust in question was a testamentary trust established by a mother for her son who had failed in business and who had assigned all of his property for the benefit of his creditors and then later filed for bankruptcy. The mother's will included a provision that stated that if any of her sons should "alienate or dispose of

the income to which they were entitled under the trusts of the will, or if, by reason of bankruptcy or insolvency, or any other means whatsoever, said income could no longer be personally enjoyed by them respectively, but the same would become vested in or payable to some other person, then the trust expressed in said will concerning so much thereof as would so vest should immediately cease and determine. In that case, during the residue of the life of such son, that part of the income of the trust fund was to be paid to the wife and children, or wife or child, as the case might be, of such son, and in default of any objects of the last-mentioned trust, the income was to accumulate in augmentation of the principal fund."

(d) In establishing the modern rule with regard to spendthrift trusts, the Supreme Court in *Nichols* stated that:

(1) "We concede that there are limitations which public policy or general statutes impose upon all dispositions of property, such as those designed to prevent perpetuities and accumulations of real estate...We also admit that there is a just and sound policy...to protect creditors against frauds upon their rights...But the doctrine, that the owner of property...cannot so dispose of it, but that the object of his bounty...must hold it subject to the debts due his creditors...is one which we are not prepared to announce as the doctrine of this court."

(ii) *Sligh v. First National Bank of Holmes County*

(a) In *Sligh*, the beneficiary of two spendthrift trusts established by the beneficiary's mother with the defendant bank, as trustee, was operating a motor vehicle while intoxicated and was involved in an accident with the plaintiff. The accident left the plaintiff paralyzed with the loss of the use of both legs, the loss of all sexual function and the loss of

his ability to control his bowel and urinary functions. The plaintiff won a $5 million civil judgment against the beneficiary for compensatory and punitive damages and tried to collect against the trusts by alleging that the beneficiary's mother had actual knowledge that the beneficiary was an alcoholic and that the beneficiary's mother had created the trusts to shield her son's interest from the likely claims of involuntary tort creditors. The beneficiary had no other assets aside from his beneficial interests in the trusts.

(b) The plaintiff alleged that it was a violation of public policy to enforce and give priority to spendthrift trust provisions over involuntary tort judgments against a trust beneficiary, and urged the court to recognize and enforce a public policy exception to the spendthrift trust doctrine in favor of involuntary tort creditors. The Mississippi Supreme Court ultimately allowed the plaintiff to collect against the trusts by concluding that spendthrift protection should not extend to judgments for "gross negligence and intentional torts."

(1) Most significant, however, is the fact that the Mississippi legislature promptly negated the import of *Sligh* in future cases through the enactment of the "Family Trust Preservation Act of 1998." Miss. Code Ann. §§ 91-9-501, *et seq.* (1998). That act provides that except in the case of a self-settled trust, a beneficiary's interest in a spendthrift trust may not be transferred nor subjected to a money judgment until the interest is actually paid to the beneficiary.

(iii) *Scheffel v. Krueger*

(a) In *Scheffel v. Krueger*, the defendant was a convicted child molester who was the beneficiary of a discretionary spendthrift trust established by his grandmother in 1985. The plaintiff filed suit in 1998 asserting tort claims against the defendant

in connection with the molestation charges and seeking an attachment of the defendant's beneficial interest in the discretionary spendthrift trust. Under the terms of the trust, all income was to be distributed to the defendant annually and distributions of principal were to be made in the trustee's discretion. The defendant had the power to invade the principal of the trust only following his fiftieth birthday on April 6, 2016.

(b) The court found no basis for relief for the plaintiff and held that nothing in the language of the relevant statute suggested that the New Hampshire legislature intended to exempt a tort creditor from the protection afforded by a spendthrift provision. The court also found that the defendant's ability to direct trust income and principal after attaining age fifty did not, in and of itself, disqualify the trust as a spendthrift trust.

(iv) *Gibson v. Speegle*

(a) In February, 1976, Gary Barwick pled guilty to several crimes, including arson, all of which resulted in damage to the Hawaiian Village Restaurant and Lounge in Delmar, Delaware, a property that Aetna insured and in connection with which Aetna paid out monies to the policyholder. At sentencing, Gary was ordered, *inter alia*, to pay restitution, including monies to Aetna. Less than five months after Gary's sentencing, his mother, Virginia, executed a Last Will and Testament which included a discretionary spendthrift trust for Gary until he should reach the age of forty (40) years. Virginia then died and Aetna made claim against Gary's new trust.

(b) Delaware Code § 3536(a) provides, in pertinent part, that "[a] creditor of a beneficiary of a trust shall have only such rights against such beneficiary's interest in the trust or the property of the trust as shall be expressly granted to such creditor by the terms of the instrument that creates or defines the trust or by the laws of [Delaware].

The provisions of this subsection shall be effective regardless of the nature or extent of the beneficiary's interest or of any action taken or that might be taken by the beneficiary. Every interest in a trust or in trust property or the income therefrom that shall not be subject to the rights of creditors of such beneficiary as provided herein shall be exempt from execution, attachment, distress for rent, foreclosure, and from all other legal or equitable process or remedies instituted by or on behalf of any creditor, including, without limitation, actions at law or in equity against a trustee or beneficiary that seeks a remedy that directly or indirectly affects a beneficiary's interest…"

(c) The Delaware Court of Chancery stated: "I am not at all comfortable with the fact that Virginia Barwick, by use of a spendthrift trust, assisted her son in avoiding his obligation to pay for his crimes. However, it is not the Court's function to write the law but only to interpret it. The statute enacted by the General Assembly contains no exceptions."

4. Self-Settled Spendthrift (a/k/a "Asset Protection") Trusts

a. Domestic Asset Protection Trusts

(i) Although every state recognizes, in general, the validity of spendthrift trusts to protect a third party beneficiary's interest from creditor claims, such clauses, as a matter of public policy, have historically been unenforceable with respect to a settlor, who is also a beneficiary of such trust, to the extent of such settlor's interest in such trust. In this regard, many states have statutes or common law prohibiting such "self-settled spendthrift trusts" and provide that a settlor cannot create such a trust to protect himself or herself from creditors.

(a) In New York, § 7-3.1(a) of the Estates, Powers and Trusts Law provides, in general, and in pertinent part, that "[a] disposition in trust for the use of the creator is void as against the existing or subsequent creditors of the creator."

(ii) These prohibitions against self-settled spendthrift trusts apply irrespective of any number of considerations that one might logically consider to be relevant to the question of whether such trusts should actually be void as against public policy, including, most significantly:

(a) Whether or not the settlor is the sole beneficiary of the trust, or one of many discretionary beneficiaries of the trust.

(b) Whether the trustee is a friend or family member of the settlor, or a bank or trust company that is completely independent of the settlor.

(c) Whether the trust is funded with a nominal amount or a large portion of the settlor's overall net worth.

(d) Whether or not the settlor has ever received a discretionary distribution from the trust.

(e) Whether or not the settlor has any existing or anticipated future creditors at the time the trust is created.

(iii) However, since 1997 sixteen states have enacted legislation extending spendthrift trust protections to a settlor-beneficiary of a discretionary trust (provided that the funding of the trust is not a fraudulent transfer). Those states are:

(a) Alaska

(b) Delaware

(c) Hawaii

(d) Michigan

(e) Mississippi

(f) Missouri

(g) Nevada

(h) New Hampshire

(i) Ohio

(j) Rhode Island

(k) South Dakota

(l) Tennessee

(m) Utah

(n) Virginia

(o) West Virginia

(p) Wyoming

(q) In addition, Oklahoma, pursuant to the Family Wealth Preservation Trust Act of June 9, 2004, permits an individual to create a trust with a bank or trust company located in Oklahoma as trustee, for the benefit of such individual's spouse, descendants and any one or more Internal Revenue Code § 501(c)(3) charities, and to retain the right to revoke the trust without causing the trust to thereby be available to creditors. In addition, the law provides that no court shall have the authority to compel the settlor to exercise the settlor's power to revoke the trust. The law does, however, limit the protection to $1 million of transferred assets plus any subsequent appreciation thereon. In addition, the corpus of the trust must consist of assets in Oklahoma based banks, real estate located in Oklahoma, and securities issued by Oklahoma based companies (including corporations, limited liability companies and limited partnerships formed or domesticated in Oklahoma and having a principal place of business in Oklahoma). However, the Oklahoma law does not technically provide for "self-settled" spendthrift trusts because the settlor himself cannot be a beneficiary of such a trust.

b. Foreign Asset Protection Trusts

(i) Historically, it was individuals residing outside of the United States that used foreign asset protection trusts, and their purpose was to avoid forced heirship and government expropriation of assets, rather than the potential claims of third party creditors. However, in the modern litigation environment within the United States, such trusts are today most often used by United States persons for more "standard" asset protection purposes.

(ii) The following foreign jurisdictions have enacted favorable asset protection trust legislation:

(a) Anguilla

(b) Antigua

(c) Bahamas

(d) Barbados

(e) Belize

(f) Bermuda

(g) Cayman Islands

(h) Cook Islands

(i) Cyprus

(j) Gibraltar

(k) Labuan

(l) Marshall Islands

(m) Mauritius

(n) Nevis

(o) Niue

(p) St. Vincent

(q) St. Lucia

(r) Seychelles

(s) Turks and Caicos

III. FRAUDULENT TRANSFER ISSUES

A. Every asset protection plan, including those involving the creation of an asset protection trust, must in the very first instance account for the law of fraudulent transfers. In general, the law of fraudulent transfers, which dates back at least to the enactment of the *Statute of Elizabeth* in England in the year 1571, provides that the transfer of assets in anticipation of a creditor claim will be disregarded by the courts and the creditor will be allowed to enforce its judgment against a transferee of the property.

B. Fraudulent transfer law can be found within the federal Bankruptcy Code, the debtor/creditor law of every state and the law of almost all foreign jurisdictions, as well.

1. For federal purposes, Bankruptcy Code § 548, entitled *Fraudulent Transfers and Obligations*, provides for the avoidance of fraudulent transfers in the Bankruptcy context.

2. At the state level, fraudulent transfer law is largely governed by one of two main bodies of law promulgated by the National Conference of Commissioners on Uniform State Law (also known as the Uniform Law Commission).

a. The Uniform Fraudulent Conveyance Act (promulgated in 1918 by the National Conference of Commissioners on Uniform State Laws and in effect today in only two jurisdictions – Maryland and New York).

b. The Uniform Fraudulent Transfer Act (approved by the National Conference of Commissioners on Uniform State Laws in 1984 and in effect today in forty three states, as well as the District of Columbia and the U.S. Virgin Islands).

(i) In 2014, the National Conference of Commissioners on Uniform State Laws adopted amendments to the Uniform Fraudulent Transfer Act. Among other things, the amendments renamed the UFTA as the "Uniform

Voidable Transactions Act". To date, these amendments have been adopted in eighteen states.

(a) As of the preparation of this outline, the Uniform Voidable Transactions Act has been introduced in New York, but is not enacted. See, Assembly Bill 1853/Senate Bill 6180.

c. The remaining states follow either a version of the Statute of Elizabeth, or provide for a civil law analogue to the common law suit to set aside a fraudulent transfer (*i.e.*, Louisiana).

C. Notwithstanding the semantic similarity between the term "fraud" and the term "fraudulent conveyance" (or "fraudulent transfer"), the two concepts are wholly unrelated under the law.

1. According to Black's Law Dictionary, a "fraud" is "[a] knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."

2. By contrast, the most common incidence of a "fraudulent conveyance" is as is set forth in § 276 of the New York Debtor Creditor Law, which provides that a "…conveyance made [or an]obligation incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors…"

a. In addition, § 273 of the New York Debtor Creditor Law provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration."

b. Finally, the mere fact that a person has been named as a defendant in a lawsuit can render all transfers made by that person without the receipt of sufficient consideration therefore as *per se* fraudulent transfers irrespective of the transferor's actual intent, or solvency, at the time of the transfer.

(i) In this regard § 273-a of New York Debtor and Creditor Law provides that "[e]very conveyance made without fair consideration when the person making it is a defendant in an action for money damages or a judgment in such an action has been docketed against him, is fraudulent as to the plaintiff in that action without regard to the actual

intent of the defendant if, after final judgment for the plaintiff, the defendant fails to satisfy the judgment."

3. The difference between a fraud and a fraudulent conveyance is also evidenced by the remedy available to the injured party; fraud vitiates all transactions *ab initio*, whereas a fraudulent transfer is merely voidable.

D. In determining when a transfer was made with the intent to hinder, delay or defraud a creditor, fraudulent conveyance law usually divides creditors into three categories:

1. Present creditors – being those persons of whom the transferor has notice when making transfers.

2. Probable future creditors – being those persons against whom the transferor harbored an actual fraudulent intent when transferring assets, including creditors whose rights arose after the transfer.

3. Potential future creditors – being those nameless, faceless persons of whom the transferor had no awareness or expectation of a debtor/creditor relationship when the transfer was made.

E. One can easily imagine that it will be the rare debtor who expressly admits or otherwise voluntarily disgorges proof that his or her transfers of property were made with an actual intent to hinder, delay or defraud his or her creditors. As a consequence of this inherent difficulty in proving the debtor's intent, the courts have permitted various "badges of fraud", frequently thought to attend the fraudulent transfer of property, to be taken into account as "proof" of the requisite intent.

1. The Uniform Fraudulent Conveyance Act relies upon common law badges of fraud.

2. In contrast, the Uniform Fraudulent Transfer Act provides a non-exhaustive list of factors that may be considered in determining the debtor's actual intent in transferring property or incurring an obligation. Those factors are:

a. Whether the transfer or obligation was to an insider;

b. Whether the debtor retained possession or control of the property transferred after the transfer;

c. Whether the transfer or obligation was disclosed or concealed;

d. Whether before the transfer was made or the obligation was incurred, the debtor had been sued or threatened with suit;

e. Whether the transfer was of substantially all of the debtor's assets;

f. Whether the debtor absconded;

g. Whether the debtor removed or concealed assets;

h. 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;

i. Whether the debtor was insolvent at the time the transfer was made or the obligation was incurred or became insolvent shortly after the transfer was made or the obligation was incurred;

j. Whether the transfer occurred shortly before or shortly after a substantial debt was incurred; and

k. Whether the debtor transferred the essential assets of his or her business to a lienor who transferred the assets to an insider of the debtor.

F. Effect of Finding a Fraudulent Conveyance and Transferee Liability

1. The Uniform Fraudulent Conveyance Act provides for several alternative remedies where a fraudulent conveyance is found to have been made. Those prospective remedies include:

a. Avoidance of the conveyance or obligation to the extent necessary to satisfy the creditor's claim;

b. An attachment or other provisional remedy against the asset conveyed or other property of the transferee; and

c. An injunction against further disposition by the debtor or a transferee, or both, of the asset conveyed or of other property of the transferee or any other relief the circumstances may require.

2. A ceiling imposed upon the relief available where a fraudulent conveyance has been found is that the creditor can obtain no greater relief in the face of the fraudulent conveyance than such creditor might have obtained had the fraudulent conveyance not been made.

a. However, under the Bankruptcy Code, the debtor's discharge may also be denied due to the debtor having made a fraudulent transfer. See, 11 U.S.C. § 727.

G. It is notable that, except as specified hereinabove, it is unimportant whether or not a creditor's claim has yet coalesced into a lawsuit (which, of course, might be months or years after the actual claim arose).

H. It is, therefore, absolutely imperative that asset protection planning be undertaken as far in advance of a potential creditor claim as possible in order to ensure that any transfer of property incident to such planning is not later undone as a fraudulent conveyance.

IV. UVTA CONTROVERSY RE SELF-SETTLED SPENDTHRIFT TRUSTS

A. Section 10 of the Uniform Voidable Transactions Act, entitled "Governing Law", provides, in pertinent part that "[a] claim for relief in the nature of a claim for relief under this [Act] is governed by the local law of the jurisdiction in which the debtor is located when the transfer is made or the obligation is incurred."

1. Section 10(a)(1) provides that "[a] debtor who is an individual is located at the individual's principal residence."

2. Thus, if the individual debtor happens to be the settlor of a self-settled spendthrift trust, it will be the law of the settlor/debtor's residence, and not necessarily that of the trust, that will control the question of whether or not a voidable transaction has occurred.

B. Section 4(a)(1) of the Uniform Voidable Transactions Act, entitled "Transfer or Obligation Voidable as to Present or Future Creditor", provides that "[a] transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation…with actual intent to hinder, delay, or defraud any creditor of the debtor."

C. Comment 8 to Section 4 of the Uniform Voidable Transactions Act, however, states, in pertinent part, as follows:

1. "Suppose that jurisdiction X, in which this Act is in force, also has in force a statute permitting an individual to establish a self-settled spendthrift trust and transfer assets thereto, subject to stated conditions. If an individual Debtor whose principal residence is in X establishes such a trust and transfers assets thereto, then under § 10 of this Act the voidable transfer law of X applies to that transfer. That transfer cannot be considered voidable in itself under § 4(a)(1) as in force in X, for the

legislature of X, having authorized the establishment of such trusts, must have expected them to be used. (Other facts might still render the transfer voidable under X's enactment of § 4(a)(1).)"

2. "By contrast, if Debtor's principal residence is in jurisdiction Y, which also has enacted this Act but has no legislation validating such trusts, and if Debtor establishes such a trust under the law of X and transfers assets to it, then the result would be different. Under § 10 of this Act, the voidable transfer law of Y would apply to the transfer. If Y follows the historical interpretation referred to in Comment 2, the transfer would be voidable under § 4(a)(1) as in force in Y."

3. Comment 8 to Section 4 of the Uniform Voidable Transactions Act thus appears to suggest, through the back door device of a Comment, and not an actual provision of the Act, that the creation of a self-settled spendthrift trust by anyone other than a residence of a self-settled spendthrift trust jurisdiction is a *per se* voidable transaction.

    a. Significantly, however, the NYC Bar Association Report submitted in connection with the possible enactment of the UVTA in New York states, in pertinent part, that:

        (i) Section 273 "…is the first of the two principal operative sections of the Act and sets out two of the four principal rules for the avoidance of transfers. Rights to avoid transfers are extended to both creditors existing at the time of the transfer and future creditors, for transfers that are voidable under Section 273. Section 273 is substantially similar to existing New York law and not intended to affect any material changes to that law. Because of this, the City Bar does not regard the general discussion of fraudulent transfer law in the Official Comments to Section 4 of the UVTA to be necessary or authoritative to interpret this section. Specifically… comment number 8 to Section 4 of the UVTA [is] inconsistent with New York law and [is] not supported by the text of the UVTA. Therefore, [this comment] should not be considered when interpreting the UVTA, as enacted in New York. It is worth noting that other jurisdictions have reached the same conclusion…"

4. For a much more thorough analysis on this issue, see Karibjanian, Nenno and Rubin, *The Uniform Voidable Transactions Act: Why Transfers to Self-Settled Spendthrift Trusts by Settlors in Non-APT States Are Not*

Voidable Transfers Per Se, Tax Management Estates, Gifts, and Trusts Journal, Vol. 42, No. 4, p. 173, 07/14/2017.

V. Delaware's "Qualified Dispositions in Trust Act," 1997 Del. Laws ch. 159 (H.B. 356)

A. Delaware's Qualified Dispositions in Trust Act (the "Act"), is a good example of self-settled spendthrift trust legislation and, as such, has served as a model for the self-settled spendthrift trust law of a number of other states. It is thus fairly representative of self-settled spendthrift trust legislation in the United States.

B. The Act affords spendthrift trust protections under Delaware law to properly established irrevocable discretionary self-settled trusts.

1. Specifically, the Act allows the settlor (referred to under the Act as a "transferor"), to retain a beneficial interest in the trust created by the settlor while at the same time protecting the trust's assets from the settlor's creditors by having the trust settlement provide that "...the interest of the transferor or other beneficiary in the trust property or income therefrom may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before the qualified trustees actually distribute the property or income therefrom to the beneficiary..." Del. Code Ann. tit. 12, § 3570(11)(c).

2. The purpose of the Act, however, as set forth in the legislative history, was not necessarily to make a debtors' haven of the State of Delaware, but rather to allow a settlor to reduce his or her estate taxes through the expedient of a Delaware spendthrift trust without irrevocably removing all possibility that the transferred assets could be used for the settlor's future benefit. See Qualified Dispositions in Trust Act, Synopsis, Pub. Act 159, 71 Del. Laws 159 (1997).

a. This result is not obtainable through a self-settled trust that is not a valid and effective *spendthrift* trust because where the settlor's creditors can reach the settlor's interest in the trust the settlor will be deemed, at least indirectly, to have retained the "use and enjoyment" of the transferred assets and the Internal Revenue Code will cause the transferred property to be brought back into the settlor's estate due to the settlor's "retained right to possession or enjoyment, or to income".

(i) Internal Revenue Code § 2036(a)(1) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration

in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death...the possession or enjoyment of, or the right to the income from, the property..."

(a) See, e.g., *Paxton v. Commissioner*, 86 T.C. 785 (1986); *German Est. v. U.S.*, 7 Cl. Ct. 641 (1985); *Outwin Est. v. Commissioner*, 76 T.C. 153 (1981), acq., 1981-2 C.B. 2; *Paolozzi v. Commissioner*, 23 T.C. 182 (1954), acq., 1962-1 CB 4 ("petitioner's creditors could at any time look to the trust of which she was settlor-beneficiary for settlement of their claims to the full extent of the income thereof. This being true, it follows that petitioner…could at any time obtain the enjoyment and economic benefit of the full amount of the trust income").

(ii) In contrast, in PLR 200944002 (which involved a self-settled spendthrift trust under Alaska law, where such a trust is also permissible), the Internal Revenue Service ruled that "…the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036."

(iii) *See also*, Rev. Rul. 76-103, 1976-1 CB 293 ("if and when the grantor's dominion and control of the trust assets ceases, such as by the trustee's decision to move the situs of the trust to a State where the grantor's creditors cannot reach the trust assets, then the gift is complete for Federal gift tax purposes under the rules set forth in § 25.2511-2 of the regulations."). The consequence of a completed gift is generally that the gifted asset is excluded from the grantor's estate for estate tax purposes.

b. Of course, the Act is not limited to trusts that serve an estate planning purpose, and, thus, the Act permits self-settled spendthrift trusts to be established purely for purposes of "asset protection".

3. In order for a self-settled Delaware trust to be protected from the creditors of the settlor as a so-called "qualified disposition" under the Act, several express statutory requirements must be met.

   a. The settlor must transfer property to a "qualified trustee".

      (i) For this purpose, a "qualified trustee" is either an individual resident of Delaware (other than the transferor) or an entity authorized by Delaware law to act as a trustee and "whose activities are subject to supervision by the Bank Commissioner of the state, the Federal Deposit Insurance Company, the Comptroller of the Currency, or the Office of Thrift Supervision or any successor thereto." Del. Code Ann. tit. 12, §3570(8)(a).

         (a) Notably, under Del. Code Ann. tit. 12, § 3570(8)(f), not all trustees are required to be qualified trustees in order for the disposition to be a qualified disposition.

         (b) Although the settlor cannot act as a trustee, the settlor can, under Del. Code Ann. tit. 12, § 3570(8)(c), appoint one or more "advisors" to the trust which according to the Act includes one or more persons "who have authority under the terms of the trust instrument to remove and appoint qualified trustees or trust advisers" or " who have authority under the terms of the trust instrument to direct, consent to or disapprove distributions from the trust."

         (c) In addition, under Del. Code Ann. tit. 12, § 3571, the settlor of a qualified disposition can serve as an "investment advisor" to a Delaware trust as such term is described in § 3313 of the Act. In this role, a settlor can "direct, consent to, or disapprove a fiduciary's actual or proposed investment decisions."

      (ii) In order to provide a certain nexus between a "qualified disposition" and the state of Delaware, Del. Code Ann. tit. 12, §3570(8)(b) requires the qualified trustee to:

(a) Maintain or arrange for custody in the State of Delaware of some or all of the property that is the subject of the qualified disposition;

(b) Maintain records for the trust on an exclusive or nonexclusive basis;

(c) Prepare or arrange for the preparation of fiduciary income tax returns for the trust; or

(d) Otherwise materially participate in the administration of the trust.

4. There must be a valid "trust instrument", which the Act defines as "an instrument appointing a qualified trustee or qualified trustees for the property that is the subject of a disposition", and which meets certain express statutory requirements. Del. Code Ann. tit. 12, § 3570(11).

a. In particular, to receive the protection of the Act, the trust instrument must expressly incorporate Delaware law to govern the validity, construction and administration of the trust. Del. Code Ann. tit. 12, § 3570(11)(a).

b. The trust instrument must also be irrevocable, but under Del. Code Ann. tit. 12, § 3570(11)(b), the trust instrument will not be deemed revocable due to the inclusion in the trust instrument of any of the following:

(i) A power in the settlor to veto a distribution from the trust.

(ii) A testamentary special power of appointment in the settlor.

(iii) The settlor's potential or actual receipt of income from the trust, including rights to such income retained in the trust instrument.

(iv) The settlor's potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust.

(v) The settlor's potential or actual receipt of income or principal from a grantor retained annuity trust or a grantor retained unitrust.

(vi) The settlor's receipt each year of a percentage (not to exceed 5%), specified in the trust instrument, of the value of the trust determined from time to time pursuant to the trust instrument.

(vii) The settlor's potential or actual receipt of principal from the trust if it is either in the discretion of the trustees or an adviser or pursuant to an ascertainable standard contained in the trust instrument.

(viii) The settlor's right to remove a trustee or adviser and to appoint a new trustee or adviser.

(ix) The settlor's potential or actual use of real property held under a qualified personal residence trust or the transferor's possession and enjoyment of a qualified annuity interest.

(x) The settlor's potential or actual receipt, within the qualified trustees' discretion, or acting at the direction of an adviser, of income or principal to pay income taxes due on income of the trust if pursuant to a provision in the trust instrument.

(xi) The ability, whether pursuant to discretion, direction or the settlor's exercise of a testamentary power of appointment, of a qualified trustee to pay, after the death of the transferor, all or any part of the debts of the transferor outstanding at the time of the transferor's death, the expenses of administering the transferor's estate, or any estate or inheritance tax imposed on or with respect to the transferor's estate.

c. Of course, the trust instrument must also contain a spendthrift clause. Del. Code Ann. tit. 12, § 3570(11)(c).

5. The statute of limitations applicable to actions brought against property subject to a qualified disposition under the Act provides that:

a. A creditor may not bring an action if the creditor's claim against the transferor arose before the qualified disposition was made, unless the action is brought within four years after the qualified disposition is made or, if later, within one year after the qualified disposition was or could reasonably have been discovered by the

creditor. Del. Code Ann. tit. 12, § 3572(b)(1); Del. Code Ann. tit., 6, § 1309.

b. For a creditor's claim that arose concurrent with or subsequent to the qualified disposition, an action must be brought within four years after the qualified disposition is made. Del. Code Ann. tit. 12, § 3572(b)(2).

c. In addition, under the Act, the amount of time that trust property is held in a predecessor trust may be tacked onto the time that property is considered held as a qualified disposition.

(i) Specifically, the Act provides that "a qualified disposition that is made by means of a disposition by a transferor who is a trustee shall be deemed to have been made as of the time (whether before or after July 1, 1997 [being the effective date of the Act]) the property that is the subject of the qualified disposition was originally transferred to the transferor (or any predecessor trustee) making the qualified disposition in a form that meets the requirements of §3570(10) b. and c." of title 12. Del. Code Ann. tit. 12, § 3572(c).

6. In addition to the statute of limitations, § 3572(a) of the Act attempts to protect a qualified disposition by providing that "no action of any kind, including…an action to enforce a judgment…shall be brought…for an attachment or other provisional remedy against property that is the subject of a qualified disposition or for avoidance of a qualified disposition unless such action shall be brought pursuant to the provisions of §1304 or §1305 of Title 6 [i.e., Delaware's Uniform Fraudulent Transfer Act]". 12 Del. Code Ann. tit. 12, § 3572(a).

7. Notwithstanding any of the foregoing, two classes of creditors are expressly excepted from the self-settled spendthrift trust protections otherwise uniformly afforded to qualified dispositions. Specifically, § 3573 of the Act provides that the spendthrift provision will not apply, as follows:

a. To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable.

b. To any person to whom the transferor is indebted on account of an agreement or order of court for the payment of support or alimony (but not to any claim for forced heirship, legitime or elective share), in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, to the extent of such debt.

(i) Importantly, however, for purposes of this rule a "spouse" or "former spouse" includes "…only persons to whom the transferor was married at, or before, the time the qualified disposition is made." Del. Code Ann. tit. 12, § 3570(9).

(a) It is upon this basis that if a person creates a Delaware "asset protection" trust prior to marriage, the trust assets should be protected from any debt for support or alimony, or for a division or [equitable] distribution of property, in favor of such person's spouse or former spouse (as well as for any claim for forced heirship, legitime or elective share).

VI. Conflict of Law Issues

A. As noted, sixteen states (not including New York), currently provide for self-settled spendthrift trust protections. Obviously, this means that thirty-four states (including New York), do not. What then will be the result when a creditor brings suit against a self-settled spendthrift trust suit in a state that does not recognize self-settled spendthrift trust protections as being valid under its own law?

B. The Restatement (Second) of Conflict of Laws § 273 (1971), speaks to the efficacy of a purported restraint on alienation of beneficial trust interests. It provides that:

1. "Whether the interest of a beneficiary of [an inter-vivos] trust of movables is assignable by him and can be reached by his creditors is determined…by the local law of the state, if any, in which the settlor has manifested an intention that the trust is to be administered, and otherwise by the local law of the state to which the administration of the trust is most substantially related."

2. Similarly, "[i]f the settlor creates a trust to be administered in a state other than that of his domicil, the law of the state of the place of administration, rather than that of his domicil, ordinarily is applicable. Thus a settlor

domiciled in one state may create an inter vivos trust by conveying property to a trust company of another state as trustee and delivering the property to it to be administered in that state. In that case the law of that state will be applicable as to the rights of creditors to reach the beneficiary's interest. This permits a person who is domiciled in a state in which restraints on alienation are not permitted, to create an inter vivos trust in another state where they are permitted and thereby take advantage of the law of the latter state." 5A ASTON W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 626, at 419 (4th ed. 1989).

C. In fact, in some jurisdictions a settlor's ability to designate the law of a particular jurisdiction as the governing law of the trust is expressly provided for by statute.

1. For example, § 7-1.10 of New York's Estates, Powers and Trusts Law provides:

a. "Whenever a person, not domiciled in this state, creates a trust which provides that it shall be governed by the laws of this state, such provision shall be given effect in determining the validity, effect and interpretation of the disposition in such trust..."

(i) Interpreting a prior version of this statute, New York's highest court stated that "[t]he statute makes [a settlor's] express declaration of intention [of controlling law] conclusive..." *Hutchison v. Ross*, 262 N.Y. 381, 187 N.E. 65, 71, 89 A.L.R. 1007 (1933).

b. Furthermore, although the *prima facie* ability of a New York domiciliary settlor to create a valid trust governed by the laws of a foreign jurisdiction is not expressly conferred by this statute, it is either set forth under existing case law or can be logically inferred.

(i) For example, see *In re New York Trust Co.*, 87 N.Y.S.2d at 792 ("It is inconceivable that a state committed to [the policy of ESTATES, POWERS AND TRUSTS LAW § 7-1.10] would deny its own residents the corresponding right to establish trusts in other states...[U]nder the law of this state, a New York resident may choose another state as the situs of a trust as freely as a non-resident may create a trust in New York.").

c. A strong argument can also be made that principles of judicial comity require that a settlor's designation of controlling law be respected by the court. *See generally* 17 C.J.S. § 12(1).

D. The Restatement (Second) of Conflict of Laws § 270 (1971), however, provides that "[a]n inter vivos trust of interests in movables is valid if valid...under the local law of the state designated by the settlor to govern the validity of the trust, provided...that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6."

1. Section 270 of the Restatement (Second) of Conflict of Laws has been cited by more than one court dealing with the question of the validity of self-settled spendthrift trusts, to the effect that the validity of a self-settled spendthrift trust should <u>not</u> be upheld. See, e.g., *In re Portnoy*, 201 B.R. 685 (Bankr. S.D.N.Y. 1996); *In re Brooks*, 217 B.R. 98 (Bankr. D. Conn. 1998); *In re Lawrence*, 227 B.R. 907 (Bankr. S.D. Fla. 1998).

   a. In contrast, see *Riechers v. Riechers*, 679 N.Y.S.2d 233 (1998), aff'd, 701 N.Y.S.2d 113 (1999). In *Riechers*, following the defense of several medical malpractice suits, the settlor, Dr. Riechers, established a self-settled spendthrift trust under the law of the Cook Islands ostensibly to guard against the likelihood of future medical malpractice claims. At the same time, Dr. Riechers and his wife were having marital difficulties, but Mrs. Riechers was alleged to have been aware that the trust was being established. Two years later, Mrs. Riechers commenced an action for divorce and sought to have the trust included in computing an equitable distribution award. The New York State Supreme Court, Westchester County, noted that since the trust was established "for the legitimate purpose of protecting family assets" the court did not have jurisdiction over the trust and that issues such as whether the wife would be entitled to any trust property should be left to a Cook Islands court to decide.

2. In any event, query whether the requirement under § 270 of the Restatement (Second) of Conflict of Laws that the court find that the application of the law of the non-forum state would violate a strong public policy of the forum state can exist where the self-settled spendthrift trust was established prior to the marriage.

3. Furthermore, the fact that the forum state might not permit self-settled spendthrift trusts to be created under its own law does not necessarily mean that it would violate a *strong* public policy of the forum state to recognize a self-settled spendthrift trust if it was validly created under the law of a foreign jurisdiction.

a. "It would seem that the policy of a state, whether it be to restrain alienation in order to protect the beneficiary, or to permit alienation in order to protect creditors and assignees, is not so strong as to preclude the application of the law to the contrary prevailing in another state." SCOTT & FRATCHER, *The Law of Trusts*, §626, at 414 (4th ed. 1989).

4. There are also a number of cases, some in the marital context, that have applied conflicts of law principles to spendthrift trusts without resort to an exception for public policy.

   a. For example, in *The National Shawmut Bank of Boston v. Cumming*, 91 N.E.2d 337 (1950), the settlor, a domiciliary of Vermont, created a trust of "the greater part of his property," which trust the settlor designated to be "construed and the provisions thereof interpreted under and in accordance with the laws of the Commonwealth of Massachusetts." *Id*. at 339. As recognized by the lower court's opinion, the *Shawmut* settlor's clearly implied intent in designating Massachusetts law as controlling was to defeat his surviving spouse's significantly greater inheritance rights under Vermont law. According to the *Shawmut* court:

      (i) "If the settlor had been domiciled in this Commonwealth and had transferred here personal property here to a trustee here for administration here, the transfer would have been valid even if his sole purpose had been to deprive his wife of any portion of it. The Vermont law we understand to be otherwise and to invalidate a transfer made there by one domiciled there of personal property there, if made with an actual, as distinguished from an implied, fraudulent intent to disinherit his spouse." *Id*. at 340.

      (ii) In holding that Massachusetts law should apply, thereby depriving the surviving spouse of the greater part of her inheritance rights, the *Shawmut* court stated that "[t]he general tendency of authorities elsewhere is away from the adoption of the law of the settlor's domicil where the property, the domicil and place of business of the trustee, and the place of administration intended by the settlor are in another State." *Id.* at 341.

VII. FOREIGN VERSUS DOMESTIC ASSET PROTECTION TRUSTS

A. Protection Issues Relating to Application of the United States Constitution

1. Notwithstanding the enactment of self-settled spendthrift trust protections under the laws of a significant minority of the states within the United States over the course of the past twenty-one years, foreign asset protection trusts will likely offer a more substantial barrier to creditors than will domestic asset protection trusts because of certain issues under the United States Constitution.

a. Full Faith and Credit Clause

(i) Article IV, Section 1, of the United States Constitution, commonly called the "Full Faith and Credit Clause", provides in pertinent part that "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State."

(a) Full Faith and Credit principles are so broadly construed that they generally require the judgment of another state to be recognized and enforced even though the original claim is illegal in, or contrary to the strong public policy of, the second state. *See, e.g.*, *United Nat'l Bank v. Lamb*, 337 U.S. 38, 41-42 (1949); *M & R Investments Co. v. Hacker*, 511 So.2d 1099 (Ct. App. Fl. 1987).

(ii) Assuming that personal jurisdiction is obtained over the trustee, there are only two apparent limitations upon the application of the Full Faith and Credit Clause to an asset protection trust.

(a) The first limitation upon application of the Full Faith and Credit Clause is that "for a State's substantive law to be selected in a constitutionally permissible manner, that State must have a significant contact or significant aggregation of contacts, creating state interests, such that choice of its law is neither arbitrary nor fundamentally unfair." *Allstate Ins. Co. v. Hague*, 449 U.S. 302, 312-13 (1981).

(b) The second limitation upon application of the Full Faith and Credit Clause is that the issue has been

fully and fairly litigated and finally decided in the court rendering the original judgment. *Durfee v. Duke*, 375 U.S. 106, 111 (1963).

(iii) Judicial Comity

(a) In contrast, the Full Faith and Credit Clause has no application internationally. Instead, principles of judicial comity may apply. "Judicial comity" is a doctrine whereby the courts of one jurisdiction will give effect to the judicial decisions of another jurisdiction as a matter of deference and mutual respect.

(b) Therefore, for a foreign asset protection trust to achieve its maximum possible creditor protection it is important that the trust be settled in a jurisdiction which has, by statute, negated the potential application of judicial comity

(c) For example, Section 13D of the International Trusts Act 1984 of the Cook Islands, entitled *Foreign Judgements Not Enforceable*, provides that:

(i) "Notwithstanding the provisions of any treaty or statute, or any rule of law, or equity, to the contrary, no proceedings for or in relation to the enforcement or recognition of a judgement obtained in a jurisdiction other than the Cook Islands against any interested party shall be in any way entertained, recognized or enforced by any Court in the Cook Islands to the extent that the judgement:

a) Is based upon the application of any law inconsistent with the provisions of this Act or of the Trustee Companies Act 1981-2; or

b) Relates to a matter or particular aspect that is governed by the law of the Cook Islands."

b. Supremacy Clause

(i) Article VI, Section 2, of the United States Constitution, which is commonly called the "Supremacy Clause", provides that:

(a) "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

(ii) In the asset protection trust context there is concern that the Supremacy Clause might apply, for example, where a federal bankruptcy court issues an order directing the trustee of a domestic asset protection trust to distribute trust assets to a creditor.

(a) Note, however, that Section 541(c)(2) of the Bankruptcy Code provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."

(b) In addition, note that since the enactment of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act, which amended § 548(e) of the Bankruptcy Code, the power of the trustee of the bankruptcy estate to avoid transfers to a "self-settled trust or similar device" is limited to situations where:

(1) The transfer is a fraudulent transfer; and

(2) The transfer was made within ten years before the date of the filing of the bankruptcy petition.

(c) In the case of *In re Mortensen* (*Battley v. Mortensen*, Adv. D. Alaska, No. A09-90036-DMD, May 26, 2011), Mr. Mortensen, a resident

of Alaska, without the aid of counsel, drafted a trust document in 2005 called the "Mortensen Seldovia Trust (An Alaska Asset Preservation Trust)" intending for the Trust to qualify as an asset protection trust under Alaska law. Following his creation and funding of the Trust, Mortensen's financial condition deteriorated, his income became "sporadic," and he ultimately filed for bankruptcy. Although the Bankruptcy Court concluded that Mortensen was not insolvent when he established and funded the Trust, due to the specific circumstances of the case the Bankruptcy Court nevertheless held that Mr. Mortensen's funding of the trust still fell under Section 548(e) of the Bankruptcy Code as a fraudulent transfer to a self-settled trust made within ten years prior his bankruptcy filing.

(1) Notably, at the time of the filing of the Bankruptcy petition, the transfer to the Trust was outside of Alaska's own fraudulent transfer statute of limitations period, which would have led to a completely difference result had the matter been determined under state, rather than federal, law.

c. Contract Clause

(i) Article I, Section 10[1], of the United States Constitution, which is commonly called the "Contract Clause", provides in pertinent part that "[n]o State shall…pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts…"

(ii) In the asset protection trust context, the concern over the Contract Clause, albeit somewhat ill defined, is that domestic asset protection trust legislation potentially infringes upon the ability of persons to contract with each other by allowing a contracting party to avoid the effect of certain contracts by protecting his or her assets from contract claims through the use of such trust.

B. Issues of Taxation and Tax Reporting

1. Background

a. It is important to note that the taxation of an asset protection trust (or any type of trust for that matter) may differ substantially depending upon whether or not the trust is a domestic trust or a foreign trust under United States tax law. It is, therefore, necessary in the first instance to determine whether the asset protection trust at issue is a "domestic trust" or a "foreign trust".

(i) Although it may seem curious to question whether an "offshore" or "foreign" asset protection trust will be deemed to be a foreign or domestic trust for United States tax purposes, in point of fact an "offshore" or "foreign" asset protection trust is simply a trust that provides that the law governing the trust will be the law of some non-U.S. jurisdiction and that will have at least one trustee not resident in the U.S. These two factors, however, do not control the tax characterization of the trust under United States law.

(ii) As a consequence, an "offshore" or "foreign" asset protection trust can be either a domestic trust or a foreign trust for United State tax purposes.

b. Internal Revenue Code § 7701(a)(31)(B) defines a "foreign trust" as a trust which does not qualify as a "United States person" under §7701(a)(30)(E). Internal Revenue Code§ 7701(a)(30)(E) defines a trust as a "United States person" if the trust meets *both* of the following requirements: (1) a court within the United States is able to exercise primary supervision over the administration of the trust (the so-called "court test"); and (2) one or more U.S. persons have the authority to control all substantial decisions of the trust (the so-called "control test"). A trust which fails either of these requirements is, therefore, a "foreign trust."

(i) Note that Treas. Regs. § 301.7701-7(a)(2) provides that "[f]or purposes of the regulations in this chapter, the term domestic trust means a trust that is a United States person".

c. The Court Test and the Control Test for Determining Trust Status

(i) The Court Test

(a) A trust will meet the court test by being under the "primary supervision" of a U.S. court.

(1) "Primary supervision" means that a court has or would have the authority to determine substantially all issues regarding the administration of the entire trust.

(2) A court may have "primary supervision" notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.

(b) If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the trust would still meet the court test.

(c) The term "administration" 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 suits by creditors, and determining the amount and timing of distributions.

(ii) A safe harbor exists for finding the court test to have been met if three conditions are satisfied:

(a) The trust instrument does not direct that the trust be administered outside the United States;

(b) The trust is, in fact, administered exclusively in the United States; and

(c) The trust does not have an automatic migration provision (also known as an automatic "flee" clause).

(iii) The Control Test

(a) The control test requires that one or more U.S. persons have the authority to control all substantial decisions of the trust.

(1) The term "United States person" is defined for this purpose as generally including a citizen or resident of the United States, a domestic partnership or a domestic corporation.

(2) "Control" is defined as 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 any of the substantial decisions.

i) To determine whether U.S. persons have control it is necessary to consider all persons who have authority to make a substantial decision of the trust, not only trust fiduciaries such as trustees.

ii) Thus, a trust which has U.S. persons as trustees, but a non-U.S. person as the protector would fail to meet the control test (assuming that one of more of the protector's authorities under the trust agreement or governing law constitutes a "substantial decision").

(3) "Substantial decisions" are defined as those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law, and that are not merely ministerial.

(4) The regulations provide a non-exclusive list of "substantial decisions" which includes decisions made with respect to:

i) Whether and when to distribute income or corpus.

ii) The amount of any distribution.

iii) The selection of a beneficiary.

iv) Whether a receipt is allocable to income or principal.

v) Whether to terminate the trust.

vi) Whether to compromise, arbitrate or abandon claims of the trust.

vii) Whether to sue on behalf of the trust or to defend suits against the trust.

viii) Whether to remove, add or replace a trustee.

ix) 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 such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic or vice versa.

x) Investment decisions.

(b) Separately, the Treasury Regulations provide that a U.S. person will not be considered to control all substantial decisions of the trust if an attempt by

any government 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 the U.S. person, for example by reason of the operation of an automatic migration provision.

2. Income Taxation

a. Provided that the grantor is a United States person, the very nature of an asset protection trust as a self-settled trust (whether foreign or domestic) will cause it to be taxed during the grantor's lifetime as a grantor trust for United States income tax purposes.

(i) This is because Internal Revenue Code § 677 provides that if trust income is or may be used for the benefit of the grantor (or the spouse of the grantor), either directly or indirectly, then the grantor will be treated as the owner of the trust.

(a) Specifically, the grantor is taxable as the owner of any portion of a trust over which the grantor or a non-adverse party has the ability, without the consent or approval of an adverse party:

(1) To distribute trust income to the grantor or the spouse of the grantor; or

(2) To hold or accumulate trust income for future distribution to the grantor or the spouse of the grantor.

b. Moreover, to the extent that the trust has been structured so that the grantor's transfer of assets to the trust constitutes an incomplete gift for gift tax purposes, typically through inclusion of a power for the grantor to veto trustee distribution decisions during the grantor's lifetime and the inclusion of a limited testamentary power of appointment for the grantor, other grantor trust powers will also have been implicated. Specifically, under Internal Revenue Code § 674, the grantor will be taxable as the owner of any trust or portion thereof over which the settlor or a "non-adverse party" (or both) has a power, exercisable without the approval of any "adverse party," to dispose of the beneficial enjoyment of either income or principal.

c. In addition, the nature of the trust as self-settled makes it a grantor trust since Internal Revenue Code § 673(a) provides that the grantor shall be treated as the owner of any trust or portion thereof in which the grantor has a reversionary interest in either the income or principal with a value (determined at the time of that transfer to the trust) that exceeds 5% of the total value of such portion of the trust.

d. Finally it should be noted that almost any foreign trust created by a United States person will be treated as a grantor trust pursuant to Internal Revenue Code § 679. This is because Internal Revenue Code § 679(a) provides that a United Statesperson who transfers property to a foreign trust shall be treated as the owner of the trust, irrespective of whether or not the grantor retained any other power under Internal Revenue Code §§ 673-677, if the trust has one or more United States persons as beneficiaries.

(i) For purposes of § 679(a), a foreign trust that has received property from a United States transferor is treated as having a United States beneficiary unless:

(a) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of a United States person; and

(b) If the trust is terminated no income or corpus of the trust could be paid to, or for the benefit of, a United States person.

e. As a grantor trust, the grantor will be treated for income tax purposes as the "owner" of all or a portion of the asset protection trust. As a consequence of the foregoing, the grantor must include in the settlor's individual income tax computation all items of income, deductions, and credits attributable to the portion of the asset protection trust for which the grantor is deemed to be the owner. Therefore, there will be no benefit or detriment to creating a domestic asset protection trust over a foreign asset protection trust, or vice versa, in terms of the income taxation of the trust's income during the grantor's lifetime.

f. An income tax issue would, however, exist upon the grantor's death, when the trust, by definition, will cease to be a grantor trust, if the trust (i) was a foreign trust, and (ii) the funding of the

trust was a completed gift (which is not typically the case with an asset protection trust).

(i) In this regard, although Internal Revenue Code § 684(a) requires that a United States person that transfers appreciated property to a foreign trust treat that transfer as a sale or exchange of such property for an amount equal to the fair market value of the property transferred, and thus recognize gain on the excess of the property's fair market value over its adjusted basis, (i) Internal Revenue Code § 684(b) provides that this rule shall not apply to a to the extent that the United States person is treated as the owner of such trust under Internal Revenue Code § 671, and (ii) Treas. Regs. § 1.684-3(c) provides that "[t]he general rule of gain recognition … shall not apply to any transfer of property by reason of death of the U.S. transferor if the basis of the property in the hands of the foreign trust is determined under § 1014(a)."

(a) Of course, the basis of the property in the hands of the foreign trust will not be determined under Internal Revenue Code § 1014(a) unless the trust property is included in the grantor's gross estate for tax purposes, which typically would not be the case where the trust was funded through one or more completed gifts.

3. Income Tax Reporting

a. With regard to a domestic asset protection trust, the trustee is required to report all items of income, deduction and credit of the trust on a separate statement attached to Form 1041, *U.S. Income Tax Return for Estates and Trusts*, rather than within the body of the return itself.

b. With regard to a foreign asset protection trust, the appropriate return is Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, prepared in the same manner as Form 1041 would have been prepared for a grantor trust.

c. As a grantor trust, no United States income tax will be payable by either the domestic asset protection trust or the foreign asset protection trust; instead, the trust's items of income, deduction, and credit shown on the statement attached to Form 1041 or Form

1040NR will be transferred to and reported on the grantor's Form 1040, *U.S. Individual Income Tax Return*.

(i) It should be noted that alternative reporting methods applicable to certain simple grantor trusts are provided for under the Treasury Regulations. Generally, under these methods, the trustee must provide the grantor with a statement of all items of income, credit, and deduction of the trust and inform the grantor that the grantor must report such items directly on the grantor's individual income tax return. However, these reporting alternatives are not available if a trust has its situs outside of the United States or if any of the assets of the trust are located outside of the United States.

4. Information Reporting in Connection with Foreign Trusts

a. Background

(i) Under §6048, distinct information reporting requirements are imposed on foreign trusts, the settlors of foreign trusts, and the beneficiaries of foreign trusts.

(ii) Proper and timely information reporting pursuant to these requirements is important since such information reporting:

(a) Avoids the serious penalties that can result from failing to properly report pursuant to such requirements.

(b) Documents in an official, structured way the fact that the foreign trust is an entity separate and apart from the grantor and, therefore, should be respected as such by the courts.

b. Reporting Obligation Relating to Transfers to Foreign Trusts

(i) Internal Revenue Code § 6048(a)(1) requires the reporting of several types of occurrences, each of which is called a "reportable event" and which are defined under Internal Revenue Code § 6048(a)(2), as follows:

(a) The creation of any foreign trust by a United States person.

(b) The 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.

(c) The 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.

(ii) The information required to be reported pursuant to Internal Revenue Code § 6048(a) includes:

(a) The amount of money or other property (if any) transferred to the trust in connection with the reportable event.

(b) The identity of the trust and of each trustee and beneficiary.

c. Reporting Obligation Relating to Beneficiaries of Foreign Trusts

(i) Under Internal Revenue Code § 6048(c), a United States person who receives a distribution, directly or indirectly, from a foreign trust is required to report for that year the name of the foreign trust, and the aggregate amount of the distributions so received from such foreign trust during the taxable year, as well as such other information as the Secretary of the Treasury may prescribe.

(a) Notice 97-34 provides that the distribution from a foreign trust is required to be reported if it is either actually or constructively received by a United States person.

(1) For example, where obligations incurred by a United States beneficiary are paid by a foreign trust, the amounts incurred will be treated as a distribution from the foreign trust that must be reported under Internal Revenue Code § 6048(c).

d. Reporting Obligation Relating to Owners of Foreign Trusts

(i) Under Internal Revenue Code § 6048(b), each United States person that is treated as an owner of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust:

(a) Files an annual return setting forth a full and complete accounting of all trust activities and operations for the year, the name of the "United States agent" for the foreign trust, and such other information as the Secretary of the Treasury may prescribe.

(1) Under Internal Revenue Code § 6048(b)(2), if a foreign trust with a United States owner does not have a United States agent appointed, the Secretary of the Treasury may determine the amounts required to be taken into account with respect to the foreign trust under the grantor trust rules.

(b) Furnishes such information as the Secretary of the Treasury may prescribe to each United States owner of the foreign trust, as well as to any United States person who receives any distribution, directly or indirectly, from the foreign trust.

(c) Note that with regard to the potential adverse impact, from an asset protection perspective, of having a U.S. agent appointed for a foreign asset protection trust, Internal Revenue Code §6048(b)(2) expressly provides that:

(1) "The appearance of persons or production of records by reason of a U.S. person being such an agent shall not subject such persons or records to legal process for any purpose other than determining the correct treatment under [the Code] of the amounts required to be taken into account…A foreign trust which appoints an [agent] described in this subparagraph shall not be considered to have an office or a

permanent establishment in the United States, or to be engaged in a trade or business in the United States solely because of the activities of such agent pursuant to this subsection."

(ii) Method of Information Reporting

(a) The Grantor's Obligation

(1) Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, is to be filed by the grantor of a foreign trust on an annual basis for the purpose of reporting any transfers to the foreign trust that occurred during the preceding taxable year.

i) After having made a transfer, the grantor of the foreign trust must then continue to file Form 3520 for every succeeding year, even those when no additional transfer is made.

(2) Form 3520 is due on the same date as the grantor's individual income tax return, including any extensions, and should be attached to the grantor's individual income tax return. A separate copy of Form 3520 must also be filed with the IRS Philadelphia Service Center.

(3) Note that an extension of time to file Form 3520 is to be requested on Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information and Other Returns*.

(b) The Trustees' Obligation

(1) Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*, is intended to provide sufficient information

to the United States owners of the foreign trust, as well as the trust beneficiaries, so that they can satisfy their obligation to report transactions with the foreign trust on Form 3520.

i) Form 3520-A requires, among other things, the foreign trust to send a "Foreign Grantor Trust Ownership Statement" to each United States owner, and a "Foreign Grantor Trust Beneficiary Statement" to each United States beneficiary who received a distribution from the foreign trust during the taxable year at issue.

(2) Form 3520-A must be filed with the IRS Philadelphia Service Center by the 15th day of the third month following the end of the foreign trust's taxable year. Copies of the owner and beneficiary statements must be furnished to the United States owners and beneficiaries by the same date.

(3) Note that as with Form 3520, an extension of time to file Form 3520-A is to be requested on Form 2758, *Application for Extension of Time To File Certain Excise, Income, Information and Other Returns*.

e. Penalties for Failure to Provide Information

(i) Substantial civil penalties exist under Internal Revenue Code § 6677 when information required by Internal Revenue Code § 6048 is not timely reported, or, if such information is timely reported, it is reported inaccurately.

(ii) Under Internal Revenue Code § 6677, any United States person who fails to comply with the reporting requirements of Internal Revenue Code § 6048(a) will be subject to a penalty equal to 35% of the "gross reportable amount."

(iii) If it is the foreign trust itself which fails to furnish the information required by §6048(b), the United States owner of the foreign trust will be subject to a penalty under Internal Revenue Code § 6677, but only equal to 5% of the "gross reportable amount."

(iv) The term "gross reportable amount" is defined in Internal Revenue Code § 6677(c) as:

(a) The gross value of the property involved in the event (determined as of the date of the event) in the case of a failure to report relating to Internal Revenue Code § 6048(a).

(b) The gross value of the portion of the trust's assets at the close of the year treated as owned by the United States person in the case of a failure to report relating to Internal Revenue Code § 6048(b)(1).

(v) Under Internal Revenue Code § 6677(d), no penalty shall be imposed, however, if the failure to report is shown to be due to "reasonable cause" rather than "willful neglect."

(a) The fact that a foreign jurisdiction would impose a civil or even a criminal penalty on the taxpayer (or on any person) for disclosing the required information, however, is not deemed "reasonable cause" for failing to report under Internal Revenue § 6677.

(b) In addition, Notice 97-34 provides that a refusal on the part of a foreign trustee to provide information for any other reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of required information, will not be considered "reasonable cause."

5. Foreign Account and Foreign Asset Reporting

a. As a preliminary matter it is important to note that a foreign asset protection trust might not necessarily have foreign accounts or foreign assets; conversely, a domestic asset protection trust might have such foreign accounts or foreign assets.

(i) However, where the grantor wants the foreign asset protection trust to maximize the creditor protections that a foreign asset protection trust might engender, it will be necessary for the foreign asset protection trust to have only foreign accounts or foreign assets constituting the trust fund.

b. Foreign Account Reporting

(i) FinCen Form 114, *Report of Foreign Bank and Financial Accounts* (commonly known as the "FBAR") (previously, Form TD F 90-22.1), is required to be electronically filed by April 15th of each year with the Financial Crimes Enforcement Network by any United States person who has a financial interest in or signature or other authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the value of which exceeds $10,000 at any time during the prior year.

(ii) A United States person is deemed to have a financial interest if the owner of record or holder of legal title is a trust if the United States person:

(a) Is the trust grantor.

(b) Has an ownership interest in the trust for United States federal tax purposes under Internal Revenue Code §§ 671-679.

(c) The owner of record or holder of legal title is a trust in which the United States person has a greater than fifty percent present beneficial interest in the assets or income of the trust for the calendar year.

(iii) Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to a civil penalty not to exceed $10,000 per violation for non-willful violations that are not due to reasonable cause.

(a) For willful violations, the penalty may be the greater of $100,000 or fifty percent of the balance

in the account at the time of the violation, for each violation.

c. Foreign Asset Reporting

(i) United States citizens and resident aliens are required to file Form 8938, *Statement of Specified Foreign Financial Assets*, with the individual's income tax return by April 15th of each year (or the extended due date), if they own:

(a) A financial account (i.e., depository account or custodial account), which is maintained by a foreign financial institution.

(b) Other foreign financial assets (i.e. stock issued by a non-United States person, interests in foreign entities or financial instruments or contracts that have a non-United States person as the counterparty).

(ii) However, the foreign financial account or other asset must have an aggregate value in excess of $50,000 on December 31st (or more than $75,000 at any time during the tax year).

(a) Higher monetary thresholds may apply depending upon various factors including the taxpayer's marital status and residence.

(iii) Although a beneficiary should not be deemed to own an interest in a foreign financial asset held by a trust, an individual who is considered to be the owner of all or a part of a trust under the grantor trust rules is considered to have an interest in any foreign financial asset held by such trust.

Dynasty Trusts: Nothing Lasts for Ever

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Dynasty Trusts: Nothing Lasts Forever

Michael M. Gordon, J.D., LL.M.

I. INTRODUCTION

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (the "2017 Act"). The 2017 Act increased the exemptions for federal estate tax, gift tax and generation-skipping (GST) tax to $11,180,000 per person for 2018. The exemptions are indexed for inflation. The tax rates on estates, gifts, and GST transfers above the exemption is forty percent (40%).

The 2017 Act contains a sunset provision. The exemptions for federal estate tax, gift tax and GST tax are scheduled to revert to the 2017 amounts effective January 1, 2026. As a result of the 2017 Act clients are presented with an estate planning opportunity to transfer significant amounts of wealth out of their estate without the imposition of transfer taxes. Dynasty trusts have become a popular tool for clients interested in using the increase in exemption to transfer assets out of their estate.

This outline will discuss the typical structure of a Dynasty Trust. The outline will also address the income taxation of Dynasty Trusts, flexible provisions to include in Dynasty Trusts, Completed Gift Asset Protection Trusts and the use of Quiet Trust language in Dynasty Trusts.

II. WHAT IS A DYNASTY TRUST?

A. <u>Overview</u>. A Dynasty Trust is simply a trust that perpetuates from one generation to the next without the requirement of terminating on a set date. For example, a mother may create a Dynasty Trust for the benefit of her son and his descendants. Upon the death of son the remaining assets in the Dynasty Trust would be divided into shares, per stirpes, for son's descendants and continue in further trust for their lifetime benefit. Upon the death of a descendant of son such descendant's trust would divide, per stirpes, for the descendant's descendants and continue in further trust.

B. <u>Statutory Recognition</u>. Many jurisdictions have either abolished the common law rule against perpetuities applicable to trusts by allowing the creation of true perpetual trusts or otherwise extending the common law rule against perpetuities applicable to trusts so that trusts may stay in existence for a very long period of time. (i.e., one thousand years). For instance, Delaware abolished the common law rule against

perpetuities applicable to trusts in 1986 and enacted legislation allowing perpetual trusts in 1995. 25 Del. C. § 503. Under Delaware law, a trust may have a perpetual existence. 25 Del. C. § 503. There is a limitation for real estate held by deed in trust name that applies a one hundred and ten (110) year rule against perpetuities to the real estate. 25 Del. C. § 503(b). However, the statute expressly excludes real estate held as an intangible through an entity such as a "corporation, limited liability company, partnership, statutory trust, business trust or other entity" where the entity ownership interest is held by the trust instead of the real estate itself. 25 Del. C. § 503(e).

C. Use of Limited Powers of Appointment. As previously explained, a true Dynasty Trust perpetuates from one generation to the next without any direction from a beneficiary as to the ultimate disposition of the Dynasty Trust assets. For flexibility purposes it is often desirable to include testamentary limited powers of appointment to allow each generation to redirect the disposition of the Dynasty Trust assets upon his or her death. Provided below is sample language we typically include in our Delaware Dynasty Trusts granting beneficiaries testamentary general powers of appointment for tax planning purposes and testamentary limited powers of appointment for flexibility purposes:

> (i) The Trustee shall distribute that portion of the assets of such Primary Beneficiary's separate trust, which if included in such Primary Beneficiary's taxable estate for federal estate tax purposes would result in a reduction of the overall transfer taxes (including Generation-Skipping Transfer tax) determined without regard to the marital and charitable deductions imposed on such trust, to such Primary Beneficiary's creditors or the creditors of his or her estate, in such manner as such Primary Beneficiary may appoint by specific reference to this power in his or her Last Will and Testament admitted to probate or pursuant to an instrument executed by such Primary Beneficiary during his or her lifetime and delivered to the Trustee, provided that the exercise of such power of appointment shall not take effect until such Primary Beneficiary's death. The Trustee shall have no duty to determine whether including any portion of the assets of the trust in the Primary Beneficiary's taxable estate will result in a reduction of overall transfer taxes. Instead, the Trustee shall rely on written direction from the personal representative of the Primary Beneficiary's estate as to whether including any portion of the trust assets in the Primary Beneficiary's taxable estate will result in a reduction of transfer taxes.

(ii) The Trustee shall distribute the unappointed (including the portion not appointed above) remainder of such Primary Beneficiary's separate trust estate in such manner as such Primary Beneficiary may appoint by specific reference to this power in his or her Last Will and Testament admitted to probate or pursuant to an instrument executed by such Primary Beneficiary during his or her lifetime and delivered to the Trustee, provided that the exercise of such power of appointment shall not take effect until such Primary Beneficiary's death, upon such conditions and terms including outright or in further trust, to the limited class of beneficiaries consisting of the Grantor's descendants (other than such Primary Beneficiary), and the spouses of the Grantor's descendants (including such Primary Beneficiary's spouse) provided, however, that the interest of a spouse may not exceed net income for the lifetime of such spouse. In no event shall the power of appointment conferred upon a Primary Beneficiary in this section be construed as a power in such Primary Beneficiary to appoint such Primary Beneficiary's trust to himself or herself, his or her creditors, his or her estate or the creditors of his or her estate. Notwithstanding the foregoing or any other provisions of this Agreement, no limited power of appointment held pursuant to this Agreement may be exercised over a trust which is exempt from the generation-skipping transfer tax to trigger the application of Section 2041(a)(3) or Section 2514(d) of the Code.

III. HOW IS THE INCOME EARNED IN DYNASTY TRUSTS TAXED?

A. Overview. A trust may be taxed as a grantor trust for federal income tax purposes under Sections 671 – 678 of the Internal Revenue Code ("IRC") or a non-grantor trust for federal income tax purposes. In a grantor trust all of the Dynasty Trust income flows through to the grantor and is reported on the grantor's personal income tax return. In a non-grantor trust the Dynasty Trust is a separate taxpayer and responsible for the payment of its own income tax liability.

B. Advantages to Structuring a Dynasty Trust as a Grantor Trust.

1. Revenue Ruling 2004-64 (the "2004 Ruling).

(a) The 2004 Ruling held that the grantor of a trust, which is taxed as a grantor trust for income tax purposes, is not treated as making an

additional taxable gift to the trust by virtue of paying the trust's income tax liability.

(b) The 2004 Ruling creates an incredibly powerful tool for grantors with large taxable estates. The grantor's payment of the income tax liability associated with the Dynasty Trust income will reduce the grantor's estate in a very transfer tax friendly manner by allowing the grantor to pay the Dynasty Trust income tax liability without being treated as making additional gifts. Furthermore, the fact that the Dynasty Trust itself is not paying the income tax liability allows the assets in the Dynasty Trust to grow at a rapid pace.

(c) Furthermore, even if a distribution is made out of the Dynasty Trust to one of the beneficiaries, the beneficiaries will receive such distribution free of any income tax liability as the grantor is responsible for the income tax liability of the Dynasty Trust.

C. Advantages to Structuring a Dynasty Trust as a Non-Grantor Trust.

1. Grantor Not Responsible for Income Tax Liability. In many situations a grantor may feel that he or she has done enough by creating the Dynasty Trust and gifting assets into the Dynasty Trust for the benefit of the grantor's descendants. The grantor does not want to be responsible for the income tax liability associated with the income earned by the Dynasty Trust. Instead, the grantor would like the Dynasty Trust itself to be responsible for the income tax liability.

2. Avoidance of State Income Tax. Many clients structure non-grantor Dynasty Trusts in jurisdictions that do not have a state income tax or otherwise exempt trusts created by non-residents from the imposition of the state income tax in order to avoid paying state income tax on the income and capital gain that is accumulated in the Dynasty Trust. For example, while Delaware does have a state income tax, Delaware does not tax that portion of trust income and capital gains accumulated and set aside for future distribution to non-resident beneficiaries. 30 Del. C. § 1636(a). If all of the beneficiaries of the Delaware non-grantor trust are non-residents, the trust pays no Delaware state income tax at all, which creates the possibility of eliminating state income tax on the income and capital gain earned in the Dynasty Trust. Many residents from high income tax jurisdictions such as New York or New Jersey create

Delaware non-grantor trusts to avoid state income tax that would otherwise apply.

D. How to Create Grantor Trusts and Non-Grantor Trusts and Flexible Provisions to Include in such Trusts.

1. Grantor Trusts.

(a) "True" Grantor Trusts. In certain situations a Dynasty Trust will automatically be structured as a grantor trust for income tax purposes under Section 677(a)(1) of the IRC due to the fact that income can be distributed to the grantor or the grantor's spouse without the consent of an adverse party. This is most common in a SLAT (Spousal Lifetime Access Trust) or Completed Gift Asset Protection Trust, both of which will be discussed later in this outline.

(b) Intentionally Defective Grantor Trusts. Many grantors are establishing intentionally defective grantor trusts for income tax purposes, i.e., a trust that includes powers that will cause the income to be taxable to the grantor even though neither the grantor nor the grantor's spouse has a beneficial interest in the Dynasty Trust. The most common grantor trust power that is utilized in Dynasty Trusts is the ability to substitute trust assets by reacquiring assets of equivalent value. Where the power to substitute is chosen to create an intentionally defective grantor trust, Delaware law provides that notwithstanding the terms of the governing instrument, the fiduciary responsible for investment decisions has a fiduciary duty to determine that the substituted property is of equivalent value to the property reacquired. 12 Del. C. § 3316.

(c) Sample Language. Provided below is sample grantor trust language that we typically include in our Dynasty Trusts structured as intentionally defective grantor trusts:

Grantor Trust Status. It is the intention of the Grantor to create a "Grantor Trust" for income tax purposes as that term is defined under Section 671 of the Code. The Grantor understands that the Grantor will be treated, for income tax purposes only, as the owner of the property in the Trust and acknowledges that even if the Grantor is liable for income taxes with respect to the taxable income of the Trust,

the Grantor shall not be entitled to reimbursement for any such taxes. In this regard, the following powers and rights shall apply to the Trust.

Power to Substitute Property. The Grantor, while he is living and competent, followed by the Trust Protector upon the Grantor's incapacity, shall have the power and the absolute right, exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire any property constituting the Trust estate by substituting therefor other property of equivalent value; provided, however, that this power shall not apply to any interest in a life insurance policy insuring the life of the Grantor, to any residence that was contributed to the Trust from a Qualified Personal Residence Trust of the Grantor and to any voting stock of a controlled corporation as to the Grantor within the meaning of Section 2036(b) of the Code. The Grantor or Trust Protector may exercise such power by an instrument in writing signed by the Grantor or Trust Protector and delivered to the Trustee and Investment Direction Adviser, provided that the Grantor or Trust Protector must certify to the Investment Direction Adviser and/or the Trustee, depending on who then holds the investment power (for purposes of this Article "Substitution Fiduciary"), in such instrument that the substituted property and the Trust property for which it is substituted are of equivalent value. Notwithstanding the foregoing, if the Grantor, or an entity the Grantor controls, is the Substitution Fiduciary, the Grantor shall appoint a person or entity that is not related or subordinate to the Grantor within the meaning of Section 672(c) of the Code to serve as Substitution Fiduciary. If the Substitution Fiduciary does not agree that the assets or property proposed to be substituted are of equivalent value with the property to be acquired by the Grantor or Trust Protector, the Substitution Fiduciary may independently determine such values, including seeking a judicial determination by a Court of competent jurisdiction that the requirement of equivalent value is satisfied. The reasonable expenses of such independent determination, including any judicial determination, shall be borne by the Grantor. To the extent that the Grantor's power under this Article would result in the inclusion of the Trust estate in the Grantor's gross estate for federal estate tax purposes under Section 2036 or Section 2038 of the Code, the Grantor shall not have such power and instead, the Trust Protector shall have the power.

Trust Protector's Ability to Terminate Powers. Notwithstanding the provisions of section (a) above as well as any other provision of this Agreement, the Trust Protector shall have the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to terminate the power conferred upon the Grantor or Trust Protector pursuant to section (a) of this Article SECOND to reacquire Trust property by providing written notice to the Grantor and the Trustee to this effect.

(d) Tax Reimbursement Provision.

(i) The 2004 Ruling also addressed the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor of the trust may or must be reimbursed by the trust for the income tax.

(ii) The 2004 Ruling held that assuming there is no understanding, expressed or implied between the grantor and the trustee regarding the trustee's exercise of its discretion to reimburse the grantor for the income tax liability, the trustee's discretion to satisfy such obligation will not alone cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(iii) However, the 2004 Ruling specifically states that the trustee's discretion to reimburse the grantor for the income tax liability combined with other factors including, but not limited to: (i) an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion; (ii) a power retained by the grantor to remove the trustee and name a successor trustee; or (iii) applicable local law subjecting the trust assets to claims of the grantor's creditors may cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(iv) For flexibility purposes we typically include a provision in our Dynasty Trusts that are structured as grantor trusts which would permit an independent Trustee or Distribution Adviser to reimburse the grantor for the income tax liability in any given year. In general a grantor may be comfortable with

paying the income tax liability of the Dynasty Trust on an annual basis. However, there could be a particular year where there is a large capital gain in the Dynasty Trust which would flow through to the grantor and the grantor would like the ability to make a discretionary request to be reimbursed for a portion or all of the income tax liability resulting from such gain. It is important to be cognizant whether including such a tax reimbursement provision in the governing instrument for the Dynasty Trust could subject the assets of the trust to creditor claims of the grantor which could result in estate tax inclusion. Delaware has a specific provision which states that the grantor's retention of the discretionary ability to be reimbursed for the income tax liability is not considered a retained beneficial interest in the trust. 12 Del. C. § 3536(c)(2). Provided below is sample tax reimbursement language that we include in our Dynasty Trusts:

Income Tax Reimbursement. Notwithstanding any other provisions of this Agreement to the contrary, the Trustee is authorized in its sole and absolute discretion to distribute income or principal from the Trust estate to the Grantor for the sole purpose of reimbursing the Grantor for that portion of the Grantor's income tax liability arising from the Trust's income being taxable to the Grantor. The Trust Protector shall have the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person serving in a fiduciary capacity, to terminate the Trustee's power to distribute Trust income and principal to the Grantor in accordance with the provisions of this section (d) of this Article THIRD by providing written notice to the Grantor and the Trustee to this effect. To the extent the Trustee's power to distribute income or principal of the Trust estate to the Grantor to reimburse the Grantor for income taxes would result in the inclusion of the Trust estate in the Grantor's gross estate for federal estate tax purposes, the Trustee shall not have such power.

2. Non-Grantor Trusts.

(a) Grantor or Grantor's Spouse Retaining Beneficial Interest In Dynasty Trust. As previously mentioned, a Dynasty Trust will typically be

structured as a grantor trust for income tax purposes if the grantor or the grantor's spouse retains a discretionary beneficial interest in the Dynasty Trust. This is due to the fact that Section 677(a)(1) of the IRC provides that if income can be distributed to the grantor or the grantor's spouse without the consent of an adverse party the Dynasty Trust will be taxed as a grantor trust. It is possible for the grantor or the grantor's spouse to retain a beneficial interest in the Dynasty Trust and still have the Dynasty Trust taxed as a non-grantor trust for income tax purposes. The trust instrument must provide that distributions can only be made to the grantor or the grantor's spouse with the consent of an adverse party as defined in Section 672(a) of the IRC.

(b) Avoiding Grantor Trust Powers. Even if the grantor or the grantor's spouse do not retain a beneficial interest in the Dynasty Trust the trust agreement must be drafted to prevent the Dynasty Trust from being taxed as an intentionally defective grantor trust under the provisions of Sections 671 – 678 of the IRC. A trust agreement could inadvertently confer a power upon the grantor or another person that causes the Dynasty Trust to be taxed as a grantor trust.

(c) Sample Language. We typically include language in our Dynasty Trusts structured as non-grantor trusts specifically stating that it is the grantor's intent that the Dynasty Trust be taxed as a non-grantor trust for income tax purposes and that all provisions of the trust agreement shall be construed and administered to carry out the grantor's intent that the Dynasty Trust be taxed as a non-grantor trust for income tax purposes. Provided below is sample non-grantor trust language that we typically include in our Dynasty Trusts structured as non-grantor trusts:

Non-Grantor Trust. Notwithstanding any other provision of this Agreement, the Trustee shall not make any distribution from the Trust estate to, or for the benefit of, the donor of any funds to the Trust. It is intended that no part of the income, deductions, or credits of any trust created hereunder shall be attributed to the donor of any funds to the Trust under the so-called "Grantor trust" rules of subpart E of subchapter J of subtitle A of the Code and, accordingly, this Agreement shall be construed and the trusts hereunder administered in accordance with and to carry out that intent and that any provision of

this Agreement to the contrary shall be of no effect. Furthermore, none of the powers granted the Trustee shall enable the donor of any funds to the Trust to buy, exchange, or otherwise deal with trust principal or income for less than adequate and full consideration in money or money's worth. None of the powers granted the Trustee shall enable the donor of any funds to the Trust to borrow the principal of the trust, directly or indirectly. None of the powers granted to the Trustee shall enable anyone to require the Trustee to exchange trust property by substituting other property of equal value

VI. FLEXIBLE PROVISIONS TO INCLUDE IN DYNASTY TRUSTS.

A. Beneficial Provisions.

1. Who should be the Beneficiaries of the Dynasty Trust?

(a) Dynasty Trusts are typically created for the benefit of the grantor's descendants. However, it is very popular, particularly for Dynasty Trusts structured as grantor trusts for income tax purposes, to include the grantor's spouse as a discretionary beneficiary of the Dynasty Trust. This creates the flexibility of allowing distributions to be made to the grantor's spouse during his or her lifetime which could in turn be used for the marital unit in the event it becomes desirable to do so. These Dynasty Trusts are typically referred to as SLATs (Spousal Lifetime Access Trusts). The beneficiary spouse could also be granted a testamentary limited power of appointment which would allow the beneficiary spouse to appoint assets in further trust for the benefit of the grantor spouse in the beneficiary spouse predeceases the grantor spouse. Under Delaware law the grantor's retention of the possibility of receiving assets contingent upon surviving the grantor's spouse is not considered the retention of a beneficial interest in the Dynasty Trust that would result in the grantor's creditors being able to reach the assets of the Dynasty Trust or otherwise result in the Dynasty Trust assets being includible in the grantor's estate for federal estate tax purposes. 12 Del. C. § 3536(c)(1).

(b) As a starting point, the grantor must determine how the trust assets will be held and administered for the benefit of the beneficiaries. Typically grantors will create the Dynasty Trust for the benefit of their lineal descendants without favoring one generation over the next. However, it is possible to designate a particular individual or a generation of individuals as the primary beneficiaries of a Dynasty Trust and to provide that each fiduciary responsible for making

distributions decisions is to consider the needs of the primary beneficiary over the needs of the other beneficiaries.

2. Distribution Standard.

(a) Another issue for grantors to consider is the distribution standard that will be contained in the Dynasty Trust. I advise clients to allow distributions to be made to the beneficiaries for any purpose in the sole and absolute discretion of the fiduciaries responsible for making such distributions. The Dynasty Trust is structured as a perpetual trust and therefore will last for a very long period of time. For this reason, I think it is best to keep the distribution provisions as flexible as possible.

(b) It is also possible to specifically direct how and when the assets of the Dynasty Trust will be distributed to the beneficiaries. For example, it is possible to provide that the beneficiaries are to receive distributions upon reaching certain milestones (i.e., graduation from college, marriage, birth of a child). It is also possible to add provisions which reward beneficiaries for certain behavior (i.e., distributions for academic accomplishments, W-2 matching provisions) and punish beneficiaries for bad behavior (i.e., substance abuse clauses which prevent distributions to beneficiaries with substance abuse problems, provisions that prohibit distributions if beneficiaries are not productive members of society).

3. Statement of Intent.

(a) I often include a statement of intent in the Dynasty Trusts I draft, particularly those that allow for broad distribution discretion, which states the reasons why the grantor created the trust and how the grantor expects beneficiaries to conduct themselves and how distributions should be made to the beneficiaries. Provided below is sample statement of intent language that we include in our Dynasty Trusts:

Statement of Intent. The following Statement of Intent shall apply to the Grantor's descendants. It is the Grantor's desire that the Trust estate provide a safety net for the Grantor's descendants that enhances the life and wellbeing of the Grantor's descendants without removing any descendant's ability to become and remain a mature, independent, productive member of the world's community capable of making his or her own living. Furthermore:

Goal. The Grantor does not intend for any beneficiary to have an expectancy of any kind from any trust created by or pursuant to this Agreement that shall cause that person to become dependent on the

trust's resources and fail to pursue an education or a career that would otherwise have enabled that person to become industrious and self-supporting or otherwise become a productive member of society. However, it is not intended that the Distribution Fiduciary (as defined in section (f) of Article TWENTIETH of this Agreement) place undue emphasis on the amount a descendant earns if he or she is actively engaged in a worthwhile pursuit.

Marriage. The Grantor supports the institution of marriage and hopes that the Grantor's descendants have happy, healthy marriages. The Grantor also recognizes the potential risk to the Trust estate if a beneficiary's marriage ends in divorce. Accordingly, it is the Grantor's desire that a descendant of the Grantor who wishes to marry (i) enter into a legally binding agreement prior to marriage (a "Prenuptial Agreement") with his or her betrothed which provides (a) all property that the descendant receives from the Trust (including any increase, appreciation, income, dividends or residuals from such property), and any reinvestments thereof, shall maintain its character as separate property and (b) such Grantor's descendant's betrothed waives any and all rights that he or she may have to any portion of the Trust estate and to all distributions under this Trust Agreement by virtue of his or her marriage to the descendant of the Grantor and (ii) deliver to the Distribution Fiduciary a signed copy of the Prenuptial Agreement. Where any doubt exists as to the specific language or requirements of the Prenuptial Agreement, the sole discretion of the Distribution Fiduciary shall control and shall be final and binding. In the event a descendant of the Grantor fails to enter into a Prenuptial Agreement, or, in the event a descendant of the Grantor who has executed a Prenuptial Agreement repudiates it or otherwise attempts to cause any portion of it related to the Trust to be void, the Distribution Fiduciary, upon knowledge of same, may immediately suspend all discretionary distributions to such descendant of the Grantor otherwise authorized in Article SECOND of this Agreement. Such distributions may remain suspended until such time as the Distribution Fiduciary is satisfied, upon written opinion of legal counsel, that the descendant's betrothed (or spouse) has no legal claim whatsoever to any portion of the Trust estate or to any distribution hereunder. For example, if a descendant of the Grantor fails to enter into a Prenuptial Agreement, such descendant of the Grantor may subsequently (i) enter into a Postnuptial Agreement with the descendant's spouse pursuant to which such descendant's spouse provides that (a) all property that the descendant receives from the Trust (including any increase, appreciation, income, dividends or residuals from such property), and any reinvestments thereof, shall maintain its character as separate property, and (b) such Grantor's descendant's spouse waives any potential claim over the Trust estate or any distribution of the Trust

estate to the descendant and (ii) deliver to the Distribution Fiduciary a signed copy of the Postnuptial Agreement, at which time the Distribution Fiduciary may resume discretionary distributions to the descendant of the Grantor.

Letter of Wishes. The Grantor may provide the Distribution Fiduciary with a "Letter of Wishes" (which may be modified, amended, supplemented, restated and/or revoked from time to time) that will provide the Distribution Fiduciary with additional guidance regarding distributions to the beneficiaries.

No Legal Obligation. The Grantor realizes that distribution decisions will be made by the Distribution Fiduciary in its sole and absolute discretion, and it is not the Grantor's intent that the foregoing create or impose any legal obligations on or binding standards for the Distribution Fiduciary in performing and fulfilling its duties and obligations under this Agreement.

B. Built-in Decanting Power. Many states have enacted decanting statutes which permit a trustee who has the authority to distribute principal from a trust to or for the benefit of one or more of the beneficiaries to instead exercise such principal invasion power by distributing the assets in further trust for the benefit of one or more of the trust beneficiaries. I always recommend including a built-in decanting provisions in Dynasty Trusts for flexibility purposes even if the laws of the jurisdiction governing the Dynasty Trust specifically permit a decanting via the enactment of a state statute. It is possible that the Dynasty Trust could be moved to another jurisdiction which does not authorize a decanting and thereby having specific language in the trust agreement itself would allow the trustees to exercise the authority under the terms of the trust agreement as opposed to local law to effect the decanting. Provided below is sample built-in decanting language that we typically include in our Dynasty Trusts:

> Subject to the provisions of Article TENTH of this Agreement relating to the Distribution Adviser, with regard to any trust created by or pursuant to this Agreement of which the Trustee has the power to invade the principal of the trust to make distributions to or for the benefit of one (1) or more persons (the "First Trust"), the Trustee may instead exercise the power by appointing all or part of the principal of the First Trust subject to the power in favor of the Trustee of another trust (the "Second Trust"), provided, the beneficiaries of the Second Trust must also be one or more of the beneficiaries of the First Trust. Notwithstanding the foregoing, the Second Trust may have dispositive and/or administrative provisions that differ from the First Trust. The Trustee must obtain the written consent of the Trust Protector prior to exercising the power conferred pursuant to this section (p) of this Article SEVENTH.

C. <u>Amendment Power</u>. I always recommend conferring upon an independent fiduciary the power to amend a Dynasty Trust for administrative and tax purposes. This will allow the Dynasty Trust to remain flexible as circumstances change in the future particularly as they relate to changes in the tax law. Provided below is sample amendment language that we typically include in our Dynasty Trusts:

> To amend the administrative and technical provisions with respect to any trust created by or pursuant to this Agreement in accordance with this Agreement, at such times as the Trust Protector may deem appropriate for the proper administration of the Trust and for tax purposes.

D. <u>Transfer of Situs and Change of Governing Law</u>. The Dynasty Trust will be created in accordance with the laws of the particular jurisdiction. For example, the Dynasty Trust could be drafted in accordance with Delaware law and provide that Delaware law shall govern the validity, construction and administration of the Dynasty Trust. It may become desirable in the future to move the situs of the Dynasty Trust to another jurisdiction and change the law governing the administration of the Dynasty Trust. While state law may contain specific provisions allowing for such a change it is advisable to include language in the trust agreement specifically allowing a power holder, such as an independent Trustee or a Trust Protector, to move the situs of the Dynasty Trust from one jurisdiction to another and to change the law governing administration of the Dynasty Trust. Provided below is sample transfer of situs and change of governing law language that we typically include in our Dynasty Trusts:

> <u>Controlling Law</u>. This Agreement creates a Delaware trust and all matters pertaining to its validity, construction and administration shall be determined in accordance with the laws of the State of Delaware subject only to the following provisions:
>
> (a) The Trust Protector shall have the power to designate the law of any other jurisdiction (under which the terms of any trust created by or pursuant to this Agreement shall be capable of taking effect) to be the governing law of any trust created by or pursuant to this Agreement, and to declare:
>
> > (1) that such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated, the courts of which shall become the forum or situs for the administration of such trust, as well as all matters applicable to the administration thereof; or
> >
> > (2) that, to the extent permitted by law, such trust shall thereafter be governed by and take effect according to the laws of the jurisdiction so designated, but that the forum or situs for the administration of such trust shall be a different jurisdiction designated by the Trust Protector.
>
> (b) Such designation and/or declaration shall be set forth in a deed or other written instrument delivered to the Trustee and the Notice Recipients that shall

contain the powers and provisions that are necessary to enable such trust to be capable of taking effect under the laws of such jurisdiction(s), and that may also contain such other powers and provisions as the Trust Protector may determine to be in the best interest of the beneficiaries, provided that such powers and provisions do not infringe upon any rule against perpetuities that is applicable to such trust.

(c) Upon the declaration by the Trust Protector that any trust created by or pursuant to this Agreement shall be governed by and administered in accordance with the laws of a new jurisdiction, the rights of all persons, parties, and entities, and the construction, effect, and administration of each and every provision of such trust shall be subject to and construed only according to the laws of the designated jurisdiction(s).

V. COMPLETED GIFT ASSET PROTECTION TRUSTS.

As previously discussed, the 2017 Act presents clients with the unique estate planning opportunity to transfer significant amounts of wealth out of their estate without the imposition of transfer taxes. However, even the wealthiest clients are often concerned with giving such large amounts of money away based on the fear that they may need to access the assets in the future.

One option that clients may have is to create a Dynasty Trust in a jurisdiction which allows for self-settled asset protection trusts. A client may make a transfer to a Dynasty Trust established in such a jurisdiction, to which the client allocates gift tax exemption and GST exemption and provide in the trust agreement that the trustee may distribute income and principal from the Dynasty Trust to a class of beneficiaries, that includes the grantor, in the sole and absolute discretion of the trustee. What follows is a summary of the relevant issues to consider when creating a completed gift asset protection trust.

A. <u>Grantor's Retention of Control</u>.

The first issue to address is whether the transfer of assets to the Dynasty Trust constitutes a completed gift for federal gift tax purposes.

1. <u>Is the Transfer to the Dynasty Trust a Completed Gift</u>?

(a) A transfer is incomplete for federal gift tax purposes if the grantor retains sufficient dominion and control over the property. Treas. Reg. § 25.2511-2(b).

(b) If an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the assets, the grantor has retained sufficient dominion and control over the assets because under local law the grantor is able to relegate his or her creditors to the assets of the trust. See Rev. Rul. 76-103; Rev. Rul. 77-378; and Paolozzi v.

Commissioner, 23, T.C. 102 (1954). As such, the trust must be established in a jurisdiction that allows for self-settled asset protection trusts thereby preventing the grantor from being able to relegate his or her creditors to the assets of the trust.

(c) Revenue Ruling 76-103.

(i) In Revenue Ruling 76-103, the grantor created an irrevocable trust which provided that during the grantor's lifetime the trustee could distribute income and principal of the trust in its sole and absolute discretion to the grantor. The trust further provided that upon the death of the grantor, the remaining principal of the trust was to be distributed to the grantor's issue. The trust was determined to be a discretionary trust under the laws of the state in which the trust was created and the entire property of the trust was subject to the claims of the grantor's creditors.

(ii) Revenue Ruling 76-103 concluded that as long as the trustee continues to administer the trust under the laws of the state subjecting the trust assets to the claims of creditors, the grantor retained dominion and control over the trust property. As such the grantor's transfer of the property to the trust does not constitute a completed gift for federal gift tax purposes.

(iii) Revenue Ruling 76-103 also concluded that if the grantor were to die before the gift becoming complete, the date of death value of the trust property would be includible in the grantor's gross estate for federal estate tax purposes under Section 2038 of the IRC because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

(d) Revenue Ruling 77-378.

(i) In Revenue Ruling 77-378, the grantor created an irrevocable trust which provided that the trustee was empowered to pay to the grantor such amounts of the trust's income and principal as the trustee determines in its sole and absolute discretion. Under the applicable state law, the trustee's decision whether to distribute trust assets to the grantor was entirely voluntary. Furthermore, the grantor was prohibited from requiring that any of the trust assets be distributed to the grantor nor could the creditors of the grantor reach any of the trust assets.

(ii) Revenue Ruling 77-378 concluded that the grantor had parted with dominion and control over the property that the grantor transferred into the trust. Although the trustee had an unrestricted power to pay trust assets to the grantor, the grantor could not require that any of the trust assets be distributed to the grantor nor could the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. Revenue Ruling 77-378 therefore concluded that the grantor's transfer to the trust was a completed gift for federal gift tax purposes.

2. Sections 2036(a)(2) and Section 2038.

Another concern relates to whether the Dynasty Trust assets will be includible in the grantor's estate under Sections 2036(a)(2) and Section 2038 of the IRC because of the grantor's retained power to terminate the Dynasty Trust by relegating the grantor's creditors to the entire property of the Dynasty Trust.

(a) Section 2036(a)(2) of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to designate the persons who shall possess or enjoy the property or income therefrom. IRC § 2036(a)(2).

(b) Section 2038 of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to alter, amend or revoke the trust. IRC § 2038.

(c) Both Sections 2038(a) and 2036(a)(2) of the IRC have been used to cause a self-settled trust whose assets are subject to the claims of the grantor's creditors to be included in the grantor's estate. See Rev. Rul. 76-103; Estate of Paxton, 68 TC 785 (1986).

B. Grantor's Retained Beneficial Interest.

Another issue to address is whether the grantor's mere retention of a discretionary beneficial interest in the Dynasty Trust will cause the assets to be included in the grantor's gross estate under Section 2036(a)(1) of the IRC.

1. Section 2036(a)(1).

(a) Section 2036(a)(1) of the Internal Revenue Code provides that a decedent's gross estate shall include property transferred in trust other

than for full and adequate consideration if the decedent retained the right to income from the property. IRC § 2036(a)(1).

(b) The use, possession, right to income or other enjoyment of the transferred property is considered as being retained by the decedent to the extent the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. Treas. Reg. § 20.2036-1(b)(2).

(c) The right to the income need not be express but may be implied. Treas. Reg. § 20.2036-1(1)(i).

2. The 2004 Ruling.

(a) As previously discussed, the 2004 Ruling specifically states that the trustee's discretion to reimburse the grantor for the income tax liability combined with other factors including, but not limited to: (i) an understanding or preexisting arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion; (ii) a power retained by the grantor to remove the trustee and name a successor trustee; or (iii) applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(b) The 2004 Ruling seems to address the concern raised in the completed gift asset protection trust context regarding whether the grantor's mere retention of a discretionary beneficial interest is sufficient to cause inclusion of the trust assets in the grantor's estate under Section 2036(a)(1) of the IRC. Following the rationale contained in the 2004 Ruling, the trustee's mere ability to distribute assets to the grantor should not alone cause inclusion of the assets in the grantor's gross estate for federal estate tax purposes.

C. The Private Letter Rulings.

Two Private Letter Rulings have been issued addressing the transfer tax consequences associated with self-settled asset protection trusts. See PLR 9837007 and PLR 200944002. Both Private Letter Rulings involved the use of Alaska trusts established by Alaska residents.

1. PLR 9837007 (the "1998 PLR").

(a) In the 1998 PLR the grantor created a trust for the benefit of herself and her descendants. The trustee could, but was not required to, distribute income and/or principal from the trust to any of the beneficiaries.

(b) The 1998 PLR concluded that the transfer to the trust would be a completed gift for federal gift tax purposes because a creditor of the grantor would be precluded from satisfying claims out of the grantor's interest in the trust. However, it expressly did not rule on whether the assets would be included in the grantor's estate for federal estate tax purposes.

2. <u>PLR 200944002 (the "2009 PLR")</u>.

(a) In the 2009 PLR the grantor created a trust for the benefit of himself, his spouse and descendants. Distributions of income and principal could be made to the beneficiaries of the trust in the sole and absolute discretion of the trustee.

(b) The 2009 PLR again concluded that the transfer to the trust was a completed gift for federal gift tax purposes. However, the 2009 PLR also concluded that the trustee's discretionary authority to distribute income and/or principal to the grantor does not by itself cause the trust to be includable in the grantor's estate for federal estate tax purposes under Section 2036(a)(1) of the IRC.

(c) The analysis contained in the 2009 PLR is based primarily on the 2004 Ruling. Both the 2004 Ruling and the 2009 PLR conclude that the assets will not be included in the grantor's estate under Section 2036(a)(1) under the theory that the trustee's discretionary authority to distribute assets to the grantor will not by itself result in estate tax inclusion. However, neither the 2004 Ruling nor the 2009 PLR address whether Sections 2036(a)(2) or 2038 of the IRC will cause inclusion in the grantor's estate under the theory that the grantor could terminate the trust by relegating the grantor's creditors to the entire property of the trust. Sections 2036(a)(2) and 2038 of the IRC should not cause the assets to be included in the grantor's estate as long as the trust is created in a jurisdiction allowing for self-settled asset protection trusts as the grantor will be prohibited from relegating his or her creditors to the assets of the trust.

D. <u>Creditor Exceptions</u>.

1. All states that have self-settled trust legislation, other than Alaska or Nevada, allow certain creditors to access the trust. For example, the Delaware Qualified Dispositions in Trust Act allows for certain family claims, including child support and alimony, provided that with respect to an alimony claim the spouse must have been married to the grantor before the trust was created. 12 <u>Del</u>. <u>C</u>. §§ 3573(1) and 3570(9).

2. A question has arisen as to whether the mere fact that a family creditor could reach the trust assets is enough to cause the transfer to the trust from being an incomplete gift or otherwise cause the trust assets to be included in the grantor's gross estate under Sections 2036(a)(2) and 2038 of the IRC.

3. The reason for this concern stems from language contained in the 2004 Ruling. The 2004 Ruling expressly states that the trustee's discretion to distribute trust assets to a grantor to satisfy the grantor's income tax liability combined with other factors, such as applicable local law subjecting the trust assets to the claims of the grantor's creditors, may cause inclusion of the trust assets in the grantor's estate for federal estate tax purposes.

4. Proponents of Alaska and Nevada law have argued that the mere existence of the family claim exception contained in statutes of other jurisdictions, such as Delaware, would be enough to cause the assets to be includible in the grantor's estate under Sections 2036(a)(2) and 2038 of the IRC and therefore a grantor should only establish a trust in Alaska or Nevada if the grantor desires for the trust assets to be excluded from his or her estate.

5. However, what is overlooked in this argument is the theory of acts of independent significance, which is discussed in the next section of this outline.

E. Acts of Independent Significance.

1. The theory of acts of independent significance is applied when determining whether the grantor retained a power which rises to the level of a power which will cause inclusion in the grantor's gross estate under Sections 2036(a)(2) or 2038 of the IRC or otherwise result in an incomplete gift. If the retained power allows the grantor the ability to act in such a way so as to affect the beneficial interest of the trust, but the possibility of such action occurring is so de minimis and speculative, the power will be found to be an act of independent significance. See Estate of Tully, 528 F.2d 1401 (1976); Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; Rev. Rul. 80-25; and PLR 9141027.

2. Courts have ruled that the possibility of divorce is an act of independent significance. See Estate of Tully, 528 F.2d 1401; PLR 9141027.

(a) Estate of Tully.

(i) In the Estate of Tully case the Court addressed whether death benefits paid directly to the decedent's widow by his employer should be included in the decedent's estate under Section 2038 of the IRC.

(ii) The decedent and his business partner entered into an agreement which provided that upon the decedent's death the company would pay the decedent's widow a death benefit equal in amount to twice the annual salary which the company had paid to the decedent for the year immediately preceding the date of his death.

(iii) One of the arguments made by the Internal Revenue Service was that the decedent retained a Section 2038 of the IRC power to revoke or terminate the transfer of the death benefits to his wife by virtue of the possibility that he could have divorced his wife prior to his death.

(iv) The Court held that the possibility of divorce is so de minimis and so speculative rather than demonstrative, real, apparent and evident that it cannot rise to the level of a Section 2038 power.

3. Courts have also determined that acts of independent significance include failure to support a spouse as well as the ability to have or adopt children. Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; and Rev. Rul. 80-255.

(a) Revenue Ruling 80-255.

(i) In Revenue Ruling 80-255, the decedent created an irrevocable trust which provided that the income was to be paid in equal shares to the decedent's children and principal was to be distributed twenty-one (21) years after the creation of the trust in equal shares to the decedent's children, per stirpes. The trust instrument also provided that the decedent's children, born or adopted after the creation of the trust, were to be additional beneficiaries.

(ii) The issue addressed in Revenue Ruling 80-255 was whether the decedent retained a power to change the beneficial interest of the trust for purposes of Sections 2036(a)(2) and 2038 of the IRC because the trust provided that children born or adopted after the creation of the trust were to become beneficiaries and the decedent had the ability to bear or adopt additional children.

(iii) Revenue Ruling 80-255 determined that the act of bearing or adopting children is an act of independent significance. Revenue Ruling 80-255 held that although the decedent's act

of bearing or adopting children will automatically result in adding the child as a beneficiary to the trust, such result is merely a collateral consequence of bearing or adopting children and is not equivalent to the decedent's retention of a power to designate or change beneficial interest within the meaning of Sections 2036(a)(2) and 2038 of the IRC.

F. Conclusion.

1. Completed gift asset protection trusts present a unique planning opportunity for clients who want to utilize the increase in gift tax and GST exemption to transfer assets out of their estate but are concerned with the possibility of needing access to the funds in the future.

2. It is extremely important that in establishing a completed gift asset protection trust there is no implied understanding between the grantor and the trustee regarding distribution from the trust to the grantor.

3. Notwithstanding the fact that all states, other than Alaska and Nevada, allow for certain creditors to access the trust, the theory of acts of independent significance should allow a grantor to establish a completed gift asset protection trust in any jurisdiction allowing for self-settled asset protection trusts and have the assets excluded from his or her estate.

VII. USE OF QUIET TRUST LANGUAGE IN DYNASTY TRUSTS

Most state laws impose requirements on trustees to keep current beneficiaries of a trust reasonably apprised of their beneficial interest in the trust which will often require the trustees to provide the beneficiaries with trust account statements on a periodic basis. This can be concerning to many grantors creating Dynasty Trusts, particularly with respect to younger beneficiaries.

Grantors fear that a beneficiary's knowledge of the wealth in the Dynasty Trust can result in a disincentive for the beneficiary to achieve their own success. This concern has resulted in the creation of the "silent trust" which eliminates a trustee's duty to inform beneficiaries of the existence of a trust for a period of time.

A. Statutory Disclosure Requirements.

1. Uniform Trust Code. The Comment to Section 813 of the Uniform Trust Code ("UTC") states that one of the fundamental duties of a trustee is to keep the beneficiaries reasonably informed of the administration of the trust. It should come as no surprise, then, that the UTC imposes broad disclosure requirements. This is, perhaps, one of the reasons why, contrary to its intended purpose, there is such a lack of uniformity among the states

(including the District of Columbia, hereafter "D.C'.") that have adopted versions of the UTC

(a) Default Requirements. Section 813 of the UTC imposes the following duties upon a trustee:

(i) To keep **qualified beneficiaries** reasonably informed about the trust's administration and of material facts necessary to allow them to protect their interests. UTC § 813(a).

a. Pursuant to UTC § 103(13) a **qualified beneficiary** is "a beneficiary who, on the date the beneficiary's qualification is determined" constitutes one of the following:

i. A distributee or permissible distributee of trust income or principal;

ii. A would-be distributee or permissible distributee if the interests of the current distributees or permissible distributee terminated on that date (without causing the trust to terminate); or

iii. A would-be distributee or permissible distributee if the trust terminated on that date.

a. The Comment to Section 813 makes clear that qualified beneficiaries do not include "appointees under the will of a living person . . . [or] the objects of an unexercised inter vivos power."

b. To promptly respond to a **beneficiary's** request regarding information related to the trust's administration, unless unreasonable under the circumstances. UTC § 813(a).

i. Section 103(3) of the UTC defines a **beneficiary** much more broadly as a person (including corporations, trusts, estates, partnerships, etc.) that has a present or future beneficial interest in the trust (either vested or contingent) or holds a power of appointment in a non-trustee capacity.

c. To promptly furnish a copy of the trust instrument to a **beneficiary** upon request. UTC § 813(b)(1).

d. Within sixty (60) days of acceptance, to notify **qualified beneficiaries** of acceptance of trusteeship. The trustee must provide his, her, or its name, address, and telephone number. UTC § 813(b)(2).

e. Within sixty (60) days after acquiring knowledge of an irrevocable trust's creation or that a revocable trust has become irrevocable, to notify **qualified beneficiaries** of the existence of the trust, the identity of the settlor(s), the right to request a copy of the trust instrument, and the right of a trustee's report. UTC § 813(b)(3).

f. To provide advance notice to **qualified beneficiaries** of a change in rate of compensation. UTC § 813(b)(4).

g. At least annually and at the termination of the trust, to send to **distributees** or **permissible distributees** of trust income or principal, as well as **qualified** or **nonqualified beneficiaries** who request it, a "report of the trust property, liabilities, receipts, and disbursements, including the source and amount of the trustee's compensation, a listing of the trust assets and, if feasible, their respective market values." In addition, upon a vacancy in trusteeship when no co-trustee remains in office, the former trustee must send such a report to **qualified beneficiaries**. UTC § 813(c).

i. This is reinforced by Section 110, which requires a trustee to give notice to any **beneficiary** who requests it whenever notice to **qualified beneficiaries** is required under the UTC.

(b) Limiting Default Requirements. Although the default requirements for notice and disclosure are rather broad, the UTC does allow a settlor to limit these requirements to a certain extent.

Section 105(b) states that the terms of a trust instrument prevail over the provisions of the UTC except for the following:

(i) A trustee's duty under Section 813(a) to respond to a request by a **qualified beneficiary** for reports and information

reasonably related to the trust's administration. UTC § 105(b)(9).

(ii) A trustee's duty under Sections 813(b)(2) and 813(b)(3) to notify **qualified beneficiaries** age twenty-five (25) or older of the existence of the trust, the identity of the trust, and the right to request a trustee's report. UTC § 105(b)(8).

The Comment to Section 105 clarifies the specifics of what a settlor can and cannot waive within the terms of a trust instrument. For example, a settlor can waive the duty to provide a copy of the trust instrument to **beneficiaries** and the duty to provide **qualified beneficiaries** with annual reports. Note, however, that such duties may be required in a given situation if the information requested is reasonably related to the administration of the trust.

With respect to **qualified beneficiaries** under age twenty-five, a trust instrument can provide that a trustee not even inform such beneficiaries of the existence of the trust. If, however, such a beneficiary should learn of the existence of the trust, a trustee is still required to respond to requests for information reasonably related to the trust's administration.

Lastly, it is worth noting that neither Section 105(b)(8) nor Section 105(b)(9) apply to revocable trusts, thereby allowing a settlor to waive <u>all</u> reporting requirements. But, if a settlor does not waive such requirements, they take effect upon the settlor's incapacity. Prior to a settlor's incapacity, the duties of a trustee are owed solely to the settlor. UTC § 603.

2. <u>Restatement (Third) of Trusts</u>. Much like the UTC, the Restatement (Third) of Trusts (the "Restatement") imposes reporting requirements on trustees, but the requirements under the Restatement are not quite as extensive. In addition, Section 74 of the Restatement also makes clear that the trustee of a revocable trust generally owes duties, including reporting requirements, only to the settlor. However, the donee of a presently exercisable general power of appointment is also treated like a settlor with respect to duties owed by the trustee. Restatement (Third) of Trusts § 74.

(a) <u>Default Requirements</u>. With respect to irrevocable trusts, a trustee has the following duties:

(i) To promptly inform **fairly representative beneficiaries** of "the existence of the trust, of their status as beneficiaries and their right to obtain further information, and of basic

information concerning trusteeship." Restatement (Third) of Trusts § 82(1)(a).

a. General Comment (a)(1) to Section 82 clarifies what is meant by **fairly representative beneficiaries**. According to the comment, a trustee is required to make a good-faith effort to "select and inform a limited number of beneficiaries whose interests and concerns appear . . . likely to coincide with . . . the trust's beneficiaries generally." For the most part, this limited class consists of present mandatory and discretionary beneficiaries of income or principal and first-tier remaindermen, i.e., those who would receive or would or be eligible to receive distributions of income or principal upon the termination of a present interest or the termination of the trust. Restatement (Third) of Trusts § 82, General Comment (a)(1).

1. The trustee is to inform **fairly representative beneficiaries** of "the existence, source, and name . . . of the trust; the extent and nature . . . of their interests; the name(s) of the trustee(s), contact and compensation information, and perhaps the roles of co-trustees; and the . . . right to further information." Restatement (Third) of Trusts § 82, Comment on Subsection (1), b.

b. Interestingly, General Comment (a)(1) to Section 82 continues by adding that, on occasion, a trustee's duty to provide information can extend to a donee of a power of appointment or a person granted the power to (1) veto or direct acts of the trustee, e.g., special trustee, distribution committee; or (2) modify the trust, e.g., trust protector. Likewise, in a situation in which there is a large class of present discretionary beneficiaries, a trustee's duty to provide inform can be more limited.

(i) To inform **beneficiaries** of significant changes in their status as a beneficiary. Restatement (Third) of Trusts § 82(1)(b).

a. Section 3 of the Restatement defines a **beneficiary** as "[a] person for whose benefit property is held in trust." Section 48 of the Restatement goes on to state that a person is a beneficiary if the settlor manifests the intent to give a beneficial interest, but a merely incidentally

benefitting from the performance of the trust is not enough.

(ii) "[T]o keep **fairly representative beneficiaries** reasonably informed of changes involving trusteeship and about other significant developments concerning the trust and its administration, particularly material information needed by beneficiaries for the protection of their interests." Restatement (Third) of Trusts § 82(1)(c). The trustee is to exercise reasonable judgment with respect to determining what is significant. Restatement (Third) of Trusts § 82, Comment on Subsection (1), d.

(iii) To promptly respond to a **beneficiary's** request for information concerning the trust and its administration, and to permit an inspection of the trust's documents, records, and holdings. Restatement (Third) of Trusts § 82(2). Typically, the trustee is also to furnish a copy of the trust instrument. Restatement (Third) of Trusts § 82, Comment on Subsection (2), e.

(iv) To provide **beneficiaries** with reports or accountings, upon request, at reasonable intervals. Restatement (Third) of Trusts § 83. This requires a trustee to submit an account to **beneficiaries** upon a trust's termination. Restatement (Third) of Trusts § 83, Comment b.

a. Such a report or accounting can be relatively informal, so long as it (1) reveals the trust's assets and liabilities, receipts and disbursements, and other transactions; and (2) discloses trustee compensation.

(b) <u>Limiting Default Requirements</u>. The statutory language of Section 82 of the Restatement expressly recognizes a settlor's ability to modify trust duties under the terms of the trust instrument. However, one must look to the Comments for further guidance to determine what can be modified.

(i) A **beneficiary** is <u>always</u> entitled to request information reasonably necessary to enforce his or her rights and/or prevent breach of trust, and the duty to respond is, therefore, <u>not</u> subject to modification.

(ii) A settlor <u>can</u> modify the trustee's duty to provide the information required under Restatement (Third) of Trusts §§ 82(1)(a)-(c), but not entirely or to a degree (or time) that

would unduly interfere with the purposes for the information requirements. Restatement (Third) of Trusts § 82, General Comment a(2).

a. A settlor can only modify these duties by "clear language" in the terms of the trust instrument and within the limit described above.

(iii) A settlor can modify and limit the duty to disclose trust provisions or other information, perhaps to prevent a spendthrift beneficiary from learning of his or her interest, but, as stated above, a beneficiary is always entitled to request information. Restatement (Third) of Trusts § 82, Comment on Subsection (2), e.

(iv) The terms of a trust instrument may allow the trustee to provide accountings to a designated person, e.g., one of the **beneficiaries** (or the settlor of an irrevocable inter vivos trust), and provide that such person's approval shall discharge the trustee's liability. However, such a provision is only effective if the designated person does not act in bad faith (or disregard for the interests of other beneficiaries) in approving the accounting and the accounting discloses material information about the trustee's conduct. Restatement (Third) of Trusts § 83, Comment d.

3. Delaware Disclosure Requirements. The Delaware Code is rather silent with respect to the default duties of trustees to provide information and reports to trust beneficiaries. However, a landmark case from 2002 sets the standard for trustee disclosure. McNeil v. McNeil, 798 A.2d 503 (Del. 2002). In fact, in response to this case, the legislature enacted 12 Del. C. § 3303, which allows a settlor to modify case law/common law trustee disclosure requirements. More on that statute shortly.

(a) McNeil Case. The basic facts underlying the case are that in 1959, Henry Slack McNeil, Sr. sold his pharmaceutical company to Johnson and Johnson and created a number of trusts with the sale proceeds. Four (4) trusts were established for the benefit of Mr. McNeil's children and a fifth trust was established for the benefit of Mr. McNeil's wife, Lois (the "Lois Trust"). McNeil, 798 A.2d at 506 (Del. 2002). Although the children were unaware for quite some time, the terms of the Lois Trust made each child a current discretionary beneficiary of income and principal. *Id.*

The original trustees of the Lois Trust were three (3) individual trustees and Wilmington Trust Company. *Id.* at 506-507. Thereafter,

two (2) individual trustees were removed and replaced with a new individual trustee and Provident National Bank ("PNC"). *Id*. All trustees were aware of the children's status as current beneficiaries of the Lois Trust. *Id*. at 507. Ultimately, Henry Slack McNeil, Jr. ("Hank") had a falling out with his family, causing disinheritance by his father and a bequest from his mother in the amount of a "paltry" amount of two million dollars ($2,000,000). *Id*. This ultimately led Hank to seek large distributions from the trustees of his trust, who were basically the same trustees of the Lois Trust. *Id*. As a result, the trustees of Hank's trust requested that Hank's children take a position on the distributions since, like the McNeil children under the Lois Trust, they were current discretionary beneficiaries of Hank's trust. *Id*.

Although not clear as to when, Hank discovered his status as a current beneficiary in the Lois Trust and filed a complaint in the Court of Chancery seeking a make-up distribution from the Lois Trust, the removal and surcharge of the trustees of the Lois Trust, and a restructuring of the operations of the Lois Trust. *Id*.

The Court of Chancery ultimately concluded that Hank's estrangement and treatment as an outsider was continued by the trustees of the Lois Trust, but such trustees shared a great deal of information with Hank's siblings. *Id*. Further, the trustees continually rebuffed Hank in his efforts to learn about the specifics of the Lois Trust and followed Lois' wish that no principal distributions be made. *Id*.

Because the trustees of the Lois Trust breached their fiduciary duties to Hank by failing to inform him that he was a current beneficiary, by showing partiality to Hank's siblings, and by allowing the Lois Trust to operate on "autopilot," the Court of Chancery ordered a make-up distribution of seven and a half percent (7.5%) of the value of Hank's interest in the Lois Trust after her death, i.e., one quarter (1/4) of the value of the Lois Trust. *Id*. at 508. In addition, PNC was removed as trustee and all trustees were surcharged one-fifth (1/5) of their commissions received from 1987-1996. *Id*.

On appeal, the trustees of the Lois Trust claimed that the express terms of the trust agreement precluded them from breaching any duties owed to Hank. *Id*. at 509. Specifically, the trustees argued that discretionary distributions were to be made in their sole judgment, that decisions by the committee of trustees were not subject to court review, and that any good faith action taken by the trustees was to be considered proper. *Id*. Further, the trust agreement relieved the trustees of "all personal liability except for gross negligence or willful wrongdoing." *Id*.

In reviewing these provisions of the Lois Trust, the Delaware Supreme Court held that the trustees were exculpated from ordinary negligence, "but not the duty to (i) inform beneficiaries or (ii) treat them impartially." *Id*. Regardless of his intent, Mr. McNeil did not relieve the trustees of these duties. *Id.* at 509-510. The court found that Hank's repeated attempts to obtain information about the Lois Trust should have put the trustees on notice that Hank did not know about his standing as a current beneficiary. *Id*. at 510.

"A trustee has a duty to furnish information to a beneficiary upon reasonable request. Furthermore, even in the absence of a request for information, a trustee must communicate essential facts, such as the existence of the basic terms of the trust. That a person is a current beneficiary of a trust is indeed an essential fact." *Id*.

Due to the "pattern of deception and neglect over a span of many years," including denying Hank information and telling him that he was only a remainderman of the Lois Trust, the Delaware Supreme affirmed all rulings of the Court of Chancery, except for the individual who was to replace PNC as trustee, which was remanded for further proceedings. *Id*. at 515.

(b) Delaware Statute. Delaware has not adopted the UTC. Instead, Delaware has enacted statutes that allow a settlor of a Delaware trust to validly create a silent trust.

Section 3303 of Title 12 of the Delaware Code provides that the terms of trust instrument may expand, restrict, eliminate, or vary the "rights and interests of beneficiaries, including, but not limited to, the right to be informed of the beneficiary's interest for a period of time," as well as a "fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from that instrument." 12 Del. C. § 3303(a)(1), (4). The Section goes on to make clear that it is intended to give maximum effect to "the principle of freedom of disposition and to the enforceability of governing instruments." 12 Del. C. § 3303(a).

With respect to limiting a beneficiary's right to be informed for a "period of time," the statute provides the following non-exclusive list of examples: "(1) A period of time related to the age of a beneficiary; (2) A period of time related to the lifetime of each trustor and/or spouse of a trustor; (3) A period of time related to a term of years or specific date; and/or (4) A period of time related to a specific event that is certain to occur." 12 Del. C. § 3303(c).

Additionally, unless the governing instrument provides otherwise, during the time that a beneficiary's right to be informed is restricted or eliminated, the beneficiary may be represented and bound by a "designated representative" for both judicial proceedings, as well as nonjudicial matters. 12 Del. C. § 3303(d).

In order to be a "designated representative," such person must be authorized to act in one of the following ways: (1) by express appointment as a designated representative or by reference to the applicable section(s) of the Delaware Code in the governing instrument; (2) by authorization or direction in the governing instrument to represent or bind beneficiaries for purposes of a judicial proceeding and/or nonjudicial matter (as defined in 12 Del. C. § 3303(e)); (3) by appointment by a person expressly authorized in the governing instrument to appoint someone described in (1) or (2), above; (4) by appointment by a beneficiary to act as his or her designated representative; and/or (5) by appointment by the settlor to act as a designated representative for the beneficiar(ies). 12 Del. C. § 3339(a). In addition, the designated representative must deliver a written acceptance to the trustee. *Id*. Finally, 12 Del. C. § 3339(b) provides that a person serving as a designated representative is presumed to be a fiduciary.

Recent Delaware case law has confirmed the effect of Section 3303 of Title 12 of the Delaware Code. "Essentially, so long as an instrument does not purport to exculpate or indemnify a fiduciary for *intentional misconduct,* the language of the contract governs. Thus, any rights or responsibilities of the trustee are expressly dictated by the terms of the [trust instrument]." *In re Rohlf*, 2011 WL 3201798, Footnote 6 (Del.Ch. 2011).

B. State Statutes that Permit Trust Instruments to Delay Notification.

Due to their rising popularity among settlors, a number of other jurisdictions have enacted legislation to allow for the creation of silent trusts, including states that have adopted the UTC but have altered the default trustee disclosure requirements.

1. Alaska. Section 13.36.080(a) of the Alaska Statutes imposes notice and disclosure requirements upon a trustee, e.g., to provide information as to where the trust is registered and the trustee's name and address, provide a copy of the terms of the trust upon request, provide annual and termination accountings, etc.

However, pursuant to AS § 13.36.080(b), a settlor may exempt a trustee from these duties with respect to beneficiaries who are not annually entitled to a mandatory distribution of income or principal. Such exemption can be

provided in the terms of the trust instrument, by amendment to the trust instrument, or by a separate writing. Such exemption only applies for the shorter of the settlor's life or determination of incapacity.

2. Arizona. Arizona has adopted its own version of the UTC. Chapter 11 of Title 14 of the Arizona Revised Statutes. Accordingly, the standard default disclosure and notification provisions apply. A.R.S. § 14-10813. However, Arizona allows a settlor to modify (to an extent) the default notice requirements. A.R.S. § 14-10105(B). A settlor cannot waive either "the duty to respond to the request of a qualified beneficiary of an irrevocable trust for trustee's reports and other information reasonably related to the administration of a trust" or the notice provisions regarding charitable trusts. A.R.S. § 14-10105(B)(8).

3. Arkansas. Arkansas has also adopted its own version of the UTC. Chapter 73 of Title 28 of the Arkansas Code Annotated. Accordingly, the standard default disclosure and notification provisions apply. A.C.A § 28-73-813. However, Arkansas allows a settlor to modify or waive the default notice requirements, as the Arkansas Code does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. A.C.A § 28-73-105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

4. District of Columbia. D.C. is another jurisdiction that has adopted a version of the UTC. Chapter 13 of Title 19 of the D.C. Code. Accordingly, the standard default disclosure and notification provisions apply. DC ST § 19-1308.13. D.C. takes a bit of a different approach by allowing a settlor, either via the trust instrument or other writing delivered to trustee, to waive or modify the trustee notification provisions in the following ways: (1) by waiving or modifying such duties during the lifetime of the settlor or the settlor's spouse; (2) by specifying an age other than twenty-five (25) at which a beneficiary is entitled to notice; or (3) by designating a person to act in good faith on behalf of the beneficiaries to receive such notice(s).

5. Florida. Florida has also adopted its own version of the UTC. Chapter 736 of Title XLII of the Florida Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. F.S.A. § 736.0813. Such duties cannot be waived or modified. F.S.A. §§ 736.0105(r), (s), (t). However, a settlor may appoint a surrogate to receive information on behalf of the current beneficiaries. F.S.A. § 736.0306. The trust instrument can also authorize anyone other than the trustee to appoint a surrogate. F.S.A. § 736.00306(1).

6. Kansas. Kansas has also adopted its own version of the UTC. Chapter 58A of the Kansas Statutes Annotated. Accordingly, the standard default

disclosure and notification provisions apply. K.S.A 58a-813. Unlike the previous jurisdictions, the Kansas statute states that the notice provisions do not apply so long as a surviving spouse is a qualified beneficiary or holds any power of appoint over the entire trust, and where all other qualified beneficiaries are issue of the surviving spouse. K.S.A 58a-813(d).

In addition, Kansas allows a settlor to modify the default notice requirements, as the Kansas Statutes do not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. K.S.A 58a-813(b). Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

7. Maine. Maine is yet another jurisdiction that has adopted a version of the UTC. Title 18-B of the Maine Revised Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. 18-B M.R.S.A. § 813. Similar to D.C., Maine allows a settlor, by the trust instrument or other writing delivered to trustee, to waive or modify the trustee notification provisions for all qualified beneficiaries other than the surviving spouse during such spouse's lifetime, but requires a designee to act in good faith to protect the interests of a current beneficiary for whom notice was waived and to receive reports on behalf of such beneficiary. 18-B M.R.S.A. § 105(3).

8. Michigan. Michigan has also adopted its own version of the UTC. Article VII of Chapter 700 of the Michigan Compiled Laws Annotated. Accordingly, the standard default disclosure and notification provisions apply. M.C.L.A. § 700.7814. The bulk of such duties cannot be waived or modified. M.C.L.A. § 700.7105(i). However, a settlor may modify or waive the duty to keep qualified beneficiaries reasonably informed, the duty to promptly respond to a beneficiary's request for information regarding the administration of the trust, and the duty to provide advance notice of any change in trustee compensation. *Id.*

9. Mississippi. Mississippi has also adopted its own version of the UTC. Chapter 8 of Title 91 of the Mississippi Code. Accordingly, the standard default disclosure and notification provisions apply. Miss. Code § 91-8-813. The Mississippi Code, however, allows a settlor to modify the default notice requirements, except with respect to providing notice to first-tier remaindermen, and possibly holders of a power of appointment, upon the termination of a current interest. Miss. Code § 91-8-81(c).

With respect to the notice provisions that can be waived, a settlor, trust protector, or trust advisor may waive such duties (in a writing delivered to trustee) in the following ways: (1) by waiving or modifying such duties as to all qualified beneficiaries during the lifetime of the settlor or the settlor's spouse; (2) by specifying a different age at which a beneficiary must be

notified; and (3) by designating a surrogate to receive such notice who will act in good faith to protect the interests of the beneficiary.

10. Missouri. Missouri has also adopted its own version of the UTC. Chapter 456 of Title XXXI of Vernon's Missouri Statutes. Accordingly, the standard default disclosure and notification provisions apply. V.M.S. § 456.8-813. A settlor cannot waive or modify either the duty to respond to a qualified beneficiary's request for reports and information reasonably related to the trust administration or the duty to notify each permissible distributee age twenty-one (21) or older of the trust's existence and such distributee's right to request trustee reports and other information reasonably related to the administration of the trust. V.M.S. §§ 456.1-105(2)(8), (9).

    However, pursuant to V.M.S. § 456.1-105(3), a settlor, by the terms of the trust instrument, can designate "one or more permissible distributees to receive notification of the existence of the trust and of the right to request trustee's reports and other information reasonably related to the administration of the trust in lieu of providing the notice, information or reports to any other permissible distributee who is an ancestor or lineal descendant of the designated permissible distributee." Essentially, a current beneficiary can be designated as a surrogate to receive information on behalf of other current beneficiaries that are the surrogate's ancestors or lineal descendants.

11. Nebraska. Nebraska has also adopted its own version of the UTC. Article 38 of Chapter 30 of the Revised Statutes of Nebraska Annotated. Accordingly, the standard default disclosure and notification provisions apply. Neb.Rev.Stat. § 30-3878. While a settlor can modify or waive many of these trustee duties, pursuant to Neb.Rev.Stat. § 30-3805(b)(8), a settlor cannot modify or waive the duty to keep qualified beneficiaries reasonably informed about the trust's administration and the material facts necessary to protect their interest, and the duty to respond to a request of qualified beneficiary of an irrevocable trust for reports and information reasonably related to the trust's administration.

12. Nevada. Pursuant to N.R.S. 165.160, except as provided by statute or federal or common law, a trust instrument can vary the right and interests of a beneficiary, including the right to be informed of the beneficiary's interest for a period of time and a "fiduciary's powers, duties, standard of care, rights of indemnification and liability to persons whose interests arise from the trust instrument."

    A settlor can waive or modify the duty to provide accountings under N.R.S. 165.135 and N.R.S. 165.137 and the duty to furnish a copy of the trust instrument pursuant to 165.147. However, a settlor cannot waive or modify the duty to provide an accounting under N.R.S. 165.139, which requires a trustee, upon request, to provide an annual account to a current beneficiary if

the amount distributable to such beneficiary is affected by administrative expenses or the allocation of principal and income. In addition, N.R.S. 165.139 requires that a trustee provide an annual accounting, upon request, to each remainder beneficiary.

13. New Hampshire. New Hampshire has also adopted its own version of the UTC. Chapter 564-B of Title LVI of the Revised Statutes of the State of New Hampshire. Accordingly, the standard default disclosure and notification provisions apply, with some variations on the age (21) for disclosure. N.H. Rev. Stat. § 564-B:8-813. However, New Hampshire allows a settlor to modify or waive the default notice requirements, as the New Hampshire Code does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. N.H. Rev. Stat. § 564-B:1-105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

14. New Mexico. New Mexico is another jurisdiction that has adopted a version of the UTC. Chapter 46A of the New Mexico Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. N.M.S.A. 1978, § 46A-8-813. However, N.M.S.A. 1978, § 46A-8-813F allows a settlor to knowingly waive the trustee's duties (in whole, in part, subject to a contingency, to only certain beneficiaries, etc.) to "respond to the request of a qualified beneficiary of an irrevocable trust for a trustee's reports and other information reasonably related to the administration of a trust," so long as the trustee is a regulated financial service institution qualified to do trust business in New Mexico. In addition, the "waiver must be conspicuous, must be contained in the terms of the trust or of a separate affidavit signed by the settlor and must state that the settlor has been informed of the risks and consequences of the waiver and that the settlor nevertheless directs that the reports and information be withheld by the trustee." N.M.S. 1978, § 46A-8-813F. Conspicuous is defined as "so written, displayed or presented that a reasonable person against which it is to operate ought to have noticed it." N.M.S. 1978, § 55-1-201(10).

Curiously, N.M.S. 1978, § 46A-1-105B(8) does not allow the terms of a trust instrument to waive a trustee's duty to notify qualified beneficiaries of an irrevocable trust who have attained age twenty-five (25) of the trust's existence, the trustee's identity, and of their right to request reports.

15. North Carolina. North Carolina has also adopted its own version of the UTC. Chapter 36C of the North Carolina General Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. N.C.G.S.A. § 36C-8-813. However, North Carolina allows a settlor to modify or waive the default notice requirements, as the North Carolina General Statutes Annotated do not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the

default notice and disclosure requirements. N.C.G.S.A. § 36C-8-105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

16. North Dakota. North Dakota has also adopted its own version of the UTC. Chapter 59-09 – Chapter 59-19 of Title 59 of the North Dakota Century Code. Accordingly, the standard default disclosure and notification provisions apply. NDCC § 59-16-13. However, North Dakota allows a settlor to modify or waive the default notice requirements, as the North Dakota Century Code does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. NDCC § 59-09-05. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

17. Ohio. Title LVIII of the Ohio Revised Code appears to be based, at least in part, on the UTC. As such, the trustee has the standard duties to provide information and notice to the beneficiaries. R.C. § 5808.13. However, pursuant to R.C. § 5801.04(C), a settlor may, within the terms of the trust instrument, modify or waive the bulk of such duties with respect to current beneficiaries. The waiver can only be made by the settlor and must designate a surrogate to receive information on behalf of the current beneficiaries. The surrogate must act in good faith to protect the interests of the current beneficiaries. *Id.* In addition, a settlor can, without the need for a surrogate, waive the duty for a trustee to provide a copy of the trust instrument to a beneficiary upon request. R.C. § 5801.04(B).

18. Oklahoma. By statute, a settlor may, within the provisions of the trust instrument (or amendment to the trust instrument), relieve a trustee from "any and all duties, restrictions, and liabilities which would otherwise be imposed upon him," subject to certain duties and restrictions for corporate trustees, none of which pertain to beneficiary notice, e.g., restriction against self-lending/self-dealing, restrictions on deposits, etc. 60 Okl. St. Ann. § 175.21.

19. Oregon. Oregon has also adopted its own version of the UTC. Chapter 130 of Title 13 of the Oregon Revised Statutes. Accordingly, the standard default disclosure and notification provisions apply, with an exception that only settlor's surviving spouse need to receive disclosures under certain circumstances. O.R.S. §§ 130.710, (8). However, Oregon allows a settlor, to an extent, to waive or modify such duties. O.R.S. § 130.020(3). A settlor has the ability, within the terms of the trust instrument or another writing delivered to a trustee, to waive the duties during the period that either the settlor is living and competent or the settlor's spouse, if a qualified beneficiary, is alive and competent. O.R.S. § 130.020(3)(a). Alternatively, a settlor may designate a surrogate, acting in good faith to protect the qualified beneficiaries' interests, to receive any disclosures. O.R.S. § 130.020(3)(b).

However, any report that contains information regarding a termination of a trust must be provided to the qualified beneficiaries or a designated surrogate. O.R.S. § 130.020(4).

20. Pennsylvania. Pennsylvania has also adopted its own version of the UTC. Chapter 77 of Title 20 of Purden's Pennsylvania Statutes and Consolidated Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. 20 Pa.C.S.A. § 7780.3. Such duties cannot be waived or modified. 20 Pa.C.S.A. § 7705(b)(8). However, a settlor may appoint a surrogate to receive information on behalf of the current beneficiaries. 20 Pa.C.S.A. § 7780.3(k).

21. South Carolina. South Carolina has also adopted its own version of the UTC. Article 7 of Title 62 of the Code of Laws of South Carolina 1976. Accordingly, the standard default disclosure and notification provisions apply. Code 1976 § 62-7-813. However, South Carolina allows a settlor to modify or waive the default notice requirements, as the South Carolina Code does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. Code 1976 § 62-7-105. This is further evidenced by the fact that the provisions of Code 1976 § 62-7-813 pertaining to notice and disclosure are prefaced by "[u]nless the terms of a trust expressly provide otherwise." Code 1976 §§ 62-7-813(a), (b), (c). Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

22. South Dakota. Not surprisingly, South Dakota has not adopted a version of the UTC. Its notice requirements are found in SDCL §§ 55-2-13 and 55-2-14, the latter of which deals exclusively with revocable trusts. Regardless of the status of the trust as revocable or irrevocable, South Dakota allows a settlor (or trust advisor or trust protector) to modify or waive the trustee's duties with respect to notice either within the terms of a trust instrument or a separate writing. SDCL §§ 55-2-13, 55-2-14.

23. Tennessee. Tennessee has also adopted its own version of the UTC. Chapter 15 of Title 35 of the Tennessee Code Annotated. Accordingly, the standard default disclosure and notification provisions apply. T.C.A. § 35-15-813. However, Tennessee allows a settlor to modify or waive the default notice requirements, as the Tennessee Code Annotated does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. T.C.A. § 35-15-105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

24. Texas. Texas imposes upon a trustee the duty, upon the request of a beneficiary, to deliver an accounting to each beneficiary. Such accounting is to cover all transactions since the last accounting or the trust's inception, and

the trustee is not obligated to provide such an accounting more frequently than annually unless required by the court. V.T.C.A., Property Code § 113.151. For the requirements that must be included in the accounting, see V.T.C.A., Property Code § 113.152. This duty cannot be waived or modified with respect to current beneficiaries and first-tier remaindermen of irrevocable trusts. V.T.C.A., Property Code § 111.0035(b)(4).

In addition, pursuant to V.T.C.A., Property Code § 111.0035(c), "[t]he terms of a trust may not limit any common-law duty to keep a [current beneficiary or first-tier remainder] beneficiary of an irrevocable trust who is 25 years of age or older informed."

25. Utah. Utah has also adopted its own version of the UTC. Chapter 7 of Title 75 of the Utah Code Annotated. Accordingly, the standard default disclosure and notification provisions apply. U.C.A. 1953 § 75-7-811. However, Utah allows a settlor to modify or waive the bulk of default notice requirements, as the Utah Code Annotated does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. U.C.A. 1953 § 75-7-105. This is further evidenced by the fact that the provisions of U.C.A. 1953 § 75-7-811 pertaining to notice and disclosure are prefaced by "[e]xcept to the extent the terms of the trust provide otherwise." U.C.A. 1953 §§ 75-7-811(1), (2).

    Interestingly, the paragraph regarding the duty of a trustee to send a report of the trust property, liabilities, receipts, and disbursements (including trustee compensation), as well as a listing of trust assets and their fair market value (if feasible) to a requesting qualified beneficiary is not prefaced with any limiting language. U.C.A. 1953 § 75-7-811(3). However, since that paragraph is not listed among the items over which a trust instrument will not prevail, it is likely that this duty can be modified or waived. U.C.A. 1953 § 75-7-105.

26. Vermont. Vermont has also adopted its own version of the UTC. Title 14A of the Vermont Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. 14A V.S.A § 813. However, Vermont allows a settlor to modify or waive the default notice requirements, as the Vermont Statutes Annotated do not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. 14A V.S.A § 105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

27. Virginia. Virginia has also adopted its own version of the UTC. Chapter 7 of Title 64.2 of the Annotated Code of Virginia. Accordingly, the standard default disclosure and notification provisions apply. VA Code Ann. § 64.2-775. However, Virginia allows a settlor to modify or waive the default notice

requirements, as the Annotated Code of Virginia does not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. VA Code Ann. § 64.2-703. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

28. Washington. Washington allows a settlor to waive or modify certain notice requirements, either within the terms of the trust instrument or a separate writing delivered to a trustee. RCWA 11.98.072(5). A settlor cannot, however, waive the duty of a trustee to (1) keep all qualified beneficiaries reasonably informed about the trust's administration and the material facts necessary for them to protect their interests; (2) promptly respond to any beneficiary's request for information related to the trust's administration, which can be satisfied by providing a copy of the entire trust instrument; and (3) distribute to each current beneficiary an annual accounting. RCWA 11.98.072(1), RCWA 11.106.020.

29. Wyoming. Wyoming has also adopted its own version of the UTC. Chapter 10 of Title 4 of the Wyoming Statutes Annotated. Accordingly, the standard default disclosure and notification provisions apply. W.S.1997 § 4-10-813. However, Wyoming allows a settlor to modify or waive the default notice requirements, as the Wyoming Statutes Annotated do not include provisions similar to UTC §§ 105(b)(8) and 105(b)(9), i.e., the UTC Sections that prevent a settlor from modifying the default notice and disclosure requirements. W.S.1997 § 4-10-105. Thus, the settlor should be able to waive or modify all notice and disclosure requirements.

30. Comparison of State Statutes. Because over half of the states provide some type of relief from the expansive notice requirements under the UTC and the Restatement, it is hard to pinpoint a common theme. That said, there appears to be a trend towards allowing a settlor to designate a surrogate to receive information on behalf of the beneficiary. In addition, it appears that a number of the above-listed jurisdictions continue to require an accounting, either annually or at a trust's termination, regardless of whether or not other trustee duties can be waived.

C. Administering Silent Trusts.

1. Introduction. Many of the potential issues that could arise with the use of silent trusts can be avoided through careful drafting. Also, communication with the grantor is important during the planning and drafting stage. As discussed *infra*, if the grantor expects that notice will be restricted or eliminated, this needs to be drafted into the trust.

2. Issues in administering a silent trust that can be handled with careful drafting of the trust.

(a) Crummey Powers or other powers of withdrawal. Although it seems obvious when pointed out, it is very important that any provisions restricting notice not conflict with requirements to provide notice such as those found within Crummey or other withdrawal powers. If the trust instrument provides that the trustee is directed not to provide notice of the trust, statements, or any other information to the beneficiaries, and yet the trust has standard Crummey withdrawal provisions with the required notice to the beneficiary, there is a conflict in the terms of the trust which leaves the trustee in an uncertain position. Careful planning in the drafting stage will avoid this. However, there are instances where the provisions restricting notice come toward the end of the trust agreement, the Crummey powers of withdrawal and related notice requirements are among the earlier dispositive provisions, and there is no coordination between the two provisions. In addition to the importance of careful drafting, a safety net might be to provide a trust protector with the power to change the provisions restricting notice to the beneficiaries, if needed.

(b) The trustee has discretion to withhold information. What if the trust instrument does not direct the trustee to withhold information but rather gives the trustee the discretion to withhold information? Arguably the trustee could be protected under the statute of the given state. However in many instances a trustee will not want to be in the position of exercising this discretion, even if protected by a statute allowing a trust instrument to permit notice to the beneficiaries to be reduced or eliminated. The preferred drafting would be to direct the trustee rather than provide the trustee with discretion to withhold information.

(c) There are no provisions in the trust regarding notice to beneficiaries. Many trust officers have faced the situation where the grantor tells the trust officer not to send statements or any information to a beneficiary who has reached the age of majority, even though there are no such provisions in the trust instrument. A common reaction from the grantor might be, "I thought this state allowed notice to be withheld from beneficiaries." However, if the trust instrument does not provide for this, it is likely that the trustee will have to go through the considerations described in the *McNeil* Case *supra*, or similar case or statutory law of the state where the trust is sitused. The important message here is to discuss the grantor's desires regarding notice and draft the appropriate provisions in the trust instrument if needed, rather than have this issue arise at a later time when it might be too late.

3. Issues which exist regardless of careful drafting. Even with careful drafting the trustee may still be faced with some issues when administering a silent trust.

   (a) If a beneficiary learns about the trust after many years after the creation of the beneficiary's interest in the trust, the beneficiary's reaction may be surprise and perhaps anger that he or she was not informed earlier. At that point a trustee might hear from the beneficiary that the beneficiary would have purchased a house or gone to medical school if he or she had known about the trust. Although the statute protects the trustee, there is still the possibility of a difficult client relationship with a beneficiary at a later time.

   (b) There is a spectrum of fact patterns which might impact the trustee's relationship with the beneficiary upon the beneficiary learning about his or her interest in the trust. For example, suppose the trustee is directed not to provide notice until the beneficiary reaches age 25 or completes his or her current college program, and that beneficiary is one or two years away from graduation. Perhaps that is a reasonable reason and amount of time to withhold notice, and it is more likely that the beneficiary would be pleased when he or she learns about the trust. On the other end of the spectrum would be the fact pattern where the trustee is directed to never provide notice to the beneficiary unless the beneficiary receives a distribution from the trust. This could lead to the dissatisfied beneficiary / client described above.

   (c) One of the more obvious issues facing the trustee is the fact that there will be no beneficiary to receive statements, which means not starting any statute of limitations for a beneficiary to bring a cause of action. For example, Delaware law provides that a beneficiary may initiate a proceeding against a trustee for breach of trust until two years after the date the beneficiary was sent a report that adequately discloses the facts constituting the claim, 12 Del. C. §3585. Furthermore, under Delaware law the terms of the trust can provide a shorter period for a beneficiary to bring a cause of action. If the trust is a silent trust, the beneficiary does not receive any report to begin the statute of limitations period. However, one method that might be utilized to address this is the use of a "beneficiary representative".

4. Beneficiary Representatives. Various jurisdictions including Florida, Ohio, Pennsylvania, and the District of Columbia have statutes that specifically provide that an individual can be named to receive notice, accountings, statements or any other information concerning the trust on behalf of a beneficiary and bind that beneficiary, fulfilling the trustee's requirement to provide notice to beneficiaries and preventing the beneficiary from later claiming that he or she did not receive the information. *See e.g.*, Fla. Stat.

§736.0306, Ohio Rev. Code Ann §5801.04(c) (creating a "beneficiary surrogate"), 20 Pa. Cons. Stat. §7780.3(k), and D.C. Code Ann. §19-1301.05(c)(3). As previously mentioned, Delaware has enacted a Designated Representative statute. 12 Del. C. § 3339. Under Delaware law the designated representative is authorized to represent and bind beneficiaries prohibited from receiving notice of the existence of the trust pursuant to the terms of the trust instrument for purposes of any judicial proceeding and for purposes of any nonjudicial matter. 12 Del. C. § 3303(d). The purpose of these statutes is to strike a balance between the grantor's right to privacy when creating the trust, and the beneficiaries' right to be informed of his or her interest in the trust

(a) What this accomplishes. The concept is that the trustee has fulfilled its fiduciary duty to provide information to the beneficiaries. The beneficiaries are represented and bound by the beneficiary representative. That person is looking out for the interests of the beneficiary. Any statute of limitations for bringing a cause of action after receipt of information (12 Del. C. § 3585 *supra*) begins to run with the receipt of the information by the beneficiary representative.

(b) Is the beneficiary representative a fiduciary? Most state statutes provide that the beneficiary representative is serving in a non-fiduciary capacity. However, Delaware's statute provides that the designated representative is deemed to serve in a fiduciary capacity unless the terms of the governing instrument provide otherwise. 12 Del. C. § 3339(b). Most of these statutes provide a "good faith" standard for the beneficiary representative, but provide that the beneficiary representative is not liable as long as she or he acts with good faith. Of course the trust instrument can provide that the beneficiary representative is a fiduciary.

(c) Who serves in this role? Generally the statute provides that the trustee cannot serve as a beneficiary representative. The various statutes have different requirements regarding who can fill this role, and the permissible methods of appointment. An equally important question is who actually is available and willing to serve in this role. In practice it seems that often times this role is filled by family members such as older siblings, aunts, or uncles; or a professional adviser close to the grantor. It is not always easy to find someone willing to take on this responsibility. Nonetheless, if the trust is created in a state that provides for this role, it would be advisable to draft the provisions into the trust so that the role can be filled at a later date if desired and if there is a viable candidate to fill the role.

D. Importing Quiet Trust Language into Existing Trusts.

1. Introduction. For practitioners and fiduciaries located in jurisdictions that allow trusts to contain some form of quiet trust language, it is not uncommon for interested parties to want to modify an existing trust to import quiet trust provisions. This can present unique challenges because, by their very terms, quiet trust provisions restrict or eliminate a right of the beneficiaries to notice of the existence of, or information regarding, the trust at issue. However, certain options for modifying the trust as desired may be available depending on the jurisdiction. This section examines, as a point of reference, the possible methods available in Delaware to add quiet trust provisions to an irrevocable trust. However, many other jurisdictions have similar options that may be utilized in a similar manner to accomplish such changes.

2. Possible Methods for Importing Quiet Trust Provisions.

   (a) Judicial Proceedings. In Delaware, the judicial procedure to modify trusts is known as the "consent petition" process, and is governed by Delaware Court of Chancery Rules 100-104. In most jurisdictions, a judicial proceeding where all interested parties consent is an available option for seeking a trust modification or deviation.

      i. Requirements and Mechanics.

         a. For an inter vivos trust that is not subject to the exclusive or continuing jurisdiction of another state, the key to utilizing the consent petition process is to ensure that a Delaware trustee is serving prior to filing the petition which will, in most cases following the *Peierls* opinions (as decided by the Delaware Supreme Court on October 4, 2013), ensure that Delaware law governs the administration of the trust.

         b. For a testamentary trust, if there is ongoing accountability to a non-Delaware court this would likely cause such other court to have "primary supervision" over the trust, necessitating an order from such court terminating their primary supervision or transferring administrative situs of the trust to Delaware before the Delaware Chancery Court will exercise jurisdiction and consider a petition to modify the trust.

         c. All interested parties, as defined in Chancery Court Rule 101(a)(7), must consent or not object to the relief requested pursuant to the petition. Under certain circumstances a guardian ad litem may need to be appointed by the Court to represent the interests of minor or unborn beneficiaries in the event Delaware's

virtual representation statute, 12 Del. C. § 3547, cannot be used.

d. In general, modifying any of the administrative provisions of a trust is permitted. In some cases, modification of beneficial provisions is also possible, especially if the goal is to obtain a specific tax benefit or objective.

(ii) Potential Advantages and Disadvantages.

a. If successful, all interested parties have consented or not objected to the modification, and the modification has been approved by a court of competent jurisdiction. This would make it difficult for a party to later challenge the modification, and in particular gives significant assurance to Trustees and other fiduciaries.

b. If the grantor of the trust is living, the grantor can sign an Affidavit stating that the grantor does not object or takes no position with respect to the relief requested in the petition, while also stating that the addition of quiet trust provisions (1) is consistent with the grantor's intent in creating the trust, and may have even been originally included in the trust of the grantor was aware of the option, and (2) does not violate a material purpose of the trust. The Affidavit will go a long way in convincing the Court that the addition of quiet trust provision would not violate the grantor's intent.

c. A potential issue is the treatment of minor or unborn beneficiaries. If an adult beneficiary may not virtually represent minor or unborn beneficiaries, the Court may appoint a Guardian *Ad Litem* to represent such minor or unborn beneficiaries, which can add to the time, expense and uncertainty of the outcome of the matter.

d. The approach that the Delaware Chancery Court would likely find most acceptable would be to add Designated Representative (or similar) position, where such Designated Representative received notice on behalf of beneficiaries under a certain age and which is acting in a fiduciary capacity.

(b) Decanting. Decanting under Delaware law is governed by 12 Del. C. § 3528.

(i) Requirements and Mechanics.

a. Delaware's decanting statute is available to a trustee when Delaware law governs the administration of the trust or when the trust is administered in Delaware. 12 Del. C. § 3528(f).

b. A trustee that has authority under the terms of the trust instrument (the first trust) to invade principal for the benefit of one or more beneficiaries, to exercise such authority by appointing all or a portion of the principal subject to the power of invasion in favor of a trustee under a separate instrument (a second trust). 12 Del. C. § 3528(a).

c. Decanting can be utilized to make significant changes to a trust by decanting it into a new trust with the desired administrative provisions.

d. Some of the key requirements of the decanting statute include:

- The beneficiaries of the second trust must also be beneficiaries of the first trust. 12 Del. C. § 3528(a)(1).
- The second trust may not alter the beneficial interests of beneficiaries of the first trust that are not proper objects of the exercise of the power of invasion. 12 Del. C. § 3528(a)(1).
- The second trust must comply with any standard that limits the trustee's authority to make distributions from the first trust. 12 Del. C. § 3528(a).
- A written "decanting instrument" must be signed and acknowledged by the trustee and filed with the records of the trust. 12 Del. C. § 3528(b).

e. While the second trust may not have beneficiaries who are not also beneficiaries of the first trust, the decanting statute specifically permits the second trust to grant a beneficiary of the first trust a limited or general power of appointment thereby allowing the beneficiary to appoint trust property to a person who is not a beneficiary of the first trust. 12 Del. C. § 3528(a).

f. Unlike consent Petitions, the trustee does not need the consent of the beneficiaries or any other interested party to exercise its decanting power. However, because decanting is an exercise of the trustee's discretion it is common practice in Delaware to have the beneficiaries consent to the decanting and release and indemnify the trustee from any liability in connection with the decanting.

(ii) Potential Advantages and Disadvantages.

a. Less time and expense than typically associated with a judicial proceeding to modify the trust.

b. Notice to beneficiaries is not required under the statute. Therefore, in certain circumstances where it might be in the best interests of a beneficiary to delay notice of his or her interest the trust beyond the time originally specified in the trust (e.g., if a beneficiary has a severe substance abuse problem), decanting can be accomplished and the desired quiet trust provisions included in the second trust without notifying the beneficiary.

c. If virtual representation is not available, certain minor or unborn beneficiaries will not be represented for purposes of any consent, release, and indemnity agreement signed by all other interested parties to the trust.

(c) Merger. Merger under Delaware law is governed by 12 Del. C. § 3325(29).

(i) Requirements and Mechanics.

a. Delaware's merger statute is available to a trustee when Delaware law governs the administration of the trust.

b. There are 35 states (including Delaware) plus the District of Columbia that allow for trust mergers without judicial involvement, and other states may permit merger via the state's common law.

c. The trustee is authorized to "[m]erge any 2 or more trusts, whether or not created by the same trustor, to be held and administered as a single trust if such a merger

would not result in a material change in the beneficial interests of the trust beneficiaries, or any of them, in the trust."

d. Any changes to administrative provisions available through the consent petition process or decanting could also be accomplished by merger, including the addition of Investment Direction Adviser, Distribution Advisers and Trust Protectors.

e. Similar to decanting, merger is an exercise of the trustee's discretion. While not required under the statute, the trustee may seek a consent, release and indemnity from the trust beneficiaries and other interested parties before effectuating a merger.

(ii) Potential Advantages and Disadvantages.

a. Less time and expense than typically associated with a judicial proceeding to modify the trust.

b. As with decanting, notice to beneficiaries is not required under the statute.

c. If virtual representation is not available, certain minor or unborn beneficiaries will not be represented for purposes of any consent, release, and indemnity agreement signed by all other interested parties to the trust.

d. Possible argument that including quiet trust provisions in the surviving trust that were not included in the original trust rises to the level of a "material change in the beneficial interests of the trust beneficiaries."

(d) Nonjudicial Settlement Agreements and Modification Agreements. Nonjudicial settlement agreements ("NJSAs") under Delaware law are governed by 12 Del. C. § 3338 and Modification Agreements are governed by 12 Del. C. § 3342. A Modification Agreement may only be entered into while the grantor of the trust is living. A NJSA may be entered into after the grantor's death.

(i) Requirements and Mechanics.

a. Parties may utilize Delaware's nonjudicial settlement agreement statute and modification agreement statute

when Delaware law governs the administration of the trust.

b. Requires the agreement of all "interested persons" whose consent would be needed to achieve a binding settlement in the Delaware Court of Chancery. 12 Del. C. § 3338(a) and 12 Del. C. § 3342(a).

c. The interested persons may enter into a binding agreement "with respect to *any matter involving a trust*…" (except with respect to charitable trusts and purpose trusts described in 12 Del. C. § 3541). 12 Del. C. § 3338(b) (emphasis added). The phrase "any matter" is inclusive rather than restrictive, suggesting that the presumption should be that any matter does fall within the proper subject matter of a nonjudicial settlement agreement rather than not, including trust modifications.

d. A nonjudicial settlement agreement is "only valid to the extent it does not violate a material purpose of the trust." 12 Del. C. § 3338(c).

e. A modification agreement is valid even if it violates a material purpose of the trust. 12 Del. C. § 3342(a).

(ii) Potential Advantages and Disadvantages.

a. Less time and expense than typically associated with a judicial proceeding to modify the trust.

b. If virtual representation is not available, certain minor or unborn beneficiaries cannot be represented, and arguably the statute cannot be used due to not having all "interested persons" enter into the agreement.

c. Any interested person may seek judicial determination to interpret, apply, enforce or determine the validity of a nonjudicial settlement agreement. 12 Del. C. § 3338(e) and 12 Del. C. § 3342(c).

Pressing the Do Over Button: A Practitioners Perspective on Strategies for Modifying Wills and Trusts After Formation

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I. TAX CONSIDERATIONS UNDERLYING MODIFICATIONS: INCOME AND TRANSFER TAXES

A. Income Taxes

Income taxes have in recent decades been imposed at the Federal level at rates ranging from 35-40% for ordinary income and 15-28% for capital gains. Historically, rates have been as high as 90%. Income taxes are revenue oriented and are paid by virtually everyone (having very minimal thresholds).

1. Individual

   Individuals are taxed under Part I of Subchapter A of the Internal Revenue Code ("IRC").

2. Corporations

   Corporations are taxed under Part II of Subchapter A of the IRC.

3. Partnerships

   Partnerships are taxed under Subchapter K of the IRC.

4. Estates and Trusts

   Estates pay income taxes after the death of an individual, and trusts pay income taxes after the transfer of property, under Subchapter J of the IRC.

5. Gifts, Legacies and Distributions

   Gifts, legacies and distributions from estate and/or trusts are generally tax exempt. Primary exceptions are:

   (a) Income in respect of a decedent ("IRD")

   (b) Distributable net income ("DNI")

   (c) Gifts to employees

6. Deductions

   (a) Charitable – subject to varying percentage caps of adjusted gross income ("AGI")

   (b) Business – subject to percentage floor of AGI

(c) Administration – subject to percentage floor of AGI under certain circumstances.

7. State and Local Taxes

Most states and some municipalities impose income taxes at varying rates. Many have no preferential rates for capital gains taxes. Nine states currently impose no income taxes.[1]

B. Transfer Taxes

Transfer taxes have, until the last few years, been imposed at the Federal level, at the 55% rate for the last several decades. Historically, rates have been as high as 90%. Transfer taxes are policy oriented and are applicable to gratuitous transfers.

1. Gift Taxes

Gift taxes are calculated on a tax exclusive basis.

2. Estate Taxes

Estate taxes are calculated on a tax inclusive basis.

3. Generation Skipping Transfer ("GST") Taxes

(a) Direct Skips

Direct skips rare calculated on a tax exclusive basis.

(b) Taxable Distributions and Terminations

Taxable distributions and formations are calculated on a tax inclusive basis.

4. Deductions

(a) Marital

The marital deduction has been unlimited for the last several decades. Historically it was limited to 50%.

[1] Alaska, Florida, Nevada, New Hampshire (income tax limited to interest and dividends), South Dakota, Tennessee (income tax limited to interest and dividends), Texas, Washington, and Wyoming

(b) Charitable

The charitable deduction has been unlimited for the last several decades. Historically it was limited to 50%.

(c) Debts/Claims

The deduction for debts and claims is a limited only by reasonableness, but must be supported by consideration.

(d) Administration expenses

The deduction for administration expenses is a limited only by reasonableness, but may be subject to a percentage floor of AGI on fiduciary income tax returns.

(e) Exclusions

From time to time, certain types of assets, such as qualified retirement plan benefits, have been exempt from transfer taxes.

5. Options for Where to Claim Deductions

In the case of certain expenses, there is an option to deduct the expense on either of three of:

(a) Estate Tax Return

(b) Income Tax Return

(c) Decedent's Final Income Tax Return

6. State and local taxes

(a) Estate Taxes

All states impose some kind of estate or inheritance tax.[2] Those that limit it to the credit for state taxes currently in effect for Federal estate tax purposes currently impose no estate tax.[3]

[2] As of June 22, 2015, the 7 States that still have an independent inheritance tax are Iowa, Kentucky, Maryland, Nebraska (County), New Jersey, Pennsylvania, and Tennessee (phases out as of January 1, 2016).

[3] As of June 22, 2015, fourteen States and the District of Columbia have a “sop” (or “pick-up”) tax which is equal to what *was* the Federal credit for State death taxes paid (as of 2005, the credit has been

(b) Gift Taxes

Two states (Connecticut and Minnesota) currently impose a gift tax.

(c) GST Taxes

Some states impose a GST tax equal to the credit for Federal GST taxes.

C. Prospects for Tax Reform

In considering any modification to a estate or trust, one has to take into account the prospects for tax reform, and, in particular, future changes to exemptions, rates, and bases for taxation.

II. RETROACTIVE MODIFICATION

A. Reformation Proceedings – to correct tax errors

1. Charitable Gifts

Reformation proceedings to correct errors that would otherwise disqualify charitable split interest trusts are Federally sanctioned (IRC 2055(e)(3)) and will be respected by Internal Revenue Service ("IRS")

2. GST Gifts

Reformation proceedings to correct errors that would otherwise disqualify trusts from being GST exempt are Federally sanctioned (Reg. 26.2654-1(b)(ii), e.g. to split trusts) and will be respected by IRS.

3. Qualified Domestic Trusts ("QDOT's")

Reformation proceedings to correct errors that would otherwise disqualify trusts for noncitizen spouses for the marital deduction

replaced by a deduction). Those States are Connecticut, Delaware, Hawaii (modified "pick-up" tax), Illinois (modified "pick-up" tax), Maine, Maryland, Massachusetts, Minnesota, New Jersey, New York, Oregon, Rhode Island, Vermont (modified "pick-up" tax), and Washington. Louisiana imposes an estate transfer tax designed to absorb the federal state death tax credit allowable under Section 2011 of the Internal Revenue Code.

are Federally sanctioned (IRC 2056(d)(5)(A)) and will be respected by IRS.

4. Qualified Terminable Interest Trusts ("QTIP's")

Reformation proceedings to correct errors that would otherwise disqualify trusts for the QTIP elections are not Federally sanctioned and will not be respected by IRS.

5. 9100 Relief

Section 9100 relief is generally for botched elections, but with mixed success in the case of QTIP elections.

6. Other

Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) – in the absence of a determination by the state's highest court, only "proper regard," not finality, should be given to interpretations by state courts, provided it was entered by a court in a bona fide adversary proceeding. See

(a) Estate of Warren v. Commissioner, 981 F.2d 776 (5th Cir. 1993)

(b) Lake Shore Nat'l Bank v. Coyle, 296 F. Supp. 412 (ND Ill. 1968), rev'd on other grounds, 419 F.2d 958 (7th Cir. 1970)

(c) Underwood v. United States, 407 F.2d 608 (6th Cir. 1969)

(d) Schmidt v. United States, 279 F. Supp. 811 (D. Kan 1968)

(e) Lakewood Plantation v. United States, 272 F. Supp. 290 (DSC 1967)

(f) United States v. White, 853 F.2d 107 (2nd Cir. 1988)

(g) Estate of Rapp v. Commissioner, 140 F.3d 1221 (9th Cir. 1998)

(h) Ahmanson Found. V. United States, 674 F.2d 761 (9th Cir. 1981)

(i) Estate of Carpenter v. Commissioner, 52 F.3d 1266 (4th Cir. 1995)

(j) Estate of Brandon v. Commissioner, 828 F.2d 493 (8th Cir. 1987)

(k) Estate of Hubert v. Commissioner, 101 T.C. 314 (1993), aff'd. 63 F.3d 1082 (11th Cir. 1995), aff'd sub. nom. Commissioner v. Estate of Hubert, 520 U.S. 93.

7. See, also

(a) Eggleston v. Dudley, 154 F. Supp. 178 (W.D. Pa. 1957), rev'd 257 F.2d 398 (3rd Cir. 1958)

(b) Piel v. Commissioner, 340 F.2d 887 (2d Cir. 1965)

(c) Daine v. Commissioner, 168 F.2d 449 (2d cir. 1948)

(d) American Nurseryman Publishing Co. v. Commissioner, 75 T.C. 271 (1980)

(e) Estate of Nicholson, 94 T.C. 666 (1990)

(f) Estate of Kraus v. Commissioner, 875 F.2d 597 (7th Cir. 1989)

(g) Estate of Rapp v. Commissioner, 140 F.3d 1211 (9th Cir. 1998)

B. Construction Proceedings – to resolve ambiguities

If there is a genuine ambiguity, IRS is more likely to respect a construction proceeding than a reformation proceeding.

1. Patent

2. Latent

3. Tax Apportionment Clauses

The presumed intent behind tax apportionment clauses is to minimize taxes

C. Qualified Disclaimers

Though originally designed simply to permit someone not to accept a gift without incurring gift tax consequences, disclaimers can be used in many circumstances to correct errors.

1. Disqualifying Dispositions

2. Disqualifying Powers

D. Nonqualified Disclaimers

Errors can be corrected, under certain circumstances, by making nonqualified disclaimers as well, though subject to gift tax.

E. Litigation Settlements

1. Probate Contests

Probate contests can often substantially rewrite wills (e.g., convert bequests from in trust to outright).

2. Elective Share Contests

Elective share contests can also rewrite wills, though with either an increase or decrease to taxes.

3. Contests involving conflicting agreements

Agreements typically trump wills. Examples of such agreement include:

(a) Separation agreements

(b) Prenuptial agreements

(c) Shareholder/partnership agreements

(d) Pledges

(e) Contracts to make wills

4. In Terrorem Clause Contests

In terrorem clause contests can also rewrite wills, though subject to the risk of forfeiture.

F. Private Letter Rulings

1. Pros

The primary advantage of seeking a private letter ruling is certainty.

2. Cons

The primary disadvantages of seeking a private letter ruling are delay, uncertainty and the possibility of a negative result.

III. PROSPECTIVE MODIFICATIONS

A. Decanting

"Decanting" is the term generally used to describe the distribution of trust property to another trust in order to achieve a variety of favorable tax and non-tax results or address changes in law, issues with respect to trust administration, changed circumstances or error.

1. Bases for Decanting

(a) Trust Instrument

Many trusts contain decanting provisions.

(b) Common Law

Many states have cases that address the question of decanting to a greater or lesser extent where the trustee has absolute power to invade principal.

(c) State Decanting Statutes Passed or Proposed:

	State	**Statutory Cite**	**Effective Date/Status**
1.	Alaska	Alaska Stat. §§ 13.36.157-13.36.159 (original § 13.36.157 repealed 9/9/13 and replaced with new 13.36.157-.159)	9/15/98; amended 2006, 9/9/13
2.	Arizona	Ariz. Rev. Stat. § 14-10819	9/30/09; amended 7/20/11
3.	Delaware	12 Del. Code § 3528	6/30/03; amended 6/24/04, 6/27/06, 7/5/07, 7/6/09, 7/13/11, 8/6/13, 8/1/15
4.	Florida	Fla. Stat. § 736.04117	1/1/07
5.	Illinois	760 Ill. Comp. Stat. 5/§ 16.4	1/1/13; amended 7/27/15
6.	Indiana	Ind. Code 30-4-3-36	7/1/10; amended 7/1/14

7.	Kentucky	Ky. Rev. Stat. § 386.175	7/11/12
8.	Michigan	Mich. Comp. Laws § 700.7820a Mich. Comp. Laws § 556.115a Mich. Comp. Laws § 700.7103 (definitions)	12/28/12
9.	Minnesota	Minn. Stat. § 502.851	1/1/16
10.	Missouri	Mo. Rev. Stat. § 456.4-419	8/28/11
11.	Nevada	Nev. Rev. Stat. 163.556	10/1/09; amended 10/1/11, 10/1/15
12.	New Hampshire	N.H. Rev. Stat. § 564-B:4-418 N.H. Rev. Stat. §564-B; 4-419	9/9/08; amended 10/1/15 7/1/14
13.	New York	N.Y. Est. Powers & Trusts § 10-6.6(b)-(s)	7/24/92; amended 8/17/11, 11/13/13, 7/22/14
14.	North Carolina	N.C. Gen. Stat. 36C-8-816.1	10/1/09; amended 7/20/10, 6/12/13, 10/1/15
15.	Ohio	Ohio Rev. Code § 5808.18	3/22/12; amended 3/27/13
16.	Rhode Island	R.I. Gen. Laws § 18-4-31.	6/23/12; amended 7/15/13
17.	South Carolina	S.C. Code §62-7-816A	1/1/14
18.	South Dakota	S.D. Codified Laws §§ 55-2-15 through 55-2-21	3/5/07; amended 2008, 2008, 2009, 2011, 2013
19.	Tennessee	Tenn. Code § 35-15-816(b)(27)	7/1/04; amended 7/1/13
20.	Texas	Texas Trust Code §§112.071-112.087	9/1/13
21.	Virginia	Va. Code § 55-548.16:1 Code of VA (original enactment) Va. Code § 64.2-778.1 (renumbered as part of consolidation of trust and estate laws)	7/1/12 10/1/12; amended 7/1/14
22.	Wisconsin	Wisconsin Trust Code § 701.0418	7/1/14
23.	Wyoming	W.S. 4-10-816(a)(xxviii)	7/1/13; amended 7/1/15

2. <u>Reasons for Decanting</u>

Reasons for trust decanting include to:

(a) Update or modify trust provisions

(b) Improve trust administration or management

(c) Correct drafting errors

(d) Address changed circumstances

(e) Remove unworkable restrictions

(f) Change provisions relating to trusts powers and succession

(g) Change trust situs

(h) Combine or divide trusts

(i) Achieve tax savings

(j) GST planning

B. Beneficiary Power of Appointment

If a trust beneficiary has a power of appointment exercisable in further trust under a different document, the trust can be decanted whenever the power is exercisable (i.e. testamentary or inter vivas).

C. Resignation of Disqualified Fiduciaries

The resignation of disqualified fiduciaries can address issues such as the reciprocal trust doctrine, though typically subject to the three year rule.

D. Trust Splitting

Whether authorized by the instrument or by law, splitting trusts can address issues including:

(a) GST taxes

(b) S corporation status

(c) Partial QTIP elections

E. Expanding Special Powers of Appointment

If addressed in the governing instrument, the expansion of special powers of appointment can avoid a flat, maximum rate GST tax and subject the property instead to estate taxes at the rate of the power holder, subject to his or her available exclusion amount and lower brackets.

F. Amending or Revoking Trust

Many times, state law permits irrevocable trusts to be amended when the grantor is alive and all parties are adult and competent.[4]

G. Litigation Settlements

The Settlement of bonafide claims brought against fiduciaries in contested accounting or breach of fiduciary duty actions can substantially rewrite wills and trusts.

IV. SPECIAL CONSIDERATIONS WITH RESPECT TO LITIGATION SETTLEMENTS

A. State Court Concerns

1. Marital Deduction (IRC 2056)
   In order for the marital deduction to be allowable, under state law the:

   (a) Interest must “pass from” the decedent

   (b) Property must be included in gross estate

   (c) Property must “pass to” the surviving spouse

   (d) Cannot be a “terminable interest,” unless statutorily excepted

   (e) See

      (1) Ahmanson, supra

      (2) Carpenter, supra

      (3) Brandon, supra

      (4) Hubert, supra

      (5) Estate of Agnello v. Commissioner, 103 T.C. 605 (1994)

      (6) Schroeder v. United States, 924 F.2d 1547 (10th Cir. 1991)

[4] See, for example, N.Y. Estates, Powers & Trusts Law § 7-1.9.

(7) Estate of Ransburg v. United States, 800 F. Supp. 716 (S.D. Ind. 1991)

(8) United States Trust Company v. Commissioner, 321 F.2d 908 (2d Cir. 1963)

2. Charitable Deduction (IRC 2055)

In order for the charitable deduction to be allowable, under state law the:

(a) Interest must "pass from" the decedent

(b) Property must be included in gross estate

(c) Property must "pass to" charity

(d) Contest must be bona fide

(e) See

(1) Bosch, supra

(2) Ahmanson, supra

(3) Northern Trust Co. v. United States, 78-1 USTC 13,229 (N.D. Ill. 1977)

(4) Oetting v. United States, 712 F.2d 358 (8th Cir. 1983)

(5) Estate of Flanagan v. United States, 810 F.2d 390 (10th Cir. 1987)

(6) Terre Haute First Nat'l Bank v. United States, 91-1 USTC 60,070 (S.D. Ind. 1991)

(7) Estate of Burdick v. Commissioner, 96 T.C. 168 (1991), aff'd 979 F.2d 1369 (9th Cir. 1992)

(8) Estate of Johnson v. United States, 742 F. Supp. 940 (S.D. Miss. 1990)

(9) Estate of La Meres v. Commissioner, 98 T.C. 294 (1992)

(10) Reed v. United States, 317 F. Supp. 1242 (S.D. Ill. 1970)

B. Tax Treatment of Settlements

1. Marital Deduction

The diversion of property from a spouse increases taxes (and perhaps interest and penalties)

2. Charitable Deduction

The diversion of property from a charity increases taxes (and perhaps interest and penalties)

3. Gift Tax Concerns

The values of interests cannot change measurably (Reg. 25.2512-8). See

(a) Commissioner v. Wemyss, 324 U.S. 303 (1945)

(b) Fehs V. United States, 620 F.2d 255 (Ct. Cl. 1980)

(c) Estate of Anderson v. Commissioner, 8 T.C. 706 (1947)

(d) Estate of Friedman v. Commissioner, 40 T.C. 714 (1963)

4. Income Tax Concerns

IRC 102(a) exempts gifts and inheritances, except:

(a) Income from gifts and inheritances

(b) Gain on conversion or deemed conversion

(c) Compensation

(i) Damages

(ii) Services

(d) IRD

(e) DNI – N.B. periodic payments

(f) See

(i) Getty V. Commissioner, 913 F.2d 1486 (9th Cir. 1990)

(ii) Tribune Publishing Co. v. United States, 836 F.2d 1176 (9th Cir. 1988)

(iii) Lyeth v. Hoey, 305 U.S. 199 (1938)

(iv) United States v. Gavin, 159 F.2d 613 (9th Cir. 1947)

(v) Estate of Vincent, T.C.M. 1992-21

(vi) White v. Thomas, 116 F.2d 147 (5th Cir. 1940)

5. Legal Fees

(a) Fiduciary's Fees

A fiduciary's fees are generally deductible by estate or trust

(b) Beneficiary's Fees

A beneficiary's fees are:

(i) Generally not deductible by estate or trust, except

A. Probate Contests

B. Construction Proceedings

(ii) May or may not be deductible by the beneficiary

(c) For fees to be deductible, they must be reasonable – U.S. v. White, 853 F.2d 107 (2d Cir. 1988)

C. Strategies

The following strategies can be employed to achieve substantial tax savings when modifying governing instruments as part of litigation settlements:

1. Establish consideration

2. Claims against estate or trust: consider

(a) High valuations

(b) Post-death events

3. Claims by estate or trust: consider

(a) Low valuations

(b) Risk of litigation discount

(c) Post-death events

4. Enhance tax advantaged trusts

(a) Estate Tax Exempt Trusts

(i) Credit shelter trust

(ii) Trusts not in gross estate

(b) Estate Tax Deferred Trusts (such as marital trusts)

(c) GST Exempt

(i) Zero inclusion ratio

(ii) Grandfathered

5. Consider possible benefits of exercising the right of contribution

6. Transfer debt to lower generations

7. Create more funds through substantive state elections

8. Discount long-term notes

9. Consider deducting payments to children

10. Buy back assets from charity

11. Characterizations of transfers as gifts vs. loans

The Art of Planning for the Collector: A Guide to Estate Planning Considerations for Art Collectors

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NEW YORK STATE BAR ASSOCIATION
TRUSTS & ESTATES LAW SECTION
SPRING MEETING, MAY 3-6, 2018, SEA ISLAND, GEORGIA

ARTFUL CONSIDERATIONS

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I. STATUS OF THE ART MARKET

a. Estate planning perspective.

   i. Valuation issues.

   ii. Family considerations.

      1. Use and allocation.
      2. Record keeping (provenance and authenticity)
      3. Investment considerations (art as an alternative "investment class")
      4. Maintenance and security
      5. Ownership structure (outright v. trust v. entity)
      6. Charitable considerations

b. Tax planning perspective (based on the Art Advisory Panel of the Commissioner of the Internal Revenue (the "Art Panel") – The Annual Summary Report for the Fiscal Year 2016.

   i. When a tax return is audited and the return includes an appraisal of a single work of art or cultural property valued at $50,000 or more, the agent or appeals officer may refer the case to the Art Panel.

ii. The Art Panel is composed of up to 25 members who serve without compensation. They are renowned art experts including dealers, advisors and curators.

iii. The Art Panel met twice and reviewed 555 items on 63 taxpayer cases.

iv. The average claimed value for an item reviewed by the Art Panel was $906,550.

v. In 2016, the Art Panel recommended accepting value of 222 items or 40% of the items. By comparison, in 2015, the Art Panel recommended accepting 35% of the items.

vi. In 2016, the Art Panel adjusted 333 items or 60% of the appraisals it reviewed. By comparison, in 2015, the Art Panel adjusted 65% of the appraisals it reviewed.

vii. Of the items adjusted, 202 (or 36%) of the items were increased and 131 (or 24%) of the items were decreased.

viii. While generally two meetings are conducted per fiscal year, a dedicated meeting to review decorative arts has not occurred since 2013.

ix. So from a tax perspective, a narrow band of estates may be affected by an adjustment to the valuation of art work for estate and gift tax purposes, but for those estate where this may present

an issue, it is important to carefully consider planning with the artwork and its valuation.

II. DUE DILIGENCE

a. While many clients may not be focused on due diligence, it is a significant estate planning and estate administration issue to carefully consider. It is important to treat an art portfolio like other valuable assets and consider issues such as title, condition, provenance and authenticity of the art work. In estate tax context, importance on getting this right is enhanced by tax overlay.

   i. The estate tax may be determined based upon one value and then sold later at lower (or zero) value (for instance in the case of a forgery).

   ii. There may also be valuation issues to consider with provenance and authenticity. For instance, in Private Letter Ruling 9152005, the IRS determined that items determined to have been stolen and possessed by the decedent at the time of his death were includible in his gross estate, but no deduction was allowed under Section 2053(a)(3) for claims against the decedent by the rightful owners.[1]

III. TITLE/DOCUMENTATION

a. **Authentication**. Failing to properly determine the authenticity of artwork that is later determined to be a forgery or fake could result in the complete

[1] Private Letter Ruling 9152005 (August 30, 1991).

loss of value for the family and potentially produce adverse tax consequences.

b. **Document Provenance**.

  i. **Family Office/Professionals**: For family office/professional advisors, consider cataloging or at the minimum keeping an inventory the artwork. Any and all documents evidencing provenance should be kept secure.

  ii. **Other Advisors**: If there is no family office, consider coordinating with other family advisors (lawyers, accountants, etc.) to secure title and other documentation.

IV. WHEN BUYING ART - SALES AND USE TAX

a. Consider what, if any, planning may be done to ameliorate sales and use taxes.

b. When planning in this area, it is important to bear in mind that many states aggressively enforce their sales and use tax statutes so careful planning is necessary. For example, the New York Attorney General has stated a commitment to "rooting out tax abuses wherever we find them, especially in the art world, where the difference can be hundreds of thousands – if not millions – of dollars in lost tax revenue."[2]

  i. Gagosian Gallery Settlement

[2] Rebecca Spalding, et al., *Art Buyers Face Scrutiny as New York Kicks Off Tax Probe*, Bloomberg.com, May 3, 2016, *available at* https://www.bloomberg.com/news/articles/2016-05-03/aby-rosen-to-pay-7-million-for-failing-to-pay-art-taxes.

1. New York Attorney General Eric T. Schneiderman settled case against Gagosian Gallery for $4.28 million for failing to collect New York sales tax on about $40 million of art to New York buyers.[3]

ii. Abby Rosen Settlement

1. New York Attorney General Eric T. Schneiderman settled case against an art collector, Aby Rosen, for $7 million for failing to pay New York and New York City sales and use tax on over $80 million worth of art.[4] Mr. Rosen claimed an exclusion from sales tax on the basis that the purchases were for resale. However, the Attorney General alleged that Mr. Rosen used the artwork for personal enjoyment and enhancement of his real estate business brand by displaying the artwork in his personal residences and in his business offices and properties.[5]

c. Before delivery of art that is purchased, consider sales and use tax of states where the art is purchased <u>and</u> delivered.

[3] *See* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $4.28 Million Settlement with International Art Dealer Gagosian Gallery for Failure to Collect and Remit New York Sales Tax* (July 19, 2016), *available at* https://ag.ny.gov/press-release/ag-schneiderman-announces-428-million-settlement-international-art-dealer-gagosian.
[4] *See* New York Attorney General's Office Press Release, *A.G. Schneiderman Announces $7 Million Settlement with Art Collector Aby J. Rosen for Failing to Pay Sales and Use Taxes on Art Acquisitions* (May 3, 2016), *available at* https://ag.ny.gov/press-release/ag-schneiderman-announces-7-million-settlement-art-collector-aby-j-rosen-failing-pay.
[5] *Id.*

V. COLLATERAL LOANS AND 1031 EXCHANGES

a. **Loans**.

i. Third party lenders may make loans secured primarily by art. In these instances, such lenders should carefully consider methods that allow them to perfect their security interest, such as a UCC filing.[6]

ii. Typically, loans secured by art may have no more than 50% loan to value.

iii. This is an appealing option for asset-rich collectors with limited cash flow looking for liquidity.

iv. Auction houses provide both short term advances as well as term loans without the expectation of immediate consignment. Collateral can include any property that can be offered at auction.

v. Only in limited circumstances can collectors retain possession of the collateral.

b. **1031 Exchanges – Like-Kind Exchanges**[7]

i. Generally, when selling property for a capital gain, the taxpayer will be subject to tax on the amount of the gain at the time of the sale. Section 1031 previously allowed a taxpayer to postpone the

[6] Uniform Commercial Code-1 Financing Statement.
[7] *See* IRC Section 1031.

payment of tax on the gain if the taxpayer reinvests the proceeds from the sale in a similar property.[8]

ii. However, under the Tax Cuts and Jobs Act of 2017, Section 1031 exchanges are now limited solely to real estate.[9] Therefore, taxpayers are no longer permitted to use Section 1031to defer capital gains on the sale of their artwork.

VI. ESTATE PLANNING/INSURANCE/FRAUD

a. As noted above, an important consideration is providing adequate property and casualty insurance for the artwork.

b. Relatedly, especially for high value artwork, proper management and care of the artwork should be considered as well. Storage, preservation, and security are all issues that could become problematic if not properly considered.

c. Collectors should be aware that retail replacement value and fair market value are not interchangeable. Retail replacement value is applicable for the purpose of insurance. If a collector is using fair market value for insurance purposes, they may run the risk of being underinsured.

d. Given frequent shifts in certain collecting categories, it is important for collectors to regularly review their values for insurance purposes and, when applicable, for their advisors to go through the process of due diligence and authentication.

[8] *See* IRC Section 1031.
[9] Tax Cuts and Jobs Act, Public Law No. 115-97, Section 13303 (2017).

VII. ESTATE PLANNING/PRIVATE PLACEMENT

a. For many art collectors and families, there is a tension between planning and access/control or enjoyment of the collection.

b. There are a number of options available for the collector to potentially relieve some of the tension between estate planning and the access/control issues.

c. **Limited Liability Company ("LLC").**[10] An LLC structure offers several benefits for holding an art collection. For instance, an LLC structure provides central management of the art and decision-making.[11] The LLC structure can also facilitate multiple beneficiaries to enjoy the same artworks (for instance on an alternating basis).

   i. The manager of the LLC would provide management services such as providing for insurance coverage, proper storage and transportation, and facilitating equitable possession of the artwork among the LLC members.

   ii. Another benefit of the family LLC to hold the art collection is that the sale of a particular piece can benefit the whole family (the members of the LLC), as opposed to benefiting one family member who owns that artwork to the exclusion of others.

[10] For a further discussion on using entities for planning with artwork, please see Darren M. Wallace and Alexis Gettier, *Using Family Entities for Planning with Artwork*, TRUSTS & ESTATES (June 2016).
[11] Darren M. Wallace and Alexis Gettier, *Using Family Entities for Planning with Artwork*, TRUSTS & ESTATES (June 2016).

iii. Once the family LLC is created and funded with the collection, the parents may then make gifts of a portion of their membership interest. This may be done without incurring a gift tax if utilizing the annual exclusion amount, currently $15,000, or using some or all of the donor's applicable lifetime exemption. Notably, appraising one's collection in order to properly value these types of gifts may cumbersome and costly

iv. One drawback of the family LLC structure is that the collector is now sharing the enjoyment and use of the collection with the other members of the LLC. The collector no longer has the sole beneficial enjoyment that they would have if they were the sole, outright owner.

v. **Estate Tax Consideration**. The family LLC should be done with care to avoid any Section 2036 issues at the death of the senior family members.[12] To the extent that the collector wishes to retain possession of one or more of the artworks in the collection transferred to the family LLC, the collector should pay fair market rent to the entity, distributable to the members of the LLC in proportion to their interest. A key for this consideration is to properly establish fair market rent.

[12] *See Estate of Scull v. Comm'r, T.C. Memo*. 1994-211.

vi. An individual may be able to apply a fractional discount to the value of their interest in a family LLC due to marketability restrictions and lack of control; however, such discounts are less likely to be viewed favorably by the IRS. The IRS appears to take the view that there is no actual market for such a fractional interest art and appears to be unwilling to approve a discount for the value of a fractional interest in such a family entity.[13]

1. ***Estate of Elkins***: One case suggests that such discounts may be available.[14] The decedent in this case owned factional interests in various artworks with his children. All the works were subject to a Cotenant's Agreement. The Tax Court disagreed with the IRS that no valuation discount should be applied. The Tax Court, however, did not agree with the estate's assessment of how much of a discount should be allowed, taking the view that only a 10% discount may be applied.
2. The IRS has not acquiesced on this issue, so planners should be wary of IRS scrutiny that may result in a higher tax burden if the artwork's value is finally determined to be more than initially reported.

[13] Section 2036(a)(1) and (3); Steven M. Fast, et al., *Context Matters: Rules for Reducing Taxable Value*, 120 Yale L.J. Online 141 (2010), *available at* http://yalelawjournal.org/forum/context-matters-rules-for-reducing-taxable-value.
[14] *Estate of Elkins v. Comm'r*, 767 F.3d 443 (5th Cir. 2014).

d. **Charitable Gifts**.[15] Many collectors have an passionate and deeply personal connection with their artwork. Their sentiment for the art is so deep that they may prefer to donate their collection for public enjoyment rather than pass it on to family members who may not share the same affinity for the art.

e. **Inter vivos v. Testamentary Bequest**. The simplest way to donate artwork to charity is by a bequest at death. The bequest at death will provide for a full estate tax deduction equal to the fair market value of the artwork on the date of death. An inter vivos transfer will produce a gift tax deduction and an income tax deduction that can offset ordinary income for the fair market value of the artwork, generally up to 30% of the donor's gross income for the year.[16]

   i. The availability of the charitable deduction is limited by the "related use test." Basically, this test requires that the contribution is made to an organization where the use of the art is related to its mission, such as a museum.[17] If the artwork is contributed to an organization such as a church or a school with an expectation (or reasonable anticipation) that the organization will sell the artwork and use the proceeds in furtherance of its mission, the donor's

[15] For further discussion into charitable donations of artwork, please see Darren M. Wallace and Alexis Gettier, *The Charitably Inclined Collector*, TRUSTS & ESTATES (August 2016).
[16] Section 170(b)(1).
[17] Treas. Reg. § 1.170A-4(b)(2), (3).

income tax deduction will be limited to the donor's basis in the artwork, instead of the fair market value (likely higher).[18]

f. Public Museum[19]

i. Contributions to public museums generally qualify for the charitable tax deduction.

ii. Most institutions prefer to accept unrestricted gifts; however, in limited circumstances, the institutions may be amenable to allowing the collector to specify certain requests for the display of the donated works. For example, a somewhat common request is that the collection should be displayed in a wing named after the donor or that the collection be kept together for a finite period of time.

iii. The overhead costs associated with maintaining a significant collection can be high, which may cause the institution or museum to consider break up the collection. One way to ensure that the collection stays together is to establish an endowment at the public museum to cover the associated costs of maintaining the collection for a term of years or indefinitely. An income tax deduction is available for the property/funds contributed to establish an endowment.

[18] Section 170(e)(1)(B)(i).
[19] *See* Darren M. Wallace and Alexis Gettier, *The Charitably Inclined Collector*, TRUSTS & ESTATES (August 2016).

iv. A gifting agreement should be negotiated at the time of the contribution in order to set appropriate expectations.

g. Private Museum[20]

i. Public museums may be selective about the artwork and collections they accept. The public museum may not specialize in the genre of the artwork to be donated or the museum may be inundated with artworks by the same artist or genre. Recently, the establishment of private museums by collectors has gained popularity.

ii. Private museums may be run by a private operating foundation controlled by the donor. The museum may even be located near to the donor's residence, but a donor should proceed with caution before doing so.

1. For the private operating foundation to qualify as an operating foundation, it must meet two requirements:

    a. First, the foundation must make "qualifying distributions" directly in pursuit of its purpose equal to the lesser of (i) its adjusted net income or (ii) its minimum investment return.[21] Qualifying distributions are any amounts reasonably paid by

[20] *See* Darren M. Wallace and Alexis Gettier, *The Charitably Inclined Collector*, TRUSTS & ESTATES (August 2016).
[21] Section 4942(j)(3)(A).

the foundation to accomplish its purpose, so long as that purpose is charitable.[22] In the case of a private museum, the charitable purpose is educational.

b. Second, substantially more than half of the foundation's assets must be devoted to the foundation's primary activity (i.e., the operation of the museum).[23] Generally, the most valuable assets of such a foundation almost certainly consist of the collection, the display of which is a use in furtherance of the foundation's charitable purpose. Of course, the foundation must report its activities, income and disbursements annually on the foundation's informational tax return, Form 990-PF.

iii. A charitable income tax deduction is available for the fair market value of any assets contributed to the private museum, for contributions to cover the museum's expenses, and for the purchase of additional works of art. The museum's expenses that can be deducted include the costs of conserving and insuring the artworks as well as the costs of storage and display space.

[22] Section 4942(g)(1); Section 170(c)(2)(B).
[23] Section 4942(j)(3)(B)(i).

iv. Contributions to private operating foundations are deductible up to 60% of the taxpayer's gross income for the year.[24] Further, contributions to a private museum to purchase new works of art can provide a sales tax benefit since the purchase by the private museum of new artwork is exempt from state and local sales tax.

v. As noted above, the purpose of the private museum must be educational. Merely displaying the artwork in the collector's personal residence and occasionally inviting school children over to view the artwork will not be considered enough to serve the educational purpose.

vi. Public access is an important element of a private museum, furthering its educational purpose. Factors to consider for public access include: advertisement, holding regular hours (or even potentially by appointment only), lending out works of art, giving grants, making the collection available for research, and engaging in public educational programs. While holding visiting hours is an important element for public access, that alone will not be enough. There must also be sufficient advertisements encouraging visitors.

vii. Museums that are located in close proximity to the donor's residence or office may draw IRS scrutiny. The IRS may argue that the museum's close proximity indicates that the primary

[24] 26 U.S.C. Section 170(b)(1)(A)(vii); 26 U.S.C. Section 170(b)(1)(F)(i).

benefit of the collection is intended for the donor and not for the public. Similarly, the close proximity to the donor's home or office suggests a higher likelihood that the painting could be used primarily for donor's personal benefit, such as in the donor's home or office. The proximity of a private museum to the donor is not a bright line rule and there are private museums that are located near the collector's home, however, they retain their exempt status by complying with the public benefit requirement in other ways.

viii. Similarly, the IRS may scrutinize private museums that are secluded or difficult to find, especially if they do not advertise their location, hours or events.

ix. There is little guidance as to what amount of public benefit is sufficient, so it is important to advise clients to be practical and generous in the public benefits of their private museums.

VIII. SALE AT AUCTION V. PRIVATE SALE

a. Inter vivos v. testamentary sale

b. Advances

c. Commissions

d. Sales and use tax issues

e. Estate tax versus income tax

f. Condition/provenance issues

g. Marketing plan and placement issues

h. Other considerations

ARTFUL CONSIDERATIONS:
A Guide to Estate Planning Considerations for Art Collectors

New York State Bar Association
Trusts & Estates Law Section
Spring Meeting, May 3-6, 2018
Sea Island, Georgia

Von E. Sanborn, Esq.
Partner
Day Pitney LLP

Darren M. Wallace, Esq.
Partner
Day Pitney LLP

Rebecca A. Lockwood, Esq.
Vice President, Trusts & Estates
Sotheby's

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Global Art Market Updates

Jean-Michel Basquiat
Untitled
Acrylic, spray paint and oilstick on canvas
72 1/8 by 68 1/8 in.

Christie's, New York, May 8, 1984
Sold for $19,000

Sotheby's, New York, May 18, 2017
Sold for $110.5M

Pablo Picasso
Femme au Beret et a La Robe Quadillee, Marie-Therese Walter
Oil on canvas
21 5/8 by 18 1/8 in.

Sotheby's, London, Feb. 28, 2018

Estimate Upon Request
Sold for $49.8M

Pink Star Diamond
Fancy Vivid Pink
59.60 carat, internally flawless

Sotheby's, Hong Kong, April 3, 2017

Sold for $71.2M

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Global Art Market Updates

Property from
the Collection of Lolo Sarnoff

An Important Imperial Jade Seal
Qing Dynasty, Qianlong Period

Sold for $4.45M
Estimate: $1 – 1.5M
New York, March 17, 2015

Wines from
the Cellar of William I. Koch

Sold for $29.1M
Estimate: $10 – 15M

20,000 bottles/2,700 lots
New York, May 19 - 21, 2016

Bowie/Collector

Achille and Pier Giacomo Castiglioni,
Radio-Phonograph, Model No RR126

Sold for $323,049
Estimate: $1,006 - 1,508
London, November 11, 2016

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IRS Art Advisory Panel – Fiscal Year 2016

- Meetings annual: 2 (both Fine Arts)
- Panel Members: 17 (gallerists, curators, advisors)
- Aggregate taxpayer valuation: $503,135,185 (63 cases)
- Net adjustments $102,406,967 (17% increase)
- Items reviewed: 555
- Average claimed value: $906,550
- Accepted: 222 items (40%)
- Adjusted: 333 items (60%)

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When to Value Art

Situation	Purpose	Value
If the art is transferred during life to a charitable donee	Income tax (charitable contribution)	Fair market value
If the art is transferred during life to an individual	Gift tax	Fair market value
If the art is owned at death	Estate tax	Fair market value
If determining premium for liability coverage	Property insurance	Retail replacement value

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How to Value Art

A qualified appraiser:

- Appraisal designation from a recognized professional appraiser organization (USPAP)
- Regularly performs appraisals for pay
- Education and experience in valuing the type of property being appraised

A qualified appraisal:

- Consistent with the substance and principles set forth in USPAP
- Includes images, condition notes, date of contribution, date of appraisal, description of appraiser's background, method of valuation used, description of fee arrangement with appraiser

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Sample Market - Picasso

CERAMIC

Taureau

Sold for £100,000

Est: £50,000 – 70,000
London, April 10, 2017

PRINT

Vieil Homme Songeant

Sold for $8,125

Est: $3,000 – 5,000
New York, Oct 23, 2017

DRAWING

Gueridon et Guitare

Sold for $212,500

Est: $80,000 – 12,000
New York, May 18, 2017

PAINTING

Le Matador

Sold for £22.78M

Est: £14 – 18M
London, Feb 28, 2018

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A Case Study: Quedlinburg Treasures (PLR 9152005)

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The Impact of Restricted Materials on Estate Tax Values

Robert Rauschenberg, *Canyon*
1959
Mixed media on canvas

Estate of Ileana Sonnabend v. Commissioner

Robert Rauschenberg, *Canyon*	
Taxpayer claimed value	$0
IRS Original Claimed Value	$13M
IRS Revised Claimed Value *(Penalties)*	$65M *$29M*

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Sotheby's

Authenticity and Value

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SALES AND USE TAX

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Collateral Loans against Art & Collectibles

DRIVERS OF DEMAND

- Appreciating value of art resulting in higher proportion of art in HNWI's assets
- Collectors more comfortable with leverage, especially in the U.S.
- Low interest rate environment
- Globalization of the marketplace
- Growth of the contemporary art market
- Asset-rich clients with limited cash flows looking for liquidity
- Improving liquidity, transparency and infrastructure of the art market (Freeports, insurance products, etc.)

KEY CHALLENGES FOR LENDERS

- Difficult to assess valuation and authenticity risk; inevitable reliance on third parties
- Difficulties of marking-to-market
- Title may be challenging to establish
- Fraud risk associated with possession
- Lack of lien perfection for non-possessory loans outside of the U.S.
- Perceived lack of liquidity
- Largely unregulated market outside of the U.S.
- Need for income beyond lending to justify capital investment

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The Impact of Damage and Loss

Picasso's *Le Reve*	
Original Purchase Price (1941)	$7,000
Value as of October 2006	$139M
Cost of Restoration *(Post-Restoration Value)* *(Claimed Loss)*	$90,000 *$85M* *$54M*
Final Purchase Price (2013)	$155M

Valuation Discounts: Fractional Interest

Estate of Elkins v. Commissioner

- 64 works of art
- Fair market value: $35,180,650

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Public Museums

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Private Museums

The Brant Foundation
Greenwich, CT

Glenstone Museum
Potomac, MD

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Fair Market Value and Buyer's Premium/Commissions

Fair market value: the price at which the property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts (Treasury Regulation Section 25.1512 – 1)

Sotheby's New York	
Buyer's premium rate payable on the hammer price up to and including $300,000	25%
Buyer's premium rate payable on the hammer price in excess of $300,000 up to and including $3,000,000	20%
Buyer's premium rate payable on the portion of the hammer price in excess of $3,000,000	12%

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The Impact of Subsequent Sales on Estate Tax Values

Estate of Bernice Newberger v. Commissioner (2015)

Title/Artist	Cost basis	Estate Tax Value (7/29/09)	Sale Result	IRS Value
Tête de Femme (Jacqueline) by Pablo Picasso	$195,000 Acquired 1/10/81	$5M	$12.9M 2/2/10	$13M ($10M)
Untitled by Robert Motherwell	$8,000 Acquired 5/27/69	$450,000 ($800,000)	$1.4M 11/11/10	$1.5M
Elément Bleu XV by Jean Dubuffet	$40,000 Acquired 6/10/82	$500,000	N/A	$750,000 ($900,000)

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QUESTIONS

Edward Ruscha, *Question Mark*, 1990

Sotheby's

Speaker Biographies

N. TODD ANGKATAVANICH, ESQ.

Biography

Todd Angkatavanich is a Principal in EY's National Tax Department, Private Client Services Group. Todd previously Co-Headed the U.S Private Client & Tax Group at the private client law firm Withers Bergman LLP. He focuses on representing domestic and international families and family offices in structuring multigenerational wealth transfer, preservation and business succession vehicles, with an emphasis on navigating the transfer tax pitfalls that often arise under Chapter 14 of the Code. At the same time, he assists families with introducing the next generation(s) to the non-tax concepts of engagement and flexible stewardship so as to achieve effective long-term wealth preservation coupled with beneficial enjoyment. He has experience structuring GRATs, Sales to Grantor Trusts, Family Limited Partnerships and Preferred Partnerships, Succession Structures and Dynasty Trusts. He also has had experience with international planning including Foreign Grantor and Non-Grantor Trusts, Pre-Expatriation and related projects.

Todd is an ACTEC Fellow and frequent speaker at conferences including the Heckerling Estate Planning Institute, serves on the Editorial Boards of Trusts & Estates and BNA Tax Management and is co-author of a BNA Portfolio on Wealth Transfer Planning with Carried Interests. He enjoys collaborating on client, industry and business development initiatives, and providing professional development mentorship to next generation colleagues.

Education

Bachelors of Arts in Economics, magna cum laude, Fairleigh Dickinson University

J.D., Tax Law Honors, Rutgers University School of Law, Camden

M.B.A. Rutgers University Graduate School of Management

LL.M, in Taxation, New York University School of Law

JENNIFER A. BECKAGE, ESQ.

Biography

Before beginning her legal career, Ms. Beckage was an owner of a technology company. She successfully helped lead the company through an acquisition to a publicly-traded company, in which she was retained in a management role overseeing operations of an e-services line of products in 11 states.

Ms. Beckage's prior technical expertise makes her uniquely qualified to handle technology-related matters. Among other things, she has represented clients on a number of data security and privacy matters, including:

PRE-INCIDENT

Preparing reasonable and defensible policies concerning record retention, litigation holds, data mapping, information security and privacy, and crisis planning; Developing cybersecurity preparedness, from tabletop exercises to board and management presentations, as well as counseling; Navigating regulatory compliance with various international, federal and state rules and regulations, including the New York State Department of Financial Services (DFS) Cybersecurity Regulation (23 NYCRR 500), GDPR and HIPAA; Counseling on emerging technologies, including artificial intelligence (AI) and blockchain technologies; and Reviewing vendor contractsfor data storage and transmission, including cloud arrangements and other technology transfer and development agreements.

DATA INCIDENT

Responding to numerous data breaches, cyberattacks, ransomware and malware incidents, inadvertent disclosures, and other thefts of data and confidential information from disloyal employees, competitors or hackers; Guiding clients through all aspects of data incident response from containment, mitigation, root cause analysis, forensics, public relations and standing the company back up again after a data incident; and Interfacing with the government in data breach matters and other investigations.

POST-INCIDENT

Handling all aspects of consumer notification, government reporting and public relations matters; and Representing clients in data breach litigation and other technology-related disputes and matters, including those concerning or addressing cyberattacks, websites, domain names, artificial intelligence (AI), big data, computer forensics and social media with experience working with complex e-discovery matters, including those involving technology-assisted review (TAR).

Ms. Beckage's business background provides her with important insight in representing clients in business disputes and commercial litigation involving, among other things, intellectual property, employee disloyalty, violations of non-compete agreements and other employment matters, breaches of contract, and fraud matters. She has assisted startups to prominent clients in the food, manufacturing, banking, technology, education and finance industries with data security and privacy, litigation, business disputes, risk mitigation efforts and regulatory matters.

JILL CHOATE BEIER, ESQ.

Biography

Jill Choate Beier is the founder of the firm, Beier & Associates, PLLC with its primary location in Lake Placid, New York. Her practice includes a broad range of matters in the personal planning area, including estate and tax planning for individuals and families; estate and trust administration; all aspects of Surrogate's Court practice, including probate proceedings, will contests and guardianships, and planning for charitable giving and philanthropy.

Prior to starting her own firm, Ms. Beier practiced law at Sullivan & Cromwell LLP and Patterson Belknap Webb & Tyler LLP in New York City. Before becoming an attorney, Ms. Beier worked for several years in the financial services sector and held senior management positions in accounting and regulatory reporting at large financial institutions such as JP Morgan and Credit Suisse.

Ms. Beier is an active member of the Trusts and Estates Law Section of the New York State Bar Association and has served in many positions of leadership such as Chair of the Estate and Trust Administration Committee and Vice-Chair of the Surrogate's Court Committee. Currently, she is the Treasurer for the Section's Executive Committee.

In addition to practicing law, Ms. Beier is active in the local community by serving on the Board of Directors of the Adirondack Council and serving as President of the Board of Trustees for the Lake Placid Center for the Arts.

Ms. Beier earned a Bachelor's degree in Finance from the University of North Texas, an MBA with an Accounting concentration from Fordham Graduate School of Business, a J.D., summa cum laude, from Touro Law School, and an LL.M. in Taxation from New York University School of Law.

January 2018

JOCELYN MARGOLIN BOROWSKY, ESQ.

Biography

Jocelyn Margolin Borowsky, a fellow of the American College of Trust and Estate Counsel ("ACTEC"), practices in the areas of estate planning, estate and trust administration and fiduciary litigation in Delaware, New Jersey, and Pennsylvania.

Sophisticated Estate Planning. A large part of her practice involves the review of clients' overall estate plans, preparation of wills and revocable trusts, and where appropriate, implementation of sophisticated trusts, such as lifetime spousal trusts, asset protection trusts, life insurance trusts, dynasty trusts, BOLI trusts, DINGs, BDITs, GRATs and IDITs. Ms. Borowsky also works with closely-held family businesses and professionals on issues involving strategic tax and business planning, the use of captive insurance and the creation of private family foundations.

Modification and Other Advice on Delaware Trusts. Ms. Borowsky routinely advises clients with respect to resolving trust administration matters, modifying trusts, structuring new Delaware trusts and transferring existing trusts to Delaware through decanting or other means. As an active participant in state bar statutory drafting committees, she is well versed in the preparation of Delaware directed trusts and in the creation of confidential trusts. Ms. Borowsky also has served as an expert witness in matters involving a Delaware directed trust and an executor’s breach of fiduciary duty.

Litigation and Audits. Ms. Borowsky represents fiduciaries and beneficiaries in trust and estate litigation. She also handles tax controversy matters, including estate and gift tax audits by the Internal Revenue Service and state taxing authorities. She is AV® Preeminent™ Peer Review Rated by Martindale-Hubbell and an Accredited Estate Planner of The National Association of Estate Planners & Councils.

Areas of Practice

- Wealth Planning
- Estate Planning
- Estate and Trust Administration
- Fiduciary Litigation

HON. STEPHEN W. CASS
Biography

HON. STEPHEN W. CASS has been serving as the Chautauqua County Surrogate=s Court Judge since 1999. Before taking the bench, Judge Cass was admitted to practice law in New York, Massachusetts, and the United States District Court. Judge Cass received his J.D. from Union University Albany Law School and his B.A. from Allegheny College in Pennsylvania. While practicing law, Judge Cass had an active litigation practice handling civil, criminal and estate issues. Judge Cass received an honorary Indian Tribal name and is an adopted member of the Seneca Nation Indian Reservation as a result of his work representing tribal members. In 1993, Judge Cass became Town Justice in the Town of Carroll until he was elected to the Surrogate=s Court in 1999. In addition to his duties as Surrogate=s Court Judge, Judge Cass has been serving as Acting Supreme Court Justice since 2001. He has served on the Administrative Board of the Public Administrator and on the New York State EPTL and SOFA advisory committees. Currently, Judge Cass is a member of the New York State Surrogate's Association having served as president from 2007 to 2009. He is a member of the New York State Bar Association, the Erie County Bar Association, the Northern Bar Association of Chautauqua County, the Jamestown Bar Association and the Magistrates Association. Judge Cass serves as a mentor to new Surrogates and is instrumental in training new Surrogate Judges. From 2000 to present, Judge Cass is involved with the Judicial Institute and currently serves on Surrogates’ Court Judicial Skills Curriculum committee. He has lectured to the New York State Bar Association Trusts and Estates Section, Elder Law Section and the Judiciary. He has taught Criminal Law and Criminal Procedure at Jamestown Community College. Under Judge Cass' direction, the Chautauqua County Surrogate's Court became one of the first electronic filing courts in the state.

HON. JOHN M. CZYGIER
Biography

John M. Czygier, Jr. was admitted to practice law in New York State in 1975. After serving as a prosecutor in the Suffolk County District Attorney's office, he entered private practice and, for twenty-five years, concentrated in estate administration and estate litigation in the New York metropolitan area. He was awarded an "AV" rating by Martindale-Hubbell, the highest rating for practicing attorneys. While in private practice, Surrogate Czygier served as a Mental Hygiene Law Article 81 Court Examiner for New York and Suffolk Counties, and was counsel to the Public Administrator of Suffolk County. Since 1999, he has been a member of the Surrogate's Court Advisory Committee to the Chief Administrative Judge of the Courts of New York.

Judge Czygier was appointed Judge of the Surrogate's Court of Suffolk County by Governor George Pataki in May 2001; in November of that year he was elected to a ten-year term, and re-elected in 2011. He is Chair of the Administrative Board for the Offices of the Public Administrators, and has served as Secretary/Treasurer, Vice President and President of the Surrogate's Association of the State of New York, and is currently the only sitting Surrogate in New York State who is a Judicial Fellow of the prestigious American College of Trust and Estate Counsel.

Judge Czygier has also been a contributing author to *Warren's Heaton on Surrogates' Courts* (Matthew Bender) and to *Weinstein, Korn & Miller New York Civil Practice* (Matthew Bender), and has written for the New York State Bar Association Trusts and Estates Newsletter, the New York Law Journal, and the New York State Bar Association Journal.

BRAD DILLON, ESQ.

Biography

Brad Dillon is a senior wealth planner in the New York office of Brown Brothers Harriman. Prior to joining BBH, he was in private legal practice in the trusts and estates department at Milbank, Tweed, Hadley & McCloy LLP, where he focused on estate, gift and generation-skipping transfer tax planning. Mr. Dillon is a frequent lecturer and writer, having published articles in several industry-leading outlets, including the NYSBA Law Journal, the Journal of Taxation, Trusts and Estates, and Leimberg. He is also a regular commentator in the print media and is regularly quoted on tax and trust and estate matters on CNBC, Bloomberg, the Wall Street Journal, and other media outlets. Mr. Dillon received his LL.M. in taxation from the NYU School of Law, his J.D. from the UCLA School of Law and his B.A. from Indiana University.

MICHAEL M. GORDON, ESQ.

Biography

MICHAEL M. GORDON is a Director at the Wilmington law firm of Gordon, Fournaris & Mammarella, P.A. He is a graduate of Fairfield University and the Catholic University of America, Columbus School of Law. He received his Masters of Law in Taxation from Villanova University School of Law in 2008 and is a member of the Delaware and Maryland Bar Associations.

Michael is the former Chair of the Estates and Trusts Section of the Delaware Bar Association. He is a Fellow of the American College of Trust and Estate Counsel. Michael is also a member of the American Bar Association where he serves as a Group Vice-Chair of the Non-Tax Estate Planning Considerations Group of the Section of Real Property, Trust & Estate Law.

Michael's practice focuses on the unique aspects of Delaware trust law, including directed trusts, dynasty trusts, asset protection trusts and all aspects of the validity, construction and administration of Delaware trusts. Michael routinely works with clients across the country to transfer the situs of trusts to Delaware and to modify trusts to take advantage of Delaware's favorable trust law. Michael drafts, reviews and comments on Delaware trust agreements for local and out of state clients and provides legal opinions on the validity of trusts under Delaware law.

Michael resides in Wilmington, Delaware with his wife, Amie, and two daughters, Samantha and Mia.

HON. PETER J. KELLY

Biography

Surrogate Kelly is a graduate of Iona College and St. John's University School of Law where he received his Juris Doctor degree in 1983.

Prior to his election to the bench, Surrogate Kelly was employed in the New York City Criminal and Civil Courts as a Law Assistant Trial Part, in the Queens Supreme Court as Principal Law Clerk, and, ultimately, as the Principal Law Clerk for Queens Surrogate Hon. Robert L. Nahman.

He was elected as a Judge of the New York City Civil Court in 1998 and as a Justice of the New York State Supreme Court in 2002. Thereafter he was elected as Surrogate of Queens County and has served in that capacity since January of 2011.

In addition to his regular duties, Surrogate Kelly has served as an instructor for court clerks and has frequently lectured at various bar associations and organizations including the Queens County Bar Association, the Nassau County Bar Association, the New York State Bar Association, the New York State Trial Lawyers Association, the New York State Surrogate's Association, and the New York State Judicial Institute.

Surrogate Kelly is a member of the Surrogate's Court Advisory Committee to the Chief Administrative Judge, and serves as Chair of the Executive Committee of the New York State Surrogate's Association. He is also a member of the Trust and Estates section of the New York State Bar association, the Queens County Bar Association, the Queens County Women's Bar Association, and the Queens Catholic Lawyer's Guild, serving as Judicial Moderator since 2009. He is also a former member of the Board of Directors of the New York City Supreme Court Justices' Association and the New York City Civil Court Judges Association.

Surrogate Kelly is admitted to the New York State Bar as well as the United States District Court for the Southern District and the United States Supreme Court.

JOSEPH T. LA FERLITA, ESQ.

Biography

Joseph T. La Ferlita is partner to the firm concentrating his practice in trusts and estates law, with an emphasis on estate planning, estate and trust administration, and tax controversy. He counsels individual planning clients, beneficiaries, individual and corporate fiduciaries, and not-for-profit entities, including public charities and private foundations, in connection with a multitude of estate and trust-related matters. These include, among others, the drafting of wills and trusts, estate tax and generation skipping tax planning, audits of estate tax returns and income tax returns, the formation of not-for-profit entities, obtaining Private Letter Rulings from the Internal Revenue Service, probate proceedings, administration proceedings, judicial accounting proceedings, judicial proceedings for advice and direction on behalf of executors and trustees, spousal elective share proceedings, and proceedings for the construction and reformation of wills and trusts. He represents clients in the Surrogates Court and the United States Tax Court.

Mr. La Ferlita is admitted to practice in the State of New York, the Commonwealth of Massachusetts and the United States Tax Court. He is a member of the American and New York State Bar Associations.

Mr. La Ferlita is especially active in the Trusts and Estates Law Section of the New York State Bar Association, where he serves as District Representative for Nassau and Suffolk Counties, Chairman of the Surrogates Court Committee and Member of the Estate and Trust Administration Committee. He plays a key role in drafting proposals for new and amended estate-related New York statutes, some of which ultimately have been signed into law by the Governor of New York State.

In 2002, Mr. La Ferlita was a Judicial Intern to the Honorable Thomas C. Platt of the United States District Court, EDNY.

Mr. La Ferlita has had two LexisNexis Expert Commentaries published on Lexis.com. The first is entitled, "Whether the Distinction Between Construction and Reformation Proceeding in New York Surrogate Courts Still Exists." The second is entitled, " The Fundamentals of the Separate Share Rule." He has also published articles regarding Trust Decanting in New York and New York Trust Law in the NYSBA Trusts and Estates Law Section Newsletter, the The American Bar Association's Property & Probate, and The Suffolk Lawyer.

Mr. La Ferlita was selected for the *Super Lawyers New York Metro Rising Stars* (Estate & Probate) list in 2013 and 2014. In May 2011, Mr. La Ferlita received an LL.M. degree in taxation from New York University School of Law. He received his Juris Doctor degree, Dean's List, from St. John's University School of Law in 2004, where he served as a member of the ***American Bankruptcy Institute Law Review***. Mr. La Ferlita earned his M.A. degree in Theology from Boston College in 1998 and his B.S. degree in Biology from Fairfield University in 1996.

REBECCA LOCKWOOD, ESQ.
Biography

Rebecca Lockwood is Vice President of Trusts & Estates at Sotheby's where she advises individual and corporate fiduciaries on the valuation and sale of personal property. She works closely with clients and their advisors to provide appraisals for insurance, gift, estate planning, or estate tax purposes and to develop sale strategies for the liquidation of assets held in an estate or trust. During her time at Sotheby's, Rebecca has been directly involved in the sale of many important collections and estates including Bowie/Collector, the Mellon Family Collection, and the Collection of Elizabeth Mead Merck.

She graduated from George Washington University with a Bachelor's Degree in Art History and received a Master's Degree in Contemporary Art from Sotheby's Institute of Art before receiving her JD from New York Law School. She is also certified in the Uniform Standards of Appraisal Practice. She previously served as Chair of the Tax, Trusts & Estates Sub-Committee of the New York City Bar Association's Art Law Committee. She currently serves as Vice-Chair of the American Bar Association's Real Property, Trusts and Estate's Section, Art and Collectibles Committee.

JOSHUA S. RUBENSTEIN, ESQ.

Biography

Joshua S. Rubenstein is national head of the firm's Trusts and Estates practice and national chair of the Private Client Services group. He is also the immediate past chair of the International Estate Planning Committee of the American College of Trusts and Estates Counsel, an officer of the Family Law Section of the International Bar Association and the Treasurer of the International Academy of Estate and Trust Law.

Josh advises closely-held businesses, family offices and private individuals, including high net worth individuals, senior executives, professionals, entrepreneurs, artists and others with unique intellectual property interests. He handles a wide variety of private matters for these clients on a local, national and international level, including personal and estate planning, the administration of estates and trusts, and contested Surrogate's Court and tax proceedings. He has counseled clients in trust and estates matters for more than 35 years, building relationships with those who value and rely upon his advice.

Josh's clients say he is "a real polymath – not just a great lawyer, but a great chap to deal with and a safe pair of hands" (Chambers USA). Globally, he is "very highly rated for his cross-border work and is very active on the international trust scene as the treasurer of the International Academy of Estate & Trust Law" (Chambers Global). He focuses on creating sophisticated, yet uncomplicated, solutions for clients. Josh finds unforeseen problems and uses an interdisciplinary approach to resolve those problems, bringing in members of teams that deal with taxes, real estate or corporate and other transactional areas of the law, as necessary.

Josh is a former adjunct professor at Brooklyn Law School and is a frequent lecturer and author. He is regularly quoted in the media, with credits in The New York Times, The Wall Street Journal, New York Law Journal, Citywealth, Forbes, Kiplinger's, Crain's, The Washington Post, FOX News, Bloomberg News and CNBC. The Katten Trusts and Estates practice has earned recognition from Society of Trust and Estate Practitioners (STEP) for Best North American Private Client Team (2011, 2012), from Citywealth for International Law Firm – USA (2012, 2013), from Chambers USA for Best Wealth Management Team – Nationwide (2010 to 2015) and from U.S. News for Best Trusts and Estates Team – Nationwide (2010 to 2015) under Josh's leadership.

DANIEL S. RUBIN, ESQ.

Biography

Daniel S. Rubin is a partner in the Trusts and Estates and Asset Protection practice groups of the New York City law firm of Moses & Singer LLP. He has a B.A. in International Relations from the Elliot School of the George Washington University, a J.D. from Brooklyn Law School and an LL.M. in Taxation from the New York University School of Law.

Mr. Rubin has been named by *Worth* magazine as one of the "Top 100 Attorneys" in the nation for private clients, by *Law & Politics* as a "New York Super Lawyer"® and as one of *The Best Lawyers in America*® for Trusts and Estates by U.S. News-Best Lawyers.

Mr. Rubin is a fellow of the American College of Trust and Estate Counsel where he is Chair of the Asset Protection Committee, a faculty member and lecturer at the Heckerling Institute on Estate Planning, and an adjunct professor at the University of Miami School of Law where he teaches *Asset Protection Planning*.

Mr. Rubin is also the co-author of the third edition of the Bureau of National Affairs' Tax Management Portfolio on *Asset Protection Planning.*

In addition to the foregoing, Mr. Rubin is also certified as an *EMT-Basic* by New York State, and is a member of the Oceanside Fire Department, in Oceanside, Long Island, New York. He is currently working towards his certification as an *EMT-P (Paramedic)*.

VON E. SANBORN, ESQ.
Biography

Von Sanborn, a partner at Day Pitney LLP, advises affluent American and international families as well as single- and multi-family offices on U.S. tax, estate planning and art law matters. He counsels clients on structuring their inbound and outbound business, real estate, passive and personal investments to minimize their overall U.S. tax burden. He also counsels individual and corporate fiduciaries on the U.S. tax consequences of trust investments and issues arising from trust administration and management. Von also provides guidance on U.S. estate and gift tax planning techniques to high and ultra-high net worth families on issues relating to all of their asset classes, and advises beneficiaries and fiduciaries of non-U.S. trusts on the U.S. tax consequences associated with foreign trust and corporate structures.

In the area of art law, Von assists clients with matters involving risk management, the formation of trusts including art assets, the use of Section 1031 exchanges for artwork, sales and use tax voluntary disclosures and the purchase and sale of works of art.

Von is the author of numerous publications and lectures worldwide on all aspects of his practice.

EDUCATION

- Villanova University School of Law, LL.M.
- Albany Law School, Union University, J.D.
- Boston University, B.A.

ADMISSIONS

- State of New York
- State of Connecticut
- State of New Hampshire
- Registered Foreign Lawyer in the U.K.

AFFILIATIONS

- New York State Bar Association
- American Bar Association, Section of Real Property, Probate and Trust Law
- American Bar Association, Section of Taxation
- International Fiscal Association
- International Bar Association
- Society of Trust and Estate Practitioners

RECOGNITION

- Selected to the list of Private Client Global Elite (Legal Week), 2017
- Selected for inclusion on the Leaders List, a directory of leading professionals in the private wealth management and private client industry, by *Citywealth Magazine* (Jones Publishing Limited), 2015, 2016
- AV rated by Martindale-Hubbell

DARREN M. WALLACE, ESQ.

Biography

Darren Wallace, resident in the firm's Stamford office, is a partner in the Individual Clients Department. His experience includes advising clients regarding all aspects of estate planning, estate and trust administration, estate and gift taxation, and probate and trust litigation.

Darren received a B.A. from Colgate University and a J.D. from the University Of Connecticut School Of Law. He is a member of both the Tax and the Estates and Probate sections of the Connecticut Bar Association, and a member of the executive committee of the Estates and Probate Section. Darren is a former co-chair of the Estates, Probate, and tax committee and a former member of the executive committee for the Young Lawyers Section of the Connecticut Bar Association. Darren is also a member of the Fairfield County Bar Association and the Estate Planning council of Lower Fairfield County. His community activities have included service on the board of directors for PLAN of Connecticut, Inc, a nonprofit organization that assists in planning for the future of family members with disabilities and provides continuity of services for such individuals.

He is a co-author of "How FLPs can survive IRS scrutiny," *Financial Advisor*, September 2004', "Planning for Property Interests in More Than One State after the Demise of the state Death rax credit," *Probate & Property*, Vol. 18, No. 5, September/October 2004; "Get Real or Get out," *Trusts & Estates Magazine*, July 2003; and "A Client's Death Doesn't Mean All planning Must Rest in Peace: Qualified Disclaimers and other Keys to post-Mortem planning Opportunities," *Probate & Property*. Vol. 17, No. 3, May/June 2003. He has also lectured at programs for the Connecticut and American Bar Associations. In 2005, Darren received the New Leaders of the Law "Advocacy Award," presented by *The Connecticut Law Tribune.*

Darren lives in Fairfield, CT, with his wife Marianne and their daughters Catherine, Sarah, and Hannah.

SEAN R. WEISSBART, ESQ.

Biography

Sean R. Weissbart is Counsel at Morris & McVeigh LLP in NYC, focusing on domestic and international estate planning, estate and trust administration, and litigated matters in the Surrogate's Court. He also advises tax-exempt organizations on matters from applications for tax exemption to avoidance of excise taxes and the unrelated business income tax.

He is an Adjunct Professor of Law at Fordham University School of Law, teaching Trusts and Estates Drafting, and New York University School of Law, teaching Income Taxation of Trusts and Estates. His numerous scholarly and practice-driven articles have been featured in The ACTEC Law Journal, the LISI Estate Planning Newsletter, The Journal of Taxation, Estate Planning, and NYSBA's quarterly Trusts and Estates Law Section Newsletter. Since 2012, he has served as associate editor of the NYSBA newsletter. He has lectured at many CLEs, including at the NYC Bar Association, CBIT Tax Day, and the Hawaii Tax Institute.

For outstanding pro bono representation of a mentally handicapped woman in a probate contest, he received the MFY Justice Award. His article "Probate by Order to Show Cause" chronicles the strategy used to secure victory in this unique matter. He serves as an officer of the Board of Directors of the Ment'or BKB Foundation, which sponsors the team representing the United States of America in the bi-annual Bocuse d'Or culinary competition, and he has chaired events for the UJA-Federation of New York as a founding member of its Next Generation Trusts and Estates division. Since 2015, he has been selected every year as a "Rising Star" by Super Lawyers magazine.