

President’s Message

Although the events and activities of the Summer Meeting in San Francisco are now only fond memories, for the record I want to thank Peggy, the ACTEC staff, and numerous Fellows in the San Francisco area for making the meeting so successful. I also want to thank the Program Committee, chaired by Carlyn McCaffrey, and the speakers for the excellent professional program entitled “Financial Analysis for Estate Planners.” The committee chairs deserve our thanks as well for their superb efforts in insuring that the committee meetings were, without exception, productive, as evidenced by the committee minutes which are available on the ACTEC Web site.

With the Fall Meeting in Bermuda at the impressive Fairmont Southampton Princess only a few weeks away, I encourage each of you to attend what I believe will be, like San Francisco, an extraordinary gathering of the Fellows. The number of rooms already booked indicates that we will have a large attendance for the professional pro-

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gram and the committee meetings.

The magnitude of the College’s work will be particularly evident at the Regents Meeting in Bermuda where, in addition to addressing regular business, i.e., approving a budget for the 2001 year, considering requests to approve the filing of amicus briefs in connection with several tax and probate cases now on appeal in the federal courts, and addressing proposed committee submissions to governmental authorities on statutes and regulations, the board will receive the final report of Task Force 2000 and an interim report of the Technology Task Force.

The Task Force 2000 report will undoubtedly confirm that the Fellows believe that they will continue to set the standards for practice in the trusts and estates area, as now broadly defined under our bylaws, and will continue to be financially and professionally rewarded, even if increasingly subject to competition. Moreover, it will set forth concrete recommendations for the Fellows and the College to insure that the Fellows will continue to find the practice this way.

The Technology Task Force will also undoubtedly present in its interim report a number of actions that the College needs to take to insure that the substantial investment in technology that we have made over the past decade will be of real current benefit to a larger number of Fellows and to the public at large, commensurate with our mission to the public to raise the standards for all lawyers who work in this area.

The professional program at Bermuda, entitled “Reacting to and Initiating Change in the World of Trusts,” will address the enormous changes that are occurring in the trusts and estates area. For example, the abolishment of the rule against perpetuities by state legislatures is accelerating and the number of states adopting asset protection statutes is increasing. As a result, drafting flexible documents that anticipate these changes is increasingly challenging. The program will also address the need of trust and estate lawyers to continue to implement techniques where the laws and regulations are only now developing and, therefore, the results of which are still uncertain. In cases where the client needs to act because of the high tax rates under our transfer tax system (which Congress, but not the President, wants to repeal), we are required to consider how to use techniques even before we understand fully their implications.

In response to those Fellows who have contacted me asking the College’s position on repeal, I have stated that the policies of the College preclude our taking a position as a College on the merits of whether the repeal legislation passed by Congress should become law. Nevertheless, as a practitioner, I know that any repeal legislation, which will not be effective for a number of years or at least will be phased in over a number of years, will require even more, rather than fewer, legal services. Working with carryover basis issues, potential new transfer taxes at the state level, charitable planning issues, unwinding techniques and dealing with the passage of wealth, with all the traditional non-tax issues, are just a few of many areas that will require continuing substantial legal services by the Fellows. Even without total repeal, significant modification actually seems possible, and if so, the likelihood of dealing with families who have considerable wealth, but not taxable estates, will increase. Instances where non-tax planning is the most important part of the task will be a new, and possibly refreshing, experience for many of us.

Finally, as we grapple with keeping abreast of these current and anticipated changes, we can expect that the developments in the multidisciplinary practice (“MDP”) arena, regardless of what positions the ABA and state bars take, will increasingly challenge the way we do business. As some of our most highly respected Fellows join accounting firms and investment management firms, we know that the concept of MDP, if not its widespread use, may begin to impact us directly. As ACTEC Fellows have long known, we must market effectively while retaining our professional independence when asked to ally with (or work for or with) non-lawyer providers, and we will surely be on the cutting edge of this issue.

What all of these developments and trends suggest is that our role as ACTEC Fellows, and as trust and estate lawyers generally, will continue to evolve and there will be more complexity in what we do and what we need to know. As a College, we are likely heading into a period where we will be called upon frequently to comment on the proposed legislation and regulation that will inevitably follow the election of a new President. We will also be asked to file more amicus briefs than in the past as the uncertainties in the laws that our planning techniques incorporate are litigated.

Moreover, as a by-product of this enormous transfer of wealth, there will be an increase in fiduciary litigation, continuing the trend of the last decade. The rapid growth of our Fiduciary Litigation Committee reflects this trend, and it is now one of the most productive committees of the College. But this explosion in litigation also demands that we and our colleagues be even more careful and diligent in meeting the ethical guidelines set forth in the ACTEC Commentaries, and be always cognizant of the need to maintain our professionalism, avoiding even the appearance of impropriety.

Finally, as noted in my first President’s Message, we must better understand the role of philanthropy in our practice. The Philanthropy Study Committee,
which is chaired by Ed Beckwith, will help us accomplish that goal. The committee had its first meeting in San Francisco and will present the initial results of its study at the Symposium at the Annual Meeting in Boca Raton.

The good news in all of these developments and trends is that the Fellows of the College are uniquely qualified and trained to lead the way for our profession. Our programs, including local, state and regional meetings, our committees and task forces, and, most importantly, our commitment to providing a structure for the most ethical and educated lawyers bode well for the future of the Fellows as well as the future of our College.

Peggy and I look forward to being with you in Bermuda. We promise an experience for you and your spouses and guests that you can literally find nowhere else. It will also be a time to better understand and appreciate these changes in our practice and how to deal with them.

[Signature]

In Memoriam

Donald H. Chisholm
Kansas City, Missouri

Charles F. Cremer, Jr.
Indianapolis, Indiana

H. Alan Curtiss
Alliance, Nebraska

Ivan A. Elliott
Carmi, Illinois

Robert G. Fleming
Golden, Colorado

Joseph B. Johnson
Duluth, Minnesota

Calvin S. Robinson
Kalispell, Montana

J. Stanley Mullin
Los Angeles, California
July 14, 1907 – July 24, 2000

Elected as an ACTEC Fellow in 1967, Stanley Mullin was a member of ACTEC’s “old guard,” which included such distinguished Fellows as Past Presidents Joseph Trachtman, Everett A. Drake, J. Pennington (“Joe”) Straus and Harrison F. Durand. This group had much to do with the founding of the college and in activating it to greater service to attorneys in our specialty and to the public in general.

One of Stan’s valuable contributions to ACTEC was his authorship of “In the Beginning,” an article summarizing the founding of ACTEC and its development during the first twenty years. In its updated form, the article is the first chapter of the History of the American College of Trust and Estate Counsel, which was produced by the ACTEC Historical Commission and published in 1999, in time for the College’s 50th anniversary. Stan was a charter member of the commission, which included Joe Straus, Bjarne Johnson, Joe Foster, and myself.

Stan was a giant in so many ways, not only in the leadership he gave to his firm, but also in the leadership he gave to our college. He remains in my mind as someone never to be forgotten.

Edward B. Winn
ACTEC President 1974-75

Any gift to the ACTEC Foundation made in the memory of a deceased Fellow will be acknowledged to the family.
### Calendar of Events

**2000 Regional and State Meetings**

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>Place</th>
<th>Speaker</th>
<th>Title</th>
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</thead>
<tbody>
<tr>
<td><strong>Friday</strong></td>
<td><strong>Colorado Fellows Breakfast</strong></td>
<td><strong>Keystone, Colorado</strong></td>
<td><strong>Robert J. Rosepink</strong></td>
<td><strong>ACTEC Secretary</strong></td>
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<tr>
<td><strong>September 8</strong></td>
<td><strong>New England Regional Meeting</strong></td>
<td><strong>Marriott Hotel on Newport Harbor</strong></td>
<td><strong>Hanson S. Reynolds</strong></td>
<td><strong>ACTEC Immediate</strong></td>
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<tr>
<td><strong>Friday-Sunday</strong></td>
<td><strong>Western Regional Meeting</strong></td>
<td><strong>The Heathman Hotel Portland, Oregon</strong></td>
<td><strong>Robert J. Durham, Jr.</strong></td>
<td><strong>ACTEC President-Elect</strong></td>
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<tr>
<td><strong>September 8-10</strong></td>
<td><strong>Mid-Atlantic Regional Meeting</strong></td>
<td><strong>Hershey Lodge Hershey, Pennsylvania</strong></td>
<td><strong>Ronald D. Aucutt</strong></td>
<td><strong>ACTEC Treasurer</strong></td>
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<tr>
<td><strong>Florida Fellows Meeting</strong></td>
<td></td>
<td><strong>Hyatt Regency Orlando Airport</strong></td>
<td><strong>Hanson S. Reynolds</strong></td>
<td><strong>ACTEC Immediate</strong> Past President</td>
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<tr>
<td><strong>Friday-Sunday</strong></td>
<td><strong>Ohio Fellows Meeting</strong></td>
<td><strong>Hyatt Capitol Square Columbus, Ohio</strong></td>
<td><strong>Robert J. Rosepink</strong></td>
<td><strong>ACTEC Secretary</strong></td>
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<tr>
<td><strong>September 19-22</strong></td>
<td><strong>Southeast Regional Meeting</strong></td>
<td><strong>The Ritz-Carlton Pentagon City, Virginia</strong></td>
<td><strong>Neill G. McBrayde</strong></td>
<td><strong>ACTEC President</strong></td>
</tr>
<tr>
<td><strong>October 6-7</strong></td>
<td><strong>Florida Fellows Meeting</strong></td>
<td><strong>Hyatt Regency Orlando Airport</strong></td>
<td><strong>Hanson S. Reynolds</strong></td>
<td><strong>ACTEC Immediate</strong> Past President</td>
</tr>
<tr>
<td><strong>October 6-8</strong></td>
<td><strong>Ohio Fellows Meeting</strong></td>
<td><strong>Hyatt Capitol Square Columbus, Ohio</strong></td>
<td><strong>Robert J. Rosepink</strong></td>
<td><strong>ACTEC Secretary</strong></td>
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<tr>
<td><strong>October 19-22</strong></td>
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<td><strong>Neill G. McBrayde</strong></td>
<td><strong>ACTEC President</strong></td>
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<tr>
<td><strong>November 30 - December 3</strong></td>
<td><strong>Florida and California Fellows Litigation Meeting</strong></td>
<td><strong>Silverado Country Club Napa, California</strong></td>
<td><strong>Neill G. McBrayde</strong></td>
<td><strong>ACTEC President</strong></td>
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<tr>
<td><strong>Wednesday December 6</strong></td>
<td><strong>Iowa Fellows Annual Meeting</strong></td>
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### New Geographic Regions as of March 14, 2000

*new addition to the region

**new region

***new name under consideration

**Western Region:**
Alaska, Arizona, California, Hawaii, Nevada, Oregon, Washington

**Big Sky Region:**
Colorado, Idaho*, Montana, New Mexico, North Dakota, South Dakota, Utah, Wyoming

**Quad State Region***:
Arkansas, Kansas, Missouri, Nebraska*, Oklahoma

**Southwest Region****:
Louisiana, Texas

**Big Ten Region****:
Illinois, Indiana, Iowa, Michigan, Minnesota, Ohio, Wisconsin

**Tri State Region***:
Alabama, Kentucky*, Mississippi, Tennessee

**New England Region**:
Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont

**New York Region****:
Upstate New York and New York City

**Mid-Atlantic Region**:
Delaware, Maryland, New Jersey, Pennsylvania, D.C.

**Southeast Region**:
Florida*, Georgia, North Carolina, South Carolina, Virginia, West Virginia*
2000 Fall Meeting

Think Bermuda, and images of white-roofed, pastel-painted cottages, pink-sand beaches and quintessential British traditions such as cricket matches and afternoon tea spring to mind, plus, of course, those professional gents going about their business in jackets, ties, knee socks and Bermuda shorts. Yet, with golf courses galore, easily accessible boating, fishing and snorkeling, extraordinary views and exceptional shopping, Bermuda is a modern day Shangri-la.

The island is situated in the western Atlantic Ocean nearly 600 nautical miles off the coast of North Carolina. The majority of visitors to Bermuda come from North America for short stays, and most consider the island to be quaintly British; the Brits, on the other hand, come in much smaller numbers but tend to consider the island highly Americanized. It is, of course, uniquely Bermudian—a product of nearly four centuries of British colonial history and an equally long reliance on American trade.

Bermuda enjoys a mild, agreeable climate because of the warming effects of the Gulf Stream. It is abloom with colorful flowers like bougainvillea, hibiscus and oleander. The average November high temperature is a warm 75 degrees, while the average November low is 60 degrees.

<table>
<thead>
<tr>
<th>Dates:</th>
<th>Thursday, November 2 through Monday, November 6</th>
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<tbody>
<tr>
<td>Place:</td>
<td>Fairmont Southampton Princess Hotel Bermuda</td>
</tr>
<tr>
<td>Thursday November 2</td>
<td>Committee meetings— as scheduled in late afternoon</td>
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<tr>
<td>Friday November 3</td>
<td>Fall Seminar for Fellows— &quot;Reacting To and Initiating Change in the World of Trusts&quot;</td>
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<tr>
<td>Evening</td>
<td>President’s Welcome Reception For all Fellows and spouses/guests</td>
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<tr>
<td>Saturday November 4</td>
<td>Committee meetings— as scheduled throughout the day</td>
</tr>
<tr>
<td>Evening</td>
<td>Cocktail reception and dinner For all Fellows and spouses/guests</td>
</tr>
<tr>
<td>Sunday November 5</td>
<td>Committee meetings— as scheduled throughout the day</td>
</tr>
<tr>
<td>11:00 a.m. to 2:00 p.m.</td>
<td>State Chairs Meeting</td>
</tr>
<tr>
<td>Evening</td>
<td>Cocktails and Dinner for Regents, Regents Emeriti, State Chairs and their spouses/guests at the Waterlot</td>
</tr>
<tr>
<td>Monday November 6</td>
<td>8:00 a.m. to 12:00 p.m. Board of Regents Meeting</td>
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</tbody>
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## 2001 Annual Meeting

<table>
<thead>
<tr>
<th>Dates:</th>
<th>Tuesday, March 6 through Monday, March 12</th>
</tr>
</thead>
<tbody>
<tr>
<td>Place:</td>
<td>Boca Raton Resort and Club Boca Raton, Florida</td>
</tr>
<tr>
<td>Tuesday March 6</td>
<td>Committee meetings— as scheduled in the afternoon</td>
</tr>
<tr>
<td>Wednesday March 7</td>
<td>Committee meetings— as scheduled throughout the day</td>
</tr>
<tr>
<td>Thursday March 8</td>
<td>Opening Breakfast and Annual Business Meeting</td>
</tr>
<tr>
<td>Friday March 9</td>
<td>Seminars, Trachtman Lecture, computer workshops, athletic events and tours</td>
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<tr>
<td>Evening</td>
<td>Open evening</td>
</tr>
<tr>
<td>Saturday March 10</td>
<td>Seminars, symposium, computer workshops, athletic events and tours</td>
</tr>
<tr>
<td>Evening</td>
<td>Committee meetings— as scheduled in the afternoon</td>
</tr>
<tr>
<td>Monday March 12</td>
<td>Board of Regents Meeting</td>
</tr>
<tr>
<td>Evening</td>
<td>Theme Party</td>
</tr>
<tr>
<td>Thursday March 8</td>
<td>Seminars, Symposium, athletic events and tours</td>
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<tr>
<td>Wednesday March 7</td>
<td>Athletic event and tours</td>
</tr>
<tr>
<td>Tuesday March 6</td>
<td>Dinner for 2000-2001 committee members and their spouses/guests</td>
</tr>
<tr>
<td>Evening</td>
<td>President’s Welcome Reception For registered Fellows and registered spouses/guests</td>
</tr>
<tr>
<td>Sunday March 11</td>
<td>Seminars, Hot Topics, athletic events and tours</td>
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<tr>
<td>Afternoon</td>
<td>State Chairs Meeting</td>
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<tr>
<td>Evening</td>
<td>Dinner for 2000-2001 Regents, State Chairs and Past Presidents and their spouses/guests</td>
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</table>
On Canada’s West Coast, nestled between rugged mountains and the Pacific Ocean, you will find a city that is unique—you will just have to see it for yourself.

A bustling port of 2.1 million and a hub for Pacific trade, Greater Vancouver enjoys rich ethnic diversity. Take a little time to explore historic Gastown, artsy Yaletown and colorful neighborhoods like Chinatown, Little Italy and the Punjabi market. The city’s scenery is unmatched and in the summer, nature is at its finest. Recreational opportunities abound; you can golf, sail, bike, hike and kayak in the morning; take a balmy walk on the beach or shop on chic Robson Street or funky Granville Island in the afternoon; and in the evening, indulge your tastebuds in unique West Coast cuisine or in a superb variety of international cuisine, and then dance the night away at one of the city’s downtown nightspots.

Greater Vancouver is extremely well-connected to all major North American cities and Vancouver International Airport is conveniently situated only 12 miles (approximately 20 minutes) from downtown.

For more information on Vancouver, start with the basics at the Greater Vancouver Convention and Visitors Bureau Web site at www.tourism-vancouver.org, or call them toll free at 1-800-926-8815 for travel tips.

The committee meetings, professional program and social functions will be held at the Hotel Vancouver, the “Grand Hotel” of the city, located in the heart of downtown. This hotel, fully renovated, represents both the gracious elegance of the past and the finest in modern conveniences. Additional guest rooms are available at the elegant Four Seasons Vancouver, which is just a block away.

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**2001 Summer Meeting**

**VANCOUVER**

*Spectacular by Nature*

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**Dates:**
Thursday, June 28 through Sunday, July 1

**Place:**
Hotel Vancouver
900 W. Georgia Street
Vancouver, British Columbia
V6C 2W6

**Tuesday-Thursday, June 26-28**

**Pre-meeting trip:**
Whistler Tour

**Thursday, June 28**
Committee meetings — as scheduled in late afternoon

**Friday, June 29**
Morning:
Professional Program—to be announced

**Morning/Afternoon, June 29**
Three Gardens Tour with lunch at Van Dusen Garden
Kayaking
Grouse Mountain/Capilano Suspension Bridge

**Sunday, July 1**
Committee meetings — as scheduled throughout the day

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**Saturday, June 30**
Committee meetings — as scheduled in late afternoon

**Morning/Afternoon**
Gastown Walking Tour
Grouse Mountain/Capilano Suspension Bridge
Biking Down Grouse Mountain
Nature Hike
Museum of Anthropology/Vancouver Aquarium

**Evening**
Cocktail Reception and Dinner
For all Fellows and spouses— as scheduled in the evening

**Sunday, July 1**
Committee meetings — as scheduled in the morning

**Sunday-Sunday, July 1-8**
Post-meeting cruise:
“Northbound Glacier Discovery” on Holland America Cruise Line’s Statendam
### ACTEC National Meeting Schedule

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<tr>
<th>Year</th>
<th>ANNUAL</th>
<th>SUMMER</th>
<th>FALL</th>
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<tr>
<td>2000</td>
<td>Friday–Wednesday&lt;br&gt;March 3–8&lt;br&gt;Scottsdale Princess&lt;br&gt;Scottsdale, Arizona&lt;br&gt;(March 1*)</td>
<td>Thursday–Sunday&lt;br&gt;June 22–25&lt;br&gt;Palace Hotel&lt;br&gt;San Francisco, California</td>
<td>Wednesday–Monday&lt;br&gt;November 1–6&lt;br&gt;Fairmont Southampton Princess&lt;br&gt;Bermuda</td>
</tr>
<tr>
<td>2001</td>
<td>Wednesday–Monday&lt;br&gt;March 7–12&lt;br&gt;Boca Raton Resort and Club&lt;br&gt;Boca Raton, Florida&lt;br&gt;(March 5*)</td>
<td>Thursday–Sunday&lt;br&gt;June 28–July 1&lt;br&gt;Hotel Vancouver&lt;br&gt;Vancouver, B.C., Canada</td>
<td>Wednesday–Monday&lt;br&gt;October 17–22&lt;br&gt;Hotel Inter-Continental&lt;br&gt;New Orleans, Louisiana</td>
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<tr>
<td>2002</td>
<td>Wednesday–Monday&lt;br&gt;February 27–March 4&lt;br&gt;La Quinta Resort and Club&lt;br&gt;La Quinta, California&lt;br&gt;(February 25*)</td>
<td>Thursday–Sunday&lt;br&gt;June 27–30&lt;br&gt;The Waldorf-Astoria&lt;br&gt;New York, New York</td>
<td>Wednesday–Monday&lt;br&gt;October 9–14&lt;br&gt;Westin La Paloma&lt;br&gt;Tucson, Arizona</td>
</tr>
<tr>
<td>2003</td>
<td>Wednesday–Monday&lt;br&gt;March 5–10&lt;br&gt;El Conquistador Resort and Country Club&lt;br&gt;Las Croabas, Puerto Rico&lt;br&gt;(March 3*)</td>
<td>Thursday–Sunday&lt;br&gt;June 26–29&lt;br&gt;Radisson Riverfront St. Paul Hotel&lt;br&gt;The Saint Paul Hotel&lt;br&gt;St. Paul, Minnesota</td>
<td>Wednesday–Monday&lt;br&gt;October 9–November 3&lt;br&gt;Charleston Place&lt;br&gt;Charleston, South Carolina</td>
</tr>
<tr>
<td>2004</td>
<td>Wednesday–Monday&lt;br&gt;March 10–15&lt;br&gt;Westin La Cantera&lt;br&gt;San Antonio, Texas&lt;br&gt;(March 8*)</td>
<td>To be determined</td>
<td>To be determined</td>
</tr>
<tr>
<td>2005</td>
<td>Wednesday–Monday&lt;br&gt;February 23–28&lt;br&gt;Hyatt Regency&lt;br&gt;Grand Cypress Hotel&lt;br&gt;Orlando, Florida&lt;br&gt;(February 21*)</td>
<td>To be determined</td>
<td>To be determined</td>
</tr>
<tr>
<td>2006</td>
<td>Wednesday–Monday&lt;br&gt;March 8–13&lt;br&gt;Grand Wailea Resort&lt;br&gt;Maui, Hawaii&lt;br&gt;(March 6*)</td>
<td>To be determined</td>
<td>To be determined</td>
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Editor’s Page

Things Aren’t What they Appear To Be

_VERITAS VOS LIBERABIT._ The word _veritas_ is used in the motto of many universities seeking to convey the importance of truth in education. Literally translated, the Latin quote means the truth will set you free. The question then is, what is the truth? The Bible states that we should separate the weed from the wheat. The question is what is the wheat? As tax lawyers in seeking to understand the nooks and crannies of the Internal Revenue Code, truth can indeed be elusive.

We have recently been bombarded with bills to eliminate estate taxes even though the advice of Benjamin Franklin for over 200 years has been that “the only thing certain is death and taxes.” Furthermore, what is not said is frequently more important than what is said. HR8 passed the House as well as the Senate this year, and is designed for the repeal of estate taxes. The bill is awaiting the President’s promised “veto.” However, what is not widely said is that the maximum estate tax imposed on estates next year applies to a lower threshold under the new proposal. What is not widely publicized is that the proposed repeal does not occur until the year 2010 and then the loss of an anticipated $50 billion in taxes a year will be replaced from the income tax regime. The new carryover basis income tax regime appeared in the tax landscape over 20 years ago and was repealed as unworkable. Why is it now workable? The confusion that things aren’t what they appear to be is not limited however, to the Internal Revenue Code.

The slogan of Merrill Lynch, namely that Merrill Lynch is “Bullish on America”, was not filmed in the United States, but rather in Mexico. The statue of John Harvard that sits prominently in the yard of one of our most prestigious universities, with the name engraved, is not John Harvard at all, but rather a replica of a person who many years later attended the university. The quote frequently used to condemn lawyers, uttered in _Henry VI_ by Dick the Butcher, namely “the first thing we do, let’s kill all the lawyers,” was not used by Shakespeare to condemn lawyers, but rather to praise them. The 38 plays, two long poems and 154 sonnets that result in the greatest canon of literary genius were written by whom? The conventional wisdom states that it was William Shakespeare, who was baptized Gulielmus Shakespere. The question of authorship, however, remains unanswered today. The evidence is significant against Shakespeare being the author. He died in obscurity and was buried anonymously. Almost 20 years after his death, an engraved monument at Stratford Church shows him holding a sack of grain. One hundred years later, the sack becomes pen and paper. It is well known that Shakespeare had at best only a grammar school education and was not noted to have traveled hardly at all, let alone in Italy prior to the date of his plays. There are no manuscripts, poems, letters, diaries, or records in his own hand. In fact, his will, dictated to a lawyer, makes no mention of a literary legacy and who should inherit it. The company of skeptics that question his authorship are indeed impressive: Walt Whitman, Henry James, Ralph Waldo Emerson, Mark Twain and Orson Welles, to name names.

Publications such as _ACTEC Notes_ help each of us with our paradigm of what is truth. The articles consistently published in this journal continue to be what they appear to be: scholarly work seeking to shed illumination of the Internal Revenue Code to its readers.

_Joseph J. Hanna, Jr._
At this writing, just after the Republican and Democratic conventions in August, no one is prepared to predict the outcome of the November elections, although the prospects and likely content of future estate tax legislation may be more dependent on that outcome than they have ever been before.

It is well known that Governor George W. Bush’s “Tax Cut with a Purpose” (released December 1, 1999) and the 2000 Republican platform call for elimination of the “death tax,” to “encourage entrepreneurship and growth.” It is also well known that Vice President Gore does not favor the repeal of the estate tax. In keeping with our history of making bold forecasts, we predict that either Governor Bush or Vice President Gore will be the next President.

Remarks by advisers at the time Governor Bush’s “Tax Cut with a Purpose” was announced—as well as fiscal realities—suggest (as we reported in the Winter issue) that the repeal of the estate tax that a Bush Administration would support is similar to the phased-out approach of the “Death Tax Elimination Act of 2000” (H.R. 8), which we described in the Summer issue and which was subsequently endorsed by both houses of the Republican Congress. Thus, we have chosen in this issue to take a closer look both at the approach to repeal taken by H.R. 8 and at other legislative changes that may be more or less likely, depending on how the voters speak in November.

Quantifying Relief and Repeal

In the public debate over H.R. 8, the actual effects of the current proposals on estate tax liability are hardly ever calculated. We were curious, though, and we prepared the following table, showing the best available calculation of the estate tax on a taxable estate of $5 million, assuming no lifetime taxable gifts, under current law, under H.R. 8, and under the substitute to H.R. 8 offered in the House Ways and Means Committee by the ranking Democratic member, Rep. Charles Rangel. These results are offered as a best-guess estimate of how the proposals would actually work. In addition, we have made no effort to take account of the special relief rules of sections 2032A and 2057, or to project the tax over the estates of two spouses.

The decrease in the 2001 tax under H.R. 8 ($177,200) is derived from the reduction of the top 55% rate (over $3,000,000) to 53% (2% of $2,000,000 = $40,000) and the conversion of the “unified credit” to an exemption, thereby allowing the exemption to be applied to the top marginal rate of 53%, rather than to the lower rates (53% of $675,000 = $357,750; $357,750 - $220,550 = $137,200). (H.R. 8 would also eliminate the 5% surtax that results in the 60% “bubble,” but that has no effect on a taxable estate of $5 million.)

The decrease in the 2001 tax under the Rangel substitute ($456,250) is derived from a reduction of all rates by 20% (20% of $2,390,800 = $478,160) and an immediate increase in the applicable exclusion amount (on which the credit is based) to $750,000 ($248,300 - $220,550 = $27,750), partially offset by

<table>
<thead>
<tr>
<th>Year</th>
<th>Current Law</th>
<th>H.R. 8</th>
<th>Rep. Rangel’s Substitute</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$2,170,250 (55%)</td>
<td>$1,993,050 (53%)</td>
<td>$1,714,000 (44%)</td>
</tr>
<tr>
<td>2002</td>
<td>$2,161,000 (55%)</td>
<td>$1,925,800 (50%)</td>
<td>$1,679,300 (47%)</td>
</tr>
<tr>
<td>2003</td>
<td>$2,161,000 (55%)</td>
<td>$1,882,800 (49%)</td>
<td>$1,615,800 (46%)</td>
</tr>
<tr>
<td>2004</td>
<td>$2,103,500 (55%)</td>
<td>$1,767,800 (48%)</td>
<td>$1,555,800 (44.5%)</td>
</tr>
<tr>
<td>2005</td>
<td>$2,064,500 (55%)</td>
<td>$1,679,300 (47%)</td>
<td>$1,475,800 (42.5%)</td>
</tr>
<tr>
<td>2006</td>
<td>$2,045,000 (55%)</td>
<td>$1,615,800 (46%)</td>
<td>$1,570,400 (44%)</td>
</tr>
<tr>
<td>2007</td>
<td>$2,045,000 (55%)</td>
<td>$1,555,800 (44.5%)</td>
<td>$1,570,400 (44%)</td>
</tr>
<tr>
<td>2008</td>
<td>$2,045,000 (55%)</td>
<td>$1,475,800 (42.5%)</td>
<td>$1,570,400 (44%)</td>
</tr>
<tr>
<td>2009</td>
<td>$2,045,000 (55%)</td>
<td>$1,395,800 (40.5%)</td>
<td>$1,570,400 (44%)</td>
</tr>
<tr>
<td>2010</td>
<td>$2,045,000 (55%)</td>
<td>0</td>
<td>$1,570,400 (44%)</td>
</tr>
</tbody>
</table>
the fact that the tentative tax on $750,000, and thus the credit, would be 20% less (20% of $248,300 = $49,660).

The Rangel substitute would also increase the $1.3 million exclusion for qualified family-owned business interests (QFOBIs) to $2 million. On the other hand, in a feature we view as very unwise, the Rangel substitute would replace the credit for state death taxes with a deduction, with an uncertain effect both on state revenues and on the calculation of the federal tax.

Under H.R. 8, additional decreases in the tax occur in 2002 from a reduction of the top rate to 50%, and in 2003 through 2009 in phased percentage-point reductions in all rates. By 2006, the applicable exclusion amount under the Rangel substitute would be increased to $1.2 million.

Under H.R. 8, of course, after 2009, the estate tax would be replaced with a carryover basis regime.

We think it is interesting that, ignoring the potential effect of converting the credit for state death taxes to a deduction, the Rangel substitute, compared to H.R. 8, would have resulted in less tax on a taxable estate of $5 million through 2006 and a lower top rate through 2007.

Debating Repeal and Relief

Likewise, in the current debate over the proposed repeal of the estate tax, there is very little public comprehensive dialogue about the policies that argue in favor of, or opposed to, repeal. While not pretending to be economists, we are happy to pass on to our readers the arguments we have most frequently heard. In favor of retaining the estate tax, it might be said that—

• The estate tax raises significant revenue for the federal government. In 1997, federal estate, gift, and GST tax revenue was about $24 billion (while the total IRS operating budget was $7.2 billion). The more modest revenue loss estimates for H.R. 8 flow from the fact that it would not be fully effective for over nine years.

• The estate tax breaks up large, economically inefficient, and socially undesirable concentrations of wealth and increases equality of opportunity.

• Taxes on multiple bases (such as the base of wealth transmitted at death) minimize economic distortion.

• There is a sort of increased “ability to pay” when the transferor (or the surviving spouse in cases where the marital deduction is used), being dead, no longer needs the property for consumption or support.

• The estate tax is the most progressive of any federal tax, paid by less than 2% of decedents’ estates, with about half of the tax paid by less than 6% of that 2%. It is thus an important backstop to the income tax, especially because it extends to unrealized appreciation and other reinvestment of tax-free income. Any lack of horizontal equity could and should be addressed directly, by extending benefits (and closing “loopholes”) on a more even basis.

• The estate tax encourages support of charity (as well as surviving spouses).

• A federal estate tax, with a state death tax credit, helps states collect revenue without fostering unseemly competition among states.

In favor of repealing the estate tax, it might be said that—

• As a tax on capital and, in effect, a tax on saving and investment, the estate tax threatens productivity and international competitiveness (mitigated somewhat to extent that the estate tax encourages some forms of saving, such as some forms of life insurance). The top rate of 55% is second-highest among the world’s industrialized countries, second only to Japan’s top rate of 70%.

• Family farms and other family businesses are uniquely burdened by the estate tax. Since a family business that represents the bulk of an entrepreneur’s estate must itself generate the funds, through redemptions or distributions of earnings, to pay the tax (if the business is not going to be sold), this is, in effect, a tax burden on family-owned businesses that is not borne by their publicly-held competitors.

• Large concentrations of family wealth are as likely to be broken up through simple dissipation as through the influence of an estate tax.

• The estate tax is a relatively small source of federal revenue (accounting for only about 1.5% of federal receipts), but it generates a disproportionate amount of cost for planning, compliance, and administration. Meanwhile, the uneven availability of tax benefits and the uneven use of tax planning techniques results in a tax with very little horizontal equity.

• Increasing exemptions removes people from the tax roles in the short term, but estate tax planning is still necessary for those who do not know how large their estates will be.

• Death is just not a good time (Chairman Archer’s visiting-the-undertaker-and-the-tax-collector-in-the-same-week argument).

The sentiments for repeal are pretty well summed up in the following poem, which Rep. Sue Myrick (R-NC) inserted into the Congressional Record on April 4, 1995:

Tax his cow, tax his goat,
Tax his pants, tax his coat,
Tax his crops, tax his work,
Tax his tie, tax his shirt,
Tax his chew, tax his smoke,
Teach him taxes are no joke.
Tax his tractor, tax his mule,
Teach him taxes are the rule.
Tax his oil, tax his gas,
Tax his notes, tax his cash.
Tax him good and let him know
After tax he has no dough.
If he hollers, tax him more;
Tax him ’til he’s good and sore.
Tax his coffin, tax his grave,
Tax the sod in which he lays.
Put these words upon his tomb:
“Taxes drove me to my doom.”
And once he’s gone, he can’t relax;
They’ll soon be after his Inheritance
Tax!

The Prospects for Repeal

While populist support for tax overhaul in general may have peaked six years ago with the “Contract With America,” the repeal of the estate tax continues to be very popular—sometimes ironically so. For example, a Gallup Poll in June 2000 found that 60% of Americans favor the elimination of the death tax, and 17% responded that they would personally benefit from repeal! Many Americans appear to view the estate tax as confiscation, not as merely a tax. The political cost of a tax cut for less than two percent of the population, with more than half of it going to the richest one-eighth of one percent of the population, seems not to matter—yet. The congressional majorities in support of H.R. 8 (279-136 in the House and 59-39 in the Senate) included one-third of House Democrats, one-fifth of Senate Democrats, and almost all Republicans.

Nevertheless, most observers think that either a Democratic President or even a Democratic-controlled House of Representatives would mean that the estate tax will not be repealed. The reasoning is that while a number of Democrats voted for repeal this year, it was in a bill they felt certain would be vetoed, and therefore their votes just did not carry the same weight or call for the same measure of responsibility as if the legislation had had a chance of enactment. In a Democratic-controlled House, Rep. Rangel would chair the Ways and Means Committee and would be expected to oppose repeal with the same vigor that Chairman Archer has promoted it.

The much more difficult question is whether the election of Governor Bush and continued Republican control of Congress would be sufficient to ensure the enactment of a “Death Tax Elimination Act.” We have always had doubts, although the large congressional majorities for repeal this year have certainly made those doubts smaller.

We do note, however, that if a repeal bill in 2001 follows the pattern of H.R. 8, a nine-year phase-out period before the estate tax is fully repealed means that there will be four new Congresses and at least one new President (after 2001) before such a law takes effect. We also remember that the “top 50% rate” enacted in the Economic Recovery Tax Act of 1981 with a four-year transition was frozen at 55% for three years in the Tax Reform Act of 1984, for another five years in the Revenue Act of 1987, and permanently in the Omnibus Budget Reconciliation Act of 1993. Furthermore, as baby boomers near retirement at the end of this decade, fiscal pressures, especially the pressure to address Social Security and Medicare, will become increasingly intense, and significant tax cuts will become increasing difficult.

Anticipating Estate Tax “Reform”

The economic theory that a tax on multiple bases minimizes economic distortion appears to contemplate taxes at low rates, which often are linked with broad bases. Base broadening is often associated with the closing of what some, at least, view as “loopholes.”

A Democratic Administration and/or Congress might be expected to work for “reform” in the form of closing perceived “loopholes,” because that is most consistent with the Democratic Party’s historical agenda, including the recent budget proposals and other proposals of the Clinton Administration.

On the other hand—and this is the scenario many Fellows will find most fascinating and most ominous—a Republican Administration and/or Congress might feel more free to pursue a reform agenda without the baggage of being viewed as “social engineers,” and as a way to both rationalize and “pay for” (with revenue offsets under the Omnibus Budget Reconciliation Act of 1990) the substantial across-the-board estate tax cuts that presumably would be their Plan B if repeal eluded them. For example, it will be remembered that the irksome anti-fractionalization-discount proposals of the Clinton Administration can be traced to the very similar ideas floated in “Treasury I” in November 1984, when Ronald Reagan was President.

Precursors of tightening of estate tax rules can be seen in recent congressional responses to perceived abuses involving accelerated charitable remainder trusts and “charitable split-dollar life insurance,” in proposals heard from time to time to apply some of the procedural private foundation rules to “donor-advised funds” in community foundations, and even in the current focus on “corporate tax shelters.” Moreover, a vehicle for reform might emerge from the current study by the staff of Joint Committee on Taxation of simplification of the tax law, expected to produce a major report on simplification in January 2001.
The Board of Directors had a very productive meeting in San Francisco on June 22.

The Board welcomed its two new members, Mack Trapp and Bruce Friedman.

As part of the financial report submitted by Treasurer Ron Aucutt for the nine months ending May 31, 2000, the Board noted, with appreciation, the increased level of contributions by ACTEC Fellows. The gifts received this year, on an annualized basis, exceed those received during each of the three preceding years.

The Board discussed the status of “Death and Taxes,” the one-hour television special on estate planning, produced as a result of a grant by the Foundation. The program is now being broadcast by a number of PBS stations throughout the country as part of the Inside the Law series. The program features ACTEC members Carlyn McCaffrey and Max Gutierrez and is hosted by Fred Graham, senior anchor for CourtTV. It explores various estate planning decisions and options available to a particular American family as the family members pass through several stages of their lives. The program was initially fed live by satellite to several hundred local PBS stations on May 7.

As of June 14, commitments to broadcast the program were received from 92 stations, airing in 151 cities. These stations cover three out of five of the top markets in the U.S., meaning the program would be available to about 36 million households. The producer, in the space of one month following the initial feed, received requests for the program from so many stations that the decision was made to refeed the program throughout the country on June 28. We have not yet received an update as to how many more stations have signed on to broadcast the program since June 28.

A great many Fellows have shared with us their efforts to persuade their local PBS stations to air the program. It is still not too late for you to call or write to your local station (or someone on the station’s board) and urge the station to broadcast the program in your community. By virtue of the two satellite feeds, a tape of the program is already available to each station. An “advisory” with suggestions (including a sample letter) about identifying and communicating with the local stations was included with the mailing of the Spring 2000 ACTEC Notes. Additional copies of the advisory are available from the Foundation’s office in Los Angeles.

An application, generated by the Elder Law Committee of the College, for a grant to produce a video and handbook for training guardians and conservators at the time of their appointment was contingently approved by the Board. The contingencies relate to commitments for the production of the necessary state specific materials for at least 10 states and for the use of the video and handbook in those states.

As you know, the Foundation has recently been involved with the publication and distribution of the third edition of ACTEC Commentaries. Bob Rosepink reported that he and a number of other Arizona ACTEC Fellows have petitioned the Arizona Supreme Court to amend its rules governing the conduct of attorneys to adopt the third edition as additional guidance for Arizona attorneys practicing in the trusts and estates fields. The Supreme Court has directed the State Bar of Arizona to analyze the petition and report back to the Court by April 2001. The Board authorized the commitment of up to $2,000 to underwrite the expenses of expert witnesses to appear before the relevant committees of the State Bar to offer testimony regarding the Commentaries.

Jeff Pennell, Chair of the Grants Committee, reported that Professor Ronald Link, of University of North Carolina School of Law, has expressed interest in writing a law review article on matters of ethics which would include consideration of the Commentaries. As previously reported to you, the Foundation’s intent in subsidizing the writing of such an article is to broaden the exposure of the Commentaries in the legal literature.

Jeff also reported on his efforts to develop a program to promote skills training in estate planning for minority lawyers in recognition of the changing demographics with respect to consumers of estate planning services.

The Board also discussed a number of informal proposals it had received for other grant-making opportunities.

The Foundation is continuing to ask the substantive committees of the College and leading legal academics throughout the country to suggest topics on estate planning, fiduciary administration and related areas that they believe warrant serious consideration in articles for law reviews and other legal publications. The Foundation intends to publish a listing of such topics to encourage legal scholarship in these areas and might, under certain circumstances, support the writing of particular articles.

We encourage the committees of the College and the Fellows individually to continue to generate worthwhile grant opportunities for the Foundation. Grant application forms may be obtained from the ACTEC office.
Committee Corner

Steve A. Brand
Minneapolis, Minnesota

Introduction

In the second Committee Corner for this year, I want to begin by thanking the committee chairs and the individuals who take minutes at committee meetings for their cooperation in providing advance drafts of their minutes for use in preparing this summary. Those Fellows who are familiar with the ACTEC Web site know that all committee minutes are available on the Web site after approval by the committees. As stated in the last issue of ACTEC Notes, my goal is to provide you with highlights of committee activities as reflected in committee minutes, leaving those so motivated to review the minutes in their entirety at their leisure.

This Corner will be devoted to a summary of committee activities at the Summer Meeting in San Francisco, California. The summary is based on committee minutes which were available at the time of submission of this Corner for publication. Suggestions for improvements in the information provided in the Committee Corner are always welcome.

Charitable Planning and Exempt Organizations Committee

The meeting was chaired by Jerry J. McCoy, Washington, D.C. The minutes were kept by Edward Jay Beckwith, Washington, DC. The Committee has apparently developed a tradition of having a presentation on charitable activities within the host community for the meeting. A panel discussion on "The 'New' Philanthropy — The Silicon Valley Experience and Beyond" was presented by ACTEC Fellow Owen G. Fiore, San Jose, California, Greg Lassonde of Community Foundation Silicon Valley, Palo Alto, California, and Stephen Goldbart, Ph.D., of the Money, Meaning & Choices Institute, San Francisco, California. The discussion included a review of research into philanthropic activities and trends in Silicon Valley, as well as the problems in dealing with clients who have realized too much wealth too soon.

After several case reports, the Committee heard a presentation from Robert Rosepink, Scottsdale, Arizona, on “Picking Up the Pieces: The Baptist Foundation of Arizona Bankruptcy.” Finally, there was a report from Edward Jay Beckwith about the Philanthropy Study Committee which has been appointed by ACTEC President Neill McBryde. The charge to the committee is to determine the appropriate role of the College and the Fellows in supporting philanthropy and in informing and advising individuals and philanthropic organizations. The goal is to have the committee present a symposium at the Annual Meeting in Boca Raton, Florida (March 2001).

Editorial Board

The meeting was chaired by A. MacDonough Plant, Baltimore, Maryland, and James D. Funnell, Jr., Norwalk, Connecticut, prepared the minutes. The Editor of ACTEC Notes for 2000-2001, Joseph J. Hanna, Jr., Portland, Oregon, reported that ACTEC Notes is back on publication schedule with the Summer 2000 issue. He encouraged members of the committee to continue seeking out articles for publication, even though there are sufficient articles for the Fall 2000 issue.

Joe then asked the Board to consider a number of possible format changes to ACTEC Notes, including additional features and a possible change in the name of the publication. The Board agreed to study the proposals and review them at the Fall Meeting in Bermuda.

Anthony Marshall, New York, New York, Editor of the ACTEC Studies, reported on the status of the studies. He noted that there continue to be three problems which need to be addressed to improve the production of the Studies. First, there is a lack of staff able to dedicate the time needed to keep the Studies process moving. Second, there needs to be some revision of current procedures to improve the progress in issuing a study. Finally, something needs to be done about the timeliness of reporting by state reporters. A subcommittee of the Board was appointed and asked to report to the Board at its next meeting.

Frederick R. Keydel, Detroit, Michigan, reported on the Pocket Tax Tables and the Indices. A schedule for the publication of the Tax Tables was presented, with the admonition that it is dependent on the Treasury issuing the 2001 rates on a timely basis.

Fred presented detailed models of the Indices that have been completed. Meeting materials since 1981 have been indexed. The project for indexing of articles from ACTEC Notes is progressing and recent editors will be asked to index the articles contained in the issues for which they were responsible.

Employee Benefits in Estate Planning Committee

The meeting was chaired by Virginia F. Coleman,
Boston, Massachusetts, and John T. Bannen, Milwaukee, Wisconsin, acted as secretary. E. James Gamble, Bloomfield Hills, Michigan, and Steven E. Trytten, Pasadena, California, led a discussion of provisions of the 1997 Revised Uniform Principal and Income Act dealing with payments to a trust from qualified plans, IRAs and other deferred compensation accounts. Special attention was called to §409 of the Act which calls for 90% of any payment to be allocated to principal with the balance allocated to income. There was extensive discussion of other provisions in the Act relating to distributions to a marital deduction trust.

Virginia Coleman, Marsha Chadwick Holt, Denver, Colorado, Mervin Wilf, Philadelphia, Pennsylvania, and Steven Trytten discussed an ALI-ABA law review program in which they participated with representatives of the IRS. They discussed how the program helped amplify the IRS’ position on Dynasty Trusts as designated beneficiaries, the impact of powers of appointment on the determination of a designated beneficiary, and why an estate as beneficiary may negate the existence of a designated beneficiary.

Betty J. Orvell, Oakland, California, led the discussion of Bunney v. Comm’r, 144 T.C. No. 17 (4/10/00) and how the IRS views community property issues in the tax context. Robert S. Ketchum, Detroit, Michigan, demonstrated the use of Datair Distribution Software.

**Estate and Gift Tax Committee**

Stephen E. Martin, Idaho Falls, Idaho, chaired the meeting. John T. Bertheau, Sarasota, Florida, served as secretary. There was a legislative update which indicated that 20% of the 250 tax bills filed in Congress related to estate and gift tax matters. The most significant legislation was HR-8 which provided for the repeal over a ten year period of the estate tax, the gift tax and the generation-skipping transfer tax. HR-8 also provides for the return of carryover basis when the estate tax has disappeared. There also was a discussion of the alternative plan which had been proposed by the House Democrats.

There was a presentation on Section 529 college savings plans by Susan T. Bart, Chicago, Illinois. There are now more than 30 state plans available. Susan amplified the significant tax and financial benefits that are available from these plans.

**Fiduciary Litigation Committee**

The meeting was chaired by Bruce S. Ross, Los Angeles, California. K. Bradoc Gallant, New Haven, Connecticut, acted as secretary. Bruce reminded the committee members that the California/Florida Fellows Annual Probate Litigation Retreat will be held November 30 through December 3 and asked those wishing to attend to notify him as soon as possible.

The Will and Trust Contests Subcommittee members T. Jack Challis, St. Louis, Missouri, Jules J. Haskel, Garden City, New York, and John T. Rogers, Los Angeles, California, gave a presentation on Contesting Inter Vivos Trusts. There was extensive discussion of two case studies.

The committee adjourned to its various subcommittees to plan for the coming year. The committee reassembled after these meetings and received reports from the various subcommittees.

The meeting concluded with a roundtable discussion of recent case developments.

**International Estate Planning Committee**

Ellen K. Harrison, Washington, D.C., chaired the meeting, with Kathryn A. Ballsun, Los Angeles, California, serving as secretary. A report from the Subcommittee on the Hague Convention on Trusts was given by Louis A. Mezzullo, Richmond, Virginia, and Professor Jeffrey A. Schoenblum, Nashville, Tennessee. Following the report, the committee decided to study the presentations and then vote at its Fall Meeting whether or not to reaffirm its support of the Convention.

There was a presentation on proposed expatriation legislation by Carlyn S. McCaffrey, New York, New York. A report on the new IRS Forms 3520-A and 4970 was presented by Virginia Coleman. The Chair gave a brief overview of the new Withholding Regulations. She also indicated that there would be a greater discussion at the Fall Meeting of the committee.

**Legal Education Committee**

The members of the Committee were encouraged to consider nominating qualified academics for admission to the College.

There was a discussion of the propriety of using the public side of the ACTEC Web Page as a clearinghouse for employment of graduates interested in estate planning. The matter has been referred to the Technology Task Force.

There was a review of a draft letter for law firm managing partners to use in contacting law schools regarding interest in our area of the law. There was a great deal of discussion about how to implement the use of such a letter and how to follow up on the use of the letter.

**Practice Committee**

George T. Shaw, Boston, Massachusetts, chaired the meeting. Karen M. Moore, Columbus, Ohio, acted as secretary for the meeting. Prior to the full commit-
tee meeting, the subcommittees met to discuss current and future projects and topics of interest. Reports were received from the various subcommittees.

Donna G. Barwick, Atlanta, Georgia, reported on the Inside the Law video project. She distributed materials and also indicated that the videotape can be made available to local civic organizations in its full format or an edited format.

J. Keith George, San Luis Obispo, California, distributed a questionnaire soliciting practice management techniques that committee members have found helpful. The results will be discussed at the Fall Meeting of the committee.

Professional Standards Committee
Charles M. Bennett, Salt Lake City, Utah, chaired the meeting. Robert M. Weylandt, Houston, Texas, served as secretary for the meeting. The Chair is working with the ACTEC Office to set up a list-serv for the committee. The Chair expects the list-serv to be activated shortly.

Three subcommittees were established to address issues relating to multidisciplinary practice, Estate Planning MDP subcommittee, MDP Response Resource subcommittee, and the Lawyer Independence subcommittee. These subcommittees are chaired by Philip J. Halley, Milwaukee, Wisconsin, Hugh F. Kendall, Chattanooga, Tennessee, and S. Shepherd Tate, Memphis, Tennessee, respectively. The chairs were asked to state the goals and objectives of their subcommittees.


State Laws Committee
Judith W. McCue, Chicago, Illinois, chaired the meeting. Richard W. Stevens, Jenkintown, Pennsylvania, served as secretary for the meeting. Reports were received from the various subcommittees of the committee.

The most extensive report was received from Gordon G. Waterfall, Tucson, Arizona, chair of the Uniform Probate Code/Uniform Trust Act subcommittee. The subcommittee had met previously and conducted an extensive review of the Uniform Trust Act. The minutes contain a lengthy discussion of several provisions of the Act.

The Chair announced that the Fall Meeting will include a presentation on the 1997 Uniform Principal and Income Act by E. James Gamble.

Professor Richard V. Wellman, Athens, Georgia, led a discussion of disclaimers and the Uniform Disclaimer of Property Interests Act. He also reported on the status of the International Wills Act, which has been adopted by 14 states. He believes that the State Department seems to be moving on ratification of a treaty on the subject.

Technology in the Practice Committee
The meeting was chaired by Robert M. Kunes, Charleston, South Carolina, and Susan S. Westerman, Ann Arbor, Michigan, acted as secretary. The Chair opened a discussion on the purpose of the committee. There was an emphasis on the sharing from each member benefits and the resource which the committee provides to the College.

William Crawford, Systems Administrator for ACTEC, presented the ACTEC home page with its most recent revisions.

The Chair demonstrated that issues of ACTEC Notes for the past five years are now located on the Web and using Adobe, can be searched by topic, scanned and downloaded. Techniques for downloading a single article were discussed.

Reports were received from the subcommittees. There was discussion of preparing a program for the Annual Meeting in Boca Raton, Florida, stressing how technology can solve practice problems.

Transfer Tax Study Committee
Linda B. Hirshson, New York, New York, chaired the meeting. Donald M. Schindel, Chicago, Illinois, acted as secretary for the meeting. There was a discussion of the comments from the Board of Regents on the new, proposed §6163A of the Code (to deal with the installment payment of estate taxes due on annuities) which the committee had approved in Scottsdale. Based on the discussion, Philip H. Ward, Sterling, Illinois, agreed to work on revisions to the draft.

There was a discussion of the report on the transferability of the unified credit and the GST exemption. There was further discussion of the marital deduction unitrust proposal.

There also was a discussion of the proposed repeal of the estate, gift and generation-skipping transfer taxes. Emphasis was placed on the impact of carryover basis on surviving spouses.
Committee Appointments 2001-2002

by Robert J. Durham, Jr.
San Diego, California

Fellows, please submit your request for committee appointment or reappointment for the coming College year, 2001-2002. Reappointments are not automatic.

As President-Elect, I will review the reports of committee chairs and appoint or reappoint members in December of this year. These appointments will become effective at the end of the 2001 Annual Meeting in Boca Raton through the 2002 Annual Meeting in La Quinta.

The committees of the College are the heart of the College’s existence. Each committee has its own personality and contributes to the College in its own way. Some committee meetings provide primarily stimulating discussion forums while others focus primarily on the production of programs for College meetings or articles for ACTEC Notes.

Most committees meet three times a year. For 2001-2002, that would be at the summer meeting in Vancouver, the fall meeting in New Orleans and the annual meeting in La Quinta. The College will reimburse each committee member as much as $350 for expenses incurred at the summer and fall meetings but not at the annual meetings. Academic Fellows are entitled to a larger reimbursement for all 3 meetings.

The College expects committee members to attend committee meetings and actively participate in committee work. Budget constraints, attendance records, contributions to committee work, potential for leadership, reasonable turnover, and other factors determine whether an appointment request is granted.

Each Fellow who would like to serve or continue to serve on a committee for the coming year should complete and submit the committee appointment request form that accompanies this issue of ACTEC Notes, or should write a letter stating her or his committee preferences. Each Fellow who is requesting a new appointment should describe any special experience or accomplishments she or he may bring to a committee’s work. Send the completed form or letter before November 15, 2000, to:

Gerry A. Vogt, Executive Director
The American College of Trust and Estate Counsel
3415 South Sepulveda Blvd., Suite 330
Los Angeles, CA 90034
Fax: (310) 572-7280

ACTEC COMMITTEES

The committees which are subject to appointment request are listed below, together with the current chair, the number of members and a brief description of the committee’s purpose and activities. Some ACTEC committees are not listed because they are not subject to appointment request, such as the Executive Committee, Nominating Committee, Membership Selection Committee and Program Committee. All committees, committee chairs and members are shown on the first several pages of the Membership Roster.

**Business Planning Committee** (70)
Susan K. Smith, Chair
The Business Planning Committee considers planning approaches and techniques under present law with a heavy emphasis on income and transfer tax considerations faced by taxpayers whose major assets are in operating businesses. Valuation, succession planning, and liquidity are topics the committee has under review.

**Bylaws and Manual Committee** (7)
William E. Beamer, Chair
The Bylaws and Manual Committee updates the Bylaws and Manual. The Bylaws and Manual are living documents and require constant adjustment.

**Charitable Planning and Exempt Organizations Committee** (71)
Jerry J. McCoy, Chair
The Charitable Planning and Exempt Organizations Committee considers all aspects of charitable planning, charitable giving, and exempt organizations.

**Editorial Board** (20)
A. MacDonough Plant, Chair
The Editorial Board has responsibility for all publications of the College, including ACTEC Notes and the ACTEC Studies, the Membership Roster, and additional materials that are published by the College from time to time, such as the annual Pocket Tax Tables. A primary responsibility of the Editorial Board is to locate, write, and update articles of interest to the Fellows.

**Elder Law Committee** (40)
Sara R. Stadler, Chair
The Elder Law Committee reviews guardianship
legislation and procedure, books and professional literature in the elder law area, health law, legal alternatives to guardianship, elder law insurance issues, government entitlements, and conservatorships.

Employee Benefits in Estate Planning Committee (47)
Virginia F. Coleman, Chair
The Employee Benefits in Estate Planning Committee considers developments in the employee benefits area, with a special emphasis on the ever changing tax implications.

Estate and Gift Tax Committee (71)
Stephen E. Martin, Chair
The Estate and Gift Tax Committee monitors tax developments in the transfer tax area, and has been active in responding to Treasury proposals and the filing of amicus briefs.

Fiduciary Income Tax Committee (30)
T. Randolph Harris, Chair
The Fiduciary Income Tax Committee reviews the latest developments relating to fiduciary income taxes, and considers proposals for reform.

Fiduciary Litigation Committee (74)
Bruce S. Ross, Chair
The Fiduciary Litigation Committee deals with will and trust contests, breach of fiduciary duty, fee matters, ad litem, evidentiary issues, liaison with judges, construction and instructions, alternate dispute resolution, and expert and fact witnesses.

International Estate Planning Committee (32)
Ellen K. Harrison, Chair
The International Estate Planning Committee focuses on the various planning issues that face individuals who have (or would like to have) multinational assets and/or multigenerational families. These issues include taxation, probate and succession, and asset protection.

Legal Education Committee (51)
Frank J. Collin and
Jeffrey N. Pennell, Co-Chairs
The Legal Education Committee has as its primary focus the quality of content of trust and estate courses offered in law schools across the country and the role of adjunct professors.

Practice Committee (49)
George T. Shaw, Chair
The Practice Committee looks at how trust and estate lawyers can expand their practices by adding other areas of expertise, and how Fellows should deal with practical and ethical problems in their existing areas of practice.

Professional Responsibility Committee (43)
Charles M. Bennett, Chair
The Professional Standards Committee considers ethical issues faced by Fellows in the trust and estate area. This committee has published or recommended for publication advisory guidelines in the estate planning, trust, and probate field, including the first, second and third editions of the ACTEC Commentaries on the Model Rules of Professional Conduct and form engagement letters. Subcommittees focus on business, disabled clients, estate and trust administration, multigenerational planning, spouses, lawyers as fiduciaries, and maintenance and update of the Commentaries and engagement letters.

State Laws Committee (55)
Judith W. McCue, Chair
The State Law Committee works on such topics as the Prudent Investor Rule, tax curative statutes, standby guardianship legislation, the Uniform Probate Code, notice in probate, apportionment of federal estate taxes, pre-mortem probate techniques, rights of creditors, and fiduciary accounting.

Technology in the Practice Committee (44)
Robert M. Kunes, Chair
The Technology in the Practice Committee provides information to the Fellows on computer hardware and software for estate planning and administration, and has been actively involved in establishing and maintaining the College’s Web site.

Transfer Tax Study Committee (21)
Linda B. Hirschson, Chair
The Transfer Tax Study Committee studies and reports on changes in the transfer tax law that would improve the tax system.

ADJUNCT MEMBERSHIP
A Fellow who wishes to obtain copies of the agenda, minutes and the written materials of the Business Planning, Charitable Planning and Exempt Organization, Estate and Gift Tax, Fiduciary Litigation and Transfer Tax Study Committee can apply at any time for an adjunct membership. The cost is $30 per year for each adjunct membership. A sign-up form is enclosed with this issue. A Fellow who wishes to become an adjunct member should fill out the form and send it with a check payable to ACTEC to the national office.
This report, which is a regular feature of ACTEC Notes, focuses on significant recent court decisions and rules, legislative enactments and IRS developments bearing on attorney compensation in the trust and estate practice. The report is heavily dependent on the willingness of all the Fellows to furnish material that they think would be suitable for inclusion. Please send Spotlight’s compiling editor a brief write-up (as little as one paragraph will do) about a recent case, rule, statute or ruling which you believe is either important in the jurisdiction in question or of widespread interest.

ARKANSAS  
Richard F. Hatfield, Little Rock

Law firm denied fees and ordered to disgorge fees previously paid by trust because it had represented clients with conflicting interests.

A Louisiana law firm which had represented a remainder beneficiary individually and in his capacity as co-trustee forfeited all rights to compensation and was ordered by the chancellor to repay $16,800 in fees it had received from an Arkansas trust. The firm represented Richardson, who was both residuary beneficiary and co-trustee and to whom the will, which was probated in Arkansas, gave final authority over decisions affecting the testamentary trust. Richardson purchased a property in Louisiana with $52,000 of the trust’s funds, titled the property in his and his wife’s names and occupied it as his own. The firm represented Richardson at closing and advised him to transfer title to the trust which he did not do. A year later Richardson entered into a lease-sale of the property and spent the $45,000 down payment for his own personal purposes. The firm received fees from the trust for its work on the lease-sale agreement and in preparing documents to transfer title from Richardson to the trust and then to the would-be purchaser. After the purchaser defaulted and filed for bankruptcy, his trustee filed a claim in the Bankruptcy Court against Richardson and the testamentary trust alleging fraud and seeking to recover the down payment. The Louisiana firm filed a motion to dismiss for Richardson and an answer for the trust. Although it withdrew as to Richardson individually, it continued to represent the trust and refused to turn over its files to counsel retained by Boatmen’s Bank, the co-trustee.

Thereupon Richardson himself filed for bankruptcy in Louisiana. In Richardson’s bankruptcy proceeding, at a hearing held in response to Boatmen’s motion to remove him as co-trustee, a lawyer in the Louisiana firm testified for him regarding his actions as trustee. The Bankruptcy Court found that Richardson had engaged in extensive self-dealing as co-trustee and entered judgment against him in favor of the trust for $147,418 and removed him as co-trustee. In its ruling the Bankruptcy Court observed that Richardson’s counsel “needs a little seasoning . . . [she] never understood what she was doing . . . “ and described the situation as “classic self-dealing” by Richardson which fooled or at least confused his counsel.

The Louisiana firm then asked the Arkansas Chancery Court to award it fees of $38,000 for representing Richardson. The court denied the fee request and ordered the firm to disgorge $16,800 previously paid to it by the trust due to its conflict of interest in representing Richardson individually and as co-trustee and in violation of a court order directing it to cease representing the trust. The Court found that most, if not all, of the services rendered in connection with the fee application were primarily for Richardson’s benefit individually and not the trust. The Arkansas Supreme Court affirmed the Chancery Court’s order and findings that the firm had represented clients with diverse interests and that the trust had been harmed by its representation of the remainderman co-trustee. Lastly, the Supreme Court declined to consider the merits of Boatmen’s request for attorneys’ fees incurred in successfully defending against the Louisiana law firm’s fee petition because Boatmen’s motion (which the law firm opposed) failed to comply with the court’s rule which specifies the method for claiming attorneys’ fees. Crawford & Lewis v. Boatmen’s Trust Co., 338 Ark. 679, 1 S.W. 3d 417 (1999).

MICHIGAN  
James H. LoPrete, Bloomfield Hills

Co-personal representative not entitled to recover attorney’s fee incurred in successful defense against surcharge claims.

The Court of Appeals summarized Michigan law as to when a fiduciary whose actions are challenged (in this case by a successor fiduciary) may obtain reimbursement for costs and attorney’s fees in defend-
ing her actions. _Geiger v. Wilcox_, No. 212692, slip. op. (Mich. Ct. App. March 14, 2000). In this case, three sisters were appointed co-personal representatives of their father’s estate. After disputes arose the sisters agreed to be removed and asked the probate court to appoint a disinterested third party. Thereupon, the newly appointed personal representative sought to surcharge the three sisters for breach of fiduciary duties. All three claimed that counsel had advised them that no federal estate tax return was due. After that issue was settled by assigning any malpractice claim against the sisters’ counsel to the successor personal representative, the other claims were adjudicated. Two of the sisters were surcharged but the probate court decided not to surcharge appellant.

Thereupon, appellant petitioned the probate court for costs and attorney’s fees incurred in her defense, basing her claim on two theories, first that she had prevailed in defending against the surcharge claim, and second that she was entitled to sanctions because the action against her was frivolous. The probate court held that the surcharge was not frivolous as to appellant and that she had not been absolved of all wrongdoing because the estate tax issue was not resolved.

The Court of Appeals analyzed the circumstances when a personal representative may be compensated for defending against an attack on the performance of her duties, stating that defense fees “are properly chargeable against the estate where no wrongdoing is proved.” The Court cited _In re Baldwin Estate_, 311 Mich. 288, 18 N.W.2d 827 (1945), holding that the rule is “to allow, but not require, the award of attorney’s fees to a fiduciary who is fully exonerated of wrongdoing in the administration of the estate.” The appellate court affirmed the probate court’s finding as being within its discretion either to award costs and attorney’s fees or to deny the award because appellant was not completely exonerated of liability for the estate tax issue.

Under Michigan law, if a matter is deemed frivolous, the imposition of sanctions, including an award of attorneys’ fees, is mandatory. The test for applying sanctions is that (1) the primary purpose of the action is to harass, embarrass or injure the prevailing party, or (2) the party had no reasonable basis to believe that the underlying facts were true, or (3) the party’s position was devoid of arguable legal merit. Appellant contended that because counsel for the successor personal representative had previously represented her in disputes with her sisters, he was aware that she had done nothing wrong. The probate court held that the successor personal representative had proved breaches of fiduciary duty, and therefore, that the successor personal representative was entitled to file a surcharge petition against all three sisters as former co-personal representatives. Although the Court of Appeals concluded that the successor personal representative should have only sought to surcharge the negligent sisters, it held that the probate court had not clearly erred in determining that the surcharge petition was not frivolously brought and thus denying appellant’s claim for fees. While this decision denied appellant’s claim, it affirmed the principle that the probate court has broad discretion in allowing or not allowing defense costs to a challenged fiduciary.

**NEW YORK**

_Sanford J. Schlesinger, New York City_

Fees of over $21 million for estate, probate and administration services reduced to less than $7.6 million because much of time spent by 17 firms was unnecessary, duplicative or excessive; principal firm’s retainer agreement held unenforceable; agreement establishing fee between principal firm and residuary beneficiary held not binding.

Despite a good faith settlement reached after extensive negotiations with the estate’s primary beneficiary, the Doris Duke Foundation, the Surrogate’s Court approved only $3.65 million of fees claimed by the Chicago firm of Katten Muchin for its services over approximately 2-1/2 years in connection with the probate and administration of the $1.3 billion estate. The firm had been paid $12.6 million for its services based in part on its retainer agreement with the preliminary executors. The settlement between the firm and the Foundation, which would have allowed $9.6 million, was rejected because the Court has the ultimate responsibility to decide what constitutes reasonable compensation regardless of the interested parties’ consent to the fees. As the Surrogate observed, “Judicial review yields an unfettered evaluation of the reasonable value of [Katten Muchin’s] services without the consideration of extraneous factors.” _Matter of Doris Duke_, N.Y.L.J. May 3, 2000, p. 28, col. 6 (NY Co. Surr. Preminger).

Initially, Katten Muchin represented both preliminary executors of the estate, Bernard Lafferty (Ms. Duke’s butler) and U.S. Trust Company. Shortly after Ms. Duke’s death in 1993 at age 80, headline-grabbing charges were raised that drugs had been administered to hasten her death. Although the matter was investigated by the Los Angeles District Attorney’s Office, no charges were ever filed. Charges were subsequently leveled that Lafferty had serious substance abuse problems and had lived lavishly at the estate’s expense. U.S. Trust was caught in the web of those charges on two theories, that it had failed to curb the butler’s spending and had loaned him $825,000, creating a conflict of interest. Although Katten Muchin had ini-
tially represented both preliminary executors, after the Surrogate appointed former Manhattan District Attorney Richard Kuh to investigate the charges, Cravath, Swaine & Moore was engaged to represent U.S. Trust. From that point on, Katten Muchin represented Lafferty only. Relying on Kuh’s findings, the surrogate removed both Lafferty and U.S. Trust as preliminary executors and replaced them with two temporary administrators, Alexander Forger, of Millbank, Tweed, Hadley & McCloy, and Morgan Guaranty Trust Co. Seven months later the Court of Appeals reinstated Lafferty and U.S. Trust, finding that the surrogate had erred in removing them on the strength of Kuh’s report without conducting a fact-finding hearing. After several months of intense negotiations, Lafferty agreed to step aside as an executor and to assume no role in the Foundation that was to receive the bulk of the estate once probate was completed. In addition, the estate agreed to accept one of the principal challengers to the will, Dr. Harry Demopoulos, who had previously cared for Ms. Duke, as a member of the Foundation’s board. The Surrogate noted that by prior application the attorneys for the temporary administrators had requested about $7 million in fees and were awarded approximately $4.6 million.

The current fee applications were pending as part of the preliminary co-executors’ final accounting in which the Court was asked to approve payment of over $21 million in legal fees and expenses to a “remarkable” number of law firms and lawyers – over 150 lawyers from 17 different law firms. The Court found that the proposed settlement of the fee dispute with Katten Muchin was not in the best interests of the Foundation and also because circumstances had changed since the settlement was reached. In addition, the Court found that the retainer agreement between the preliminary co-executors and Katten Muchin was not enforceable, because the firm failed to demonstrate its reasonableness at the time it was made or, in retrospect, because the $8 million flat fee (plus disbursements) for estate administration established by the agreement covered too narrow a range of services to be realistic and the administration was not so complex as to make it likely that a fee in that amount would be necessary. The Court also held that, while the size and breadth of the assets required extensive legal services authorizing substantial compensation to Katten Muchin, there was no reason based on the facts of this case to award a premium over its hourly rates. Thus, the court found that the retainer agreement was unreasonable and excessive and therefore unenforceable.

One of the principal reasons for reducing Katten Muchin's fee so sharply was that it had engaged two other firms to represent Lafferty. The Surrogate faulted the firm in particular for spending many hours on the removal proceeding and appeals during the period when former federal Judge Herbert Stern, of Stern & Greenberg, had assumed the lead role in the court proceedings and negotiations. She also noted that Katten Muchin had retained Willkie, Farr & Gallagher purportedly as New York trusts and estates counsel. The Surrogate reduced the fees of the other principal firms, including Cravath which received $2,200,000, Willkie $900,000 and Stern $440,000, after noting that the estate consisted of unusually containable assets, the estate tax issues were less complex than usual and some services provided by the firms were executorial or otherwise nonlegal. The Court noted that although the size of the estate required the retention of reputable attorneys to provide necessary services, it did not relieve them of the responsibility to operate as efficiently as possible and only to the extent necessary to accomplish particular goals. The Court also found that because substantial time spent was unnecessary, duplicative or excessive the time factor is of even less significance. Despite duplication and overlap the Court allowed compensation to the extent that separate or additional counsel were engaged where (1) the interests of the preliminary co-executors may have diverged, or (2) separate counsel was not employed to perform the same work, or (3) to allow leeway for transition beyond counsel’s control, or (4) to allow for time pressures, and (5) where the circumstances were unforeseeable, complex or exceptional. The Court did not, however, approve compensation where the use of multiple attorneys from different firms was excessive or unnecessary and disallowed compensation for excessive attorney communications, such as were shown by proofs submitted by the various firms disclosing “countless internal conferences and communications among attorneys of different firms” or where the Court was presented with vague time sheets or other incomplete documentation. Thus, the Court determined the reasonable value of the fees rendered by the four principal law firms, based on the relevant factors applicable to fixing fees, at $7,300,000 (reduced from over $21 million). It also allowed a total of $240,160 to several other firms that played lesser but discrete roles in the proceedings, in many instances substantially reducing the amounts claimed by the firms because of duplication of services or lack of contemporaneous time records. Lastly, the Court disallowed certain requests for disbursements, such as in-house photocopying, telephone and fax charges (except for actual long-distance charges) and certain travel costs and various markups over actual costs incurred.
Order allocating attorneys’ fees primarily to one of two companion trusts found not to be an abuse of court’s discretion.

A contingent beneficiary of two companion trusts challenged an order of the Probate Court which approved payment of attorneys’ fees primarily from the first trust and left sufficient assets to pay the claim of a substantial creditor of the second trust. The fees arose from a controversy, which had been settled, relating to the rights of shareholders of closely held stock owned by both trusts. On appeal the beneficiary complained that the Court failed to allocate the fees between the two trusts in proportion to the services rendered by the attorneys to each trust. The allocation of the payment primarily to the first trust depleted that trust and left sufficient assets in the second trust to pay the claim of its substantial creditor.

The Court of Appeals affirmed the allocation of fees primarily to the first trust, holding that the Probate Court did not abuse its discretion. The Court pointed out that apportioning the fees equally between the two trusts would have resulted in the distribution of the remaining assets of the first trust to the current beneficiary and payment of the creditor’s claim, which was superior to the contingent beneficiary’s interest, from the second trust. In both cases the contingent beneficiary would have received nothing. While charging most of the fees to the first trust was not beneficial to that trust, approval of the payment plan advanced by the trustee was not unreasonable, arbitrary or unconscionable and therefore not an abuse of the Probate Court’s discretion. Thompson v. Hlavin, 2000 WL 777054 (Ohio App. 8th Dist. June 15, 2000).

Recent changes to Ohio’s declaratory judgment act creates uncertainty about the recovery of attorneys’ fees in litigation involving trusts and estates.

The Ohio General Assembly recently amended the Declaratory Judgment Act (Chapter 2721 of the Ohio Revised Code) to provide that “a court of record shall not award attorney’s fees to any party on a claim for declaratory relief under this Chapter,” except where expressly authorized by statute. According to the legislative history, this provision generally reaffirms the “American rule” — each party in litigation pays its own attorneys’ fees, absent a contractual or statutory fee-shifting provision — and specifically overrules a line of insurance cases involving declaratory judg-

ments. The new provision was not intended to affect fiduciary litigation. But some have noted that a literal reading of this provision casts doubt upon a court’s ability to award attorneys’ fees when declaratory relief is sought in fiduciary litigation, because no Ohio statute expressly authorizes fees in such cases.

In Ohio, as in many other states, the practice of awarding fees in fiduciary litigation (whether or not declaratory relief is sought) is ancient and rooted in a number of different concepts — concepts that have long co-existed with the American rule and its exceptions. Some courts have held that the practice of awarding attorneys’ fees in fiduciary litigation is grounded in equitable principles (e.g., compensating those who advance the interests of the trust or estate). This is similar to the “common fund” analysis, a well-recognized exception to the American rule. Other courts have found support for the award of attorneys’ fees in governing fiduciary documents, such as a trust instrument that authorizes a trustee to hire counsel at the trust’s expense. This is similar to a contractual fee-shifting provision. Regardless of the basis, such awards generally have not been grounded in the language of the Declaratory Judgment Act, which is implicated in only a portion of fiduciary litigation matters.

A close examination of the new provision’s language, the General Assembly’s intent and the historical basis for awarding attorneys’ fees in fiduciary litigation reveals that the new provision should not preclude the long-standing practice of awarding fees to fiduciaries in declaratory judgment actions and other fiduciary litigation. Rather, the new provision should be interpreted to provide that an award of attorneys’ fees in fiduciary litigation cannot be based on the Declaratory Judgment Act, but rather must be based on something else (as it historically has been). Until remedial legislation is adopted, or until a court clarifies this issue, attorneys should consider basing their claims for fees on equitable principles or the provisions of the governing documents, not on the Ohio Declaratory Judgment Act. They should also be prepared to explain away the literal language of this new provision in Ohio law. See Fabens, A. and Lamb, B., Recent Changes to Declaratory Judgment Act Should Not Affect the Award of Attorney’s Fees in Fiduciary Litigation, 11 Probate Law Journal of Ohio __ (Sept./Oct. 2000) (to be published).

Recent Ohio legislation complicates allowance of attorney’s fees.

Substitute Ohio House Bill No. 58, which became effective on September 24, 1999 amended ORC Section 2721.16(A). The revised statute provides generally that a court of record shall now award attorney’s
fees to any part on a claim for declaratory relief under ORC Chapter 2721 unless a section of the ORC explicitly authorizes a court of record to award attorney’s fees on a claim for declaratory judgment under ORC Chapter 2721 or unless an award of attorney’s fees is authorized by ORC Section 2323.51 [the frivolous conduct law], by Civil Rules, or by an award of punitive or exemplary damages against the party ordered to pay the attorney’s fees.

In fiduciary litigation the award of attorney’s fees traditionally is based upon equitable principles or the provisions of the governing document. An example of an allowance based on equitable principals would be an award of attorney’s fees to a party that promoted the interests of an estate or trust. An example of an allowance based on the governing document would be the provisions of a trust agreement that expressly authorize the trustee to retain an attorney at the trust’s expense.

It could be argued that the new statutory language prohibits the court from allowing attorney’s fees based upon equitable principles or based upon the provisions of a governing instrument and only permits the allowance of attorney’s fees based upon the conditions set forth in the statute. However, neither the new legislation nor its legislative history indicate that the Ohio General Assembly intended to overrule the long-standing practice of awarding attorney’s fees to fiduciaries and beneficiaries based upon equitable principles or provisions of governing documents. Until remedial legislation is adopted, or until a court clarifies this issue, attorneys should consider basing their claim for fees on equitable principles or provisions of the governing document and not based on ORC Chapter 2721. Fabens, A. and Lamb, B., Recent Changes to Declaratory Judgment Act Should Not Affect the Award of Attorney’s Fees in Fiduciary Litigation, 11 Probate Law Journal of Ohio __ (Sept./Oct. 2000) (to be published).

PENNSYLVANIA
Karen A. Fahrner, Philadelphia

Attorney’s fee reduced where estate services were not complicated and administrative in nature percentage-based fee held improper and hourly rate reduced.

Disputes over attorneys’ fees for services related to the administration of an estate continue to be fact sensitive and not readily predictable in Pennsylvania. This is because the authorities in Pennsylvania concerning compensation to an attorney who represents an executor or administrator merely state that the court shall allow such fees as shall under the circumstances be reasonable and just. In Abloe Estate, 20 Fid. Rep. 2d 159 (O.C. Div. Lawrence 1999), the Orphans’ Court allowed attorneys’ fees totaling $19,737 on a gross probate estate of $488,805 distributable to decedent’s two children. Of the total fees claimed in the amount of $24,440, the Court allowed $6,187 to attorney Henderson (whose fee was not contested) and $13,550 to attorney Krantz (whose fee was challenged). The Court observed that the administration of the estate was not complicated or procedurally involved. The only real difficulty was that some of decedent’s stock certificates were lost and had to be replaced by Krantz, most of whose services were principally administrative in nature. The Court found it significant that Krantz did not prepare the inheritance tax return or account or prepare for the court audit. The Court also rejected Krantz’ contention that the fee was justified because the behavior of decedent’s son, the child who objected to the fee, was “a bit intrusive into the details of the estate administration.”

Krantz originally set his fee at $24,440 based on a flat 5% of the gross probate estate. After the son objected, Krantz submitted a bill itemizing 135.5 hours at $150 per hour for a total of $20,325 out of which he paid Henderson $6,187. The Court upheld the master’s finding, in accordance with the leading Pennsylvania case, Preston Estate, 385 Pa. Super. 48, 560 A.2d 160 (1989), that a percentage-based fee is improper and observed that the “sometimes . . . delicate and difficult question” in an estate case is to determine the reasonable value of the services actually rendered by the attorney. Although recognizing that Krantz is “a skilled lawyer of good standing,” the Court could not justify his hourly rate of $150 in light of the administrative nature of his services. After examining Krantz’ itemized bill, the Court stated, “It is questionable to automatically assume a lawyer’s efforts and time are always worth his hourly rate,” and, further, “[T]he determination of reasonable compensation to attorney for an estate is not relegated to a clock and computer.” Examining Krantz’ time records, the Court noted that many hours on his bill were grouped together and not itemized. The Court concluded that because his services were primarily administrative, his hourly rate would be allowed at $100 and his fee reduced to $13,550, not including the $6,187 payment to Henderson.
New Developments in Construction and Instruction Case Law

Compiled by John F. Meck
Pittsburgh, Pennsylvania

The following case summaries are a project of the Construction and Instruction Subcommittee of the Fiduciary Litigation Committee. The Project is intended to update Fellows regarding cases in the instruction and construction area. The committee invites all Fellows to furnish material that would be suitable for inclusion in the column. The material may be sent to any member of the subcommittee.*

MISSOURI
Clifford S. Brown, Springfield

Construction – “Bodily Heirs,” Foreclosure Notice
Decedent’s personal representative borrowed funds to pay estate taxes. The loan was secured by real property specifically devised to a daughter of decedent and “her bodily heirs, in fee simple”. Subsequent to the loan transaction, the real property was deeded to the daughter “and her bodily heirs”. In 1988 the loan went into default and after actual notice to the personal representative and the daughter, there was a foreclosure sale.

After the daughter’s death in 1993, the daughter’s “bodily heirs” sued to set aside the foreclosure. The basis of the action was that actual notice of foreclosure had not been given to the “presumptive” bodily heirs, that is, the descendants of the daughter living at the time of the foreclosure. The court determined that by virtue of the deed transferring title to the daughter “and her bodily heirs,” the contingent remaindermen were “owners of record” and entitled to actual notice of foreclosure. Since actual notice had not been given to the bodily heirs, the sale was void.

*Williams v. *Kimes, 996 S.W. 2d 43 (Mo. banc 1999).

MISSOURI
Clifford S. Brown – Springfield

Construction – Vested or Contingent Remainder, Disposition of Resulting Trust
By their trust, Theodore and Elinor Short each provided that upon the death of the survivor of Theodore, Elinor and their only son, Teddy, the remainder was to be distributed to Teddy’s then living issue, per stirpes. If, however, no descendant of Teddy was living, then the remainder was to be divided into two equal portions and disposed of as follows:

“One equal portion shall be divided among [Theodore’s] surviving brothers and sisters, per capita…. the remaining one-half (1/2 )… shall be distributed to [3 individuals]..., or those that survive, on a per capita basis.”

Elinor died, intestate, on January 11, 1973, survived by Theodore, Teddy and four of Theodore’s siblings. Theodore died, testate (pour over will), on April 7, 1973, survived by Teddy and four siblings. Teddy died, testate, on June 5, 1996, survived by no issue and no sibling of Theodore.

The successor Trustee sought declaratory judgments regarding the one-half distributable to Theodore’s “surviving” siblings. The Trustee’s position was that the remainder to the siblings was a contingent remainder requiring the siblings to survive Teddy’s dying without issue. Heirs of the siblings contended the remainder was vested at Theodore’s death, in the then “surviving” siblings, subject to divestment if Teddy was survived by issue.

The court discussed at some length the distinctions between vested and contingent remainders, concluding the remainder involved was a contingent remainder because it “cannot vest until there has been compliance with a condition precedent … either as to the persons who are to take or as to the event on which the preceding estate is to terminate.’…” Here, there were two conditions precedent: (1) There must be a remainder at Teddy’s death, and (2) Teddy must die without issue. The siblings had to be living at the time determination of the conditions could be made, i.e., at Teddy’s death.

The court further determined there was a failure to dispose of one-half and a resulting trust in favor of the estates of Theodore and Elinor. With respect to Theodore, even though Theodore had a valid will, the pourover provision would not be effective to return the one-half to a defective trust. The interest passed by intestacy to Teddy’s estate. *Short Trust v. Fuller*, 7S.W. 3d 482 (Mo.App. S.D. 1999).

NEW YORK
by Arlene R. Harris – New York

Disposition of Undisposed Remainder
Each trust under the will provided for the payment of income for the life beneficiary and contained an invasion power up to the full amount of the principal of the trust. The trusts did not contain a bequest of the remainder upon the deaths of the life beneficiaries. The petitioner requested that the Court reform the will to include a bequest of the remainder to the children of the income beneficiaries, alleging that this would provide tax relief in that the descendents GST exemption could be allocated to the trusts. The Court found nothing in the record to lead to the conclusion that it was the testator’s intent that his grandchildren be the remainderman of the trust. The Court stated that it cannot reform, rewrite or reconstruct the will and it may not add new provisions. The Court held that it cannot draft a disposition of the remainder, under the guise of reformation. The Court further determined that where a will creates a valid life estate but fails to dispose of the remainder, it falls into the residuary. Although the life beneficiaries are the same as the residuary beneficiaries (the descendant’s children), the Court held that the trust will continue for their lives with the remainder payable to their respective estates, stating that there is nothing incongruous or illegal in a life beneficiary being vested with a remainder that can never come into actual possession. Matter of Louis Grossman, N.Y.L.J. May 18, 2000, p.34, col. 6 (Nassau Co. Surr. Radigan).

PENNSYLVANIA
John F. Meck – Pittsburgh, Pennsylvania

Modification From Income Only Trust To Total Return Unitrust Denied
In 1989 William created a “dynasty” Trust to which William and his wife contributed $2,000,000 and applied their combined GST exemptions. The trust was to last for a perpetuities period. The Trust directed income to be accumulated during the lives of William and his wife. At the death of the survivor of William and his wife in 1994, the Trust was worth $2,930,000. The Trustee was to then periodically pay so much of the net income among the descendents of William living at the time of each income distribution as determined by an advisory committee. The advisory committee was made up of William’s children plus a representative from the family of each deceased child. If the advisory committee recommended that no income be distributed then the Corporate Trustee was permitted to periodically distribute some or all of the income among William’s then living descendents. There were no Trust provisions allowing distribution of principal. At the end of the perpetuities period the Trust was to be distributed to William’s then living descendents per stirpes.

In 1999 the Trust was worth $7,000,000 and annual income had increased from $60,000 at Trust inception to $140,000 or 2% of Trust value. The Trust was invested heavily in equities. The Corporate Trustee filed a Petition in 1999 to modify the Trust to have net income defined as a 5.5% unitrust pay-out so as to convert the Trust from an income only trust to a total return unitrust. In response to the report of the Trustee ad litem who opposed the modification the Corporate Trustee amended its Petition to reduce the proposed unitrust payout from 5.5% to 5%. The Corporate Trustee argued that the modification would benefit all beneficiaries—a central theme of total return unitrust theory—including the beneficiaries represented by the Trustee ad litem. The Court noted that even if it could modify the Trust, which the Court held it could not, that a lower unitrust rate might have been more appropriate. The Court, noting the “revolution” concerning total return unitrusts cited the work of Pennsylvania ACTEC Fellows Robert B. Wolf and Robert L. Freedman. (Moreover, ACTEC Fellow James R. Ledwith represented the corporate Trustee and ACTEC Fellow John A. Terrill, II, was appointed Trustee ad litem.) “The trend to total return trusts is being encouraged by certain statutory changes in Pennsylvania”, including a new Pennsylvania statutory provision that allows “charitable trusts to convert existing income only funds to unit trusts”, plus Pennsylvania’s adoption of a modified version of the Prudent Investor Rule.

The Court denied the requested modification of the Trust noting:
Pennsylvania’s statutory definition of income for non-charitable trusts remains unchanged, generally limiting income to interest and dividends.

The change of the definition of “net income” would involve invasion of principal “not currently allowed by the Trust”, because the proposed 5% unitrust rate exceeds the current 2% income yield.

“A review of the cases cited by the Trustee and other case law in Pennsylvania and elsewhere has disclosed no case in which a court has so drastically altered the fundamental dispositive provisions of a Trust as the Trustee seeks here.”

The only way for the Court to authorize the invasion of principal which is otherwise not permitted by the Trust is if “the original purposes of the conveyor cannot be carried out or is impractical of fulfillment and that the... allowance more nearly approximates the intention of the conveyor.” 20 Pa. C.S.A. §6102(a). The Corporate Trustee attempted to show a conflict in trust purposes to invoke the statutory rule—on one
hand a purported trust purpose to provide education, with the 2% income rate being insufficient given the current number of college age descendants (great grandchildren), and on the other hand the Settlor’s long held belief, accepted by all parties and the Court, to invest solely in equities. Because no one objected, the Court considered extrinsic evidence as to the trust purposes and found that there no educational trust purpose. The Court then determined that the trust purpose of investing primarily in equities was met and could be carried out by the Trust and was not impractical of fulfillment. Also the Court felt the Petition was a reflection of some of the children desiring a larger pay out.

The Court discussed the projections presented by the Corporate Trustee to support the requested trust modifications using a 90 year period based on both a 10.5% or 9% total rate of return to compare the proposed 5% unitrust to “income only”. Interestingly, the numbers set forth in the opinion reflect that over the entire 90 year period, that both income beneficiaries and remaindermen were better off leaving the trust alone—2% income and equity investments in essence a total return unitrust—although the proposed unitrust would provide more pay out during the first 40 years after which the “income only” status was superior.

The Court concluded that if the Settlor wanted to allow the income beneficiaries some access to principal he would clearly have done so. If the Court “were to grant the Trustee’s request, virtually every income-only trust in Pennsylvania could be converted to a unitrust. If that is to happen, it should be by action of the legislature in amending the definition of income to PEF Code.”

*Murphy Trust, 20 FID. Rep. 2d 46* (Montgomery County 1999)
Few recent technological developments spur the intense partisanship demonstrated by users of handheld computing devices. Is this new genre of computer a necessity, or simply another overhyped toy? Do you need to get on the PDA bandwagon? If so, which model is best for you? If you are already a Palm user, what more do you need to know?

We begin with background information. Personal Digital Assistants (PDAs) have been around for years, but have mostly been viewed as toys for cybereeks. Screens were small and difficult to read, entering data difficult (sometimes impossible), and functions and utility were both lacking in early PDAs. All that changed with the release of the PalmPilot by 3Com Corp. in 1996. In hindsight, the simplicity of 3Com’s approach was impressive: the developers decided to focus on a straightforward machine which did a few things well and did not try to duplicate more sophisticated desktop (or even portable computers). They succeeded wildly.

The PalmPilot included built-in functions for a simple address book, a calendar, a to-do list and a free-form memo pad. The software linking those functions to a desktop computer, however, was the real functional breakthrough—suddenly the PDA could be used to carry desktop database information into the field. In fact, information could be updated, added to, even deleted while away from the desk and later synchronized with the desktop database.

Almost immediately third-party programs and conduits began to appear, and suddenly it became possible to maintain an electronic calendar simultaneously at the office and in the pocket. Because lawyers are so reliant on calendars, the legal profession was an early beneficiary of this improved functionality. Lawyers have been strong users of the mobile technology ever since.

Competition and Consolidation

Microsoft, never shy about entering a field dominated (even created) by a smaller competitor, saw the possibilities for PDAs quickly. The Microsoft corporate response was to enter the market quickly with a well-designed, but feature-rich, competitor. To that end, Microsoft announced the release of Windows CE (in early 1998), and a number of hardware makers promptly announced their intention to offer handheld computers based on the new operating system. Unlike the PalmPilot’s operating system, Microsoft’s offering would be capable of running at least slimmed-down versions of many popular Windows programs, permitting the power user to really go mobile. Windows CE machines were soon offered by Casio (the “Casiopeia”), Hewlett Packard (the “Jornada”) and Vadem (the “Clio”), among numerous others. More recently Microsoft decided to abandon the “Windows CE” name, and began to market the next generation of handheld software as PocketPC. In classic Redmond style, the PocketPC software will have the effect of making previous instruments obsolete, and will require more computing power rather than less. Jerry Brown’s “less is more” mantra does not play well north of his home state.

Meanwhile PalmPilots also began to change. After renaming the units Palm (dropping the …Pilot), 3Com spun the division off into its own company. In rapid succession it released a series of units distinguished by size, sturdiness, available memory, connectivity and/or color screens. Last year, the original Palm developers set up their own company and began offering a Palm-compatible competitor, the Visor Handspring.

What does this mean for the hapless lawyer, trying to figure out which technical marvel he or she needs? It means that the marketplace is simultaneously robust and confusing. It also means that it will take a little digging to determine the feature set and choice of operating system.

First Things First

Before dispensing advice about the choice of units, however, we must first convince you that you need to consider the palmtop computing genre at all. What can these little computers do that can’t be done with old-fashioned notepads and spiral-bound pocket calendars?

Not much, as it turns out. Except that the computers can do it effortlessly, efficiently and without permitting mistakes. Scraps of paper, scribbled appointments or hearings found only on the portable calendar (and unknown to the office staff) and pockets filled with business cards from strangers can all be electronically banished.

This sounds simple, and disturbingly nerdy, but the effect is astonishing. At the court’s status and scheduling conference, you will be the only lawyer absolutely sure whether you are available for trial on a given day.
four months from now. After a public presentation on estate planning, you will be able to make an appointment with an interested attendee on the spot—and you will even be able to enter the new client’s name and address to send a confirming letter when you return to the office. At an ACTEC committee meeting you will be able to make a note to yourself about a new strategy and know that it will appear on your calendar to remind you when you return to work.

That is all positive, and if that is all the handheld computer could accomplish it would be wonderful. That, however, is not all. If your office uses a case management program (Outlook, TimeMatters, Amicus Attorney or Abacus, for example) the data in that program will seamlessly transfer to at least some of the handheld devices, and data entered directly on the device will move effortlessly to the office database. In other words, your pocket-sized computer can have all your clients, appointments, to-do items and email messages available interactively, and changes you make on that device will update your office computer information, without forcing you to use an inferior information management program. You can have full functionality and portability together.

A word about email on the Palm. When the instrument is placed in its “cradle” and the synchronization process completed, it will (if set to do so) transfer email from most popular email programs, including Outlook, Outlook Express and Eudora. You can read email messages away from your desk, and even respond. You cannot, however (or at least not with any but the Palm VII), immediately send your email wirelessly, or check for updated messages while away from your desk. If mobile email access is important you will need to look into yet another genre of devices, typified by the Blackberry “wireless email solution.” Check it out at www.blackberry.com.

**Palm vs. PocketPC**

The first choice is, for most users, between the two powerhouses in the PDA world. Palm units account for the vast majority of current sales, with Microsoft’s PocketPC representing a fraction of the market. For most lawyers, though, the decision will be easy: if you already use a case management program other than Outlook or a homemade database based on Microsoft Access, you will probably not be a candidate for a PocketPC-based machine.

If you are using Outlook or Access, or if you do not now have a case management program and would like to choose your handheld computer first, you might consider one of the PocketPC. They are somewhat more powerful, since they permit the handheld unit to load at least a version of Excel, Word and other Microsoft programs. They also tend to have more powerful processors and options, including color units (though Palm has recently released a color device as well). For most users, however, it is the Palm’s very simplicity that is appealing—it is designed to do (and does) only a handful of things, but it does them extremely well. The Palm does not attempt to be a replacement for even a low-end desktop machine.

Assuming that you opt for the Palm-based line (and we will make that assumption for the rest of this material, even though the PocketPC option is viable and reasonable), you still have several options. Although there are only two manufacturers (Palm and Handspring), they produce a variety of units, ranging from the basic Handspring Visor at $149 to the Palm IIIc (in color) or Palm VII (internet ready) (each typically about $450). Consider what type of machine you are looking for:

- Do you want to check out the options, and maybe trade up later (giving your first unit to a junior associate)? Try the Handspring Visor Deluxe—it has more memory than the basic Visor, and it comes in cool colors like “ice”, green, blue and orange in addition to staid black (“graphite”). The Visor series also features improved expandability, using its own proprietary expansion slot. Buy it at www.handspring.com. Or, if you want to start with the basic Palm unit, look for a Palm IIIc (with 8 megabytes of storage space, which you will be glad to have). It recently sold for $245 at Harmony Computers (www.shopharmony.com), though it was on a one-week backorder.
- Do you want to stay connected to the internet at all times, including the ability to surf the web wirelessly? Then look into the Palm VII, available recently for $399.99 at TriState Computers (www.tristate-computer.com). Remember that you must separately pay for your internet access.
- Do you think you need color? At least in the Palm world, color is somewhat elusive. While the introductory screen is in color, and there is some color in some of the individual component programs, the implementation of color is not yet very effective. Still, the screens are noticeably more legible, and the battery life doesn’t seem to have been hurt much. If you need/want color, try the Palm IIIc, which you could buy recently for $379 at www.Shop4Digital.com.
- Are you looking for efficiency, ruggedness and (not incidentally) sleek good looks? Check out the Palm Vx (don’t bother with the plain-vanilla Palm V—you will eventually wish you had gotten the extra memory, and it cannot be upgraded). Buy it at TriState Computers (see URL above) for $393.99, or at any of a dozen online stores for $399 (including www.Egghead.com, www.Computers4Sure.com, or www.CDW.com).
How Do These Things Work?

Here’s the easy part. After you have chosen your Palm device, plug the cradle in to the serial slot in the back of your computer (don’t worry—it’s the only one the plug will fit into). If you have bought a Palm V series or a Palm IIIc, it will also have an electrical plug to hook up. Then run the software supplied by Palm with the new unit. Follow the instructions (they are not even complicated). If you are using TimeMatters, Amicus Attorney or Abacus (or, for that matter, another case management program—or PIM—that is Palm-aware), follow the instructions for that program to enable the Palm link. In TimeMatters, for example, go to File, Synchronize, Palm Organizer and follow the prompts (when in doubt accept the default choices). Then push the little button on the front of the Palm cradle and go get a cup of coffee. When you return, you will have become at least a nerd, and perhaps a geek.1

Now What?

For the novice or devoted Palm user, there are a host of shareware, freeware and commercial offerings to make the Palm even more useful. A few of our favorites include:

• STRIP. This handy utility (the acronym stands for Secure Tool for Remembering Important Passwords, so settle down) keeps track of all your passwords, including the logon to your office machine, your ACTEC Web site password and even your ATM card’s PIN. The utility is itself password-protected (of course). It can also generate passwords for you, so that you don’t have to use your mother’s maiden name, or your alma mater (either of which can be figured out by enterprising hackers). It is free (at least in the low-impact version), and can be downloaded from http://www.zetetic.net/download.html. (Note: The instructions are a little confusing, so just know you need to download the file named Strip05d_bin.zip and unzip it to a folder on your hard drive)

• TimeReporter for Timeslips. If you are a Timeslips user, this nifty program will pay for itself in about one day. It allows you to actually post time to Timeslips from your Palm organizer; the first evening at home when you remember something which didn’t get billed you will probably pay for the modest ($119.95) cost. Buy it from Iambic software at www.Iambic.com (note that you are looking for TimeReporter for Timeslips, not the TimeReporter program itself).

• Trip Deluxe. You know how hard it is to keep track of your work-related auto mileage? Wouldn’t it be nice if someone made a simple computer-based utility to keep the records and make the calculations? It would be even nicer if the whole thing could be exported on demand to an Excel spreadsheet. And just imagine if the computer could keep track of your clients’ names, so that you could bill for mileage where appropriate. Check it out: it is available, it is designed for the highly portable Palm and it costs just $29.95 at www.handshigh.com.

• Silver Screen. This one is mostly for fun. It permits you to select from a large (and growing) number of themes for your Palm icons, and it does manage to keep better track of things like battery status for you. It also includes a cool method for launching your favorite Palm programs easily, though that is not usually a very important feature (since the Palm is so easy to operate without its assistance). It costs just $12.95 and you can read about it at www.PocketSensei.com.

• Documents To Go. For just $39.95, you can install a program which permits you to send Word, Excel and other files to your Palm. Copy recent cases, or the tax code, or your state probate statutes, or all of the above, to your Palm for later review, reading, searching or whatever. This one can eat up your Palm’s memory, since the range and size of documents can be so large. Download it from www.dataviz.com.

Most of the programs described here, and thousands of others, can be downloaded (and paid for, where necessary) at either of the two main sources for Palm software. Visit www.handango.com and www.palmgear.com for much more information on software, reviews of popular programs, updates of existing programs and much more. There are at least two excellent web sites dealing specifically with the use of Palm devices by lawyers. One is operated by Los Angeles lawyer Joseph Kornowski and can be found at www.palmlaw.com. The other, hosted by NetTech, Inc., and prepared by St. Louis lawyer (and well-published technology guru) Dennis M. Kennedy, is at www.nettechinc.com/palm.htm.

1 Although there might be some who would argue that a geek is less nerdy than a nerd.
# The 2000 Annual

Joseph Trachtman Memorial Lecture

**ACTEC and the Practice at 2000: Where Have We Been and Where Are We Going?**

*by Rodney N. Houghton*

*Newark, New Jersey*

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*The 2000 Joseph Trachtman Memorial Lecture was presented at the 2000 ACTEC Annual Meeting in Scottsdale, Arizona, on March 5, 2000. Copyright 2000. Rodney N. Houghton. All rights reserved.*
1. INTRODUCTION
The Trachtman Lecture was first given a quarter of a century ago at the 1974 Annual Meeting in Hawaii. It was known then as the “Learned Lecture.” My fellow New Jerseyan, Harrison Durand, was president of the College, then called the American College of Probate Counsel. Another distinguished New Jerseyan, Judge Alfred C. Clapp, delivered the first lecture, entitled “Postmortem Planning.”

Joseph Trachtman was a native of Philadelphia who practiced in New York City. He was, by all accounts, a superb trust and estate lawyer who became president of the College in 1966 and served on its Board of Regents until 1970. He developed a national reputation as an outstanding lecturer in the field of probate, estate and trust law.

Joe Trachtman died in 1975. In recognition of his many contributions to the College and to our field of practice, the Board of Regents that same year renamed this lecture “The Joseph Trachtman Memorial Lecture.”

The invitation to give this lecture was quite a challenge. I agreed to give it because the topic President Hanson Reynolds suggested interested me, and also because of something that the late J. Pennington (“Joe”) Straus wrote in the College history. Joe said, “Many spouses attend the lecture, and consequently the lectures that have the broadest appeal are those that are directed less to the technicalities of the law than to the broad aspects of its social, cultural, economic and political consequences in our systems of transferring property at death.”

Heeding Joe’s observation, I will be concerned less with the technicalities of the law and primarily with the broad social, political and economic aspects of our practice, and with the past and future direction of our College.

I will start by reviewing ACTEC’s first 50 years and the recommendations of estate planning brainstorming sessions held in 1974 in Kansas City and in 1987 in Houston. I will then discuss practice trends and where I see our field of practice going in the years ahead. Finally, to get a glimpse of where ACTEC itself may be headed, I will briefly review the preliminary conclusions of the College’s Task Force 2000, chaired by Martin Heckscher, which has studied this subject extensively over the last two years.

2. WHERE HAVE WE BEEN?
A. ACTEC’S First 50 Years
ACTEC was founded in 1949 in Los Angeles. As president in 1992, and in anticipation of its 50th anniversary last year, I appointed a commission to write a history of the College’s first 50 years. The ACTEC Historical Commission, as it was called, was chaired by Joe Straus until his death in 1996. It consisted of Bjarne Johnson, Stan Mullin, Ed Winn and Joe Foster, Jr. What I have to say here is largely gleaned from the work of the commission, published last year as The History of the American College of Trust and Estate Counsel 1949-1999.

(i) The Early Days—1900-1950
In the first half of the century, lawyers were mostly single practitioners. They were generalists, not specialists. In 1947, Gail B. McKay organized a group of lawyers handling probate matters. This was essentially a law list for the interchange of business. It consisted of lawyers and trust officers.

In 1949, the Probate Attorneys Association was incorporated in California as a non-profit corporation by Henry Mabry, who became the first president of the association, although he has never been recognized as such in any list of past presidents.

In 1951, the Articles of Incorporation and Bylaws were amended to delete trust officers as a category of membership and to delete as a corporate purpose the...
words for “the interchange of law business.”  

Mr. Mabry disappeared from the organization in 1950, just one year after its founding, but Gail McKay held the position of paid (when finances permitted) executive secretary for 25 years, until shortly before his death in 1974.  

1950s

The 1950s saw the gradual maturing and growing respectability of the association. Perhaps the 3 leading figures during this period were three presidents: John G. Clock of Long Beach, California, Joe B. Houston of Tulsa, Oklahoma and Leon Schaefer of New York City.  

Leon Schaefer was responsible for several significant developments in the life of the young association. He broadened the geographical scope of the association by bringing in many Easterners as members. He instituted the ACTEC Studies, correlating the probate law of the various states. He also instituted the Newsletter, subsequently renamed Probate Notes, then later ACTEC Notes.  

Leon Schaefer is also credited with being responsible for the change of name of the association to “The American College of Probate Counsel.”  

This name continued in use until March 1990, when the Board of Regents approved changing it to the present “American College of Trust and Estate Counsel.”  

1960s

ACPC, as it was then called, truly came of age in the 1960s with the infusion of talented lawyers from the ABA’s Section of Real Property Probate and Trust Law, many of whom became presidents. Many of them were recruited by Joe Trachtman. 

Joe Trachtman became president of the College in 1966 and greatly enhanced its reputation. As previously noted, this lecture was named in his honor.  

During this time, the College devoted increasing attention to the taxation of estates and trusts. The emphasis of our practice had shifted from the probate of estates and the administration of trusts to tax-oriented estate planning.  

1970s

The 1970s saw an increase in membership, a great increase in the quality of members, and improved governance. By the time Joe Trachtman died in 1975, the College had completed its first quarter of a century and had become a strong, mature organization with an ever increasing reputation. 

The College’s reputation continued to increase during the remainder of the century until it became the leading national organization in its field, with membership restricted only to outstanding trust and estate lawyers with 10 years experience. 

(ii) Membership (Chart I – College Membership)**

In the early years of the College, membership selection was made largely by Gail McKay. He solicited new members, and it is said his compensation took the form of a bounty for each new member.  

In 1970, President Joe Strauss reported the creation of a new category of membership known as Academic Fellows, open to outstanding law school professors specializing in the fields of probate and trust law.  

During the presidency of Ed Winn in 1975, a national Membership Selection Committee was created for the screening of all nominees for membership. Detailed requirements were established for the filing of nominations and for action by each State Membership Committee. 

In 1990, President Waller Horsley emphasized the need to bring more qualified women and law school faculty members into the College. He also expressed concern that the median age of Fellows was approximately 60 years, but he noted that this was dropping.  

Today, the median age of Fellows is still 59. There are 282 female Fellows compared to 112 in 1990. There are now 62 Academic Fellows, compared to 44 then. 

In 1994, President Jack Bruce appointed the Demographics Committee to study matters relating to membership and meetings. A membership survey was conducted, to which 1/3 of the Fellows responded. Eighty-nine percent of the respondents found the present qualifications for membership appropriate. This was certainly a ringing endorsement of the membership selection procedures. 

(iii) Committees

According to the report of the ACTEC Historical Commission, little is known of the early committee structure of the College. Committee statistics are not available before the 1980s.  

What is known is that the early committees were primarily governance and management committees such as the Executive Committee, the Nominating Committee and the Membership Selection Committee. Other management committees, such as Budget and Finance, Bylaws and an Office Management Committee, were created later.  

The year 1973 was a significant one for the College. A new emphasis was placed on substantive law committees. That year the Executive Committee recommended the establishment of “…a committee structure which will extend to the Fellows an opportunity to serve on committees engaged in the study of particular areas of probate law. The Executive Committee hopes that these committees will develop in-depth reports either for publication or for the formulation of policy ** Charts follow endnotes.
positions to be taken by the College.”

In 1976, the Estate and Gift Tax Committee was established. The Board of Regents resolved that, after consultation with this new committee, the Executive Committee would be authorized to take substantive and technical positions with respect to pending federal estate and gift tax legislation, regulations and rulings. However, the College does not engage in lobbying.28

The 1980s and 1990s were truly prolific for the creation of new substantive law and tax oriented committees. The 1980s saw the establishment of such committees as Professional Standards, Income Taxation of Estates and Trusts, Employee Benefits in Estate Planning, Transfer Tax Study, State Laws and others.29

In 1989, a computer task force was disbanded and in its place a Committee was established, renamed in 1992 as the Technology in the Practice Committee. This was to mark the advent of the College’s increasing interest in and promotion of technology to improve the efficiency and proficiency of its Fellows. Also in 1989, the Expanded Practice and Personal Counseling Committee, subsequently renamed the Practice Committee, was formed. In 1991, the Fiduciary Litigation Committee, now the College’s largest, and the Elder law, Guardianship and Health Care Law Committee were established. In 1994, the Business Planning Committee was created. The Charitable Planning and Exempt Organizations Committee was created in 1995 and the International Estate Planning Committee in 1997.30 (Chart 2- Substantive Law Committees)

With all of this committee activity, the number of committee members has increased significantly. In 1989, there were 241 Fellows serving on Committees. By 1999, that number had increased to 500.31 This year, there are 521 Fellows serving on committees. (Chart 3 – Total Number of Committee Members)

Even more remarkably, approximately 65% of committee members regularly attend national committee meetings. At the Annual Meeting in Scottsdale, Arizona, there were 369 committee members in attendance, which was 71% of all committee members.32

Both the increased activity and the broadened scope of the College’s committees are crucial to our future in our chosen field of practice.

(iv) Tax Legislation and Law Reform

Not until 1976 did the College become seriously involved with the tax writing activities of Congress. We realized that the great changes in the transfer tax system contained in the 1976 Tax Act had occurred without our effective involvement. It was also apparent that the cumbersome bureaucracy of the American Bar Association made it difficult for the Real Property, Probate and Trust Law Section to address these issues in a timely manner, if at all.33

Around this time, the Estate and Gift Tax Committee was formed to develop positions for the College and actively to participate in the federal tax legislative process.34 Thereafter, College representatives testified regularly before Congressional Committees. They became very effective. The College successfully led the fight against carryover basis, resulting in its repeal in 1980. The College also contributed to development of the generation-skipping tax regulations under the 1976 Tax Reform Act.35

According to Tom Eubank’s recollection in the ACTEC History, the College proposed almost every change made in the Economic Recovery Tax Act of 1981, including the unlimited marital deduction, the increase in the unified credit and the QTIP trust (strongly advocated by Fellow Frank Berall). Since then, the Estate and Gift Tax Committee has been continuously engaged in monitoring and speaking on transfer tax issues.36

Tax legislation is not the only legislative area in which the College has been involved. The College has also contributed importantly to substantive law reform and improvement. The most notable example has been the College’s collaboration with the National Conference of Commissioners on Uniform State Laws for the promulgation of the Uniform Probate Code through the Joint Editorial Board. This effort started in 1970 and still continues.37 The State Laws Committee was formed by Past President George Nofer, who asked me to be the committee’s first chair. It has been active in substantive law reform with such projects as the National Fiduciary Accounting Standards, among others.38

(v) Publications

In past surveys, the Fellows have repeatedly said that the College’s publications were the most important benefit of membership. As mentioned, the Studies were started in the 1950s by Fellow Leon Schaeffler of New York. They have been published and improved ever since. There are now 26 state by state studies of various aspects of trust and estate law, updated periodically.39

In 1984, the Pocket Tax Tables were first produced at the suggestion of Milt Greenfield, under the guidance of Fred Keydel.40 The College’s seminar materials are available to all Fellows, as is the work product of some of its committees.41 The Joseph Trachtman Lecture was published annually as the Probate Lawyer.42 All of this activity is overseen by the Editorial Board.

In recent years, the College has established its own Web site, which will undoubtedly grow in importance.43

(vi) The ACTEC Foundation
The idea of a College Foundation was advanced most vigorously by Harold Fallon of Ohio. The Foundation was incorporated in California in 1982, and attained an exempt status ruling from the IRS. Over the years, the Foundation has received contributions from Fellows and from fundraisers such as the Tucson bike ride, conceived and organized by Oklahoman Tom Coffman.44

The Foundation has used its funds in a variety of ways. It has made grants to committees for special projects, such as to the Accessions Tax Committee for the production of a brochure on organ and tissue study, and to law school professors for the study of particular subjects of interest to our field of practice.45

In 1987, the Foundation organized and funded a think tank session attended by 33 leaders of the trust and estates bar entitled “A Colloquy on Estate Planning, Financial Planning, and Beyond: The Next Progression; the Role for Lawyers; the Role for Law Schools.” The colloquy held in Houston, Texas, was the brainchild of President Thomas Eubank. It provided in depth discussion of the future of the trust and estates bar. I will return to this subject a little later.46

In the early 1990s, the College financed a series of modules prepared by law school professors on subjects related to our area of practice, such as Modern Financial Theory and A Guide to Understanding Family Businesses.47

One of the most significant projects of the Foundation has been the financing and publishing of the Commentaries on the Model Rules of Professional Conduct, developed by the Professional Standards Committee and reported by Professor John Price and Fellow Bruce Ross. These Commentaries are now in their third edition and are being widely cited in courts across the country.48

To encourage the teaching of trust and estates law and related fields in law schools, the Foundation has funded a project at the Temple University Law School. It has also financed a project for the preparation of a manual to be used by adjunct professors teaching federal and state gift tax courses at law schools. The Foundation has also financed a project to develop a multimedia set of teaching materials to be used in trust and estate and related law school courses.49

One of the most recent grants made by the Foundation has been to support a public television program called “Death and Taxes,” a one-hour segment for PBS’s Inside the Law series. A program on estate planning has been produced.50

(vii) Meetings and Conventions

In the early years we held a mid-winter meeting and a summer meeting, but no fall meeting.51 These meetings took place during the ABA mid-winter and summer meetings. Not until 1973 did our first meeting take place separate from the ABA. That meeting was the 1973 Hawaii mid-winter meeting. Its format was expanded to 6 days, primarily because air fares were cheaper over that length of time. The format of that first expanded meeting formed the basis for all annual meetings thereafter.52 Although the format may have been born of necessity, because of something as inconsequential as air fares, it has nonetheless served the College well. In 1981, there was a change of the annual meeting dates from the summer to the mid-winter meeting, where it is today. That same year, we added a fall meeting to the College’s schedule. Until that time, the College’s meetings had been organized by a small convention committee. In 1982, Convention Coordinators, Inc. was formed as a wholly owned subsidiary of the College. This enabled CCI to negotiate on behalf of the College and to obtain commissions, which in turn have helped reduce the cost of meetings.53

The first fall meeting separate from the ABA took place at Sea Island, Georgia, in 1987.54 The first summer meeting separate from the ABA took place in Minneapolis in 1994.55

The first educational program at a College meeting was at the mid-winter meeting held in 1967 in Houston.56 The first educational program at a fall meeting was in 1988 in Kansas City.57 The first educational program at a summer meeting was in 1997 in Chicago.58

(Charts 4-6—Meeting Attendance)

The charts of the annual, summer and fall meetings of the past 11 years show that annual meeting attendance has held fairly steady. On the other hand, the attendance at the summer and fall meetings has grown dramatically, especially since the addition of educational programs at these meetings. One interesting observation is that while the attendance of Fellows at national meetings has steadily climbed, the attendance of spouses has held steady or declined. On a relative basis, the attendance of spouses has declined significantly. At the 1982 annual meeting in Coronado, California, 88% of spouses attended that meeting. Today, that attendance is down to 50% or 60%. This can probably be attributed in large measure to the number of spouses with careers of their own.59

In 1995, the Demographics Committee conducted a survey of Fellows to determine whether the College’s meetings were filling members’ needs and also to plan the future of the College for the 21st century. It showed that the Fellows overwhelmingly approve the current format of the national meetings and strongly favor holding the three national meetings separate from the American Bar Association. The Fellows strongly favor the location and structure of the meet-
ings. The Fellows also believe that state and regional meetings should be encouraged to provide increased participation by Fellows. That certainly has been happening.  

B. Past Prognostications: Kansas City and The Houston Colloquy

In the past 25 years, much thought and attention has been given to our area of practice and its future. Perhaps the most thoughtful author on this subject has been Past President Tom Eubank. At a seminar on “Future Planning for Estate Lawyers 1975-2000” sponsored by the American Bar Association, Section of Real Property, Probate and Trust Law in Kansas City, Missouri, on November 8, 1974, Tom delivered a paper entitled “The Future for Estate Lawyers.”  As President, Tom wrote extensively on this subject in his President’s Message in the summer of 1984 issue of Probate Notes and he delivered a paper entitled “A.D. 2001: Estate Planning in the Future” at the 1987 Heckerling Estate Planning Institute in Miami. In December 1987, Tom presided over a conference in Houston, Texas, to which 33 leading trust and estate lawyers and law school professors were invited to discuss this same subject. The conference became known as the Houston Colloquy and was funded by the ACTEC Foundation. Others have picked up the same theme. President Bill Cantwell wrote an article entitled “The Probate and Trust Lawyer in 2000 A.D.,” which appeared in the Real Property, Probate and Trust Law Journal in 1975. John Wallace, Waller Horsley and Jerry Horn have all written thoughtfully on this subject in their Presidents’ Messages in ACTEC Notes.

Now that we stand at the threshold of a new century, we have the opportunity of taking stock and seeing whether the changes foreseen by these prophets have come about. I think they have partly, but not entirely.

Tom Eubank described the evolution of our field of practice from generalists who handled probate, real estate and other family matters prior to the second World War. With the increasing importance of federal estate and gift taxation, these lawyers brought in specialists who were referred to as tax lawyers. Over time, probate lawyers and tax lawyers began to merge into what became known as estate planning lawyers. As Tom pointed out, lawyers became increasingly more immersed in the complexities of transfer taxation, and they often became tax technicians.

By 1975, Tom foresaw that another major change was underway. In part, this was the result of changes in the federal estate tax through the increase in the unified credit to $600,000, thus sharply reducing the number of estates for which federal estate tax returns had to be filed. It was also because of the simplification and avoidance of probate through simplified administration and the proliferation of living trusts and other non-probate assets. The effect of these two developments was a decreased need for sophisticated tax planning for all but the wealthy and a reduction in the amount of probate administration work. Tom also foresaw increased competition from non-lawyers for work that had traditionally had been done by us.

In the introduction to his 1974 paper, Tom wrote “the assessment in this paper is that the future for estate lawyers is uncertain and perhaps bleak, unless the practice of estate law is changed significantly.” Tom’s prescription for change was that lawyers should significantly expand the services they offer to their clients to meet their needs in a world growing ever more complicated. This theme was picked up by Tom in his President’s Message in the summer of 1984 and was the central theme of the Houston Colloquy.

Essentially, the prescription for declining probate administration work and tax services was to offer legal and counseling services to families and family business owners in areas where we had not traditionally offered advice before. A full range of these services would require expertise in corporate and partnership law, real property law, income taxation, tax litigation, business advice and litigation, employment law, divorce law, will contests, other probate and trust litigation, elder law, health law and the law of charitable giving and foundations, among others. In addition, it was suggested that in broadening the scope of our practice, we might offer services usually performed by non-lawyers, such as fiduciary administration services (citing the Boston example), financial counseling and a full range of services related to wealth accumulation and transmission during life and at death. While clearly not all trust and estate lawyers would be qualified to offer all of these services, nonetheless, a strong move in this direction was seen as essential to the future viability of our practice. We have moved a long way in this direction in the past 25 years. One proposal, which Tom advanced in 1974, which has not been realized, is that we should fund a national research and development corporation to address practice expansion possibilities.

(i) The Kansas City Seminar

At the ABA Kansas City seminar in 1974, those in attendance divided into working sessions which made the following recommendations and predictions:

1. Fees. As estate lawyers, we should move from fee schedules to fees based upon the amount of work performed in settling the estate, the responsibilities assumed, the novelty and difficulty of the questions, the skill requisite to perform the services
promptly and the sufficiency of assets to pay for the services. Certainly, in most parts of the country this has in fact become the way in which most estate lawyers are compensated.  

2. Probate Reform. It was suggested that Congress develop a national probate code. This proposal obviously has not come about.  

3. Small Estates. It was suggested that for the handling of small estates, a public trustee’s office should be created, to be funded by public money. This has occurred only to a limited extent.  

4. Specialization Accreditation. On the subject of specialization accreditation, the participants believed that this would likely occur. Although there has been some movement in this direction, it has not gone very far.  

5. Prepaid Legal Services. The participants felt that estate planning services and the administration of estates should be included in prepaid legal plans. The availability of prepaid legal plans has increased, but it is certainly not a significant factor in our current practices.  

6. Interstate Practice of Law. Here the participants were of the view that regional or national law practice was not particularly responsive to any problems that clients or law firms were facing. While at the local level this may still be true, there certainly has been significant movement towards interstate practice as people have moved around more and own property in more than one state. The emergence of regional and national law firms has also spurred some movement in this area.  

7. Estate and Gift Tax Reform. Numerous recommendations were made with respect to this subject. The first suggestion was that a unified transfer tax should replace the dual estate and gift tax structure. This has happened. Another suggestion was that the exemption equivalent amount be raised to $100,000. As we know, it has gone first to $600,000 and is now on its way to $1 million. Changes were also suggested in the marital deduction. One suggestion was that the marital deduction be increased to 100% and that the requirement for a general power of appointment in the spouse be eliminated. Both of these changes have come to pass. It was also suggested that a generation-skipping tax was equitable and should be enacted, but without any tax on direct skips. We have a generation-skipping tax, but it includes a tax on direct skip gifts. The suggestion was made that a step up in basis was unfair. As we all know, an attempt to tax capital gains at death was ultimately defeated, primarily through the efforts of the College.  

8. Competition from Non-Lawyers. The participants recognized that competition from banks, financial service companies, national accounting firms, life insurance companies and financial planners was likely to increase. This has certainly proved to be true. The participants recommended that a national cooperative probate support organization be considered to provide lawyers with the expertise needed for total financial planning, as strongly recommended by Bill Cantwell and Tom Eubank. This was an imaginative idea, but there has been no progress in that direction of which I am aware.  

9. Paralegals. The group recognized that paralegals would be an increasing factor in the development of our practices. That has most certainly come true.  

10. Standards of Competence. It was recommended that a statement of principles be developed that would clearly define the duties of lawyers undertaking estate planning or estate administration work. This has not come about, although an effort was made in this direction by the Professional Standards Committee.  

11. Fiduciary Accounting. It was suggested that a national standardization of the form of accountings be developed. This has happened to some extent with the development of the national fiduciary accounting standard formats which the College helped to develop.  

12. The Lawyer as Fiduciary. The suggestion was made that lawyers should avoid serving as fiduciaries except in unusual situations, such as family and small estates. This continues to be the view in some parts of the country, but as lawyers are expanding their practices, I have the sense that they are increasingly willing to serve as fiduciaries. However, an influence in the other direction is the increased malpractice risk.  

(ii) The Houston Colloquy  
Let’s now look at the work of the Houston Colloquy. The colloquy took place over the weekend of December 5, 1987. The principal conclusions and recommendations were reported by Professor Jeffrey Pennell in the Summer 1988 issue of Probate Notes. His report was titled “Report of the ACPG Colloquy on Estate Planning, Financial Planning and Beyond: The Next Progression; the Role for Lawyers and Law Schools.” Professor Pennell used the term “personal counseling” to describe the expanded scope of our practice. He said “it is this next transition into personal counseling, that was the focus of the colloquy because it represents a challenge and an opportunity of unprecedented proportions to the public and the practicing bar.” The term “personal counseling” has not taken hold, but other terms such as personal law and private clients practice are now being used in law.
firms. Whatever term is used, we are talking about expanded practice.

Professor Pennell divided his report into two parts. The first dealt with our profession, and the second with legal education. Prior to the Houston Colloquy, considerable thought had been given to the problems of our profession, but not a great deal to the subject of legal education in our field of practice. At the Houston Colloquy, to which law professors were invited, considerable attention was given to this subject. It was perceived that a waning importance of trust and estate practice in law firms was being felt in law schools. Fewer courses were being offered. Trust and estate professors were not being replaced, and the brightest students were not signing up for trust and estate courses.88

The Houston Colloquy made recommendations to address these problems. In the order in which they were presented in Professor Pennell’s report, these recommendations were as follows:

1. That an effort be undertaken to emphasize to students and new attorneys the tangible and psychic benefits of a personal counseling practice, so that students and new attorneys might make a better decision about their future career paths.89 I do not think we have made much progress on this recommendation.

2. The Colloquy correctly foresaw the change in demographics. Professor Pennell’s report pointed out that post war baby boomers were by the late 1980’s becoming financially established and in need of quality professional services. The Colloquy also correctly saw the increasing needs of an aging population for services with respect to planning for retirement, the possibility of incompetence, planning for health care or the termination of life support systems and for government benefits.90 Certainly, we have seen all this come about. The formation of the Elder Law, Guardianship and Health Law Committee was a direct response to this client need.

3. The Colloquy correctly foresaw the substantial increase in litigation involving will contests, fiduciary administration, tax litigation and malpractice litigation in the trust and estate area.91 The Fiduciary Litigation Committee was created to address these issues and is now the largest committee in the College.

4. Recognizing that most lawyers could probably not achieve competence in all areas of an expanded practice, the Colloquy recommended that ACTEC develop guidelines to assist lawyers in making referrals in areas where they were not qualified. The Colloquy suggested that a lawyer’s cooperative might be developed to provide various non-legal services such as accounting, investment advice, safekeeping and insurance coverage.92 This has not happened and perhaps was not such a sound idea in the first place.

5. The Colloquy recommended that the College consider designing continuing legal education programs and seminars to teach personal counselors how to recognize issues with respect to such matters as insurance, investments, property management and appraisals and to distinguish among various products or services so as to be able to identify and advise clients in need of these services. It was suggested that training modules be developed for lawyers to use at their own convenience. Specifically, the Colloquy recommended that the College consider hiring professional educators to design and produce such modules to help move lawyers along the learning curve.93 While the Foundation has produced several such modules, I cannot say that I really think we have developed the kind of training modules that were envisioned to help lawyers achieve proficiency in the expanded areas of practice.

6. The Colloquy next recommended that personal counselors learn how to provide all of the services needed by a client either directly or through referrals. Reference was made to the role of financial planners. Clients want advice on all of their problems and estate planning lawyers were ideally suited to this role. The Colloquy participants recommended that helping to develop a method of practice where the lawyer would be in control of the entire personal counseling engagement either through his own services or through referrals should be among the highest priorities of the College.94 I think we have made some progress in this area, but there is still far to go.

7. The Colloquy recognized that the traditional estate planner or personal counselor was ideally suited to serve as a fiduciary, providing services to clients and their families and other beneficiaries. However, concerns were raised with respect to the potential for malpractice liability and the adequacy of insurance coverage to protect against it. The Colloquy also pointed out the importance of avoiding even the appearance of impropriety in the form of conflicts of interest, over-reaching or self-dealing. The Colloquy participants recommended that the College undertake a study of questions of state law relating to these activities, the availability of malpractice insurance, what kinds of special agreements should be drafted and how such a practice should be structured.95 I am not aware of such a study having been undertaken.

8. The Colloquy participants strongly recommended that the College or the Foundation arrange for the production of a videotape for distribution to law schools explaining personal counseling as a career choice including the human as well as intellec-
tual issues involved. Such a videotape would point out that our clients need our services, which reach deeply into the personal lives of our clients. This practice is challenging, gratifying and remunerative. It was suggested that such a videotape or other product be made available early in the law student’s career so that they could make appropriate course selections. While some attempt was made to fulfill this recommendation, it cannot be said that it was a success. The Colloquy recommended that the College should encourage law schools to offer interdisciplinary courses in the expanded practice areas and to fund an effort to produce course materials. To my knowledge, not much progress has been made on this recommendation.

9. Finally, the Colloquy recommended that the College make efforts to support academics in our expanded area of practice by supporting them at their law schools, through our alumni associations, and by providing reduced fees for participation in the activities of the College. The Colloquy discussed providing direct financial support to law schools by creating endowed professorships for the teaching of the expanded practice. The only instance in which this has occurred, to my knowledge, is the Foundation’s contribution to the funding of the Edward C. Halbach Chair at the University of California. The newly created Legal Education Committee may be helpful in addressing these recommendations.

All in all, I believe that we have come a long way in the last 25 years, but that we have a lot farther to go. I believe a high priority for future leaders of the College should be to encourage the development of our role as counselors to families and the owners of family businesses in the areas of expanded practice through increasing this emphasis in our committees, our educational programs and our publications. In addition, I would urge the ACTEC Foundation to focus its funding in support of these objectives.

I now turn to our future both as practitioners and as a College. First, let’s look at practice trends and then where we may be headed as a College as I see it and as viewed by Task Force 2000.

3. WHERE ARE WE GOING?

A. Practice Trends

(i) Overview

My general thesis, about which I feel strongly, is that the future for trust and estate lawyers is bright. Fellows responding to the survey conducted by Task Force 2000 (about which more later) apparently share this view. The reasons for my optimism are the dramatic aging of the population, the massive accumulation of wealth which is taking place in this country, the explosion in fiduciary litigation, and the opportunities presented by the expansion of our practices into new areas beyond the traditional ones of estate planning, probate and administration.

(ii) Increasing Life Expectancy and the Aging of the Population. (Chart 7 – Life Expectancy at Birth)

Life expectancy has been increasing rapidly in the United States in the last century. In 1900 life expectancy was 46.3 years for men and 48.3 years for women. In 2000 it is 73.0 years for men and 79.7 years for women. This is due to a variety of factors such as improved nutrition, hygiene, water and sewer systems and especially as a result of advances in medical technology. Because of new and improved drugs, diseases such as smallpox, polio, measles and others, have been all but wiped out. An exception is of course AIDS. Most deaths today are the result of heart disease, cancer and accidents. Even here, as a result of open heart surgery and new drugs, the prospects for survival are consistently becoming greater. Organ transplantation and genetics are extending life even further.

The population of the United States in 1900 was 75,995,000. The population in 1999 was 272,330,000, and it is projected to increase to 393,931,000 by the year 2050. Not only is the population increasing, but the population is aging. (Charts 8-13–U.S. Population)

The consequences of the aging of the population is profound for us as practitioners. As can be seen from the charts, a greater and greater percentage of the population will be in their senior years and these additional elder citizens will increasingly need our services as family counselors. Clearly, they will need our services in the area of estate and gift planning and taxation, and in the preparation of their wills and trusts. They are also likely to need our advice with respect to retirement planning, business succession planning, charitable giving, elder law issues, guardianship issues, nursing home law, living wills and right-to-die issues, government entitlements and durable powers of attorney. That lawyers are becoming interested in these subjects is evidenced by three continuing legal education flyers I received in the mail just the other day. One is entitled “Nuts and Bolts of Elder Law – A Basic Introduction to Elder Law, from Wills, Powers of Attorney and Living Trusts, to Tax Considerations, Estate Administration, and Long Term Care Insurance.” Another is entitled “Keeping Your Elderly Clients Out of Nursing Homes, Assisted Living and Home Care in New Jersey – Explore the Options Available to Your Client Who Does Not Want to Enter a Nursing Home,” and the third is “Living Wills: A Matter of Life and Death! – Learn How to Draft Living Wills and Other Health
Care Directives That Will Clearly and Accurately Express and Protect your Client’s Wishes.”

(iii) Wealth Accumulation

Along with an aging population, we are seeing an increasingly wealthy population. Writing recently in the Boston Globe syndicated columnist George Will wrote:104

The resulting wealth creation is radiating large, if unpredictable, consequences. Neal Freeman of the Foundation Management Institute says America is about to experience a stunning intergenerational transfer of wealth; the Reagan entrepreneurs, lots of them, are about to leave large estates, lots of them to their baby boomer children. Between now and 2020, Americans between ages 35 and 53 will inherit $12 trillion. Nothing of this financial magnitude has ever happened in this economy or any other and its effects in our society will be transformational.

A recent Boston College Study estimated that wealth transfers in the U.S. in the next 55 years will be between $40 trillion and $136 trillion depending on assumptions about inflation.105

The number of millionaires increased from 3,000 in 1900 to 3.5 million in 2000. According to Forbes Magazine, the number of billionaires in the U.S. increased to 268 in 1999, from 79 in 1998. The minimum required to get on the Forbes 400 list in 1999 increased to $625 million from $500 million in 1998.106 Obviously, the nation’s new wealth is increasing at a very rapid rate. (Charts 14-16–Investments)

Law Professor Joel C. Dobris referred to this phenomenon in a recent Law Review article titled “Changes in the Role and the Form of the Trust at the New Millenium, or We Don’t Have to Think of England Anymore.”107 Alluding to Kurt Vonnegut’s “God Bless You, Mr. Rosewater” Professor Dobris said “… everyone wants to slurp at the great river of money that is roaring through our society at the end of the century, as the depression generation starts to pass its money to the baby boomer generation, and as the market soars to new heights.”108

A February 1, 2000, article in Legal Times reported on the effect of new, “dot com” wealth on trust and estate lawyers in northern Virginia. The article reports that trust and estate lawyers there have taken to calling themselves “asset protection” and “wealth transaction management” practitioners, the old term “trusts and estates” lawyers now being considered old school. Business is booming and this new breed of lawyers is in demand to serve the newly wealthy and younger clients awash in new found wealth. Interestingly, the young age of these entrepreneurs has caused a change in emphasis from death oriented planning to lifetime financial planning with a particular emphasis on planning for charitable giving.109 This phenomenon also exists in Boston and Silicon Valley. Similarly, Wall Street and the financial industry have brought unprecedented wealth to young people in the New York area and other financial centers.

We will certainly feel broader consequences from the flow of this great river of money. With or without estate and gift taxes, the need for our services in all other areas of our practice will be immense. Not only will our clients need advice with respect to the transmission of all this wealth, but so will those who receive it. There is probably no better argument for the necessity of our developing skills in the areas of expanded practice than this. Certainly, our clients will need advice and services with respect to their wills and estate plans for the transmission of this wealth, but they and their beneficiaries will also need advice with respect to all aspects of their financial lives. Of course, there will be a huge need for fiduciary and investment services with respect to the transmission and management of all this wealth. It is not unreasonable to think that our clients will turn to us for these services if we are competent to provide them.

The one message I would like to leave from this talk, is that the College should commit itself to providing opportunities for its Fellows to obtain this competence, and to encourage the education and training of young lawyers, to enable them to provide those services which our increasingly wealthy and elderly clients will require. Clearly, the financial services industry and other non-lawyer competitors are gearing up to provide these services. Whether we are able to compete with them successfully will depend as much or more on our own efforts as on theirs.

To digress for a moment, there are some disturbing aspects from all this wealth. Perhaps the most serious is the widening income and wealth disparity between rich and poor. This can be seen in this country and throughout the world.

The Federal Reserve Board reports that the top one percent of U.S. households have net worths over $2.7 million and account for 35.1 percent of the total net worth in the U.S. This is the carriage trade which is our primary target client base. The top 10 percent of U.S. households account for 68 percent of total net worth. By contrast, 64 percent of U.S. households have net worths below $100,000 accounting for just 9.8 percent of the nation’s total net worth.110

In the world, the disparity is dramatic. In a
Newsweek special edition of December 1999, it was reported that the ratio between the richest and poorest countries of the world was about 35 to 1 in 1950 and had risen to approximately 727 to 1 by 1997.111 It was further reported that the assets of the world’s three richest people, of whom the first is Bill Gates, total more than the combined gross national product of 26 of the world’s poorest countries. And finally, that the assets of the world’s 200 richest people are more than the combined income of 41% of the world population.112

Also alarming is that the ratio of working age people under 65 to persons 65 and older is expected to drop from 4.1 to 1 in 1995 to 2.3 to 1 in the year 2030.113 This means that 30 years from now, there will be approximately two workers paying social security taxes to support each retiree. Since we have always acted as counselors and concerned citizens, it is likely that we will find ourselves caught up in the consequences of this looming social crisis.

(iv) Education
In addition to becoming more numerous, older and more affluent, our population is also becoming better educated (Chart 17–Education) and more urban (Chart 18–Urban vs. Rural Population).

It is reasonable to expect that as people become better educated and wealthier, they will also expect more sophisticated legal and financial services. As the population continues to move from rural to urban and suburban areas, it is probable that lawyers will increasingly practice in those same areas. That is, of course, also where the financial services giants and multidisciplinary practices will be.

(v) Fiduciary Litigation
One trend which is firmly established and which I see accelerating in the future is an increase in fiduciary litigation. That this is recognized by our Fellows is evident from the fact that the Fiduciary Litigation Committee which was formed in 1991 is now the largest committee in the College with over 70 members.114 Many more Fellows attend meetings of the committee as spectators. However, I understand that only a small number, about one-fifth, responding to the Task Force 2000 survey said that litigation was more than 10% of their practice. In my view, this will likely increase in the future.

My definition of fiduciary litigation is a broad one. I intend it to cover the whole range of issues faced by our clients concerning estates, wills, trusts, family relationships, family businesses, right to die issues, guardianships, tax disputes, government entitlements, nursing home rights and others. How this litigation is handled varies considerably. In many instances our Fellows take direct responsibility for the litigation and seek the assistance of general litigators only in special circumstances when needed. Other Fellows refer cases to litigators, but retain a consulting role. Still others refer litigation away altogether. Personally, I think our clients are best served when we take primary responsibility for this litigation. The law in our field of practice is complex and we know it best. That is usually a significant advantage in litigation. Granted, not all trust and estates lawyers are suited by temperament to be litigators, nor do they want to be litigators, but at a minimum, they should be familiar with the issues and keep an advisory role for litigation affecting their clients.

It is my belief that fiduciary litigation will not only increase but increase dramatically in the years ahead. Indeed, I believe that this increase in litigation in the aggregate may well offset any loss of work which may come from changes in the tax system or the probate administration process. Furthermore, while we can expect increased competition from non-lawyers, only lawyers can litigate. Why do I think there will be such a great increase in litigation? It is for many of the reasons about which I have already spoken. Let me summarize them here.

The aging of the population will inevitably lead to increasing incapacity later in life. This will mean more will contests. Dementia raises questions of testamentary capacity and also makes for greater vulnerability to undue influence. Such undue influence comes not only from family members, but increasingly from caregivers, be they home care workers or professionals, and in some instances from charities. During life, financial abuse and guardianship issues are increasingly the subject of litigation.

The vastly increasing accumulation of wealth will further increase the likelihood of litigation. The more wealth there is, the more wealth there is to fight over. It is also true that lawyers will not litigate unless there is enough at stake to justify the litigation and to pay the increasingly high counsel fees. Certainly, our clients are not as reluctant to litigate as they used to be. Increasing litigiousness in our society is something of which we are all aware. There will be no shortage of lawyers to handle this litigation. In 1950, when ACTEC was born, there were 200,000 lawyers in the United States. As of 1999, there were just over 1 million and the number is growing.115 Lawyers are multiplying at a much faster rate than the general population, and they will be looking for things to do.

The breakdown of traditional family structure is also likely to cause litigation. With increasing divorce and serial marriages, disputes between blood issue and stepparents are commonplace. Disputes between other members of fractured families are also on the rise. Lit-
igation, resulting from new lifestyles, same sex marriages, adult adoptions and so on is only just beginning, and is likely to burgeon as these new arrangements begin to break down. The modern view that children born out of wedlock have the same rights as any other children will also result in challenges to estate plans.

On the cutting edge of litigation are disputes arising from the new biology. Old notions of parental relationships are changing and the law will have to catch up with them. In part, this will happen through litigation. Right-to-die issues are already the subject of frequent litigation and are likely to become more so as science becomes increasingly able to preserve life both at the very beginning of the life cycle and at the end. Cryogenics may even permit people to suspend their lives for extended periods until a cure is found for the diseases from which they suffer.

The increasing complexity of the law and competition by non-lawyers can be counted on to keep the litigation fires burning. Because of this complexity, we will increasingly be cleaning up the messes caused by less qualified lawyers and by non-lawyers. Consider a sampling of acronyms from our tax laws: UCT, QTIP, QDOT, GRIT, GRAT, CRAT, NIMCRUT, QSST, QPRT and QFOBI to name just a few. Each of these is a minefield for the unwary. Tax litigation to clean up the mess when they are not properly used is on the increase. Misapplication of the tax laws also results in changed dispositive results giving rise to litigation between beneficiaries.

Ever more frequently we are called upon to defend or sue fiduciaries for their failure, or perceived failure, to function the way beneficiaries believe they should in a fast moving world. Frequent changes in the law such as the new Prudent Investor Act and disputes over commissions and fees are increasing.

We see an emerging trend for courts to stretch the law to effectuate the intent of testators and grantors. Perhaps no state has moved further than my own state of New Jersey where our courts will admit extrinsic evidence to show that a testator intended one thing when the words used in his or her will and trust have said something to the contrary. In other countries, and I am thinking in particular of Australia, the traditional formalities of will execution are being relaxed. Challenges to the long established order are fertile breeding grounds for litigation. In addition to relaxing the formalities of will execution, legislatures and courts are beginning to eliminate the distinction between wills, trusts and other testamentary substitutes. The breakdown of these distinctions is frequently accomplished through litigation.

Elective share litigation is increasing because of multiple marriages and the inevitable disputes between blood heirs and successive spouses. It only takes a few minutes to perform a wedding ceremony that results in a third of the estate becoming the property of the new spouse, sometimes of very short duration. Often, the spouse is many years younger than the testator and not infrequently was the decedent’s former nurse, home care worker or other domestic employee. Witness the much publicized Johnson family litigation.

Revised Article II of the Uniform Probate Code with its phased in entitlement to an elective share should be widely adopted to address this problem. Claims to take against the will, while restricted to spouses in the United States, presently extend well beyond spouses in other parts of the world. In England, Canada, Australia and continental Europe, various other persons can claim against the estate. Under civil law in Europe and in Puerto Rico, children have always been entitled to a forced share. In the other jurisdictions mentioned, dependents who are not even blood relatives may have claims against the estate if they can show they were supported by the decedent. Thus, an elderly aunt, an old family retainer and even a mistress can make a claim against the estate. While I’m not aware that this is the law in any state of the United States, I have no doubt that in the future, these concepts will creep into our law and when they do, we can expect litigation to follow. In addition to new claimants, we are also seeing the emergence of new causes of action. The concept of tortious interference with the right to inheritance is a relatively new cause of action and no doubt others will follow.

While malpractice and ethics issues are not exactly the same, it is the rare malpractice case against a trust and estate lawyer in which ethical transgressions are not alleged. Because of our involvement in some of the trends previously discussed, such as testamentary capacity, undue influence claims, complexity of the law, breakdown of traditional family structures, increased litigiousness and heightened ethical concerns, we family lawyers increasingly find ourselves on the receiving end of clients’ and beneficiaries’ disgruntlement. Also on the rise is dissatisfaction with fiduciary performance. If we are fortunate enough not to be the targets of this litigation, we may well be asked to file actions against our clients’ former lawyers, or find ourselves defending them. We are also increasingly being asked to testify as expert witnesses. It is the policy of the College that, because of our expertise we should be willing to serve on either side in such cases. However we become involved, we are essentially in the business of cleaning up messes left by others. This is especially likely to be true of messes left by our non-lawyer competitors. Who among us
has not run into clients who have been the victims of trust mills and who died with incomprehensible documents originally sold to them at an exorbitant price? For all of these reasons, I feel certain that the explosion in litigation is only just beginning.

(vi) Breakdown of Traditional Family Structure

According to author and futurist Gerald Celente, in America today, only about one-half of American children live in traditional two-parent families. In 1900, 0.3% of men and 0.5% of women were divorced. In 2000, 8.2% of men and 10.3% of women are divorced. The divorce rate is about half the marriage rate and multiple marriages are more the rule than the exception. Indeed, the concepts of marriage and family are undergoing new definitions. Same sex marriages are not legal in any state, but domestic partnerships are currently the subject of legislative consideration as an alternative to same sex marriages and have been legalized in Vermont. Adoptions by same sex couples, whether legally married or living together as a family unit, are becoming commonplace. Mothers are choosing to conceive and raise children as single parents. Children are frequently being raised in one-parent households as a result of divorce, or in households with stepparents and not infrequently serial stepparents. The size of the average American household has dropped from 4.76 persons in 1900 to 2.62 persons today. The laws that stand in the way of these changes are constantly under attack and ways around them are sought. An example is adult adoption in the same sex couple situation.

Throw into this mix the geographic mobility of our population. It is said that the average American family moves once every five years. Thanks to a relatively free market economy, whole industries restructure, generating mass migration from one section of the country to another for reasons of job mobility. Witness the move of the textile industry from New England to the south and of refugees from the steel and manufacturing industries in the rust belt of the mid-west to the south and west in pursuit of new job opportunities. What this means for us is that clients, who a century ago were likely to live and die in the same communities, no longer do so. A benefit of membership in the College is the availability of a source of qualified practitioners to whom to refer clients who have moved to other jurisdictions.

Another result of all this mobility has been the proliferation of suburban and out-of-state branch offices in an attempt to hold on to clients. As the population has become more mobile, state lines have become blurred. I would predict that at some time in this new century, American lawyers will be able to practice nationwide with few if any state imposed limitations.

(vii) Changes to the Transfer Tax System

The participants at both the Kansas City seminar in 1974 and the Houston Colloquy in 1987 foresaw that changes in the transfer tax system would reduce tax work for trust and estate lawyers. The charts of federal estate and gift tax returns filed show the drop off in returns filed as a result of increases in the unified credit and other changes brought about by the three major tax reform acts in 1976, 1981 and 1986. (Charts 19-20- Tax Returns)

In the recent presidential primaries Governor George W. Bush campaigned on a promise to repeal the transfer tax system entirely and Senator John McCain has promised that he would exempt from tax all estates under $5 million. There is also a gathering trend among the states to eliminate their separate estate, inheritance and succession tax regimes in favor of a pick up tax, or so-called sponge tax, based on the federal credit for state death taxes. Massachusetts is a recent example. To the extent that this trend continues, there will be a further reduction of tax oriented work at the state level.

These changes would have a significant effect, not only on the number of federal estate tax returns required to be filed, but also on transfer tax planning in general. For those practitioners whose practice is concentrated heavily in sophisticated tax planning, there would likely be a sharp drop off in work. Two thirds of the Fellows responding to the Task Force 2000 survey believed that repeal would have a significant adverse impact on their practice. However, while estate and gift tax planning is an important part of what our Fellows do, it is by no means the only thing we do. There are many trends which are likely to increase the need for our services rather than decrease it, which in my opinion may well offset any reduction.

My guess is that a further rise in the lifetime estate and gift tax exemptions is more likely than outright repeal. I think this because the new governmental budget estimates for estate tax revenue as a percent of total tax revenue is expected to increase from approximately 1% to 6%. If this estimate is reliable, it is likely to attract the attention of our politicians.

(viii) Probate Reform

Another trend which may decrease the need for our services is the move to simplified estate administration or unsupervised estate administration. This trend was recognized by the participants in Kansas City and at the Houston Colloquy and continues to this day, although perhaps at a slower pace than was anticipated. Probate avoidance, as advocated in Norman Dacey’s book How to Avoid Probate, and the increas-
ing volume of assets passing outside of probate have been reactions to the frustration of beneficiaries and lawyers over the time and expense caused by court supervision of the probate process and the administration of estates. Much of this so-called supervision is seen as unnecessary, overly bureaucratic and as a self-serving way of keeping court personnel and probate lawyers busy and enriched.

The Uniform Probate Code’s approach to unsupervised administration is a reform directed to meet this criticism of the probate system. There are those who would argue that court supervision of probate is necessary to protect widows and orphans and other vulnerable beneficiaries. I think the answer is that experience shows otherwise.

In New Jersey, where I have practiced for 36 years, there has been virtually no court supervision of probate during all that time. Our only contact with the probate court is a 15-minute appearance before a probate clerk to offer the will for probate. The total bill for this service is usually under $100. Letters testamentary are usually received from the court within one week, and in the typical estate there is no further contact with the probate court at all. There is no need for filing an inventory nor for an accounting at the end of the estate administration nor for anything else. New Jersey has a self-policing system. The court only becomes involved if a beneficiary is dissatisfied with the performance of the executor or is unable to obtain information from him. In this situation, the disgruntled beneficiary can complain to the court or move to compel the executor to account. The court will require the executor to respond and will be the judge of whether there has been maladministration. In the universe of estates under administration in New Jersey, very few require court intervention. Although I have no empirical evidence that there is any greater maladministration of estates in New Jersey than in states with a court supervised administration, I nonetheless doubt that this is so.

Today, more than 50% of all assets pass outside the probate system. These assets do not go through probate and do not pass through the executor’s hands, but rather go directly to the beneficiary or survivor. These assets take the form of joint assets with right of survivorship, assets held in inter vivos trusts, life insurance, joint property and employee benefit plans among others. In New Jersey, the amount of work and the expense in terms of court costs, executor’s commissions and attorneys’ fees is not appreciably different whether assets pass through the probate process or outside of it. It is undoubtedly higher in states with supervised administration.

(ix) Competition from Non-Lawyers.

The extent to which competition from non-lawyers is cutting into the work of trust and estate lawyers is difficult to measure. However, one thing is certain. There are a great many non-lawyers out there attempting to eat our lunch. This competition comes in many forms. It comes from banks, accounting firms, life insurance companies, brokerage firms, financial services companies and from financial planners. New developments on the scene are the repeal of the Glass-Steagall Act of 1933, the move towards multi disciplinary practices and the establishment of ancillary businesses.

The Glass-Steagall Act, which was repealed last year, had since its enactment in 1933, prevented banks from engaging in non-banking activities and prevented other financial firms such as securities firms and life insurance companies from engaging in banking activities. Now that the walls have come down, it is highly probable that banks and other financial services firms are likely to combine and to target their services at the full range of financial needs, including estate planning, of the high net worth individuals who are our clients. They will offer one-stop shopping and are likely to be formidable competitors. The fact that they are already hiring lawyers to provide some of these services can be of little comfort to us as private practitioners. The announcement in January of the acquisition of United States Trust Company of New York by Charles Schwab and Company is a dramatic example of what we can expect. Who could have envisioned that a mass market discount broker would own the august U.S. Trust Company, which has always held itself out as the number one provider of services to high net worth individuals, the cream of the carriage trade and our prime clients? We can fully expect to see a torrent of similar new merger and acquisition announcements. I suspect that the landscape of providers of financial and estate planning services to high net worth individuals (defined as the top 1% of wealth holders) will look very different in 25 years than it has looked for the past 100 years.

In the December 20, 1999 issue of Newsweek, columnist Jane Bryant Quinn, said:

Here’s what the firms of the future could look like: a planner to help you diagnose your needs; legal, insurance, tax and investment specialists to create your plan; and a high tech system to deliver services. As a model, AmEx could be pretty close.121

For sure, not all of our clients will want to go to American Express for the services they will offer, including estate planning, but surely some of them will, especially when courted by an aggressive sales
force.

The Federal Reserve Board has estimated that in 1999 financial assets in the U.S. were controlled as follows: 29.6% by pension funds, 22.1% by commercial banks, 21.7% by investment companies, 14.8% by insurance companies, 4.4% by thrifts, 3.5% by securities, brokers and dealers and 3.5% by financial companies. The percentage will undoubtedly change dramatically as a result of future consolidations.122

Multidisciplinary practices have already swept through western Europe, Canada and Australia. Multidisciplinary practices, or MDPs as they are called, have been defined by the ABA Commission on Multidisciplinary Practice as entities that include lawyers and non-lawyers and have as one, but not all, of its purposes the delivery of legal services to clients, not just to the MDP itself. Clients would pay fees for legal services to the entity and not to the lawyers. Indeed I understand that there are more lawyers working for accounting firms in western Europe than in private practice.

Much of the present debate centers on the ethical issues posed by MDPs to the lawyer-client relationship. The American Bar Association is struggling with this issue. So far, the House of Delegates of the ABA has not come out in favor of MDPs despite two commissions which have recommended approval of MDPs with significant ethical guidelines, but it is probably only a matter of time before the American Bar Association will give approval to some sort of MDPs. The states will eventually follow suit. Already, the large accounting firms are wooing experienced lawyers and are hiring recent law school graduates. Once MDPs are allowed, it is likely that they will offer legal services in much the same way as banks and other financial services firms like American Express.

Indeed, the Big Five accounting firm, Ernst & Young, has announced plans to open a Washington, D.C., law firm called McKee, Nelson, Ernst & Young. While Ernst & Young claims it is not sharing profits with the new firm, it would be naive to think that it is financing it out of a pro bono spirit. Change is coming and we had better be prepared for it.

Competition is coming not only from giant financial services firms, accounting firms and life insurance companies, but also from financial planners and others acting on a much smaller scale. Furthermore, the services and advice being offered are aimed at the full financial needs of the prospective client. They are much like the expanded practice opportunities which we have envisioned for ourselves as personal and family counselors.

I believe we should expand the areas in which we offer advice to our clients notwithstanding that others may be offering the same advice. The fact is that we are, or should be, the best qualified to give this advice and are looked to and trusted more by our clients. We owe it to our clients and to ourselves to be sure that we are competent to provide these expanded services. I believe that if we indeed are competent, our clients will prefer to come to us. Not only must we be competent to provide these additional services, but we will have to market ourselves more effectively to our clients so they are aware that we are also able to provide them with something approaching one-stop shopping.

(x) Scientific and Medical Advances/New Biology

Advances in science and medicine are bringing about amazing things that are and will increasingly affect us as family lawyers. Life expectancy beyond 100 is probably not far away as a result of the factors talked about earlier. With this will come more late-in-life remarriages, nursing home and long-term care needs, increasing demands on our health delivery system, and increased tensions between older and younger generations. Other issues related to increased life expectancy in an aging population are right-to-die issues and euthanasia. While we have made great strides with living wills and health care powers of attorney, this area of the law will become increasingly more complicated as more and more people live longer and longer. So far, Oregon is the only state to legalize euthanasia. It is probable that more states will.

Advances in reproductive technology are seeing such developments as in vitro fertilization for couples for whom reproduction was not previously possible, birth after death, surrogate parenting and, looming ominously, the possibility of genetic engineering and cloning. All of these changes will affect our clients. They will look to us for advice about them.

In the January 24, 2000 issue of Newsweek, there is a report of a Florida couple who in 1989, after 15 years of infertility, decided to try in vitro fertilization. Nine eggs were frozen of which 6 currently remain. The couple has now decided to offer the remaining 6 embryos for adoption. While seemingly bizarre, stories such as these are becoming commonplace and bring with them hosts of new social and legal issues in which we as family practitioners should be involved. By the way, I use the term “family lawyers” keeping in mind Roberta Cooper Ramo’s comments in her superb Trachtman lecture of a few years ago.123 As Ms. Ramo correctly pointed out, we are truly family lawyers and should not have allowed that term to have been co-opted by the divorce bar. I agree with her fully and I am not reluctant to use that term here.

Also at the beginning stage of life are right-to-life
issues. Under what circumstances should a mother have the right to terminate new life in her body? I do not intend to get into a debate on abortion, but clearly this is an issue that affects our clients and their children, and not one from which we can stand aside.

Not much talked about but significant to us are advances in DNA testing. It is only in the last few years that DNA testing has become accepted by our courts. While primarily used in the criminal law field for identification purposes, it nonetheless has significant implications for us as estate and trust practitioners. I am presently involved in a major litigation in which one of the primary issues is whether one of a grandfather’s seventeen grandchildren is his blood issue. Even a one-seventeenth share amounts to millions of dollars. The trial judge refused to order DNA testing but was reversed by the Appellate Court, and the matter was remanded to the trial judge for discovery and further findings, leaving to his discretion the issue of DNA testing. I do not know what the outcome of this case will be, but I do know that we are likely to be increasingly involved with DNA testing in litigated disputes in the future.

(xi) Globalization

Just as cross-border movements are increasingly common within the United States, so they are among nations. Progress, if that’s what it is, from the agrarian age to the industrial age and now to the information age has transformed this planet into an increasingly small place. Aircraft which did not exist at the beginning of this century have now made it possible to be physically present in distant parts of the world in only a matter of hours. It is reasonable to think that by the end of this century it may be possible to reach anywhere on the planet in an hour or two. The World Wide Web, which did not exist even a quarter of a century ago is a presence even in the remotest regions of the world. This mass spread of access to information globally has implications that are hard to grasp as we enter the new century. Advances in science and technology are accelerating at such a rate that it is impossible to make more than wild guesses at what the world will be like at the end of this century. However, it is certain that transactions across international borders will become increasingly common. Already we see mass movements of capital around the world. Transnational corporations are becoming an increasing presence in our lives. Property ownership by individuals in other countries is no longer unusual. Indeed, among the carriage trade, it is quite common. We should expect therefore to obtain competence in the law of international transactions and should become familiar with the legal systems in other parts of the world quite different from our own. The International Estate Planning Committee of the College is a good start in this direction. A good recent example of the increasing movement of people and capital across state boundaries can be found in the European union.

(xii) Business Succession Planning

While corporate America is consolidating, new businesses continue to be born and to proliferate in the United States. Indeed, small business employs more people in the United States than big business. Of the 15 million businesses in the U.S. today, 90% are family owned and they produce 40% of the gross national product.

The owners of these small and medium-sized businesses are our clients. One of the biggest, if not the biggest challenge, facing a family business owner, especially as he or she ages, is the successful planning of succession to ownership of the business. Increasingly we are looked to for counsel in this regard. Seventy percent of family owned businesses do not survive the second generation and less than 5% survive the third generation. The problems involve not just tax issues, but also matrimonial issues, family issues, employee benefits issues, retirement planning issues, insurance issues, corporate issues, partnership law issues and others. We are ideally suited to provide counsel in this area, but must be competent to do so. Indeed ancillary businesses have sprung up employing not just lawyers, but accountants, psychologists, businessmen and others. One of these is the LeVan Company formed and owned by a Fellow of this College, Gerald LeVan.

(xiii) Employee Benefits

An increasing amount of the nation’s wealth is held in tax sheltered employee benefit plans. These plans are growing in number and size by leaps and bounds, and are likely to continue to do so. (Charts 21-22–Value Summaries)

Not only that, but new plans are occurring with regularity. Witness the new Roth IRA. The increasing number of programs devoted to this subject at meetings of the College are a good indication of the importance which this area of practice is commanding from us. Certainly, our clients are increasingly seeking our advice with respect to their employee benefit plans and retirement planning. We must become better informed than we have been to take advantage of this practice opportunity. We can no longer view employee benefits law as the province of a small group of specialists. We must all strive to develop this expertise.

(xiv) Charitable Giving

Charitable giving, also referred to as planned giving, is likely to become increasingly important in our practices in the years ahead. This is because of the rapid accumulation of wealth in this country, especial-
ly among our wealthiest citizens. According to GIVING USA 1999, charitable donations in 1998 totaled $175 billion.\textsuperscript{126}

A recent \textit{New York Times} article reported on studies by Boston College and the Internal Revenue Service. These studies showed that for estates above $20 million, 39\% of the money went to charity, 23\% to heirs and 37\% to taxes and expenses. For estates between $1 million and $5 million, only 8\% went to charity, 66\% to heirs and 26\% to taxes and expenses.\textsuperscript{127} Clearly, charitable giving is a major concern of our wealthiest clients.

\textbf{(xv) Creditors’ Rights and Offshore Trusts}

Along with accumulating wealth has come the increasing desire of certain of our clients to protect this wealth against the claims of creditors. Not only have some states such as Alaska and Delaware enacted legislation catering to this desire, but offshore trusts have become a lucrative industry. Offshore trust institutions have proliferated in places like the Cayman Islands, the Channel Islands, the Isle of Man, Bermuda, the Cook Islands, the Bahamas and other exotic locations. Lawyers are now specializing in establishing these trusts and are marketing them heavily. Fees are commonly in the $20,000 range. For an interesting discussion of the use of offshore trusts in the matrimonial context, see the discussion about the role of an offshore trust established by David Westra, the owner of National Business Institute, in his litigation with his wife, Barbara Westra, in the \textit{ABA Journal} of October 1998 at page 55.\textsuperscript{128}

\textbf{(xvi) Technology}

Advances in computer science have had and are having a major impact on the way we practice law. Increasingly, our Fellows are becoming adept at the use of estate planning numbers crunching software, document assembly programs to prepare wills and trusts, tax return preparation programs, fiduciary accounting programs, securities valuation services, will retrieval and database programs, client database marketing programs and more. In addition, the World Wide Web has opened up a whole new world of research possibilities in the legislative, tax and case law areas and has provided opportunities for exchange of information on billboards and in chat rooms about subjects of interest to us. Without question, the marketing of our services and those being offered by our non-lawyer competitors will proliferate on the web.

Hanson Reynolds told me recently that Bob Kunes, who chairs the Technology Task Force, had done a Yahoo search for “estate planning” which revealed over 900 sites. There can be little question but that the Web will be an ever increasing presence in our lives as family lawyers. To give some idea of how fast this technology is advancing, it took radio 38 years to reach 50 million users, television 13 years and the World Wide Web only 4 years. In 1900, only 8% of American homes had electricity; today 99.9% do. In 1900, there were only 8,000 automobiles registered in the U.S.; today, there are 130 million.\textsuperscript{129}

\textbf{(xvii) Modernization of Estate and Trust Law}

There appears to be a quickening trend towards modernization of estate and trust law. We have seen the Prudent Investor revision of the Restatement of Trusts in 1992, the Uniform Prudent Investor Act of 1994 and the Uniform Principal and Income Act of 1997. Work is continuing on the Restatement of Trusts and also on the Uniform Trust Act. Among other changes, these reforms have introduced modern portfolio theory, which is the subject of one of our ACTEC Foundation modules. Modern portfolio theory has brought us the concept of the total return trust, which has been the subject of so much discussion recently.

We are seeing increasing competition among states to attract trust business. Thus, in Alaska, Delaware, South Dakota, Wisconsin and New Jersey, we have seen the abolition of the Rule Against Perpetuities, bringing to life the Dynasty Trust for those of our clients who want to preserve their wealth for their descendants in perpetuity. Alaska and Delaware now enforce asset protection trust law provisions which insulate trusts from creditors of their grantors and beneficiaries. I have already alluded to the relaxation of will formalities and the elimination of distinctions between wills, trusts and other testamentary substitutes.

Arkansas, North Dakota and Ohio have enacted antemortem probate statutes. These statutes permit pre-death challenges to wills on the usual grounds of lack of capacity and undue influence. Thus, it is possible to test the testator’s capacity while still living. While there are problems concerning notice to adversely affected persons, and the binding effect of orders on persons not receiving notice, nonetheless, we will probably see more of these statutes.

\textbf{(xviii) Continued Transition to Boutiques}

I have previously spoken of trust and estates practitioners moving from large firms to boutique practices. Because of the nature of our practice as family counselors, the pressure cooker environment of the large law firm litigation and corporate practice worlds are making them difficult places for us to practice. The needs of our clients and our own professional needs and requirements make it increasingly hard for us to compete and to practice in these environments. There are, of course, exceptions, and there are many large law firms in which our Fellows practice and thrive in
departments now called private clients, or personal law departments, or other such terms connoting a practice well beyond the traditional scope of a trust and estate department.

In my own firm, our private clients group handles the usual estate planning and administration work, fiduciary litigation and matrimonial law practice. We have a close relationship with the tax and employee benefits practice group, and I would not be surprised to see both groups come under the same umbrella in the not too distant future. In any event, these practice realignments are a trend which will likely increase. The ready availability of computer hardware and software can only facilitate and expedite this process.

(xix) Mediation, Arbitration and Alternative Dispute Resolution

In recent years, there has been a movement towards mediation, arbitration and alternative dispute resolution of trust and estate litigation. This is a reflection of the growing dissatisfaction with the expense, and time-consuming nature, of modern day litigation and also of a hope that the destruction of family relationships may be lessened. The practice is more prevalent in some places than in others. In Texas, it has gained acceptance. In New Jersey, it is taking place in certain counties, but not in others.

I have personally been involved in several successful mediations. I am presently involved in a mediation that has been unsuccessful, but where the parties agreed to having the mediator serve as an arbitrator to resolve the final differences by binding arbitration.

I am also involved as an expert witness in a case in which the parties have submitted the case for alternative resolution to an organization of experienced, retired judges and lawyers who offer their services as a way of resolving disputes at a significantly lower cost, and in a more speedy fashion than is typically true of cases which go to court. There are many such organizations around the country. I expect that alternatives to court resolution of trust and estate cases will gain increasing acceptance.

(xx) Expanded Practice Opportunities

In sum, I believe the effect of all these trends will be to increase the practice opportunities available to us if we are willing to gain the competence to take advantage of them. I believe that these practice opportunities will more than offset any lost opportunities resulting from tax repeal or probate simplification. After all, the transfer tax system, while important, is only one aspect of our clients’ lives. Disputes over wills and trusts, right-to-die and right-to-life issues, the breakdown of marriages, the new biology and new reproductive technologies, business succession planning, creditor protection, environmental and land conservation issues and myriad other aspects of our clients’ personal and financial lives may have nothing to do with taxes but will require our involvement and counsel.

To the extent that the population continues to grow and to live longer, and wealth continues to accumulate at its present rate, our clients will increasingly need our counsel. There are those who may think our futures are bleak. I am not one of them. I believe that not only will there always be a need for our services, but that the need will become greater, not less, in the foreseeable future.

B. Task Force 2000 and the Task Force on Membership Selection

(i) Task Force 2000

In October 1997, during his term as President, Jerry Horn formed Task Force 2000, consisting of approximately 20 Fellows from both large and small law firms. In his President’s Messages in the Winter 1997 and Spring 1998 issues of ACTEC Notes, Jerry discussed what he referred to as “by far the most important” subject that he had addressed during his year as president. This subject was what he called “the economic and professional malaise that befalls the legal specialty in which we practice.” He charged the Task Force to examine and define the role of the trust and estate lawyer in the 21st century.

The Task Force conducted a survey of Fellows, deliberated and is expected to issue its report soon. Since the Task Force has as its primary goal looking to the future of our area of specialty, and of the College’s role with respect to it, its conclusions are obviously central to the question of where we are going as a College. Martin Heckscher has been good enough to share with me the preliminary conclusions and recommendations reached by the Task Force. They can be summarized as follows:

1. ACTEC should have as its mission to assist practitioners to practice better and more effectively and to meet competition by being more skilled in what they do rather than attempting to eliminate or curtail competition.

2. ACTEC should provide high quality substantive law knowledge through programs and publications and should assist Fellows in utilizing developing technology. The College should also provide Fellows with technical assistance such as practice forms.

3. ACTEC should oppose relaxing ethical rules for lawyers whether practicing privately or in accounting or in multidisciplinary practices.

4. ACTEC should renew its efforts at law schools to recruit young lawyers into trust and estates practice.

5. The Practice Committee should col-
lect and disseminate information on the unauthorized practice of law and either the Professional Standards Committee or the Fiduciary Litigation Committee should monitor and report on malpractice cases and ethics issues.

6. ACTEC Fellows should serve as expert witnesses and as counsel in malpractice cases in order for Fellows to use their expertise in support of the public interest.

7. ACTEC should maintain its high standards of membership and should maintain its policy of not admitting to membership lawyers who are not in private practice.

8. ACTEC should provide marketing assistance to Fellows in the form of a periodic bulletin or newsletter.

9. ACTEC should help to identify practice trends and to keep Fellows informed of them.

10. The networking opportunities afforded to Fellows by membership in the College should be preserved and encouraged.

11. ACTEC should assist Fellows in broadening their expertise into other fields or areas related to trust and estate practice, what we have referred to in the past as the expanded practice.

12. ACTEC should undertake to educate the public as to the value of ACTEC Fellows in the process of estate planning and estate administration.

13. A mechanism should be created to allow the sharing of professional experiences of Fellows through development of the ACTEC Web site and through local and regional programs.

14. ACTEC and the Committee on Legal Education should seriously consider undertaking a major new initiative in the education of young lawyers and lawyers in general practice in the fields of estate planning and trust and estate administration. ACTEC should consider furnishing continuing legal education in our area of practice to non-Fellows with ACTEC furnishing the curriculum and faculty.

15. An effort should be made to disseminate information at law schools as to the satisfying nature of trust and estate practice with the goal of encouraging law students to take courses in the trust and estate and expanded practice areas.

Again, I should emphasize that these are preliminary conclusions and recommendations. A final report of the Task Force is expected later this year.

(ii) The Task Force on Membership Selection

Another Task Force, the Task Force on Membership Selection, has also been hard at work. The Task Force is proposing that the bylaws of the College which describe us as “lawyers skilled and experienced in the preparation of wills and trusts, estate planning; probate procedure and administration of trusts and estates of decedents, minors and incompetents” be broadened to “lawyers skilled and experienced in the practice of trust and estate law, including one or more of the following related practice areas: preparation of wills and revocable and irrevocable trusts, probate, trust, guardianship and conservatorship administration, transfer taxation planning and administration, fiduciary income taxation, incapacity planning, elder law, employee benefit planning, donative planning, charitable planning, advising exempt organizations, and probate, trust and protective proceedings litigation.” This new description of Fellows reflects the expanded practice emphasis of the College and more closely reflects the twenty-first century reality of our practices.

4. CONCLUSION

The new century and the new millennium will see changes we cannot even imagine today, just as changes have occurred in the last century and the last millennium in ways that could not possibly have been imagined then. However, of one thing I am certain, and that is as long as the human race survives, there will be a need for family lawyers such as we. The advice we are asked to give will no doubt change. It will be up to us to obtain the competency to provide it. Helping Fellows obtain this competency is a highly worthy mission for this illustrious College.
Endnotes

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**CHART 1 College Membership**

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**CHART 2 Substantive Law Committees 1999**

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Source: Federal Reserve

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Drafting and Counselling for Distributions to Trusts from Qualified Plans and IRAs

by Jerold I. Horn
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Interests in individual retirement accounts ("IRAs") and qualified plans, and the interface between the interests and private trusts, affect millions of people and perhaps trillions of dollars. Nevertheless, many years after the enactment of the governing statute, the rate at which an interest is distributable to a private trust remains unclear and even unfathomable.

The last change in the Internal Revenue Code ("Code") which materially affected the rate at which an interest is distributable to a beneficiary was effective as of the beginning of 1984. See Code §401(a)(9). The Internal Revenue Service ("IRS") issued proposed regulations in 1987 and modified them slightly at the end of 1997. Relatively recently, the IRS has issued letter rulings that not even a devotee of the proposed regulations reasonably could have foreseen. The "law," such as it is, consists of an unclear statute, proposed regulations, letter rulings (many of which were not reasonably foreseeable), the utterances of an IRS person and rumor based largely upon the utterances.

As it concerns lawyers and their clients, this situation is unfair. Well-intentioned, conscientious lawyers (and their clients) who, despite every effort, are unable reliably to determine the law should not have to bear the risk of how the law might develop, these many years after the enactment of the statute. The problem has much more to do with process than with substance.

Unless an interest in a qualified plan or IRA is payable to a "designated beneficiary," distribution of the interest cannot extend beyond (i) the life or life expectancy of the participant or owner or (ii) if the participant or owner dies before reaching his or her required beginning date (i.e., usually April 1 of the calendar year after the calendar year in which the participant or owner attains age 70 1/2), five years after the death. Any longer (i.e., extended) period of distribution is a function of (i) the existence of a designated beneficiary and (ii) if a designated beneficiary exists, the life expectancy of the designated beneficiary who has the shortest life expectancy. Reduced to its essentials, the uncertainty relates to whether, and to what extent, features that are common to private trusts preclude the existence of a designated beneficiary.

 Virtually all of the features to which the uncertainty relates are central, not peripheral, to why property owners create trusts. Without limitation, the features include

(i) the ability of a trustee to pay death costs,
(ii) the discretion of a trustee to allocate trust property to a disposition,
(iii) the ability of a trustee to use trust property to benefit a nonindividual,
(iv) the ability of a trustee to distribute trust property to the estate of a beneficiary,
(v) the discretion of a trustee to distribute or accumulate income and to distribute principal,
(vi) the ability of a donee to appoint trust property and
(vii) the ability of a trustee to retain trust property beyond the life expectancies of those who are living at the creation of the trust.

These, in truth, represent many uncertainties, each significant.

The uncertainty emanates from the confluence of interests in individual retirement accounts and qualified plans, on the one hand, and private trusts, on the other. Obviously, a lawyer can eliminate the uncertainty by avoiding the use of trusts as beneficiaries. However, for the reasons discussed in I, infra, the writer rejects that solution. One who agrees with the reasoning expressed in I cannot avoid the uncertainty and must address the issues that the uncertainty presents.

A purpose of this paper is to address some of the issues. A particular focus is the scope of the services that the attorney should provide to particular clients and how the attorney can, and should, counsel the clients concerning the issues.

If a reader were to conclude that the system is broken and urgently in need of repair, the writer heartily would agree. The system is too vague, too complex, too arbitrary, too difficult to understand and apply, too easy in some respects to avoid or evade, too unforgiving, too intrusive and too risky, even for those lawyers (and their clients) who make every effort to understand and to comply. Many of these problems do not inhere in the statute. 2

I. Trusts as Beneficiaries of Qualified Plans and IRAs.

The writer posits two objectives. First, integrate interests in qualified plans and IRAs with other assets in the estate plan. Second, defer income. The first objective is a short-hand reference to the objectives that the client seeks to apply to his or her other assets. As applied to beneficiaries other than first spouses, the first objective usually seems more important than the

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2 Those who are not fully conversant with the issues that this paper addresses should read Coleman, "If a Trust is Named as Beneficiary of a Qualified Plan or IRA," 25 ACTEC Notes 137 (Fall, 1999). Upon reading Virginia Coleman’s article, even a person who is conversant with the statute and the proposed regulations but not with the letter rulings which the IRS has issued during the last two years or so might feel as Rip Van Winkle felt upon awakening from his sleep. Those who would like to review more generally and broadly the nominal requirements for payment of interests to private trusts consistently with the existence of designated beneficiaries should read Chouteau, Life and Death Planning for Retirement Benefits (Ataxplan Publications, 3d ed. 1999).
second. The reasoning is that if trusts are the vehicles of choice for the other assets, a presumption exists that the trusts also are the vehicles of choice for the interests in qualified plans and IRAs.

Payment outright to a first spouse might work little or no violence to the values that are implicit in integration. However, payment outright to anyone other than a first spouse is more likely to undermine these values.

This writer’s clients tend to agree that, as applied to beneficiaries other than first spouses, integration is more important than deferral. The anecdotal experience of the writer is that nonlawyers (such as accountants, financial planners, trust officers, life insurance underwriters and stock brokers) who counsel with respect to interests in qualified plans and IRAs tend to focus solely upon deferral and to ignore integration entirely.

Different degrees of disintegration include (i) interference with transfer-tax objectives (such as inability fully to use applicable credits and GST exemptions and inability otherwise to avoid inclusion in gross estates of beneficiaries), (ii) interference with nontax objectives (such as management of assets, protection of assets from creditors and protection of assets from spouses) and (iii) inability to marshall assets in order to facilitate allocation of assets among various dispositions and payment of death costs. The different degrees of disintegration have different degrees of importance depending upon the client’s objectives that apply to the other assets and upon the ages and abilities of the beneficiaries. Accordingly, for some estate plans (for example, outright distribution to descendants, per stirpes, who survive the participant, where all children are living and are mature adults), deferral might trump integration. However, in most cases where the client regards trusts as important for other assets, notwithstanding that trusts have negative (or, at least, uncertain) impacts on deferral of income for income tax purposes, trusts seem important as well for interests in qualified plans and IRAs.

II. Objectives: Integrate Qualified Assets in Estate Plan and Yet Defer Income Tax.

Most trusts that are appropriate for use for other assets are not clearly compatible with the existence of a designated beneficiary whose life expectancy can determine the distribution periods for interests in qualified plans and IRAs. Examples include trusts (such as usual forms of credit-shelter trusts and QTIP trusts) for the life of an individual with the individual having any usual form of nongeneral power to appoint by will. See VI, infra. Similarly, the extent to which alteration of these trusts is necessary to accomplish the posited objectives is unknown. Nevertheless, the attorney can include generic provisions (“Generic Provision”) in each trust for the purpose of increasing the possibility of accomplishing the objective of deferring income and yet not interfering unacceptably with the objective of integrating qualified plan and IRA interests with other assets in the estate plan.

A Generic Provision with unlimited effect would risk undermining the integration objective. Accordingly, (i) this writer limits the application of the Generic Provision to those cases in which its application is necessary to accomplish the deferral objective; (ii) among the “universe” of beneficiaries that (absent the provision) would determine the distribution period, the Generic Provision permits distributions only to individuals; (iii) among the “universe” of individuals who (absent the provision) would determine the distribution period, the Generic Provision permits distributions only to those individuals who are younger than the putative designated beneficiary whose life expectancy is to control the distribution period; (iv) the Generic Provision limits powers of appointment so that their exercise cannot avoid principles (i), (ii) and (iii); (v) the Generic Provision modifies the scheme of payment upon termination in order to assure that payments will inure only to permitted individuals; (vi) optionally (as an alternative to (c), below), the Generic Provision directs the trustee to pay proceeds of interests to trust beneficiaries as soon as (but no sooner, because of the Generic Provision, than) necessary to permit the existence of a designated beneficiary; (vii) if the governing instrument otherwise does not include a system of allocation of qualified plan and IRA interests to particular dispositions, the Generic Provision might direct the allocation; and (viii) the Generic Provision includes the following safeguards so that the Generic Provision does not undermine the integration objective:

(a) The Generic Provision does not apply to (i) charitable trusts, (ii) marital trusts (other than nongeneral powers of appointment) that only can qualify according to other than Code section 2056(b)(7) or (iii) any income interest in QTIP during the life of the surviving spouse.

(b) If the Generic Provision includes an acceleration provision as described in (vi), above, the acceleration provision states that it shall not require acceleration of any payment from the trust estate to any indi-

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1 Perhaps this phenomenon is a function of the writer’s counselling, or of how the writer poses the issues and asks the questions. Indeed, all can ponder why clients of one attorney use a particular technique while clients of another attorney use a competing technique.

4 Perhaps this phenomenon is attributable to a lack of appreciation of nonlawyers for the role of trusts in estate plans and to a lack of ability of nonlawyers to harmonize deferral and integration.
vidual who has not attained thirty-five years of age.

(c) Optionally (as an alternative to (vi), above), the Generic Provision states that it does not require acceleration of any payment from the trust estate.

(d) The Generic Provision states that it does not preclude payment, from assets that are disclaimed (and, optionally, that are destined to pass to a disclaimer trust), of death costs that result from the disclaimer.

Due to the uncertain state of the law, flexible language is essential. “Savings”-type language and expressions of purpose and intention supply the flexibility. Hopefully, a court will respond to any Procter-type argument by showing sympathy for draftsPERSONs who arguably have little alternative. See e.g., Commissioner v. Procter. 142 F.2d 824 (4th Cir. 1944), 44-1 USTC ¶10,110, certiorari denied, 323 U.S. 756 (1944). Among the uncertainties are the following:

(i) Whether proposed regulations section 1.401(a)(9)-1 E-5 A.(e)(1) properly is interpreted as if the bracketed language were included:

(e) Death contingency. (1) If a beneficiary’s entitlement to an employee’s benefit is contingent on the death of a prior beneficiary [before the end of the prior beneficiary’s life expectancy], such contingent beneficiary will not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy under paragraph (a) or whether a beneficiary who is not an individual is a beneficiary. This rule does not apply if the death occurs prior to the applicable date for determining the designated beneficiary.

Arguably, this interpretation is not reasonably foreseeable from the literal language and is contrary to the meaning of “contingent” as used elsewhere (e.g., proposed regulations section 1.401(a)(9)-1 D-2 A.(a)(1)) and, therefore, is not binding.

(ii) Nongeneral powers to appoint IRA and qualified plan interests and proceeds — Arguably, most, or even all, inter vivos, nongeneral powers should not be taken into account.

(iii) Discretion of a trustee to pay income to one or more individuals or to accumulate income, and to pay principal to one or more individuals or not pay principal — Arguably, spray powers should not prevent the existence of a designated beneficiary.

(iv) Ability of a fiduciary to allocate interests among dispositions — Arguably, this ability should not prevent the existence of a designated bene-

(v) Payment of IRA and qualified plan interests and proceeds to the estate of, or subject to a general power of appointment held by, an individual beneficiary — Arguably, payment subject to a general power of a beneficiary to appoint, payment to the estate of a beneficiary, and the latter in default of the former, are functionally the same, and should have the same tax result, as payment to the individual beneficiary.

(vi) Possible use of IRA and qualified plan interests and proceeds to satisfy death costs of participant — Arguably, the IRS is wrong and these payments instead are payments to the persons whose interests bear the payments.

(vii) Whether Code section 401(a)(9) controls the rate of payment of proceeds of IRA and qualified plan interests from a private trust — Arguably, what the Service allegedly is saying about this issue is wrong. See VI, infra.

III. Disposition of Any Interest that Remains Undistributed When Primary Beneficiary Dies After Owner Dies.

Ever since E. James Gamble made the observation a number of years ago, this writer has wondered whether a standard form of beneficiary designation (such as IRS Form 5305) might leave unanswered the question of what happens to a benefit when, for example, (i) the owner names as first beneficiary the owner’s spouse if the spouse survives the owner and (ii) the spouse does survive the owner but dies before the spouse withdraws all of the interest. Judging from the effect of similar forms of beneficiary designation for insurance policies, the remaining interest would seem to pass to the estate of the spouse. However, concern about this issue causes this writer to provide explicitly that any interest which an individual beneficiary could have withdrawn, but did not withdraw, before the death of the individual passes to the estate of the individual.

The suggested result seems implicit, in any event, in the preamble of this writer’s designation coupled with the actual designation. According to the preamble, “Upon my death, my interest [emphasis supplied] shall pass as set forth below.” The actual designation is contingent only upon the individual beneficiary surviving the owner or participant. Sometimes, to permit avoidance of probate, the writer’s form provides for passage to the estate of the deceased individual in default of the individual’s exercise of a general power to appoint by will. Others provide that the interest passes to the secondary beneficiaries or to one or more individuals (or trusts for their benefit), directly or in default of a nongeneral power to appoint.

Fidelity Investments explicitly uses the same tech-
niche (without any power of appointment) that this writer uses. Many others seem also to use this method but nevertheless to leave gaps. Although some say that no secondary beneficiary shall receive anything if any primary beneficiary survives the owner or participant, their language is unclear about whether if two primary beneficiaries survive the owner or participant and one dies before withdrawing all of his or her interest, (i) all passes to the surviving primary or (ii) one half passes to the estate of the now-deceased primary and one half passes to the surviving primary.

1. Saying nothing leaves an ambiguity. Many forms say nothing.

2. Might the IRS say that doing what this writer does might allow someone other than the owner (or participant) to change the beneficiary after the death of the owner (or participant) (see prop. reg. §1.401(a)(9)-1 E-5.A(f)) and, therefore, preclude the existence of a designated beneficiary? According to proposed regulations section 1.401(a)(9)-1 E-5.A.(f), (f) Designations by beneficiaries. If the plan provides (or allows the employee to specify) that, after the employee’s death, any person or persons have the discretion to change the beneficiaries of the employee, then, for purposes of determining the distribution period for both distributions before and after the employee’s death, the employee will be treated as not having designated a beneficiary. However, such discretion will not be found to exist merely because the employee’s surviving spouse may designate a beneficiary for distributions pursuant to section 401(a)(9)(B)(iv)(II).

Some have said that the principal draftsman of the proposed regulations has said that proposed regulations section 1.401(a)(9)-1 E-5A.(f) applies only to an ability that exists before the death of the primary beneficiary. However, is this construction consistent with the words of the first sentence? Also, how does it apply to a power of a trustee to spray the trust estate among the members of a described class? Similarly, how does it apply to a power of a trustee to allocate an interest to one disposition or to another?

3. Does the possibility of payment to the estate of the beneficiary preclude the existence of a designated beneficiary for another reason? See prop. reg. §1.401(a)(9)-1 D-2A.A.(a). The apparently conclusive answer, at least in the case in which the beneficiary is not a spouse whose life expectancy is being recalculated, is that the estate will receive nothing unless the individual dies before the end of his or her life expectancy (i.e., the interest of the estate is contingent on the premature death of the individual) and, therefore, the estate is not a beneficiary for purposes of determining the existence of a designated beneficiary. See prop. reg. §1.401(a)(9)-1 E-5. A.(e)(1).

4. If the life expectancy of the spouse is being recalculated, will the IRS say that the possibility of payment to the estate of the beneficiary permits payment to other than an individual even if the designated beneficiary attains his or her life expectancy, and, therefore, the technique precludes the existence of a designated beneficiary? If the owner names his or her spouse (without saying anything more, i.e., “to my wife, Carol H. Horn, if she survives me”), elects recalculation for the spouse (regardless of what the owner elects for himself or herself), the spouse survives the owner and the interest that the spouse does not withdraw during his or her life will pass to his or her estate at his or her death, the possibility technically exists that the interest which the spouse has not withdrawn can pass to other than an individual even if the spouse does not die prematurely. Contrary arguments include (i) the reduction of a recalculated life expectancy to zero in the year after death is a technical device that, for this purpose, the IRS should ignore, (ii) the estate is the same (for this purpose) as the individual and (iii) even if the estate is not the same as the individual, the IRS is wrong about the effect of payment to an estate.

5. These issues are not properly a function of whether the interest will pass according to state law or, instead, according to affirmative provision in the plan document or form of beneficiary designation.

6. The passage to a successor beneficiary of any interest that a primary beneficiary does not withdraw before the primary beneficiary dies can solve the income-tax problem, but it can create other problems.

a. Even if this type of remainder disposition is in default of a power of appointment, it is a less flexible solution than passage of the remainder to an estate.

b. A provision that a remainder shall pass to a successor might induce the primary beneficiary to withdraw all of the interest, in order to defeat the remainder. An attorney should not have to create this possibility in order to avoid the risk of being unable to determine law which is not determinable.

c. Conceivably (or, perhaps more accurately, incredibly), passage of a remainder to a successor can produce its own tax issues.

i. Depending upon the plan or IRA, the naming of a successor taker, instead of paying the interest to the estate of the deceased beneficiary, might call into question the availability of the marital deduction. See Estate of Neugass v. Commissioner, 555 F.2d 322 (2d Cir. 1977), reversing 65 T.C. 188 (1975);
Mackie v. Commissioner, 64 T.C. 308 (1975), acq., 1982-1 C.B. 1, affirmed per curiam, 545 F.2d 883 (4th Cir. 1976); and Rev. Rul. 82-184, 1982-2 C.B. 215.

ii. The naming of a successor taker in default of the exercise of a nongeneral power to appoint to certain individuals (or trusts for their benefit) might raise the issues that are mentioned in both 2 and 1, above.

IV. Allocation of Interests Among Dispositions

Alternative methods are available to allocate qualified plan and IRA interests to dispositions to or for beneficiaries.

(i) Nonformula, specific allocation according to the beneficiary designation or the trust instrument. This system allocates the interest specifically to a particular disposition (for example, to a spouse or marital trust) regardless of the size of the interest and the intended size of the disposition.

(ii) Formula, specific allocation according to the trust instrument, to any extent that method (i) does not control. This system allocates the interest among dispositions, identified by name or by criteria, in a specified order, to the extent (in each case) of the lesser of the interest and the disposition.

(iii) Prorata allocation, to any extent that methods (i) and (ii) do not control. Depending upon underlying state law, this system might exist according to underlying state law, or according to “pick-and-choose” authority in the governing instrument, if no explicit authorization exists to allocate nonprorata without regard to bases for income-tax purposes.

(iv) Completely discretionary allocation, to any extent that methods (i), (ii) and (iii) do not control. This system exists according to “pick-and-choose” authority, in the trust instrument, which explicitly permits nonprorata allocation without regard to bases for income-tax purposes. Depending upon underlying state law, this system also might exist according to underlying state law, or according to pick-and-choose authority in the governing instrument, which does not explicitly permit nonprorata allocation without regard to bases for income-tax purposes.

Each of the methods can accommodate, with different efficiency, a feature which provides that a disclaimer by the spouse results in passage of the disclaimer assets to an alternative disposition, perhaps, for example, a disclaimer trust, a credit-shelter trust which the disclaimant cannot appoint, descendants or trusts for the benefit of descendants.

Ranked in terms of dispositive flexibility (i.e., ability flexibly and efficiently to allocate an interest among dispositions), from most to least, consider (iv), (ii), (iii) and (i). However, ranked in terms of income-tax flexibility (i.e., ability flexibly and efficiently to select the period of distribution of the proceeds), from most to least, consider (i), (ii), (iii) and (iv). Dispositive flexibility and income-tax flexibility appear not to coincide.

Although method (i) appears to offer the best control in terms of incidence of income tax, it appears to offer the worst in terms of optimization of sizes of dispositions for other purposes. Although method (iv) appears to offer the best control and to offer the greatest efficiency in terms of optimization of sizes and characters of dispositions, it might offer the worst in terms of planning for income tax. Method (iii) appears unappealing in both categories. Method (ii), on the other hand, appears near the top of the list in both categories.

As foreshadowed above in I, an owner or participant might regard a first spouse as an alter ego in terms of implementing the estate plan. Therefore, the owner or participant might regard outright payment to a first spouse as the equivalent of payment to the owner or participant himself or herself. Other things being equal, this type of owner or participant is satisfied to pay the interest to the spouse and to allow the spouse to implement the balance of the estate plan with respect to the interest.

Consistently with the reasoning discussed in the preceding paragraph, a client who does not object, as a matter of principle, to naming his or her spouse as first beneficiary might (i) pay all to the spouse rather than (ii) direct to the credit shelter the fractional portion that is necessary to “fill” the credit shelter and pay the balance to the spouse. The writer prefers to direct the entire interest to the spouse and to “fill” the credit shelter voluntarily by disclaimer rather than mandatorily by a formula. The income-tax benefits that can attend outright payment to the spouse might exceed the estate-tax benefits that can attend a mandatory “filling” of the credit shelter.

Completing the argument, perhaps the method of choice is method (ii), modified, however, so that it yields to method (i) in the case of an owner or participant who is not adverse to using method (i) for a disposition to his or her first spouse.

Similar to underlying Illinois law, the pick-and-choose language of this writer provides for “equitable [emphasis supplied] division or distribution, . . . .” Again similar to Illinois law, the language does not explicitly permit allocation without regard to bases for income tax purposes. This writer uses many beneficiary-interested fiduciaries. A deviation from underlying state law might create a general power of appointment in the hands of a beneficiary-interested fiduciary. Query whether, and to what extent, the underlying law of Illinois (and of other states) and the “pick-and-choose” language that this writer uses
require proportionate allocation of both (a) fair market values and (b) bases for income-tax purposes. A constraint based upon prorata allocation of bases would reduce discretion and even might tend to require prorata allocation of assets other than interests in qualified plans and IRAs and might require prorata allocation of interests in qualified plans and IRAs.

Interests in IRAs and qualified plans are items of income in respect of a decedent described in Code section 691. They share with all other items of income in respect of a decedent the characteristic that they are “pregnant” with future liability for income tax. However, these interests also have a characteristic that is not common to all other items of income in respect of a decedent. These interests have the future ability to generate ordinary income without also generating current liability for income tax.

The advisability of any system of ordering the allocation of interests in IRAs and qualified plans among the dispositions that are the possible recipients seems a function of, among other things, a complicated comparison of (a) the extent to which the deferral-of-income feature that is unique to these interests increases the value of the interest compared to the values of other assets and (b) the extent to which the income-tax vulnerability of the interest decreases the value of the interest compared to the values of other assets. Is the income-tax pregnancy a greater detriment than the tax-free buildup is an advantage? If yes, this type of asset would seem less valuable than an asset that did not defer income and, therefore, was not pregnant with future liability for income tax.

The development of a system of ordering of allocations among competing dispositions might include, among other things, (i) an analysis of the purposes and characteristics of the dispositions, (ii) a projection of rates and frequencies of income tax (both ordinary and capital gain), estate tax, gift tax and generation-skipping tax, (iii) a projection of rates of return on the interests and on other investments, (iv) an appraisal of flexibility and cost for tax and nontax purposes (including, for example, the use of disclaimers, the probability of adverse consequences if the owner must make changes, or must leave allocations uncertain, after his or her required beginning date and before his or her death and the need to retain investments and managers that are qualified for the interests) and (v) a determination of the probability that the particular interests can accommodate the tax and nontax advantages that an “ideal” interest could accommodate. Conceivably, one system should apply to IRAs and another should apply to interests in qualified plans.

If a method such as method (ii) were used, what complexion might it have? Consider simplifying the analysis by breaking the analysis into component parts, evaluating the parts separately and reassembling the parts.

Proceeding in the manner suggested in the preceding paragraph, assume (for purposes of the analysis) that the interest includes only the characteristic of “pregnancy” with future liability for income tax (i.e., the inherent characteristic of items of income in respect of a decedent) and does not include an ability to generate deferred income in the future. Compared to other assets, this asset would tend to have less value per dollar of value for transfer-tax purposes. Accordingly, this asset appears relatively disfavored compared to others.

Efficient allocation would seem to consist of “teaming” assets that are relatively disfavored with dispositions that also are relatively disfavored. Conversely, efficient allocation also would seem to consist of teaming assets that are relatively favored with dispositions that also are relatively favored. Consider, for example, allocating interests in IRAs and qualified plans, first, to nonpecuniary dispositions that are (or, if the primary beneficiary attains an age within the life expectancy of the primary beneficiary, would be) includable in a beneficiary’s gross estate, with any “ties” in this tier being resolved, first, in favor of allocation to dispositions in descending order of the generation assignment of the primary beneficiary assigned to the highest generation, second, in descending order of inclusion ratios for generation-skipping tax purposes and, third, by allocation prorata. Consider allocating any balance of the asset to nonpecuniary dispositions that are not included in a gross estate, in descending order of inclusion ratios for generation-skipping tax purposes, with any “ties” in this tier being resolved by allocation prorata.

Applying the assumption and the precepts of the preceding paragraph to particular dispositions, consider the hypothesis that a formula, specific system should allocate interests in qualified plans and IRAs among classes of nonpecuniary dispositions in the following order, to the extent of the lesser of the interest and the aggregate of the dispositions within the class.

1. First, to marital gifts and GST-nonexempt marital trusts;
2. Second, to GST-exempt marital trusts;
3. Third, to dispositions to or for descendants which are (or, if the primary beneficiary attains an age within the life expectancy of the primary beneficiary, would be) includable in the gross estate of the primary beneficiary;
4. Fourth, to dispositions for one or more of the surviving spouse and descendants which are not includable in a gross estate and which are not GST-exempt; and
5. Fifth, to dispositions for one or more of the
surviving spouse and descendants which are not includable in a gross estate and which are GST-exempt.

Depending upon underlying state law, a failure to specify allocation to dispositions within a class might limit discretion to allocate within the class, even to the extent of requiring prorata allocation. Alternatively, it might permit a greater or lesser degree of discretion to allocate within the class. The system can allocate by formula among classes of dispositions, with (depending upon one’s view) discretionary or prorata allocation resulting among dispositions within classes. Alternatively, the system can allocate by formula both among and within classes.

A method of expressing the analysis, in order to take into account both the “bad” and the “good” aspects of interests in IRAs and qualified plans, is to allocate the interest to each disposition to which the allocation will cause the present value, at the death of the owner, of the minimum required distributions (determined according to Code section 401(a)(9), assuming no possibility of rollover distributions, a rate of return of \( W \%) per annum, compounded \( X \), a rate of tax upon ordinary income of \( Y \%) and a rate of tax upon capital gains of \( Z \%) to exceed the value of the interest for purposes of determining the United States estate tax payable because of the death of the owner, in descending order of the distribution period which is permissible for the particular disposition according to Code section 401(a)(9). The interplay of the variables, \( W, X, Y \) and \( Z \), should produce a fixed period of time against which is measurable the period of distribution that the disposition permits. Another way of treating the analysis is to frame it as a comparison between (i) an interest in an IRA with a given value for estate tax purposes and (ii) an amount of cash equal to the estate-tax value of the IRA.

The underlying hypothesis is that the tax-free buildup aspect of the IRA interest requires time to overcome the income-in-respect-of-a-decedent aspect and that the time is a function of the rate of return. The object, then, is to determine the distribution period (if any) that can cause the interest to have a value greater than that of cash, to allocate the interest to those dispositions that (by virtue of offering the longest period of distribution which is not subject to “premature” termination because of imposition of estate tax or generation-skipping transfer tax) tend to maximize the amount by which the value of the interest exceeds the value of cash, and, conversely, to the extent that no disposition can cause the interest to have a value greater than that of cash, to allocate the interest to those dispositions that tend to maximize the amount by which the value of cash exceeds the value of the interest. The inquiry focuses not only upon alternative dispositions of interests in IRAs and qualified plans but, first and also, upon dispositions of interests in IRAs and qualified plans relative to dispositions of assets that at the time of disposition have the value and tax characteristics of cash.

Even if no coupling of an IRA or qualified plan interest with a disposition can cause the interest to have a value greater than the value of cash, consider the theoretical possibility that allocation of the interest to a disfavored disposition (and, thus, forcing the allocation of other assets to favored dispositions) might reduce the value of the interest more than the allocation increases the value of the other assets. However, due to the tendency of compound interest to magnify any differences with the passage of time, this possibility seems more theoretical than real.

Assume that an IRA owner who has not reached his required beginning date and is terminally ill is planning his estate and will give to his elder child (C1) the child’s choice of the IRA or an amount of cash equal to the estate-tax value of the IRA. The owner will give to his younger child (C2) whichever asset C1 does not select.

Should C1 select the IRA or the cash?

1. Assume that after the death of the owner both the cash and the IRA will grow at a pre-tax rate of 10% per year. Assume rates of tax of 40% on ordinary income and 20% on capital gains.

2. What period, if any, of distribution of the IRA (assuming no intervention of estate tax and generation-skipping transfer tax), after the death of the owner, will cause the IRA to have a value greater than that of the cash, assuming that the recipient of the cash invests the cash, alternatively,
   a. To yield 0% of ordinary income per year and to appreciate 10% in value per year, with
      i. All capital gain recognized at the end of the deferral period; and
      ii. Alternatively, ten percent of capital appreciation recognized each year and all remaining appreciation recognized at the end of the deferral period;
   b. To yield 4% of ordinary income per year and to appreciate 6% in value per year, with
      i. All capital gain recognized at the end of the deferral period; and
      ii. Alternatively, ten percent of capital appreciation recognized each year and all remaining appreciation recognized at the end of the deferral period;
   c. To yield 1.3% of ordinary income per year and to appreciate 8.7% in value per year, with
      i. All capital gain recognized at the end of the deferral period; and
      ii. Alternatively, ten percent of capital appreciation recognized each year and all remaining appreciation recognized at the end of the deferral period;
i. All capital gain recognized at the end of the deferral period; and
ii. Alternatively, ten percent of capital appreciation recognized each year and all remaining appreciation recognized at the end of the deferral period.

3. The apparent determinants are:
   a. The age of C1 and, thus, the life expectancy of C1 and the distribution period that is permissible according to Code section 401(a)(9);
   b. Whether the premature death of C1 will subject the disposition to transfer tax before the end of the permissible period of distribution;
   c. The rates of return consisting of
      i. ordinary income and
      ii. capital gain;
   d. The times of imposition of tax (i.e., the rate of turnover of investment); and
   e. The rates of tax on
      i. ordinary income and
      ii. capital gain.

4. Because the availability of a deduction (according to Section 691(c) of the Code) for estate tax attributable to income in respect of a decedent will reduce the effective rate of tax and, other things being equal, tend to reduce the period necessary for an IRA to outperform cash, perhaps the allocation formula should require a deferral period of X years if the spouse survives and a period less than X years if the spouse does not survive.

5. The best deferral that the IRA can offer is periodic payments that each year are based upon a numerator which consists of one and a denominator which consists of the number of years of life expectancy determined without recalculation, with each payment subject to a tax of 40%, over the life expectancy of C1. By contrast, the investment scenario at 2.a.i. can offer total deferral of all income until the end of the life expectancy of C1, at which time capital gains are subjected to tax at the rate of 20%. Obviously, cash so invested always is superior to the IRA.

The determinative issues, then, are (i) the extent to which identical returns are reasonable to assume for the IRA and the cash, (ii) the extent to which investment to yield solely capital gain, no ordinary income and no turnover until the end of the investment period is realistic and desirable and (iii) the extent to which C1 wants to invest the cash and the IRA to maximize the value that, given a tolerable level of risk, exists at the end of the permissible period of deferral.

First, (i) seems a reasonable assumption absent evidence to the contrary. No reason is apparent why an individual who seeks to maximize return at a given level of risk could not invest both an IRA and cash to produce the same rate of return pre-tax.

Second, (ii) also seems realistic, at least as a model for purposes of analysis and comparison. Many equities are available that do not yield dividends and, therefore, offer only the attraction of capital appreciation. Conceivably, a prudent investor could assemble from these a diversified portfolio suitable for long-term retention. The model, in any event, is used only for purposes of instruction. An actual investor can deviate from the model, in the direction of the models at 2.b. and 2.c., and test at each step the effect upon the comparison between the IRA and the cash. Increases in rates of return, decreases in rates of tax and increases in periods of deferral tend to increase values. Conversely, decreases in rates of return, increases in rates of tax and decreases in periods of deferral tend to reduce values.

Based upon the assumptions and methodology suggested above, the writer has created and analyzed models to determine the period (if any) of deferral of income that will cause an IRA to have more value than cash. The determination involved “amortization” of the IRA over the determined period and comparison of the value at the end of the period with the value of the proceeds of the alternative investment at the end of the same period. Viewing all periods not longer than sixty-six years, rounding all decimals to the nearest whole number and applying the posited scenarios, each of which implies (to greater or lesser extent) an objective of maximizing value at the end of the period, no period of distribution appears to cause an IRA to have more value than cash. The apparent conclusion is that the empirical data tend to confirm the hypothesis, discussed above, concerning the order in which a formula, specific system should allocate interests in qualified plans and IRAs among classes of nonpecuniary dispositions.

Letter ruling 199918065 (as modified by letter ruling 200008048) addresses another issue concerning discretion to allocate. The inquiry was whether the surviving spouse could treat as her own an interest that was payable to a trustee of a trust which resulted in both a credit-shelter trust and a marital trust. The answer depended upon whether the spouse had complete control over the interest. Whether she had complete control depended, in turn, upon whether the trustee was required to allocate the interest to the marital trust from which the spouse had an absolute right to withdraw all of the trust estate.

Specific allocation can facilitate accomplishment of economic objectives. Additionally, at least if the owner or participant dies before the required beginning date, specific allocation should limit (and, therefore,
permit the most judicious selection of) the beneficiaries that determine the existence of a designated beneficiary and the shortest life expectancy. Specific allocation avoids the possibility that discretion, per se, permits a person to change beneficiaries and, therefore (according to proposed regulations section 1.401(a)(9)-1 E.5. A.(f)), causes no designated beneficiary to exist. Specific allocation might increase the possibility of a spousal rollover. Additionally, if the draftsperson does not use a Generic Provision to avoid the possibility of a beneficiary that is incompatible with the existence of a designated beneficiary, a specific allocation that exists at all times from and after the required beginning date until the death of the owner or participant might prevent a taint that could result from the existence of a particular beneficiary of a particular disposition.

V. Rumored Rules About Payment of Death Costs.

A. Of Owner or Participant.

1. General.

Although signs of wavering are appearing, the IRS appears to assert that even the mere possibility of payment of proceeds of plan interests to the estate of the owner or participant can preclude the existence of a designated beneficiary. This situation exists where a trust is named as beneficiary as of the earlier of the participant’s death and required beginning date and the trust estate is available to pay death costs. The applicable date (i.e., required beginning date or, if earlier, date of death) seems the appropriate date for determining the possibility.

How is this regime to operate in the common case in which the participant survives his or her required beginning date? Must the participant, and (subsequently) the personal representative of the participant, demonstrate from and after the required beginning date that the dispositive documents foreclose use of proceeds of plan interests to pay death costs? Must the participant, and (subsequently) the personal representative of the participant, also demonstrate from and after the required beginning date that the participant has (or at all times had) the wherewithal to pay all death costs by use of other assets? What happens if the situation changes at any time after the required beginning date?

As mentioned above, the only workable and tenable rule is a rule to the effect that any use of proceeds of interests in qualified plans and IRAs is a payment, pro tanto, to the person whose beneficial interest bears the liability for the death cost that the proceeds pay. If one or more individuals are the only parties that bear the burden of payment of death costs that an interest in an IRA or qualified plan is available to discharge, the evil that the IRS is attempting to avoid is most elusive. This configuration presents no possibility of enhanced deferral of income, as, obviously, any use of the interest in the IRA or qualified plan to pay any death cost requires a prior transformation of the interest into proceeds and, thus, inherently terminates deferral. As in other cases, the IRS rules (or, more accurately, rumored rules) appear functionless and arbitrary.

2. In Case of QTIP.

Assume that an interest in a qualified plan or IRA is included in the trust estate of a trust that upon election can qualify as QTIP. Assume also that the executor of the decedent has discretion to elect, or not elect, to qualify the trust for the marital deduction. Does the possible use of the interest to pay the death taxes that would result from nonelection preclude the existence of a designated beneficiary?

The adjusted taxable gifts of a taxpayer can exhaust the applicable credit of the taxpayer and cause all property that does not qualify for the marital deduction to generate liability for tax. If no other assets were available, the nonelected property itself would have to bear the tax. Viewed in this perspective from and after the required beginning date, all QTIP arrangements for which the election is not mandated can generate tax. Thus, all QTIP arrangements for which the election is not mandated present the issue. The issue is significant, as surely the vast majority of QTIPs are subject to election discretion.

Based upon the reasoning in the preceding paragraph, unless the IRS is willing to say that no QTIP arrangement which includes election discretion can have a designated beneficiary, the most extreme position the IRS apparently would assert is that if a failure to elect actually would require use of the proceeds of the interest to pay tax, no designated beneficiary would exist. Even this moderate possibility would undercut the attempt of the IRS to force income-tax reporting during the life of the participant based upon whether a designated beneficiary exists at and at all times after the required beginning date. It would postpone the determination until death and, as a practical matter, cause it to affect income tax only after death.

Some conclusions emerge for planning and drafting purposes. First, based to some extent on the adage that safety exists in numbers, do not remove election discretion solely as a result of the designated-beneficiary issue. Second, as a possible means of avoiding the issue, especially if possible rather than actual use is enough to prevent a designated beneficiary, consider using a disclaimer to control the amount of the interest that is to qualify for the marital deduction, regardless of whether the executor does, or does not, have discretion to elect. This approach seems useful for other reasons in the very situation in which, in this writer’s
practice, interests in qualified plans and IRAs most often are payable to QTIP trusts or to revocable trusts for allocation to QTIP trusts. This situation is the second-spouse, children-by-a-prior-marriage scenario in which perhaps, in any event, the settlor should mandate the QTIP election subject only to a countermand by the spouse. An alternative method of attempting to avoid the issue is to include in any nonelection a sufficient amount of other property (i.e., property other than interests in IRAs and qualified plans) to enable the other property to pay the tax.

If the law were to develop to the effect that the possible or actual use of proceeds of an interest to pay tax would preclude the existence of a designated beneficiary, the Generic Provision would exonerate qualified plan and IRA interests and proceeds from paying the tax. If this were to happen, the part of the Generic Provision that applies to a disclaimer clearly would override and require disclaimed assets to bear their equitable share. No similar provision would override and require nonelected QTIP to bear its equitable share. This difference seems appropriate considering the theory of a disclaimer compared to the theory of an election (or nonelection). Arguably, the imposition of the tax in the case of a disclaimer seems less likely to prevent the existence of a designated beneficiary than the imposition of the tax in the case of a nonelection. If they are sufficient, other nonelected assets can pay the tax. If they are insufficient, the situation will be the same as if the gross estate of the taxpayer includes only an interest (and its proceeds), which the Generic Provision bars from paying the tax, and no deductions are available. One way or another, the tax will be paid. However, even though the IRS has attempted to prevent the system from accommodating the uncertainty, one must await the death of the taxpayer in order to know definitively what property will do the paying.

3. Equitable Apportionment.

Speculation, based on rumor, exists to the effect that the IRS ultimately will announce that equitable apportionment of death tax against interests in qualified plans and IRAs will not preclude the existence of a designated beneficiary but the possibility of any greater imposition will. This type of distinction appears to have no foundation in law.

B. Of Beneficiary.

Upon the death of a surviving spouse who is the beneficiary of a QTIP trust that qualifies for the marital deduction, the trust typically provides that the trust estate shall pay death taxes which are attributable to inclusion of the trust estate in the gross estate of the surviving spouse. Alternatively, Code section 2207A requires the QTIP trust to reimburse the estate of the spouse on this basis. The estate of the surviving spouse, not the owner of the qualified plan interest or IRA, owns this right of reimbursement. The owner of the qualified plan interest or IRA seems unable to eliminate the right.

Does the payment provision, or alternatively the right to reimbursement, permit passage of the interest to the “estate” of the beneficiary and prevent the existence of a designated beneficiary? Arguably, the estate of an owner is one thing, the estate of a beneficiary (including the spouse) is another and, whatever the effect of payment (or the mere possibility of payment) of an interest (or, more accurately, the proceeds of an interest) to the estate of the owner, payment (or the mere possibility of payment) of an interest (or, more accurately, the proceeds of an interest) to the estate of a beneficiary does not prevent the existence of a designated beneficiary. Any difference in result based upon a distinction between affirmative provision in the QTIP, on the one hand, and reimbursement according to Code section 2207A (or any other statutory rules of apportionment), on the other, would seem arbitrary (i.e., a distinction without a difference) and, therefore, untenable.

VI. Trusts that Suspend Ownership.

A. The Statutory Scheme.

If a participant dies before reaching his or her required beginning date, a trust is the beneficiary of his or her interest and the participant seeks distribution of his or her interest over the life expectancy of a designated beneficiary, a statutory requirement is that “any portion of the employee’s interest is payable to (or for the benefit of) a designated beneficiary [i.e., ‘any individual designated as a beneficiary by the [participant]’] . . . .” Code §§401(a)(9)(B)(iii)(I) and 401(a)(9)(E). A second requirement of the statute is that “such portion will be distributed . . . over a period not extending beyond the life expectancy of such beneficiary . . . .” Code §401(a)(9)(B)(ii)(II). The first requirement seems to relate to the interest itself. The second seems to relate to the transformation of the interest into its proceeds. The statute seems to say one thing about the interest, another thing about transformation of the interest into proceeds and nothing about disposition of the proceeds. Although something in the statute requires payment of the interest for the benefit of a particular individual, the statute seems not to include any corresponding requirement about payment of the proceeds.

Perhaps the writer would reach a different conclusion if “exclusive” were to appear in the statute before “benefit.” However, it does not appear, and neither the writer nor anyone else of whom the writer is aware is arguing that the proceeds must be paid solely to the same individual whose life expectancy determines the rate of payment of the proceeds.
Code section 401(a)(9) is no model of clarity concerning the connection between a trust and an individual who can be the designated beneficiary and whose life expectancy can determine a distribution period. However, Code section 401(a)(9) does use distinctive-ly (and, therefore, arguably purposefully) the words “distributed” (and the related word “distribution”) and “payable,” each in relation to the word “interest.” Arguably, the word “interest” means the rights that a person possesses in an IRA or qualified plan, the word “payable” refers to the linkage between an interest and its beneficiary and the word “distributed” (and the related word “distribution”) refers to the transformation of an interest into its proceeds.

The purpose of Code section 401(a) (of which paragraph (9) is a part) is to establish criteria for determining whether the plan trust is “qualified.” Therefore, Code section 401(a)(9) seems concerned with the rate of distribution of an interest from the plan trust. Additionally, once an “interest” is distributed by being transformed into its proceeds (which clearly is how the idiom of Code section 401(a)(9) operates in the case of an interest that is payable outright to an individual), how can an “interest” again be “distributed” by the proceeds being paid to a payee of the trust? Accordingly, “interest” seems to refer to the undistributed portion of the rights of the participant in the plan. As to “payable,” the part of the statute that is quoted above requires only that the interest be “payable to (or for the benefit of) a designated beneficiary. . . .” Arguably, this requirement is satisifiable by a trust being the beneficiary of the interest under circumstances in which the designated beneficiary is a (i.e., one, not necessarily the only) beneficiary of the trust.

Clearly, Code section 401(a)(9) controls the rate of transformation of an interest into its proceeds. However, nothing in Code section 401(a)(9) seems to condition the existence of a designated beneficiary upon whether the trust that receives the proceeds requires payment of the proceeds to one or more individuals within a particular period of time.

B. Same Treatment for Same Situations.

An interpretation of Code section 401(a)(9) contrary to that which is suggested in the preceding paragraph would seem either (i) to produce different treatment of situations that, although distinguishable, are not different for purposes of this issue or (ii) to create an incompatibility between most QTIP trusts, most credit-shelter trusts and other common trusts, on the one hand, and the existence of a designated beneficiary, on the other. The first alternative would seem grossly unfair. The second would seem to work untold disruption.

If a perpetual trust is incompatible with the existence of a designated beneficiary whose life expectancy can determine the period of distribution, this result should not depend upon whether the grantor creates the perpetual trust directly (according to the governing instrument) or, on the other hand, grants to a benefici-ary the ability to create the perpetual trust (by exercising a nongeneral, testamentary power of appointment). Consider, as a first model, a trust which participant H creates at his death before his required beginning date for the life of his surviving spouse W, followed by a separate trust for H’s and W’s son S for life, and followed in turn by separate trusts for the descendants of S for their respective lives, on a per stirpital basis, with this arrangement to continue perpetually except to any extent that a life beneficiary terminates his or her portion by exercising a nongeneral power to appoint by will. Consider, next, as a second model, a trust which participant H creates at his death before his required beginning date for the life of his surviving spouse W, with W (or W and each subsequent beneficiary for life, seriatim, with respect to his or her trust) having a non-gener-axl power by will to extend his or her portion of the arrangement by creating the system described in the preceding sentence, remainder (in default of appointment) at the death of W to the descendants, per stirpes, of the participant and W who survive W. Assume additionally that the terms of each model preclude payment to anyone who is not an individual and also preclude payment to any individual who has a life expectancy which is shorter than that of W.

Together, the two models comprehend most QTIP trusts and most credit-shelter trusts. The issue that they present is probably common to most estate plans. Indeed, the issue that the second model, by itself, presents is probably common to most estate plans. The experience of this writer, albeit anecdotal, is that most QTIP trusts and most credit-shelter trusts, or at least most well-drafted QTIP trusts and most well drafted credit-shelter trusts, do include nongeneral, testamen-tary powers of appointment which, even if limited in scope of permissible appointees, a donee can use to avoid assurance of outright distribution during the life expectancies of those in being at the outset.

The first model depicts a perpetual trust with a beneficiary in each generation having the ability (by means of exercise of a nongeneral, testamentary power of appointment) to terminate or alter the trust. The second model depicts a trust for the life of a beneficiary with the beneficiary having the ability (by means of exercise of a nongeneral, testamentary power of appointment) to transform the arrangement into the trust described in the first model. Whereas the first model can exist in perpetuity without any appointment, the second requires at least one appointment if it is to continue beyond the life of W and have the complexion of the first. If the necessary appointment is made, the
second can have exactly the same complexion as the first. Conversely, if the necessary appointment is made, the first can have exactly the same complexion as the second.

Different treatment of these arrangements would present a major, unwarranted discontinuity in the law. Also, because each model is transformable at will into the other, different treatment would present a trap for the unwary.

The common denominator among the second-model situations that are the subject of this comment is a trust (i) which can benefit one or more individuals for life but is not inherently included in their gross estates (e.g., a QTIP or a credit-shelter trust or a trust for the life of a child), (ii) of which the individual has a nongeneral, testamentary power to prevent the remainder from passing outright until after the life expectancies of those who are living at the outset and (iii) of which in default of appointment the trust estate is to pass outright to one or more individuals within the life expectancy of someone who was living at the outset. The thesis of this writer is that, for purposes of this discussion, if (ii) exists, (iii) is immaterial.

The alternate resolution, that each model prevents the existence of a designated beneficiary, seems even more untenable. It would rely upon the concept that any possibility of extension beyond the life expectancy of the youngest beneficiary in being at the death of the participant, before the required beginning date, prevents the existence of a designated beneficiary, per se, even if the possibility inheres in an unexercised power of appointment. The disruption that this alternative would produce is incapable of exaggeration.

The lessons of the models do not apply only to the models or even only to trusts for the benefit of a surviving spouse. They seem to apply also to all trusts for a beneficiary for life, remainder (in default of appointment) to one or more persons who include at least one descendant of the life beneficiary who was living at the creation of the trust. Consider, for example, a trust for the benefit of a child of the participant, remainder (in default of appointment) to the descendants, per stirpes, of the child who survive the child, where a child of the child was living at the death, before the required beginning date, of the participant.

Reiterating the critical point, even the most common types of trusts (i.e., credit-shelter and QTIP trusts that exist for the life of a single individual and grant the individual a nongeneral, testamentary power of appointment) seem to present precisely the same issue that some commentators posit for trusts that, from the beginning, are drafted as perpetual trusts. Accordingly, if these commentators are correct about trusts that are perpetual trusts from the outset, their conclusion should apply as well to most (or, at least, to most well-drafted) QTIP and credit-shelter trusts. Perhaps their conclusion about perpetual trusts is correct, but, if it is, no one should underestimate the impact upon trusts that are not perpetual trusts at the beginning but that upon exercise of a nongeneral, testamentary power of appointment, can become perpetual trusts.

C. Policy.

What policy would Code section 401(a)(9) serve if it were to regulate not only the rate at which an interest is transformed into proceeds but also the rate at which the interest and its proceeds are paid from a trust? Even if someone could conjure such a policy, why would Congress implement it by linking the former rate to the life expectancy of the oldest member of a group of individuals while linking the latter rate to the life expectancy of the youngest?

VII. Reading of Plans and IRAs.

Whether, and, if so, how, the attorney should review each qualified plan and IRA before undertaking any work with respect to any interest in it is a function of (i) the nature of the work, (ii) what the plan or IRA can disclose and (iii) the possible effects of any disclosure upon planning.

A. Determination of How Plan Calculates Life Expectancy.

The system that this writer uses for selection of no recalculation, or recalculation, of life expectancy of the owner and his or her spouse enables selection without prior reading of the plan or IRA to determine what, if any, selections are permissible. This writer usually counsels recalculation of the life expectancy of only the owner when the spouse is, and no recalculation whatever when the spouse is not, the primary beneficiary. The bracketed language is added when the spouse is the primary beneficiary.

“(A) I elect determination of life expectancy on the basis of no recalculation [; provided, if my spouse and I are living at my required beginning date (as defined in the Internal Revenue Code and applicable regulations) and the method described in this provisory clause is permissible according to the governing instrument and applicable law, I elect determination of life expectancy on the basis of no recalculation for my spouse and annual recalculation for me]. My election according to the preceding sentence shall become irrevocable at the time of the first distribution required according to the Internal Revenue Code and applicable regulations.”

Of course, whoever determines the minimum required distribution (for the second and subsequent distribution calendar years) must know the permissible selections before making the determination.
B. Determination of Effect of Identity of Beneficiary Upon Method of Distribution, in Order to Enhance Selection of Beneficiary.

Sometimes, the available methods of distribution are a function of the identity of the beneficiary. For example, some plans provide optional methods of distribution if the spouse is the beneficiary and a lump sum if anyone else (including a trust) is the beneficiary. These situations raise the question of whether prior reading of the plan is necessary to allow the client to know how various designations in fact will affect distributions.

This writer tends to create many beneficiary designations in favor of a spouse, a much smaller number in favor of a revocable trust (during the life of a surviving spouse) and very few in favor of a QTIP trust. The writer distinguishes between (i) a participant who is married to a first spouse and (ii) a participant who is married to a second or subsequent spouse and has children by a prior marriage. Although the writer could counsel designation of a QTIP trust as beneficiary in a first-marriage situation, rollover possibilities cause the writer generally to suggest designation of the spouse. Although the writer could counsel designation of a QTIP trust as beneficiary in a subsequent-marriage situation, considerations of flexibility in making allocations cause the writer generally to suggest designation of the revocable trust.

Even if they use QTIP trusts for other assets, most of this writer’s clients who are married to first spouses do not have strong objections to outright distributions of qualified plan and IRA interests to their spouses. This particularly is true where the primary purpose of the QTIP trust is to facilitate planning for generation-skipping tax and, upon survival by fifteen months, the surviving spouse can withdraw everything in excess of that which is designed to absorb the GST exemption of the predeceasing spouse. Accordingly, this writer tends relatively rarely to encounter the situation in which the designation of beneficiary most likely will depend upon whether the plan requires distribution in a lump sum when the beneficiary is not the spouse but permits distribution over life expectancy when the beneficiary is the spouse. Rather, this writer tends to confront the requirement of a lump-sum distribution only in the subsequent-marriage, children-by-a-prior-marriage situation, in which the client tends to have a strong inclination to retain the property in the family and is not likely to distribute the asset to the spouse even if distribution to the spouse would avoid the lump-sum requirement.

Given the foregoing, a lump-sum requirement for distributions to other than spouses tends to have relatively little significance for this writer for planning purposes. Generally, those clients who would tend to avoid the requirement by naming their spouses have no need to avoid the requirement, as they tend to name their spouses in any event. Conversely, those clients who confront a lump-sum requirement are precisely those who would tend not to name their spouses in order to avoid the requirement.

Even in the relatively rare cases in which the issue does occur, a counselling technique often is available to resolve the issue without a prior review of the governing instrument. The lawyer can tell the subsequent-marriage, children-by-a-prior-marriage client to assume (for purposes of analysis) that payment to a trust (QTIP or other) would require a lump-sum distribution and that payment to the spouse would avoid the requirement. The lawyer then can ask the client whether this requirement, and this method of avoiding it, would cause the client to name the spouse (instead of the trust) as beneficiary. If the client were to respond negatively, reading the plan to determine whether the plan would require a lump sum would not alter the planning. Only an affirmative answer would cause the lawyer to have to determine whether the plan would require a lump sum if the spouse were not, but would permit deferred distribution if the spouse were, the beneficiary.

C. Determination of Whether Participant Should Transfer Interest in Qualified Plan to IRA, or Should Transfer Interest in IRA to Another IRA, in Order to Avoid Undesirable Method of Distribution.

This writer divides clients into two groups for purposes of this inquiry. See “First-Group Client” and “Second-Group Client,” infra. This preamble explains why, even though the writer does devote substantial attention to qualified plan and IRA interests for first-group clients, the writer encounters a relatively small (but rapidly increasing) number of situations in which the writer must review the plan documents.

The overwhelming majority of clients who engage the writer to perform estate-planning services is in the first group at the time of the engagement. Relatively few clients who have moved from the first group to the second have engaged the writer, after the movement, to work with their interests in qualified plans and IRAs. Additionally, relatively few clients who were members of the second group when they engaged the writer to perform estate planning work have had interests in qualified plans and IRAs. Accordingly, the profile of the typical client for whom this writer performs ordinary estate planning work is a client who either (i) is in the first group and is a person for whom, because of the reasons discussed below, a review of plan documents seems unnecessary, or (ii) is in the second group but does not have interests in qualified plans or IRAs and thus also is a person for whom a review is unnec-
essary. The profile is changing rapidly. The clientele is becoming older. Additionally, a rapidly increasing portion of the clients owns interests in qualified plans and IRAs.

1. “First-Group” Client.
A first group includes the ordinary estate-planning client who is not approaching his or her required beginning date, any other date on which distribution otherwise must begin, any date on which he or she must select a method of distribution or, in the case of a qualified plan, the date of his or her retirement. Described more precisely in terms of chronology, this group includes the client who is not approaching his or her required beginning date or, in the case of an interest in a qualified plan, his or her retirement. As explained below, except when a required beginning date occurs before retirement, the date of retirement (or perhaps disability) is the first date upon which the participant or (if the participant dies) the beneficiary can become subject, partly or wholly, to an undesirable system of distribution which the participant could avoid by undertaking affirmative action.

The underlying premise for the classification is that, as a practical matter, the first-group client cannot avoid a qualified plan, and need not avoid an IRA, that will prove undesirably restrictive. Therefore, no planning opportunity depends upon the available alternatives. An employee can cease to participate in a qualified plan but generally cannot transfer his or her interest while remaining in the service of the employer. The beneficiary of an IRA of a first-group client who dies before his or her required beginning date can transfer the IRA to another trustee or custodian, and apparently avoid the detriments of an undesirable method of distribution, and obtain the benefits of a desirable method, even after the death of the account owner. *See particularly* LTR 9704031 (death of IRA owner before required beginning date). *See also*, among many others, LTRs 200008044, 9810031 and 9433032.

According to the hypothesis based upon the preceding paragraph, determination of the availability of a desired method of distribution for a first-group client is untimely for planning purposes. If the hypothesis is correct, an appropriate response for planning purposes is to instruct the first-group client to consult about this issue when the consultation becomes timely.

2. “Second-Group” Client.
A second group includes the client who shortly is to reach his or her required beginning date, any other date on which distribution otherwise must begin, any date on which he or she must select a method of distribution or, in the case of a qualified plan, the date of his or her retirement. Described more precisely in terms of chronology, this group includes the client who is approaching his or her required beginning date or, in the case of an interest in a qualified plan, his or her retirement. The second group includes the client who shortly is to retire under circumstances in which a qualified plan either links distribution to retirement or might restrict distribution options available to the client, to the beneficiary or to both the client and the beneficiary.

The availability of a desired method of distribution might determine whether the second-group client should remain a participant in a qualified plan (or an owner of an IRA of which a particular company is the custodian) or, alternatively, should transfer his or her interest to an individual retirement account that does make available the desired method. Reading of the plan document to determine the alternatives that are available to the second-group client is necessary to determine the planning opportunities.

VIII. Selection of Method of Distribution.
This writer tends to select a system for selection of method of distribution, rather than select a method of distribution, *per se*. The system is a “cascade” of selections. The cascade is designed never to detract, and the test of whether it serves its purpose is whether it does detract, from any flexibility that would exist, absent its inclusion, according to any method of determining timing and amounts of distributions.

The cascade consists of the following, in order:
(i) Such distributions as the owner or participant determines;
(ii) If the owner or participant is deceased, such distributions as the beneficiary determines;
(iii) To such extent as no method of distribution is selected according to (i) or (ii), the method of distribution which is available according to Code section 401(a)(9) to maximize deferral but yet permit withdrawal of any greater amount at any time;
(iv) If no method of distribution is selected according to (i), (ii) or (iii), the method of distribution which is available according to the
plan or IRA to maximize value but yet permit withdrawal of any greater amount at any time; and

(v) If no method of distribution is selected according to (i), (ii), (iii) or (iv), a final method of distribution, not mentioned in the form, consisting of whatever method of distribution the plan or IRA imposes notwithstanding that the form includes four prior methods.

The only things in the Code that require a selection of method of distribution are the annuity rules and the Code section 401(a)(9) rules concerning the timing and the amount of each minimum required distribution. However, even many who work in this area seem to believe that, even before the first distribution, predetermination of all distributions is necessary. Many plans seem to impose complete methods of distribution where none are required (by law) or selected by owners or beneficiaries.

This writer includes his own mechanism for selection of method of distribution in order to attempt to prevent a plan or IRA from imposing a worse method by default. Viewed in this perspective, the writer includes a selection mechanism solely for defensive purposes, in order to maximize flexibility. If, absent the selection mechanism, the plan or IRA would not limit flexibility of distribution, the purpose of the selection mechanism is to affirm the flexibility. However, if, absent the selection mechanism, the plan or IRA would limit flexibility of distribution, the purpose of the selection mechanism is to attempt to restore the flexibility that would exist if nothing in the plan or IRA purported to limit it.

IX. A Modest Proposal.

Many of the rules that the IRS is imposing in the name of the requirements of Code section 401(a)(9) address matters that seem beyond the purview of Code section 401(a)(9). Why should the IRS care about when a private trust pays proceeds to beneficiaries? If the exercise of a power to appoint an interest is regarded as a receipt of the proceeds followed by an assignment of the proceeds, and the exercise terminates the period during which the proceeds are deferrable, why should the IRS care whether a person possesses a power to appoint? Why, in any event, should the IRS care whether a recipient of an interest uses the interest to pay death costs that the recipient is obliged to pay, particularly when this use of the interest transforms the interest into proceeds and thus terminates the deferral period?

A. An Illustrative Exercise.
The following exercise illustrates these issues and provides hints of possible solutions:

Facts: A and B are siblings. A is 25. B is 30.
Scenarios:

1. The primary beneficiary is A, outright. A attempts to assign the remaining interest to B before all of the proceeds of the interest are distributed to A.

2. The primary beneficiary is A, outright, or, if A dies before all of the proceeds of the interest are distributed to A, A’s estate. A’s estate attempts to assign the remaining interest to B (the residuary beneficiary of A’s estate) before all of the proceeds are distributed to A or to A’s estate.

3. The primary beneficiary is a trust for the sole benefit of A during the life of A. The trustee must distribute income currently to A. A attempts to exercise a power to appoint the remaining interest to B before all of the proceeds of the interest are distributed to the trustee.
   a. Assume that the power is exercisable during the life of A.
      i. Assume that the power is non-general.
      ii. Alternatively, assume that the power is general.
   b. Alternatively, assume that the power is exercisable upon the death of A.
      i. Assume that the power is non-general.
      ii. Alternatively, assume that the power is general.

4. The primary beneficiary is a trust for the sole benefit of A and B until the death of the survivor of A and B. The trustee can spray income and principal to A and B. The trustee attempts to assign the remaining interest to A before all of the proceeds of the interest are distributed to the trustee.

5. The primary beneficiary is a trust. The trust divides at the death of the owner of the plan or IRA interest into two separate and identical trusts, one for A (as in 3, above) and one for B (as if B were A in 3, above). The trustee allocates the remaining interest solely to the trust for A before all of the proceeds of the interest are distributed to the trustee.
   a. Assume that the trustee has discretion to make the allocation.
   b. Alternatively, assume that the trust instrument directs the allocation, i.e., the trustee has no discretion to make the allocation.

Question: Assuming that nothing otherwise prevents the existence of a designated beneficiary, how, in each
case, is the interest taxed for income-tax purposes?

B. Principles.

Consider, among other things, the effects of (i) Code section 401(a)(13), (ii) state law concerning the ability to assign IRA interests, (iii) the tax rules that permit and prohibit rollovers of interests in qualified plans and IRAs, (iv) the tax rules of Code section 691 that govern acceleration of income upon assignments of rights to receive items of income in respect of a decedent and (v) the tax rules that generally govern anticipatory assignments of income.

Does Code section 401(a)(13) preclude the grant of a power of appointment, testamentary or inter vivos, general or nongeneral, because the mere existence of the power would permit the alienation of interests that 401(a)(13) prohibits and would disqualify the qualified plan? If a power of appointment were impermissible, an unknowing lawyer in Peoria, writing a trust for a client, could disqualify the General Motors plans, a ludicrous and intolerable result. Alternatively then, does Code section 401(a)(13) alter the effect of a power of appointment with respect to interests in the plan, i.e., does the trustee of the plan have a duty to regard the power as though it does not exist and, therefore, to disregard its exercise?

Arguably, a nongeneral power of appointment in a beneficiary should produce the same result as a spray power in a trustee. Conceptually similar, also, is the pick-and-choose discretion of a trustee to allocate an interest to a disposition. Each might permit a transfer of interests in the private trust, but perhaps none permits a transfer of the interest of the private trust in the qualified plan. Stated differently, perhaps the exercised power shifts the plan benefits only to the extent that the trustee of the qualified plan has distributed them to the trustee of the private trust. Any other formulation might permit anticipatory assignment of income (beyond that which the rules of tax accounting for trusts permit) and might permit a beneficiary (i.e., the trustee of the private trust, by means of the spray power) or even a third party (i.e., the donee of the nongeneral power, by means of the nongeneral power) to assign the benefit or to change the beneficiary. Cf. prop. reg. §1.401(a)(9)-1 E-5(f).

According to regulations section 1.401(a)-13(c),

For purposes of this section, the terms “assignment” and “alienation” include — [a]ny direct or indirect arrangement (whether revocable or irrevocable) whereby a party acquires from a participant or beneficiary a right or interest enforceable against the plan in, or to, all or any part of a plan benefit payment which is, or may become, payable to the participant or beneficiary. Emphasis supplied.

Do Code section 401(a)(13) and regulations section 1.401(a)-13(c) preclude a trustee from allocating, assigning, to trusts or other dispositions, any right to receive payments from a qualified plan (but, because Code section 401(a)(13), by its terms, does not apply to IRAs, not an IRA) before the trustee of the allocating trust collects all payments? Cf. Code §§408(a)(4), (b)(1) and (b)(4). Similarly, what is the effect of proposed regulations section 1.401(a)(9)-1 E-5(f), which states that the ability to change a beneficiary after the participant’s death precludes the existence of a designated beneficiary? Does the rule of proposed regulations section 1.401(a)(9)-1 E-5(f) lead to the same conclusion as Code section 401(a)(13) but with respect to payments from IRAs as well as qualified plans?

Interestingly, if Code sections 401(a)(9) and 401(a)(13) were to have the effect mentioned in the preceding paragraph, they might produce an effect similar to that of a general (rather than a specific) designation of beneficiary that accords some discretion to allocate an interest between or among dispositions. Stated differently, the payout period that would result if Code sections 401(a)(9) and 401(a)(13) were to preclude assignment before collection might approximate the payout period that would result if Code sections 401(a)(9) and 401(a)(13) were to permit assignment before collection and allocation according to discretion were to require the use of the same individual as the measuring life for all of the competing dispositions.

C. The Proposal.

Current law might (or, perhaps with relatively few changes, the law could) provide for termination of the deferral privilege upon the occurrence of any change of beneficial ownership and enjoyment that tends to approximate, for example, the change that is described in scenario 1, above. This type of regime would seem fully to protect the justifiable interests of the IRS in the raising of revenue. Additionally, the system is simple, sensible and unintrusive.

X. Conclusion.

The lines between the situations that might, and those that do not, prevent the existence of a designated beneficiary are unclear and, in some cases, arbitrary. The subjection of an interest to an obligation to pay death taxes is functionally the same regardless of whether the governing instrument imposes the obligation or, on the other hand, state or federal law (for example, Code section 2207A) imposes it. Similarly, for purposes of Code section 401(a)(9), no functional difference exists between the ability of a life beneficia-
ry indirectly to create a perpetual trust and the direct creation of the trust, by the settlor, at the outset. Rules that tolerate or exploit these distinctions which are not differences might placate some of those who will restrain their criticism if they have available a means of continuing business largely as usual. However, arbitrary rules are not good for a system of law, and, as a practical matter, are destined not long to continue. The IRS should cease compounding confusion and complexity in the name of purposes that do not exist. Rather, the IRS promptly should turn its attention to providing desperately needed guidance in the form of principled, reasonable rules that are confined to the issue of when, according to Code section 401(a)(9), the federal fisc is to receive its due.
Recent Settlements on Family Limited Partnerships and Other Investment Entities

by Curtis R. Kimball
Atlanta, Georgia

INTRODUCTION

Family limited partnerships (FLPs) have become a popular medium for estate planning over the past two decades in particular.

As with any closely-held, private security, the Internal Revenue Service (IRS) requires the taxpayer to set forth the basis for the fair market value of any interests transferred and therefore potentially taxable for gift, estate or generation-skipping tax purposes.

The IRS has expressed its skepticism of FLPs as nothing more than a “wrapper” for family assets. Thus, discounts for the relative lack of control and marketability of fractional limited partnership interests are often rejected by the IRS.

This article will discuss the areas of the law and valuation logic that receive the most attention from the IRS for FLPs.

I will also outline a number of cases in which the taxpayers and the IRS have reached a settlement and magnitude of the discounts suggested by these settlements.

Sources for further information on FLP settlements are attached to this article.

At the end of this article I will solicit your participation in developing further documentation of implied discounts in settlement agreements or gift and estate tax audits.

THE SETTLEMENT PROCESS

The IRS generally has three years after the date of filing of an estate or gift tax return to conclude an audit inquiry at the agent level. This period can be extended for gift taxes by mutual agreement of the taxpayer and the IRS. Estate tax examinations generally cannot be so extended.

If settlement cannot be reached, then the agent writes up the IRS’ position regarding the disagreed issues and refers the case to the Appellate Division.

The Appellate Conferee generally reviews cases in the order they are filed.

Unagreed cases filed directly with the U.S. Tax Court may be sent back to Appeals, or settled by District Counsel in lieu of trial.

LEGAL ISSUES IN FLP CASES

The IRS has raised four chief legal issues in reviewing FLP transactions.

One, the Step Transaction argument. The formation and ensuing transfer of an FLP interest are part of a single integrated plan, and are devoid of substance. Thus, the FLP interest should be valued based only on its undiscounted underlying asset value. If an FLP interest should be discounted, then a gift was made to the other owners on formation as the LP interest received was worth less than the assets contributed.

Two, the Section 2703 argument. The FLP transaction is not a bona fide business arrangement, but a device to transfer property to family members who would normally inherit such assets anyway.

Three, the Lack of Operating Substance argument. The IRS reviews FLP cases to: (1) see if the family is commingling FLP asset cash flows with personal cash flows, or (2) see if the FLP was properly established and transfers properly made. Sometimes the transfers are challenged because the FLP restrictions allegedly do not create a present interest that is transferable.

Four, the Section 2704 argument. The restrictions in the FLP are more restrictive than state law, and state laws allow a partner to withdraw and receive fair value (deemed to be an undiscounted liquidation value by the IRS) on six month’s notice.

AREAS OF IRS SENSITIVITY

FLPs formed shortly before the death of a terminally ill senior generation member.

FLPs formed where a senior generation partner is incompetent and a power of attorney is used to form the entity or transfer interests.

FLPs that consist completely of cash and marketable securities.

Statements from IRS officials indicate that they clearly feel that the IRS has inadequate resources to fight every suspicious FLP transfer.

VALUATION ISSUES IN FLP CASES

The chief challenges seen for valuations of FLP interests transferred relate to the adequacy of the valuation report.

The appraiser may have to provide a supplement to
the original valuation report in order to satisfy the new “adequate disclosure” rules under the proposed regulations arising from recent changes in the tax law in 1997-98.

For transfers after July 22, 1998, the burden of proof will shift to the IRS on factual issues such as valuation. This only happens if the taxpayer first introduces credible evidence regarding the disputed factual issue.

FLP SETTLEMENT DATA

The following data was compiled by Curtis Kimball and members of Willamette from our own case files, and from materials presented by others.

Settlement data is interesting because it shows what the IRS and taxpayers have agreed to as fair market value in cases that are similar in nature to current FLP valuation engagements in which you may be involved. Absent a comprehensive list of private transactions in non-publicly registered limited partnerships, these data may be helpful in providing the appraiser with some insight into the issues that create conflicts between the IRS and taxpayers. These cases, however, should not be treated as something akin to guideline transactions, but rather should be viewed in the same manner as court case decisions. Please remember that these settlements do not represent arm’s-length transactions. In fact, given the prospect of further litigation if a settlement is not reached, settlements are anything but arm’s-length!

SETTLEMENT 1

• By: Willamette Management Associates  
• Date: 1993  
• Type: Estate, plus six prior gifts (1987-92)  
• Interest: FLP  
• State law: Georgia  
• Assets: Real estate and a closely-held business conducted on the real estate (bed and breakfast)  
• Other factors: the real estate was environmentally sensitive.  
• Discount settlement: -75%

SETTLEMENT 2

• By: Willamette Management Associates  
• Date: 1997  
• Type: Gift (1995)  
• Interest: FLP  
• State law: Alabama  
• Assets: Real estate (60%), municipal bonds, and a closely held business (real estate management company).  
• Other factors: Gift made under a power of attorney. IRS hired outside appraiser after this case was docketed for Tax Court.  
• Discount settlement: -35.6%

SETTLEMENT 3

• By: Willamette Management Associates  
• Date: 1996  
• Type: Gift (1995)  
• Interest: FLP  
• State law: Arizona  
• Assets: Real estate - Shopping center interests  
• Other factors: Significant leverage  
• Discount settlement: -55%

SETTLEMENT 4

• By: Attorney  
• Date: 1997  
• Type: Gift (1992)  
• Interest: FLP  
• State law: Nevada  
• Assets: Predominantly real estate (no debt) and some publicly traded securities  
• Other factors: 83 year old donor  
• Discount settlement: -30%

SETTLEMENT 5

• By: Attorney  
• Date: 1997  
• Type: Estate and gifts (1986-91)  
• Interest: General partnership (preferred interest)  
• State law: California  
• Assets: Real estate, promissory note, vechicles and equipment  
• Other factors: Real estate management activities  
• Discount settlement: -35%

SETTLEMENT 6

• By: Management Planning, Inc.  
• Date: 1998  
• Type: Gift (1995)  
• Interest: FLP  
• State law: Florida  
• Assets: Fixed income - bonds (70%) with some common stocks (30%)  
• Other factors: 89 year old donor  
• Discount settlement: -35%

SETTLEMENT 7

• By: Attorney  
• Date: 1998
• Type: Gift
• Interest: FLP
• State law: Washington
• Assets: Publicly traded stock
• Other factors: Other problems with prior family gifts made attorney willing to settle quickly
• Discount settlement: -35%

SETTLEMENT 8
• By: Attorney
• Date: 1997
• Type: Gift
• Interest: FLP
• State law: Delaware
• Assets: Publicly traded stock
• Other factors: Client instructed attorney to avoid Tax Court at all costs
• Discount settlement: -25%

SETTLEMENT 9
• By: Attorney
• Date: 1997
• Type: Estate (1994)
• Interest: FLP
• State Law: Texas
• Assets: Publicly traded stocks and municipal bonds (93%) and real estate and gas (7%)
• Other factors: Settlement after taxpayer’s attorney filed motion for partial summary judgment.
• Discount settlement: 56%

SETTLEMENT 10
• By: Attorney
• Date: 1997
• Type: Estate (1993)
• Interest: FLP
• State Law: Texas
• Assets: Publicly traded stocks (39%) real estate (13%), cash (12%), municipal bonds (10%) other assets including mineral interests
• Other factors: Settlement after taxpayer’s attorney filed motion for partial summary judgment.
• Discount settlement: 55%

SETTLEMENT 11
• By: Attorney
• Date: 1998
• Type: Gift (1992)
• Interest: FLP
• State Law: California
• Assets: Real estate (unimproved)
• Other factors: Small size of FLP and gift made it uneconomic to litigate
• Discount settlement: 15%

SETTLEMENT 12
• By: Management Planning, Inc.
• Date: 1996
• Type: Gift (1992)
• Interest: FLP
• State Law: Illinios
• Assets: Publicly traded stock and cash
• Other factors: None
• Discount settlement: 35%

SETTLEMENT 13
• By: Attorney
• Date: 1998
• Type: Gift (1992)
• Interest: FLP
• State Law: California
• Assets: Real estate (improved)
• Other factors: None
• Discount settlement: -33.33%

SETTLEMENT 14
• By: Attorney
• Date: 1998
• Type: Gift (1993)
• Interest: FLP
• State law: California
• Assets: Real estate
• Other factors: None
• Discount settlement: -40%

SETTLEMENT 15
• By: Willamette Management Associates
• Date: 1997
• Type: Gift (1995)
• Interest: FLP
• State law: Georgia
• Assets: Cash (to be invested in venture capital interests over a multi-year period)
• Other factors: none
• Discount settlement: -42%

SETTLEMENT 16
• By: Attorney
• Date: 1998
• Type: Gift (1993)
• Interest: FLP
• State law: Texas
• Assets: Cash (67%) and marketable securities (33%).
• Other factors: No appraisal report filed initially, per decision of clients’ CPA.
• Discount settlement: -15%

SETTLEMENT 17
• By: Attorney
• Date: 1998
• Type: Gift (1992)
• Interest: FLP
• State law: Texas
• Assets: Real estate.
• Other factors: None
• Discount settlement: -40%

SETTLEMENT 18
• By: Attorney
• Date: 1998
• Type: Gift (1992)
• Interest: FLP
• State law: Maryland
• Assets: Real estate.
• Other factors: Senior generation donor died within two months after gift (no prior history of health problems).
• Discount settlement: -41%

SETTLEMENT 19
• By: Willamette Management Associates
• Date: 1997
• Type: Estate (1995)
• Interest: S corporation stock (control block)
• State law: Georgia
• Assets: Publicly traded common stock (97%), real estate (3%)
• Other factors: Election made just prior to date of death; substantial built-in gains on stock
• Discount settlement: -30%

SETTLEMENT 20
• By: Willamette Management Associates and Management Planning, Inc.
• Date: 1998
• Type: Gift (1994)
• Interest: S corporation stock (minority)
• State Law: Pennsylvania
• Assets: Municipal bonds (90%), publicly traded stocks (15%), real estate (5%).
• Other factors: Review by IRS National Office
• Discount settlement: -43%

SETTLEMENT 21
• By: Attorney
• Date: 1999
• Type: Estate (1993)
• Interest: General partnership
• State law: Florida
• Assets: Real estate (timberland)
• Otlier factors: A 2032A special use valuation deduction was also allowed.
• Discount settlement: -30%

SETTLEMENT 22
• By: Attorney
• Date: 1999
• Type: Estate
• Interest: General partnership
• State law: Oregon
• Assets: Real estate (unimproved), cash, equipment.
• Other factors: Fractional interest in the real estate. Partnership alleged to have dissolved upon death of partner. IRS faced trial date without having retained an expert witness on valuation.
• Discount settlement: -35%

SETTLEMENT 23
• By: Houlihan Valuation Advisors
• Date: 1999
• Type: Gift
• Interest: Limited partnership
• State law: Rocky Mountain state
• Assets: Municipal bonds, Real estate (ranch land).
• Other factors: Municipal bonds represented most of the assets; an additional of the discount was allowed to account for call and bidding inconsistencies which made the value of the bonds less certain.
• Discount settlement: -36%

SETTLEMENT 24
• By: Willamette Management Associates
• Date: 1996
• Type: Gift
• Interest: Limited partnership
• State law: North Carolina
• Assets: One block of publicly traded stock (not large enough to require a blockage discount).
• Other factors: Transferor was in a coma.
• Discount settlement: -33%
REQUEST FOR MORE DATA

If you wish to participate in broadening this data base of FLP settlement discounts, please send me your experiences with settlements, in the format shown below, including as much key information as possible.

My e-mail address is: crkimball@willamette.com

I will try to keep this database current as additional information is received from ASA members and other practitioners, and post the data periodically on our Web site at www.willamette.com.

LIMITED PARTNERSHIP/LLC SETTLEMENT DATA

Whom should we say contributed this data? ______________________________________________________

(Note: you can either insert your name, your firm’s name, or an anonymous generic identification such as “Attorney,” “CPA,” “Appraiser” or “Taxpayer Advisor.”)

Type of transfer: ____________________________________________________________________________

(gift, estate, generation-skipping, charitable)

Year in which the subject transfer occurred: ______________________________________________________

(month and day would be helpful but not absolutely necessary)

Year in which the settlement was concluded: ______________________________________________________

(month and day would be helpful but not absolutely necessary)

Type of interest: ______________________________________________________________________________

(LP, LLC or other entity such as an S corporation)

Please identify the state under whose laws the subject LP/LLC/entity was formed. ______________________

Type of assets held by the subject LP/LLC/entity with approximate percentage of total assets in each category: (by categories such as: “publicly traded stock,” “commercial real estate,” “ranch lands,” “municipal bonds”).

__________________________________________________________________________________________

__________________________________________________________________________________________

__________________________________________________________________________________________

__________________________________________________________________________________________

Other factors you feel may have impacted the settlement:
(such as the taxpayer’s level of preparation or documentation, factors regarding the circumstances of the transfer, or other unresolved tax issues)

__________________________________________________________________________________________

__________________________________________________________________________________________

__________________________________________________________________________________________

__________________________________________________________________________________________

Total discount of agreed-upon fair market value of the subject interest relative to its undiscounted net asset value.

__________________________________________________________________________________________

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The State of Death Taxes*

by Robert M. Brucken
Cleveland, Ohio

We are approaching the stage where new ACTEC Fellows may ask, “What was a state death tax?” For more mature Fellows, obscure inheritance tax calculations are becoming only a bad memory. With sponge taxes in effect in 36 states, phasing in now in two more states and under consideration in the remaining thirteen states, most of our specialized knowledge of state death taxation has become obsolete. As our clients become increasingly mobile, we need good current information on state death taxes in all states; if a particular state still has a tax, we can assess the need to contact local counsel and determine how to avoid overpaying it.

The purpose of this article is thus not to describe the remaining death taxes in detail, but to alert our fellows to where they remain, so one is on inquiry.

Sponge Taxes
There are at the time of this publication 36 states (including the District of Columbia in the count) where the only state death tax is a sponge tax. They are:

Alabama Mississippi
Alaska Missouri
Arizona Nevada
Arkansas New Mexico
California New York
Colorado North Carolina
Delaware North Dakota
District of Columbia Oregon
Florida Rhode Island
Georgia South Carolina
Hawaii Texas
Idaho Utah
Illinois Vermont
Kansas Virginia
Maine Washington
Massachusetts West Virginia
Michigan Wisconsin
Minnesota Wyoming

In addition, sponge taxes are phasing in now in Connecticut (by 2005, but by 2001 for family members) and in Louisiana (by July 1, 2004). With these additions, there will be 38 sponge tax states, three quarter’s of the states in number.

Partial Sponge Taxes
There are another nine states that still levy a separate death tax, but each of them has modified it so that most family beneficiaries are exempt from tax, that is, it has become an additional tax on inheritance by collaterals and non-relatives only. For this purpose, exempt family beneficiaries include descendants and ancestors, and in some states also siblings, uncles and aunts, nephews and nieces and even some cousins; of course, spouses are already exempted by marital deductions.

These states achieve this result in different ways, so each must be examined separately, as follows:

Iowa All transfers to the family exempt.
Kentucky All transfers to the family exempt.
Maryland All transfers to the family exempt.
Montana All transfers to the family exempt.
Nebraska Transfers to the family taxed at flat rate of 1%; in all but the smaller estates (under the federal filing threshold) this is less than the federal credit so it is in effect a sponge tax for the family.
New Hampshire All transfers to the family exempt.
New Jersey All transfers to the family exempt.
Oklahoma A $1 million exemption for the estate as a whole is phasing in; under the rate structure of the regular tax, most estates over this exemption passing to the family will be subject to only the sponge tax.
Tennessee Same as Oklahoma, but full $1 million exemption now available.

These states have continued to levy their own tax on collaterals and strangers, but have generally exempted the family from that tax (but not from the sponge tax). One might quibble over whether Nebraska should be included in this group, though, as it does levy a flat 1% tax on small estates passing to the family; this study treats it as a service charge rather than a real tax. These states have retained their death tax procedures, and their taxes are inheritance taxes (except for Oklahoma, but its estate tax has lower rates for the family like an inheritance tax), so their procedures are

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generally more complicated than those of estate taxes. However, an inheritance tax does lend itself to distinctions among beneficiaries, and these states have made those distinctions.

Taxing States (With Substantial Exemptions)

We are now down to four states, and only four states, that tax the family with other than a sponge tax. Three of them allow exemptions intended at least to free modest estates from tax, as follows:

- **Indiana**
  The first $100,000 to each descendant is exempt; gifts to the family exceeding this sum are taxed at up to 10%.

- **Ohio**
  There will be a $200,000 blanket exemption in 2001, rising to $338,000 in 2002; estates in excess of the sum are taxed at up to 7%.

- **South Dakota**
  The first $100,000 to each descendant is exempt phasing in through July 1, 2006; gifts to the family exceeding this sum are taxed at up to 7.5%. There is a ballot issue in South Dakota in November to repeal its inheritance tax, retaining only its sponge tax.

Taxing States (Without Substantial Exemptions)

The last of the 51 jurisdictions is Pennsylvania, the only one in this classification. It levies a flat 6% inheritance tax on everyone (other than the spouse), and the exemption for descendants collectively is a nominal $3,500 only. Pennsylvania may become the last inheritance taxing state, which seems appropriate; it was also the first, in 1826. Back then its rate was only 2.5%.

The Future of State Death Taxes

It is does not look good for them! The author’s experience is probably typical. Ohio replaced its old New York-type inheritance tax with an efficient estate tax in 1968. The result was a tax that worked, was easy to collect and generated lots of revenue. All this made it difficult to repeal. The Estate Planning, Trust and Probate Law Section of the Ohio State Bar Association commissioned a study that concluded that the overall revenue effect of repeal would be positive, that the lost estate tax revenue would be more than replaced by income and sales tax revenue. The Ohio General Assembly has responded by enacting 2000 SB 108, expanding the credit that nominally exempts from tax the first $25,000 only to one exempting the first $200,000 in 2001 and the first $338,000 in 2002. The act also creates a legislative Joint Committee on Estate and Death Taxes to report “a proposal to eliminate or phase out all remaining estate taxes by 2006”, retaining only a sponge tax. Perhaps actual repeal will be achieved next year.
U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*

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The Small Business Job Protection Act of 1996 (the “1996 Act”) made significant changes to the rules applicable to foreign trusts and trusts established by non-U.S. persons. The new rules were intended to prevent tax avoidance through the use of foreign trusts and the exploitation of the grantor trust rules. The 1996 Act imposes an array of reporting requirements, imposes harsh penalties on failures to comply with these requirements, increases the interest charge imposed on taxes paid on distributions of accumulated income from foreign trusts, treats loans of cash from foreign trusts as distributions, expands the kinds of gifts that can be treated as indirect transfers from foreign trusts, limits the circumstances in which a non-U.S. person will be treated as the owner of a trust under the grantor trust rules and allows certain gifts to be recharacterized as taxable distributions from corporations, partnerships or trusts. Curiously, the 1996 Act encourages the creation of foreign trusts by its adoption of a set of criteria for foreignness that is both more objective than the criteria formerly used and biased in favor of foreign status.

This chapter discusses how to create foreign trusts, examines their exposure and the exposure of their U.S. beneficiaries to U.S. income tax and describes the reporting requirements imposed on their creators, their beneficiaries and the trusts themselves, explains the new grantor trust rules applicable to non-U.S. persons and immigrants, and covers anti-avoidance provisions that require reporting of foreign gifts, redefine who is the grantor and recharacterize purported gifts from “intermediaries” and from partnerships, foreign corporations and certain trusts. In addition to explaining the rules, it also considers the extent to which foreign trusts continue to be useful planning tools for U.S. persons.

I  HOW TO CREATE A FOREIGN TRUST
A. How to Determine Whether a Trust is a Foreign Trust

1. Before the 1996 Act

Before the 1996 Act there was no clear standard for determining a trust’s nationality. The former statutory definition consisted only of a statement that a foreign trust is a trust

“the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.”

This statement is merely descriptive of the consequences of foreign trust status and gives no guidance as to how to determine its existence.3

Judicial and administrative authority partially filled the definitional void by establishing a test that required weighing of a trust’s foreign contacts against its U.S. contacts.4 The guidance these authorities provided was of little help in determining the foreign or domestic status of trusts with both foreign and domestic contacts.

2. After the 1996 Act

New Code §§ 7701(a)(30)(E) and (31)(B) attempt to provide clarity, but do so in a way that creates a strong statutory bias in favor of foreignness.

Under new Code §§ 7701(a)(30)(E) and (31)(B), a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.5

Under this test, a trust may be a foreign trust even if it was created by a U.S. person, all of its assets are

References to “Code §” are to sections of the Treasury regulations promulgated thereunder.

1 Curiously, the domestic or foreign status of an estate continues to be governed by the same provision. Code § 7701(a)(31)(A).

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located in the U.S., and all of its beneficiaries are U.S. persons. All it takes is one foreign person who has control over one “substantial” type of trust decision. Consider the following example:

**Example 1:** Jenny, a U.S. citizen and resident of New York, created a trust for the benefit of her children, all of whom are U.S. citizens and residents. She named the Gotham Trust Company, a New York corporation, and her brother Pat, a citizen and resident of Ireland, as cotrustees. The trust instrument gave Pat the right to determine the ages at which each of the children would receive his or her share of the trust fund. It directed that the trust funds be maintained in the U.S. in the custody of Gotham and that the laws of the State of New York were to govern the trust’s administration.

Despite its significant U.S. contacts, the new law will treat Jenny’s trust as a foreign trust since an obviously substantial decision is controlled by a foreign fiduciary. The new definition fulfills the Treasury Department’s goal, to

“increase the flexibility of settlor and trustees administrators to decide where to locate and in what assets to invest. For example, if the location of the administration of the trust were no longer a relevant criterion, settors of foreign trusts would be able to choose whether to administer the trust in the United States or abroad based on nontax considerations.”

It is understood that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level the competitive playing field for trust business between U.S. and foreign institutions. Under the former definition, a foreign person who might have preferred to use a U.S. financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a U.S. domestic trust. Under the new law a foreign person can easily use a U.S. financial institution without creating a domestic trust.

The new definition may level the competitive playing field for trust business between U.S. and foreign institutions. Under old law, a foreign person who would have liked to use a U.S. financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a U.S. domestic trust. Under the new law, she can easily use a U.S. financial institution without creating a domestic trust.

Although the new Code provision establishes a more objective method for determining whether a trust is domestic or foreign, it falls short of establishing the bright line test that was intended.

**a. The Treasury Regulations**

Some clarity is provided by Treas. Reg. § 301.7701-7, which is applicable to trusts for taxable years ending after February 2, 1999. The regulations provide that a trust is a U.S. person on any day that the trust meets both the “court test” and the “control test.”

**b. The Court Test**

The “court test” is the regulatory explanation of the statutory requirement that “a court or courts within the United States is able to exercise primary supervision over administration of the trust.” The final regulations provide a safe harbor for the court test. The safe harbor provides that a trust satisfies the court test if the following three requirements are met:

1. The trust instrument does not direct that the trust be administered outside the U.S.;
2. The trust in fact is administered exclusively in the U.S.; and
3. The trust is not subject to an automatic migration provision described in Treas. Reg. § 301.7701-7(c)(4)(ii).

According to the preamble to the regulations, the

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1 The Administration’s explanation of this rule issued in connection with its original proposal offered some protection from this harsh rule by expressing an intention that the Service would allow a trust “a reasonable period of time to adjust for inadvertent changes in fiduciaries (e.g., a U.S. trustee dies or abruptly resigns when a trust has two U.S. fiduciaries and one foreign fiduciary).” Treasury Department, “General Explanations of the Administration’s Revenue Proposals” 25 (February 7, 1995). The Joint Committee Explanation offers similar comfort. Joint Committee Explanation at 274. The Administration’s intention is reflected in Treas. Reg. § 301.7701-7(d)(2). The Act’s version of the definition referred to “fiduciaries” rather than persons. Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 changed the word “fiduciaries” to “persons.”

2 A trust that is treated as a foreign trust for federal tax purposes under the new rule may continue to be a local trust for state income tax purposes. Jenny’s trust, for example, although it may pay no federal income tax, will continue to be subject to New York State income tax because it was created by a resident of New York and has a New York trustee. N.Y. Tax Law § 605(b)(3).

3 Treasury Department, “General Explanation of the Administration’s Revenue Proposals” 25 (February 7, 1995).

4 This understanding is based on conversations with David K. Sutherland, former Associate International Tax Counsel and a principal draftsman of the new statutory definition.

5 Treas. Reg. § 301.7701-7 may be relied on by trusts for taxable years beginning after December 31, 1996 and by trusts whose trustees have elected under section 1907(a)(3)(B) of the 1996 Act to apply new Code §§ 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996. Furthermore, a trust created after August 19, 1996 and before April 3, 1999 that satisfies the “control test” set forth in the proposed regulations but not the “control test” described in the final regulations may be modified to satisfy the final regulations by December 31, 1999. Such modified trust will be treated as satisfying the control test set forth in the final regulations for taxable years beginning after December 31, 1996 (or for taxable years ending after August 20, 1996 if the election under section 1907(a)(3)(B) of the 1996 Act has been made for the trust).
Internal Revenue Service (the “Service”) included the court test safe harbor in the final regulations because it recognized the difficulty in determining whether the courts of a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before any court in that state.

Treas. Reg. § 301.7701-7(3) provides the following definitions critical to the application of the court test:

1. “Court” includes federal as well as state and local courts.
3. “Is able to exercise” means “that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust.”
4. “Primary supervision” means the judicial “authority to determine substantially all issues regarding the administration of the entire trust . . . notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property.”
5. “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 the trust from suits by creditors, and determining the amount and timing of distributions.”

Treas. Reg. § 301.7701-7(c)(4) describes four types of trusts that satisfy the court test and one that does not. The four types of trusts which satisfy the court test are:

1. Trusts that are registered in a court within the U.S. by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.\(^{10}\)
2. Testamentary trusts if all fiduciaries of the trust have been qualified as trustees by a court within the U.S.
3. Inter vivos trusts if the fiduciaries and/or beneficiaries take steps with a court in the U.S. to cause the administration of the trust to be subject to the primary supervision of such court.
4. Trusts that are subject to primary supervision with respect to their administration by a U.S. court and a foreign court.

This list of trusts that satisfy the court test is not intended to be an exclusive list. Thus, other types of trust may also satisfy the test.

A trust whose trust instrument contains a provision that would cause the trust to migrate from the U.S. if a U.S. court attempted to assert jurisdiction over it or otherwise attempted to supervise its administration, either directly or indirectly, does not satisfy the court test. However, a trust will not fail the court test solely because “the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.”\(^{11}\)

c. The Control Test

The “control test” is the regulatory explanation of the statutory requirement that “one or more United States persons have the authority to control all substantial decisions of the trust.” Treas. Reg. § 301.7701-7(d)(1)(ii) provides the following critical definitions.

2. “Substantial decisions” means, all decisions other than ministerial decisions that any person, whether acting in a fiduciary capacity or not, is authorized or required to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:
   (a) The timing and amount of distributions;
   (b) The selection of beneficiaries;
   (c) The power to determine whether receipts are allocable to income or principal;
   (d) The power to terminate the trust;
   (e) The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust;
   (f) The power to remove, add or replace a trustee;
   (g) The power to appoint a successor trustee (even if such power is not accompanied by an unrestricted power to remove a trustee) unless the appointment power is limited in such a way that it cannot be exercised in a manner that would alter the trust’s residency; and
   (h) The power to make investment decisions.\(^{12}\)

\(^{10}\) § 7201 of the Uniform Probate Code gives exclusive jurisdiction over the internal affairs of a trust to the courts of a state in which a trust is registered. Sixteen states have adopted the Uniform Probate Code. They are Alaska, Arizona Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota and Utah. 8 Uniform Laws Annotated 1 (West Supp. 1998).

\(^{11}\) Treas. Reg. § 301.7701-7(c)(4)(ii).
(3) Ministerial decisions “include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions” made by the fiduciaries.

(4) “Control” means “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.”

Certain employee benefit trusts will be deemed to satisfy the control test as long as U.S. fiduciaries control all of the substantial decisions to be made by trust fiduciaries.13

d. Reversing an Unintended Loss of U.S. Status

If a trustee whose U.S. status caused a trust to be treated as a U.S. trust ceases to be a trustee or ceases to be a U.S. person, the regulations give the trust twelve months from the date of such cessation to make whatever changes are necessary to give control over all substantial decisions of the trust to U.S. persons.14 If the change is made within this period of time, the trust will be treated as having maintained its U.S. status even during the time when one or more substantial decisions were not controlled by U.S. persons. If the change is not made within this time period, the trust will be treated as having lost its U.S. status on the date the trustee lost her U.S. status or ceased to serve as trustee. The district director has the power to extend this time period for reasonable cause.

e. Election Available for Trusts in Existence on August 20, 1996

Section 1161 of the Taxpayer Relief Act of 1997 (the “1997 Act”)15 permits nongrantor trusts that were in existence on August 20, 1996 and that were treated as domestic trusts on August 19, 1996 to elect to continue to be treated as U.S. trusts notwithstanding the new criteria for qualification as a U.S. trust.16 According to Treas. Regs. § 301.7701-7(f), a trust is considered to have been treated as a domestic trust on August 19, 1996 if:

(1) the trustee filed on behalf of the trust a Form 1041 (U.S. income tax return for estates and trusts), and not a Form 1040NR (U.S. nonresident alien income tax return), for the period that includes August 19, 1996; and

(2) the trust had a reasonable basis (within the meaning of Code § 6662) under Code § 7701(a)(31), prior to amendment by the 1996 Act, for reporting as a domestic trust for that period.17

Trusts that are not required to file either the Form 1041 or the Form 1040NR will be considered to have been treated as a domestic trust on August 19, 1996 if they satisfy the second criteria and if they have a reasonable basis for filing neither form.18

Treas. Reg. § 301.7701-7(f)(3) details the procedure for making the election to remain a domestic trust. Once the election is made, it may only be revoked with the consent of the Service. However, an election will terminate if changes are made to the trust after the effective date of the election that cause the trust to no longer have a reasonable basis for being treated as a domestic trust under old Code § 7701(a)(30).

B. Creation of and Transfer of Property to a Foreign Trust by a U.S. Person

1. Tax Consequences of Creation and Transfer

No tax consequences are imposed on a U.S. person on account of her creation of a foreign trust, but, under some circumstances, income tax may be imposed on her transfer of property to a foreign trust, whether that trust was created by her or by another. Code § 68419 treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred and requires that the transferor recognize gain on the excess of such fair market value over her basis in the transferred property. This rule does not apply to the

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12 If a U.S. person hires an investment advisor on behalf of the trust and can terminate at will such advisor’s power to make investment decisions, the U.S. person will be treated as retaining control over the investment decisions made by the investment advisor. Treas. Reg. § 301.7701-7(d)(ii)(J).

13 Such employee benefit trusts include qualified trusts described in Code § 401(a); trusts described in Code § 457(g); trusts that are individual retirement accounts described in Code § 408(a); trusts that are individual retirement accounts described in §§ 408(k) or (p); trusts that are Roth IRAs described in Code § 408A; trusts that are educational retirement accounts described in Code § 530; trusts that are voluntary employees’ beneficiary associations described in Code § 501(c)(9); and such additional categories of trusts designated by the Service.

14 Treas. Reg. §301.7701-7(d)(2).


16 Trusts that were wholly owned by their grantors under the so-called “grantor trust” rules set forth in Code §§ 671 through 679 on August 20, 1996 may not make this election. Treas. Reg. § 301.7701-7(f). However, this election is available to a trust if only a portion of the trust was treated as owned by the grantor on August 20, 1996; in this instance, the election is effective for the entire trust. Id.

17 The final regulations supersede Notice 98-25, 1998-1 I.R.B. 11, which provided guidance as to the application of Section 1161 of the 1997 Act.

18 Trusts that are not required to file include certain group trusts described in Revenue Ruling 81-100, 1981-1 C.B. 326, and domestic trusts that do not meet the income requirements for filing under Code § 6012(a)(4).

19 Code § 684 was added to the Code by the 1997 Act.
extent that any person (including the transferor) is treated as the owner of such trust under Code § 671.

2. Tax Treatment During the Life of a U.S. Creator or Transferor

If a foreign trust to which a U.S. person has made any direct or indirect gratuitous transfers has one or more U.S. beneficiaries, Code § 679 treats the trust as a so-called “grantor trust” owned by the U.S. person within the meaning of Code § 671 to the extent of her transfer.

A transfer is not a gratuitous transfer if it was made for full fair market value. For purposes of determining whether full fair market value has been received, if the transferor is the grantor or a beneficiary of the trust (or a person related within the meaning of Code § 643(i)(2)(B) to any grantor or beneficiary of the trust), any obligation issued by the trust (or by certain related persons) is disregarded, except as provided in regulations. Treasury has not yet proposed regulations to deal with this issue, but the Service has indicated that regulations will be issued that will provide that certain “qualified obligations” will be recognized as consideration. An obligation is a qualified obligation only if:

"(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation’s maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. person extends the period for assessment of any income tax attributable to the loan and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation issued in consideration for the loan (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person’s taxable year and is paid within such period); when properly executed and filed, such an agreement will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d); and (vi) The U.S. person reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding."22

A trust is treated as having a U.S. beneficiary in any year in which income or corpus may be paid to or for the benefit of or accumulated for future distribution to or for the benefit of a U.S. person or in any year in which, if the trust terminated, any part of the income or corpus could be paid to or for the benefit of a U.S. person.23 For this purpose the term “U.S. person” includes a controlled foreign corporation as defined in Code § 957(a), a foreign partnership with one of more U.S. partners, and a trust or estate, one of more beneficiaries of which are U.S. persons.24 A beneficiary who became a U.S. person more than five years after a gratuitous transfer to a trust will not be treated as a U.S. person for purposes of that transfer.25

The test for determining whether a foreign trust has a U.S. beneficiary is done on a year by year basis. If a foreign trust has no U.S. beneficiaries in one year and acquires one in a subsequent year, the U.S. gratuitous transferor will be required to include in his gross income in such year, an amount equal to all the undistributed net income of the trust at the end of the prior year that is attributed to her transfer.26 Since Code § 679 does not apply after a transferor’s death, it should be possible to structure a foreign trust with future U.S. beneficiaries that is not subject to Code § 679. So long as the U.S. beneficiaries could receive no trust distributions during the transferor’s life and no future distributions of income or principal accumulated during the transferor’s life, Code § 679 should not apply.

3. Tax Treatment at the Death of U.S. “Owner” of a Foreign Trust

The death of a U.S. person who was treated as the owner of a foreign trust during her lifetime may be a gain recognition event under Code § 684. Here’s the argument for such treatment. Until the U.S. person’s death, she was the owner of the property for U.S. income tax purposes under Code § 671. Her death terminates the trust’s grantor status. Treas. Reg. § 1.1001-2(c), Example 5, treats the termination of grantor status as a transfer of the trust property by

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21 Code § 679(c)(2).
22 Code § 679(c)(3).
23 Code § 679(b).
24 Code § 679(c)(1).
25 Code § 679(c)(1).
26 Code § 679(c)(1).
the grantor. If this regulation is applied to Code § 684, and if it applies to terminations caused by death, the deceased U.S. person will be treated as having made a transfer to a foreign trust at the moment of her death.

Some suggest that this result will occur even if the property held in the foreign trust is included in the U.S. person’s estate for estate tax purposes and receives a basis adjustment under Code § 1014. Code § 1014, it is argued, does not provide the decedent with a basis adjustment. Instead, Code § 1014 seems to give the basis adjustment only to the recipient of the property. It is unlikely that this result is intended by Congress. If it were, it would apply not only to the treatment of U.S. persons whose death causes their foreign grantor trusts to become foreign nongrantor trusts but also to any U.S. person who owns or whose grantor trust owns at her death property, the transfer of which would result in gain recognition. For example, the death of a grantor whose revocable trust holds property subject to debt in excess of basis would trigger tax on the excess.

The risk of this result can be avoided in the case of a foreign grantor trust, by giving a U.S. person, perhaps a U.S. trust, the right to withdraw the foreign trust’s property immediately upon the death of the U.S. person. The withdrawal power would give the deceased U.S. person the protection of Code § 684(b). Code § 684(b) excepts transfers to trusts to the extent such trusts are owned by any person (other than a foreign nongrantor trust) under Code § 671.

A transfer by the will of a U.S. decedent of property to a foreign nongrantor trust generally will not be subject to Code § 684. This is so because the estate will receive the property from the decedent with a basis adjustment under Code § 1014. If the estate transfers the property before any postdeath appreciation occurs, there will be no gain to which Code § 684 can apply.

4. Tax Treatment After Death of U.S. Person

After the death of the U.S. person who has made transfers to a foreign trust, the trust will no longer be subject to Code § 679 and will be treated as a foreign nongrantor trust.

5. Reporting Requirements

A U.S. person who creates a foreign trust or who transfers property to a foreign trust, other than a transfer in exchange for consideration equal to the full value of the transferred property, is required to report the creation or transfer on Form 3520. For purposes of determining whether full consideration has been received, notes issued by the trust or related persons are to be disregarded to the same extent they are disregarded for purposes of Code § 679 (a)(3) as discussed above. Qualified obligations, as defined in Notice 97-34, will be treated as consideration, but an obligation will be treated as qualified only if reported.

Form 3520 is due at the same time as her income tax return is due for the year in which such creation or transfer took place. Failure to file may subject a transferor to a penalty equal to 35% of the amount transferred.

A U.S. person who is treated as the owner, within the meaning of Code § 671, of a foreign trust is required to ensure that the trust files an annual return that sets forth a full accounting of all trust activities and operations for each year that she is treated as owner. The U.S. “owner” is required to disclose on Form 3520 the existence of the trust, its taxpayer identification number, the names of other persons who are considered “owners” of the trust, the code section which causes the trust to be treated as owned by the U.S. person and others who are treated as owners, the country in which the trust was created and the date of creation. Form 3520 is due at the same time as the U.S. person’s income tax return is due. The information required to be furnished by the trust must be disclosed on Form 3520A, which is due on each March 15 following the year for which reporting is required. If Form 3520A is not filed, the U.S. person who is treated as the owner may be liable for a penalty equal to 5% of the value of the trust assets that are treated as owned by her.

The executor of the estate of a U.S. person who transfers property to a foreign trust at her death, who was treated as the owner of a foreign trust during her lifetime or whose estate includes, for estate tax purposes any portion of a foreign trust, must report the death and the transfers on Form 3520. Form 3520 is due at the same time as the executor’s income tax return is due for the year in which the decedent’s death occurred. Failure to file may subject the executor to a penalty equal to 35% of the amount transferred.

6. Treatment of Trusts That Become Foreign Trusts


A trust will be treated as an owner of another trust to the extent it has the power to withdraw that trust’s assets. Treas. Reg. § 1.671-2T(e)(6) Example 8.

Code § 6048(a); Notice 97-34, 1997-2 C.B. 422.

Notice 97-34, 1997-2 C.B. 422.

Code § 6677(a).

Code § 6048(b).

Code § 6677(b).

Code § 6048(a).

Code § 6677(a).
a. In General

If a U.S. trust with U.S. beneficiaries becomes a foreign trust during the life of a U.S. person who has made gratuitous transfers to it, the trust and the U.S. person will be treated in the same manner as they would have been treated under Code § 679 if the trust had been a foreign trust when the transfers were made.37

If a U.S. trust becomes a foreign trust (1) at a time when there is no living U.S. person who ever made a gratuitous transfers to it or if it has no U.S. beneficiaries, and (2) if it is not treated as owned by another person within the meaning of Code § 671, the trust will be treated as having transferred all of its assets to a foreign trust immediately before becoming a foreign trust.38 As a result, Code § 684(a) will treat it as having sold all of its assets for an amount equal to their fair market value.

b. Reporting Requirements

A U.S. trust that becomes a foreign trust is required to report its change of status on Form 3520.39 Form 3520 is due at the same time as the trust’s income tax return is due for the year in which the transfer took place. Failure to file may subject a trust to a penalty equal to 35% of the amount transferred.40

C. Creation of a Foreign Trust by a NonU.S. Person

Neither Code § 684(a) nor Code § 679 applies to a transfer to a foreign trust by a non-U.S. person. As a result, no U.S. income tax will be imposed on such transfer. The trust’s income will be treated for U.S. income tax purposes as if earned by a foreign nongrantor trust unless Code § 672(f) applies to the trust. Prior to the 1996 Act, trusts created by non-U.S. persons were subject to the so-called “grantor trust” rules set forth in Code §§ 671 through 679 to the same extent as trusts created by U.S. persons. The application of the grantor trust rules shifted the trust’s income, for virtually all U.S. income tax purposes, from the trust to its grantor.

As discussed more fully below, Code § 672(f), which was added by the 1996 Act, denies grantor trust status to trusts with non-U.S. grantors unless (1) the grantor retains the right, exercisable either unilaterally or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; (2) or the only amounts permitted to be distributed from the trust during the grantor’s life are amounts distributable to the grantor or her spouse.41

II. TAX TREATMENT OF FOREIGN NONGRANTOR TRUSTS

A. In General

Nongrantor trusts calculate their taxable incomes in the same manner as individuals with certain modifications set forth in Code §§ 642, 643, 651, and 661. For this purpose, foreign nongrantor trusts are treated as nonresident individuals who are not present in the U.S. at any time.42

B. Gross Income

The gross income of a foreign nongrantor trust consists only of (1) gross income derived from sources within the U.S. that is not effectively connected with the conduct of a trade or business within the U.S., and (2) gross income that is effectively connected with the conduct of a trade or business within the U.S.43 Gross income from sources within the U.S. includes:

1. interest from the U.S. (or any of its agencies), the District of Columbia, from noncorporate residents of the U.S. and from domestic corporations;44
2. dividends from domestic corporations;45
3. rentals and royalties from property located in personal property is generally sourced according to the residence of the seller. But, under Code § 865(e)(2)(A), a nonresident alien who maintains an office in the United States has United States source income to the extent she sells personal property attributable to that office. Prior to the 1997 Act, it was unclear whether a trust that was a foreign trust within the meaning of new Code § 7701(a)(31) but that had a United States trustee with an office in the United States would be treated as having United States source income to the extent that trustee directed the sale of personal property. See Schwab and Davies, Tax Risks When U.S. Fiduciary Acts as Trustee of Foreign Trust, New York Law Journal (January 7, 1997). Section 641(b) was amended by the 1997 Act to provide that, in determining the income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the United States at any time.

41 Code § 872(a).
42 Code § 861(a)(1).
43 Code § 861(a)(2).

37 Code § 679(a)(5).
38 Code § 684(a).
39 Code § 6048(a).
40 Code § 6677(a).
41 Code § 672(f).
42 Trusts with foreign grantors that were in existence on September 19, 1995 and that were treated as grantor trusts under Code § 676 (relating to trusts, the property of which may be returned to the grantor) or Code § 677 (relating to trusts the income from which may be paid to the grantor or her spouse) other than Code § 677(c) (relating to trusts the income from which may be used to pay life insurance premiums on the life of the grantor or her spouse) will continue to be treated as grantor trusts except to the extent transfers were made to such trusts after September 19, 1995. P.L. 104-188 § 1904(d)(2).
43 Code § 641(b). Code § 871(a)(2) provides that a nonresident alien individual who is present in the United States for a period of 183 days or more in a taxable year is subject to a 30 percent tax on her net capital gains allocable to sources within the United States. Under Code § 865(a)(1) income from the sale of

26 ACTEC Notes 165 (2000)
the U.S. including rentals or royalties for the use in the U.S. of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and the like; and 46

4. gains from the disposition of U.S. real estate. 47

C) Imposition of U.S. Income Tax

Foreign nongrantor trusts are subject to U.S. income tax on the types of income described below:

1. Income Effectively Connected With U.S. Trade or Business

Foreign nongrantor trusts are taxable on taxable income which is effectively connected with the conduct of a trade or business within the U.S. 48

Although it is unlikely that a foreign nongrantor trust would be engaged directly in a trade or business, some foreign trusts may have this type of income as a result of investments in partnerships that engage in U.S. trades or businesses. A foreign nongrantor trust that is a general or limited partner in a partnership engaged in a U.S. trade or business is deemed to be engaged in that trade or business. 49

2. Election With Respect to Income From Real Property

In addition, a foreign nongrantor trust that receives income from real property located in the U.S. may make an election to treat all such income as income effectively connected with a U.S. trade or business if the property is held for the production of income. 50 In the absence of such an election, such income would be taxed on the basis of gross receipts unreduced by any deductions.

3. Disposition of U.S. Real Property Interests

A foreign nongrantor trust’s gains from the disposition of “United States real property interests” are treated as income that is effectively connected with a U.S. trade or business. 51 For this purpose, a “United States real property interest” is “any interest, other than an interest solely as a creditor, in either:

i) real property located in the United States or theVirgin Islands, or
ii) a domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii). 52

The term “interests in real property” includes fee ownership and co-ownership of and leaseholds of land, improvements thereon, personal property associated with the use of real estate, and options to acquire such land, improvements, leaseholds, and personal property. 53

A U.S. real property holding corporation is any corporation unless the value of its U.S. real property interests is less than 50% of the sum of the value of all of its real property interests plus the value of all of its assets that are used or held for use in its trade or business. 54

A foreign nongrantor trust’s receipt of consideration for the disposition of a partnership interest in a partnership that holds any U.S. real property interests is treated as consideration received for the disposition of a U.S. real property interest to the extent attributable to U.S. real property interests. 55

4. Fixed or Determinable Annual or Periodic Income

Foreign nongrantor trusts are taxed on their U.S. source fixed or determinable annual or periodic income such as interest, dividends, rents, and annuities and the like. 56 They are also taxed on their U.S. source gains from certain timber, coal and iron ore transactions, 57 on their U.S. source gains from the sale or exchange of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises and similar property to the extent the gains are from payments which are contingent on the use of the transferred interest, 58 and, subject to the important exceptions described below, on their original issue discount from U.S. sources. 59 These types of income are all subject to the same type of taxation, except to the extent they are effectively connected with a U.S. trade or business. For convenience they are referred to in this chapter as “fixed or determinable annual or periodic income.”

5. Other Gains

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*Code § 861(a)(4).
*Code § 861(a)(5).
*Code § 871(b).
*Code § 871(d)(1).
*Code § 897(a).
*Treas. Reg. § 1.897-1(c)(1); see Code § 897(c)(1).
*Code § 897(c)(6).
*Code § 897(c)(2). Shares of any class of securities that are regularly traded on an established securities market will not be treated as a United States real property interest except as to a person who holds more than 5% of the stock. Code § 897(c)(3).
*Code § 897(g); Notice 88-72, 1988-2 C.B. 383.
*Code § 871(a)(1)(A).
*Code § 871(a)(1)(B).
*Code § 871(a)(1)(D).
*Code § 871(a)(1)(C).
Nonresident aliens who are present within the U.S. for more than 183 days in a particular taxable year are normally subject to tax on gains derived from sources within the U.S. from the sale of capital assets. As discussed above, Code § 641(b) prevents this rule from applying to foreign nongrantor trusts. It provides that, for purposes of calculating the taxable income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the U.S. at any time. Thus, even though the trustees of a foreign nongrantor trust reside permanently in the U.S., the trust will be treated for U.S. income tax purposes as if the trustees had never been present in the U.S.

6. Exceptions
a. No U.S. income tax will be imposed on a foreign nongrantor trust’s receipt of so-called “portfolio interest” unless such income is effectively connected with the conduct of a U.S. trade or business. For this purpose, portfolio interest is interest (including original issue discount) which is paid on certain obligations of U.S. persons issued after July 18, 1984.

b. No U.S. income tax will be imposed on a foreign nongrantor trust’s receipt of interest from a U.S. bank, savings and loan association, insurance company or similar institution unless such income is effectively connected with the conduct of a U.S. trade or business.

c. No U.S. income tax will be imposed on a foreign nongrantor trust’s receipt of original issue discount income on obligations that mature in 183 days or less from the date of original issue unless such income is effectively connected with the conduct of a U.S. trade or business.

D. Deductions
1. Income Effectively Connected With U.S. Trade or Business

In computing a foreign nongrantor trust’s taxable income that is effectively connected with the conduct of a trade or business within the U.S., the trust is entitled to reduce its gross income so connected (or treated as so connected) by the deductions that are “connected” with such income. The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treas. Reg. § 1.873-1. In addition, it is also entitled to deduct against its effectively connected income the following:

a. the deduction for losses allowed by Code § 165(c)(3) if the loss occurred with respect to property located in the U.S.;

b. the deduction for charitable contributions allowed by Code § 170; and
c. the deduction for personal exemptions allowed by Code § 151.

Nothing in the Code or the Regulations indicates whether the distributions made to beneficiaries by a foreign nongrantor trust with income effectively connected with the conduct of a trade or business within the U.S. are connected with such income and, therefore, deductible under Code §§ 651 and 661. It is appropriate to permit a foreign nongrantor trust to deduct that portion of its distributions to beneficiaries that consist of effectively connected income.

2. Other Income

No deductions are permitted against U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business.

3. Foreign Tax Credit

A foreign nongrantor trust engaged in a trade or business within the U.S. (either directly or through investments in partnerships that are so engaged) that pays foreign income, war profits or excess profits taxes on income that is effectively connected with such trade or business may, subject to certain limitations, credit the foreign tax against its U.S. income tax liability. Alternatively, it may deduct such taxes. The total amount of the credit:

a. is limited to the proportion of the U.S. tax against which such credit is taken as the trust’s taxable income from for-

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60 Code § 871(a)(2). Income from the sale of personal property (other than inventory property) attributable to an office or other fixed place of business in the U.S. that is maintained by a nonresident in the U.S. is sourced in the U.S. Code § 865(e)(2).

61 Code § 871(h).

62 Code § 871(i).

63 Code §§ 871(a)(1)(C), 871(g)(1).

64 Code § 873(a).

65 Code § 873(b).


67 Code §§ 901(b)(4), 906(a).

68 Code § 164(a)(3). If the trust claims the credit, the deduction is not permitted. Code § 275(a)(4).
foreign sources bears to its entire taxable income effectively connected with its U.S. trade or business; a.

b. may not be used against any income tax imposed on income not effectively connected with such business; and
c. is not allowed to the extent it is properly allocable under Code § 901(b)(5) to the trust’s beneficiaries.

In some cases foreign income, war profits or excess profits taxes will be imposed on the foreign grantor of a foreign nongrantor trust rather than on the trust itself. This would occur, for example, if the trust were treated as “owned” by its grantor under foreign tax rules similar to the so-called grantor trust rules set forth in Code §§ 671 through 679. There is no mechanism in the Code that permits the foreign nongrantor trust to credit the taxes paid by the grantor against the trust’s U.S. income tax.

Until the 1997 Act’s imposition of significant limitations on the availability of grantor trust status for trusts created by non-U.S. persons, the absence of a credit mechanism was unlikely to be a problem. This was so because the U.S. grantor trust system is so broad that any trust treated as owned by its grantor under foreign tax law was also likely to be treated as owned by its grantor under U.S. tax law. Under current U.S. law, the absence of a credit mechanism can result in serious foreign tax credit misallocations.

E. Tax Rates

1. Income Effectively Connected to a U.S. Trade or Business

This type of income is subject to the normal tax rates applicable to trusts under Code § 1(c).

2. Other Income

U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business, is subject to tax at a flat rate of 30%.

F. Withholding

1. Income Effectively Connected With U.S. Trade or Business

Withholding is generally not required for income (including fixed or determinable annual or periodic income) to the extent it is effectively connected with a U.S. trade or business. Withholding obligations are, however, imposed on partnerships that have taxable income that is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business if such income is allocable under Code § 704 to a foreign partner. The withholding rate applicable to foreign nongrantor trusts that are partners in such partnerships is the highest rate of tax specified in Code § 1.

2. U.S. Real Property Interests

The transferee of a disposition by a foreign person of a U.S. real property interest is required to withhold. The withholding rate is 10% of the amount realized.

3. Fixed or Determinable Annual or Periodic Income

Code § 1441(a) requires any person paying any of the items of income listed in Code § 1441(b) to withhold a 30% tax to the extent such income constitutes gross income from U.S. sources of any nonresident alien individual or of any foreign partnership unless such income is effectively connected with the conduct of a U.S. trade or business. The income items listed in Code § 1441(b) are the various kinds of fixed or determinable annual or periodic income. Code § 1442 imposes a similar requirement with respect to the income of foreign corporations. Curiously, neither section refers to withholding with respect to the income of trusts. Nevertheless, the regulations state that income paid to a foreign fiduciary is subject to the withholding requirements of Code § 1441. As discussed above, however, a foreign trust does not necessarily have nonresident alien trustees. Whether the withholding requirements apply to payments made to the U.S. trustees of a foreign nongrantor trust is not clear.

G. Effect of Tax Treaties

The principles described above may apply differently to foreign nongrantor trusts that are residents of countries with which the U.S. has an income tax treaty. For example, most income tax treaties to which the U.S. is a party reduce the tax imposed on dividends not effectively connected to a U.S. trade or business to 15% from 30%.

H. Taxable Year; Reporting

1. Taxable Year and Estimated Tax Payments

Foreign nongrantor trusts must adopt a calendar taxable year and are required to make estimated Form 8804 and send Form 8805 to each such foreign partner.

88 Code §§ 904(a) and 906(b)(2).
89 Code § 906(b)(3).
90 Code § 11.622(a).
91 See discussion at III.B.2.d of credit that may be allowed to a foreign trust by regulation for foreign taxes imposed on its foreign grantor in certain circumstances.
92 Code § 971(b)(1).
93 Code § 971(a).
94 Code § 1446(a). Such a partnership is required to file Form 8804 and to send Form 8805 to each such foreign partner.
95 Code § 1446(b).
96 Code § 1445(a). The transferee is required to file Form 8288 and to furnish Form 8288A to the transferee.
97 The person withholding is required to file Form 1042 and to furnish Form 1042S to the person from whom tax is withheld.
98 Code § 1441(c)(1).
income tax payments in the same manner as U.S. trusts.\textsuperscript{81}

2. U.S. Nonresident Alien Income Tax Return – Form 1040NR

The trustee of a foreign nongrantor trust is required to file Form 1040NR for a particular year if:

a. the trust was engaged in trade or business in the U.S. during such year even if no income was derived from such trade or business; or
b. the trust had income in such year that is subject to tax in the U.S. unless the trust’s liability for such tax is fully satisfied by withholding.\textsuperscript{82}

If a foreign nongrantor trust is required to file Form 1040NR for a particular year, the return must be filed by the 15th day of the 6th month following the close of the year if the trust does not have an office or place of business in the U.S. If the trust does have an office or place of business in the U.S., its Form 1040NR must be filed by the 15th day of the 4th month following the close of the year.\textsuperscript{83}


A U.S. trustee of a foreign nongrantor trust must file Form TD F 9022.1 if she has a financial interest in or signature authority or other authority over any financial accounts, including bank, securities, or other types of financial accounts in a foreign country if the value of such accounts exceeds $10,000. A person has a financial interest in any such account if she has legal title to it. Trustees generally have legal title to accounts in which trust funds are invested. In addition, if legal title to an account is held by a corporation or partnership and the trustee owns more than 50% of the corporation or partnership, the trustee will be treated as having a financial interest in such account. A person has signature authority over an account if she can control the disposition of account property by the delivery of a document signed by her and one or more other persons. A person has other authority over an account if she can control such disposition by direct communication to the person with whom the account is maintained.

Form TD F 9022.1 must be filed by June 30th of the year following the year in which the U.S. person had such financial interest or signature or other authority.

4. Taxpayer Identification Numbers

Code § 6109 requires persons to obtain a U.S. identifying number to the extent required by regulations. Treas. Reg. § 301.6109-1(b) requires a foreign nongrantor trust (or any other nonresident alien) to obtain a U.S. taxpayer identification number if:

a. it has income effectively connected with a U.S. trade or business, it has a U.S. office or place of business;
b. it files a U.S. income tax return or refund claim; or,c. after December 31, 1998, it furnishes a withholding certificate claiming a reduced tax rate under a treaty (other than for dividends and interest from stocks and debt that are actively traded and certain other securities), or an exemption from withholding from income that is effectively connected with a U.S. trade or business.

III. TAX TREATMENT OF U.S. BENEFICIARIES OF FOREIGN NONGRANTOR TRUSTS

A. In General

U.S. taxpayers who are beneficiaries of foreign nongrantor trusts may be subject to U.S. income taxes on distributions of cash or other property received from such trusts. In some cases, loans made to them or to persons related to them from such trusts will be treated as distributions.

The determination of a U.S. beneficiary’s U.S. tax liability with respect to distributions and loans depends on a number of factors, including whether the distribution was made during a year in which the foreign nongrantor trust earned income and the relationship between the size of that income and the value of the distributions made in that year to the U.S. beneficiary and to other trust beneficiaries, whether, if the amount of the trust’s distributions exceeded the amount of its income for the year of distribution, the trust had undistributed income accumulated from prior years, and whether the trust previously paid U.S. income tax or foreign income tax.

U.S. beneficiaries of foreign trusts may also be subject to tax on income earned by certain corporations whose shares are owned by the trust. The types of corporations that are the source of such potential liability are controlled foreign corporations, foreign personal holding companies and passive foreign investment companies. This subject is discussed more fully below.

B. Distributions of Income in the Year Earned

1. General Rules

a. Distributable Net Income

\textsuperscript{81}Code §§ 664(a) and 6654(l); Notice 87-32, 1987-1 C.B. 477.

\textsuperscript{82}Treas. Reg. § 1.6012-1(b).

\textsuperscript{83}Treas. Reg. § 1.6072-1; T.D. 7426.
A U.S. beneficiary of a foreign nongrantor trust is required to include in her gross income for any particular year:

1. the amount of any trust income in such year required to be distributed to her from a so-called “simple trust” (whether or not actually distributed to her) to the extent of her share of the trust’s distributable net income (“DNI”) for the year;\(^8\)

2. the amount of any trust income required to be distributed to her in such year from any other foreign nongrantor trust, a “complex trust” (whether or not actually distributed to her) to the extent of her share of the trust’s DNI for the year,\(^8\) and

3. any other amount required to be distributed to her (whether or not actually distributed to her) or properly and actually distributed to her from a foreign complex trust in such year to the extent of her share of the trust’s DNI for such year.\(^9\)

b. Determining a Beneficiary’s Share of DNI

In the case of a simple trust, if the amount of income distributions required to be made exceeds the trust’s DNI, each beneficiary shares in the trust’s DNI in the proportion that the amount of income required to be distributed to her bears to the amount of income required to be distributed to all beneficiaries.\(^8\) The same rule applies to income distributions from complex trusts.\(^8\)

If a complex trust’s DNI exceeds the amount of income required to be distributed to its beneficiaries and if there are other amounts either required to be distributed or properly distributed to a beneficiary, that beneficiary will share in the trust’s remaining DNI in the proportion that the amount of the trust’s distribution (or required distribution) to her bears to the amount of all such distributions (or required distributions) to all beneficiaries.\(^8\)

Consider the following example:

Example 2: Kate is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). Under the terms of the trust all income is (and always has been) required to be distributed currently to Kate’s mother, M, a nonresident alien. The trustees are permitted to make principal distributions to Kate. In 1997, the trust’s income (and its DNI) consisted of $100,000 of dividends from foreign corporations, all of which were distributed to M. FNT has never had any income from capital gains. The trustees made a principal distribution of $100,000 to Kate. Kate is not required to include any portion of the $100,000 distribution in her gross income.

c. Meaning of “Income”

For purposes of these rules, the term “income” (unless part of the phrase “taxable income,” “distributable net income,” “undistributed net income,” or “gross income”) means the amount of income for the taxable year of the trust determined under the terms of the governing instrument and applicable local law.\(^8\) To avoid confusion, this chapter refers to “income” as “trust accounting income.” The term “income” or “trust accounting income” is generally used to describe for local law purposes the amount required or permitted to be distributed to current trust beneficiaries when the terms of the trust instrument require or permit trust income, but not trust principal, to be distributed to such beneficiaries. The items that are included in the term “income” or “trust accounting income” vary from jurisdiction to jurisdiction. There is no standard federal definition. The term generally includes items such as dividends and similar distributions made with respect to investments in business or investment entities, interest, and rent. It generally excludes gains from the disposition of property. Trust provisions whose definitions of income depart fundamentally from local law are not recognized for purposes of this definition.\(^9\)

d. Sixty-Five Day Election

At the trustee’s election, an amount that is properly paid to a beneficiary within 65 days after the end of a taxable year will be treated as having been paid to her within such taxable year.\(^9\)

e. Specific Gifts

An amount that the trust instrument requires to be paid to a beneficiary as a gift of a specific sum of money or of specific property and which is actually paid to her all at once or in no more than three installments is not treated as a distribution and, therefore, is not included in the gross income of the U.S. beneficiary. This exception does not apply to amounts that can be paid only from trust income.\(^9\)

Consider the following example:

\(^{8}\) Code § 651(a). The term “simple trust” refers to a nongrantor trust that is not permitted to make payments to charity and that, in the year for which the characterization is made, makes no principal distributions, and is required to distribute all current income.

\(^{9}\) Code § 662(a)(1). The term “complex trust” refers to a nongrantor trust other than a simple trust.

\(^{9}\) Code § 663(a)(1).
Example 3: Pat is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). The terms of the trust document require the trustees of FNT to pay Pat $1,000,000 on his 30th birthday. Pat reached age 30 during 1997, a year in which FNT’s income and DNI exceeded $1,000,000. FNT’s principal in that year was worth $10,000,000. Pat is not required to include the $1,000,000 paid to him by FNT in his gross income.

f. Distributions of Property Other Than Cash

The amount of any distribution to a beneficiary of property other than cash (other than a required distribution of trust accounting income or other fixed amount) is the lesser of the trust’s basis in the property or its value at the time of distribution unless the trustee makes an election to recognize gain on the distribution. If the trustee makes such an election, the amount of the distribution will be the value of the property. The trust will recognize gain equal to the excess of the value of the property over its basis. If the trustee does not make the election, the beneficiary’s basis will be the same as the trust’s basis.

Consider the following example:

Example 4: Jenny is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). During 1997, the trustees of FNT distributed 100 shares of X corporation stock to her. The shares were worth $1,000,000 at the time of distribution. The trust’s basis in the shares was $1,000. FNT’s income and DNI in 1997 exceeded $1,000,000. The trustees did not make the election described above to recognize gain on the distribution. Jenny will not be required to include any amount in excess of $1,000 in her gross income on account of the distribution. Her basis in the X shares will be $1,000.

These general rules are no different than the rules that apply to U.S. beneficiaries of U.S. nongrantor trusts.

2. Special Rules Applicable to Nongrantor Trusts That Are Foreign

a. Different Definition of Distributable Net Income

Generally, the DNI of a U.S. nongrantor trust for a particular year is equal to its taxable income for that year adjusted by adding to taxable income the amount deducted as a personal exemption, the amount of its tax exempt income, and the amount of the trust’s deduction for distributions to beneficiaries and by subtracting from taxable income the trust’s capital gains except to the extent such capital gains are “paid, credited or required to be distributed to any beneficiary during the taxable year.”

The DNI of a foreign nongrantor trust includes its capital gains. In addition, a foreign nongrantor trust’s DNI includes the amount of its income from non-U.S. sources reduced by amounts which would be deductible in connection with such income in the absence of Code § 265 and the amount that was excluded from its gross income by treaty under Code § 894.

Consider the following example:

Example 5: John is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). During 1997 the trust had foreign source dividend income of $10,000 and long term capital gain from the sale of securities of $10,000. Its U.S. gross income and taxable income is zero. The trust distributed $15,000 to John. It neither made nor was required to make distributions to any other beneficiary. The trust’s DNI was $20,000. John’s gross income from the trust, therefore, is $15,000. If FNT had been a U.S. trust, its DNI would have been only $10,000, and John’s gross income on account of his distribution from the trust would have been $10,000.

b. Tax Character of Distributions

The tax character of distributions received by a beneficiary in a particular year reflects the character of the trust’s income for that year proportionately.

Example 6: John, the U.S. taxpayer in the above example, who received a $15,000 distribution from FNT, which had dividend income of $10,000 and long term capital gains of $10,000, will be treated as having received ordinary income of $7,500 and long term capital gains of $7,500.

If the trust document or local law requires that particular types of trust income be allocated to particular beneficiaries and if such requirement has economic significance independent of the tax consequences, the character of the amounts received by the beneficiaries will reflect such required allocation.

Example 7: The terms of FNT, the foreign nongrantor trust described in the example...
above, required that all of FNT’s dividend income be distributed annually to F. John’s nonresident alien father. F will be treated as having received all of the ordinary income included in the trust’s DNI. John’s $15,000 distribution, therefore, will consist of $10,000 of long term capital gains. The balance of $5,000 will not be included in his gross income.

c. Credit for U.S. Withholding Tax

As discussed above, if the foreign nongrantor trust had fixed or determinable annual or periodic income or income from the disposition of U.S. real property interests, it is likely that the trust paid U.S. income tax on such income through withholding under Code § 1441 or Code § 1445. The Service takes the position that a U.S. beneficiary who receives a distribution from a foreign nongrantor trust that includes U.S. source income from which U.S. tax has been withheld must include in her gross income not only the amount she actually receives but also the amount of the withheld tax. She may then credit the withheld tax against her personal income tax liability.101

Example 8: FNT, the foreign nongrantor trust described in the above example, had, in addition to its $10,000 of foreign source dividend income and $10,000 of long term capital gains, $10,000 of dividends on U.S. securities from which $3,000 of tax was withheld. FNT distributed $13,500 to John. John will be treated as having received a distribution of $15,000 consisting of foreign source dividend income of $5,000, long term capital gains of $5,000, and U.S. dividend income of $5,000. The U.S. dividend income has been “grossed up” by his $1,500 share of the taxes withheld from it. The $1,500 will be credited against his U.S. income tax.

d. Credit for Foreign Income Taxes Paid by Trust

A U.S. person who pays income, war profits or excess profits tax to a foreign country may credit the amount of such taxes against her U.S. income tax liability or may claim such taxes as an itemized deduction.102 The total amount of the credit is limited to the proportion of the tax against which such credit is taken as her taxable income from foreign sources bears to her entire taxable income.103

If a foreign nongrantor trust pays such foreign taxes, its U.S. beneficiaries who receive distributions of income on which such taxes have been paid may elect to take a credit for the share of foreign taxes attributable to their share of the income or a deduction.104 The credit is subject to the limits described above.

Neither the Code nor the regulations explain whether the beneficiary must include in her gross income the amount of foreign taxes paid with respect to the income distributed to her if she elects to take the credit. The Service’s internal position seems to require such inclusion. The current edition of the Service’s foreign trust training manual provides the following guidance for its agents:

“While many foreign trusts are established in countries having no income taxes, such as Bermuda or the Bahamas, some are established in countries with income taxes. Some also pay taxes to other countries where they have investments.

In either case, a U.S. citizen or resident taxed on the income of such a trust may claim credit for his/her allocable share of foreign income taxes paid by the trust. If the credit is claimed, the amount of income reported should be grossed up to include the foreign taxes paid.

The taxpayer may deduct the taxes instead if he/she chooses. Failure to gross up trust income should be regarded as an election to take a deduction.”105

If foreign income, war profits or excess profits taxes are imposed on a foreign nongrantor trust’s non-U.S. grantor or on another non-U.S. person rather than on the trust itself and if the trust would have been treated as owned by the grantor or such other person under subpart E of the Code but for Code § 672(f), Code § 901(b)(5) may permit these taxes to be treated for foreign tax credit purposes as if they had been imposed on the trust. Unfortunately, the implementation of this portion of Code § 901(b)(5) appears to require regulatory action, which has not yet occurred.

C. Distribution of Income Accumulated in a Prior Year – the “Throwback Rules”

101 Treas. Reg. §§ 1.1441-3(f) and 1.14621(b); Rev. Rul. 56-30, 19561 C.B. 646; Rev. Rul. 55-414, 19551 C.B. 385.
102 Code §§ 901(a) and 164(a)(3). An election to take the credit precludes the deduction. Code § 275(a)(4).
103 Code § 904(a).
104 Code § 901(b)(5).
105 “Foreign Trusts and the IRS,” 1997 Training 3325002 (0597), 98 TNI 14944. The manual cites no authority for this conclusion. Its discussion of the issue is quite similar to Howard Zaritsky’s speculation as to how the issue should be resolved in Zaritsky, Foreign Trusts, Estates, and Beneficiaries, 854 T.M. A32.
1. In General
If a foreign nongrantor trust makes distributions in excess of its DNI for a particular year, the U.S. beneficiaries who receive such distributions are likely to be required to include such distributions in their gross incomes, may be required to calculate their U.S. income tax on such distributions under a complex rule generally referred to as the “throwback rule,” and may be subject to interest on these taxes.

2. Accumulation Distributions
   a. In General
The throwback rule and its accompanying interest charge apply only if the foreign nongrantor trust has made an “accumulation distribution.” An accumulation distribution is a distribution under Code § 661(a)(2) (dealing with amounts properly paid or credited or required to be distributed other than trust accounting income required to be distributed currently) to the extent such distribution exceeds the trust’s DNI for the year reduced (but not below zero) by trust accounting income required to be distributed currently.106

The following two important exceptions to this definition may be applicable to distributions from foreign nongrantor trusts:
   b. Exceptions
      (1) Specific Gifts
      A distribution in satisfaction of a gift of a specific sum of money or of specific property described in Code § 663(a)(1) (described above) is not an accumulation distribution.107

      Example 9: FNT, the foreign nongrantor trust described above of which Pat is a beneficiary had no DNI in the year in which Pat reached age 30. The trustees distributed the sum of $1,000,000 to Pat as they were required to do under the terms of the trust instrument. The distribution to Pat is not an accumulation distribution.

      (2) Distributions Not in Excess of Trust Accounting Income
      Distributions that do not exceed trust accounting income in the year in which made are not accumulation distributions. The Code establishes this exception with the following text:
      “If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year.”108

This principal is illustrated by the following example:

Example 10: Isaac is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). The terms of the trust permit the trustees to distribute income and principal to any one or more beneficiaries at such times and in such amounts that they believe appropriate. In 1997, FNT received $100,000 in dividends from foreign corporations. It paid trustee commissions of $60,000, $40,000 of which was allocable to principal. Its trust accounting income for the year was $80,000, $100,000 reduced by the $20,000 of expenses chargeable to income. Its DNI was $40,000, $100,000 reduced by the total amount of the trustee commissions. The trustee distributed $80,000 to Isaac. The distribution is not an accumulation distribution because it is not in excess of trust accounting income.

(3) Default Method of Calculating an Accumulation Distribution
In some cases the U.S. beneficiary of a foreign nongrantor trust will not have received sufficient information about her distribution and the trust to enable her to determine whether or not she has received an accumulation distribution. Notice 97-34109 and the current version of Internal Revenue Service Form 3520 (1997) gives her a so-called “default” method of making this determination. A beneficiary is required to use this method if the trust did not provide her with a Foreign Nongrantor Trust Beneficiary Statement.110

The required steps of the default method are as follows:
   Step 1 Calculate the total amount of distributions the beneficiary has received from the foreign nongrantor trust during the three prior years.
   Step 2 Multiply the total by 1.25.
   Step 3 Divide the product determined in Step 2 by the lesser of 3 or the number of years the trust has been in existence (other than those years in which it was treated as a grantor trust).

   The amount treated as a distribution of current income will be the smaller of the actual distribution or the amount determined in Step 3. The balance of the

106 Code § 665(b).
107 Treas. Reg. § 1.665(b)-1A.
108 Code § 665(b). The word “income” in this quotation refers to “trust accounting income.”
109 1997-1 C.B. 422.
110 Internal Revenue Service Form 3520, Line 36 (1997). Presumably the Service’s authority for enforcing this requirement is found in Code § 6048(c)(2)(A), which provides, “If adequate records are not provided to the Secretary to determine the proper treatment of any distribution from a foreign trust, such distribution shall be treated as an accumulation distribution includible in the gross income of the distributee under chapter 1.” The information that must be furnished in a Foreign Grantor Trust Beneficiary Statement is described below.
distribution will be treated as an accumulation distribution. If the default method is used, the number of years used for purposes of calculating the interest charge under Code § 688, as discussed below, will be one-half of the number of years the trust has been in existence.  

Consider the following example:

**Example 11:** Andrew is the beneficiary of a foreign nongrantor trust ("FNT") that has been in existence for 10 years. At the end of 1997 the FNT had assets worth $20,000,000. In each of the 10 years 1988 through 1997, FNT has earned $1,000,000. Assume FNT has no income in 1998, 1999, 2000, and 2001 and that FNT distributes $2,000,000 to Andrew in each such year. The amount of Andrew’s accumulation distribution in each year would be $2,000,000 under Code § 665(b). His situation is improved considerably by using the default method.

In 1998, the accumulation distribution is the full $2,000,000 because there were no distributions in any of the prior three years. In 1999, the amount of the accumulation distribution is reduced to $1,166,667 ($2,000,000 - ($2,000,000 X 1.25/3)). In 2000, the amount of the accumulation distribution is reduced to $333,333 ($2,000,000 - ($4,000,000 X 1.25/3)). In 2001, the amount of the accumulation distribution is reduced to $0 ($2,000,000 - ($6,000,000 X 1.25/3)).

Because the default method of calculating the amount of an accumulation distribution can have the effect of significantly reducing that amount, the use of this method can significantly reduce the interest imposed on the taxes paid on accumulation distributions.

(4) Undistributed Net Income

(a) In General

"Undistributed net income" ("UNI") limits the amount of an accumulation distribution that will be subject to tax. If a foreign nongrantor trust has no UNI, no tax will be imposed on its accumulation distributions. A trust’s UNI for any particular year is equal to the amount by which its DNI for such year exceeds the sum of:

(i) the amount of trust accounting income required to be distributed in such year;
(ii) the amount of any other amount properly paid or credited or required to be distributed for such year; and
(iii) the amount of any taxes imposed on the trust that are attributable to its DNI for the year.

(b) Addition of Taxes

The taxes taken into account in the UNI calculation include U.S. income taxes and foreign income, war profits and excess profits taxes that are imposed on the trust and that are allocable to the undistributed portion of the trust’s DNI. In addition, if any such taxes are imposed on a foreign nongrantor trust’s nonU.S. grantor or any other nonU.S. person and if that person would have been treated as the owner of the trust under the normal grantor trust rules but is prevented from being treated as the owner by Code § 672(f), these taxes may also reduce the trust’s UNI. Unfortunately, the effectiveness of the portion of the Code that permits such reduction appears to require regulatory action, which has not yet occurred.

(c) Reduction of UNI

The original UNI for a particular year of a trust will be reduced by accumulation distributions made in later years to the extent that such distributions are deemed to have been made in such year under Code § 666(a). A distribution paid or used for charitable purposes within the meaning of Code § 642(c) is not treated as an accumulation distribution. As a result, such distributions do not reduce UNI.

(d) Default Method of Calculating UNI

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, the instructions to Internal Revenue Service Form 3520, in effect, require her to assume that the trust’s UNI is at least equal to the amount of the accumulation distribution.

(5) Calculation of Throwback Tax on an Accumulation Distribution

(a) In General

If a beneficiary has received an accumulation distribution from a foreign nongrantor trust, her tax, the “throwback tax” on the distribution can be calculated by following the complex series of steps outlined below. The steps are intended to produce a rough approximation of the tax the beneficiary would have been required to pay if the foreign nongrantor trust had paid income to her in the year earned instead of accumulating it and paying it to her in a later year.

(b) The Steps

**Step 1** Allocate the accumulation distribution

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111 Code § 6048(c)(2)(B).
112 Code § 665(a).
113 Code § 665(d).
114 Code § 665(d)(2).
115 Treas. Reg. § 1.665(a)-1A(c).
116 Treas. Reg. § 1.665(b)-1A(c)(2).
among the preceding years of the trust for which there is any remaining UNI, starting with the earliest such year.**117** If the amount of the accumulation distribution exceeds the UNI for the earliest year, the excess is allocated to the next year for which there is any remaining UNI. The process continues in the same manner until all of the accumulation distribution has been allocated to a preceding year. Each portion of an accumulation distribution allocated to a particular preceding year is deemed to have been distributed on the last day of such year.

**Example 12:** Michael is a U.S. beneficiary of a foreign nongrantor trust (“FNT”). FNT was created in 1990 by Michael’s non-U.S. mother. FNT distributed $100,000 to Michael in 1997, a year in which FNT’s DNI and trust accounting income was $20,000. Therefore, $80,000 of the distribution is treated as an accumulation distribution. FNT’s DNI, none of which was distributed, in each of its preceding years was as follows:

- 1990: $4,000
- 1991: $20,000
- 1992: $30,000
- 1993 through 1996: $40,000

Michael’s $80,000 accumulation distribution is deemed to have been made $4,000 on the last day of 1990, $20,000 on the last day of 1991, $30,000 on the last day of 1992, and $26,000 on the last day of 1993.

**Step 2** Add to the amount deemed, under Step 1, to have been distributed on the last day of a preceding year the taxes that were imposed on such amounts in such year.**118** Such taxes include U.S. income taxes and foreign income, war profits and excess profits taxes.**119**

**Example 13:** Assume that FNT, the trust described in the preceding example, paid taxes in each of its preceding taxable years equal to 40% of its DNI. The total amount deemed to have been distributed to Michael on the last day of each of 1990, 1991, 1992 and 1993 will be $5,600, $28,000, $42,000, and $36,400, respectively. The total amount deemed distributed, or “thrown back” will be $112,000.

**Step 3** Determine the number of preceding taxable years in which a distribution is deemed to have been made.**120** For purposes of this calculation, if any year’s deemed distribution is less than 25% of the total amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated, that year will not be included.**121**

**Example 14:** In the above example the number of preceding taxable years in which a distribution is deemed to have been made will be 3. The year 1990 is disregarded because the amount of the accumulation distribution allocated to that year ($4,000) is less than 25% of the total accumulation distribution ($80,000) divided by the number of years to which the distribution is deemed allocated (4).

**Step 4** Identify the beneficiary’s computation years. The computation years are those three of the beneficiary’s five preceding taxable years left after eliminating the year in which her income was the highest and the year in which her income was the lowest.**122**

**Example 15:** Assume in the above example that Michael’s taxable income in 1992 was $50,000, in 1993 was $100,000, in 1994 was $200,000, in 1995 was $150,000, and in 1996 was $175,000. The year of the highest taxable income, 1994, and the year of the lowest taxable income, 1992, are eliminated. Michael’s three computation years are the remaining years, 1993, 1995, and 1996.

**Step 5** Determine the average annual distribution amount by dividing the amount deemed distributed (the amount of the accumulation distribution plus the amount of taxes deemed distributed) by the number of preceding years in which the distribution is deemed to have been made as determined under Step 3.**123**

**Example 16:** In the above example, the amount deemed distributed is $112,000 and the number of preceding years in which the distribution is deemed to have been made is 3. The average annual distribution amount is

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**Footnotes:**

117 Code § 666(a). If the trust’s records are not sufficient to establish which years have UNI, the accumulation distribution will be allocated to the earliest year that the trust was in existence. Code § 666(d).

118 Code § 666(b) and (c).

119 Code § 665(d). If the beneficiary has received distributions from more than two trusts that are deemed to have been distributed to her on the last day of the same preceding taxable year, the taxes that were imposed on the third trust and any additional trusts on account of such amounts are not deemed to have been distributed to the beneficiary. Code § 667(c). This is detrimental to the beneficiary rather than beneficial because the consequence of the failure to treat taxes as having been distributed is the loss of the ability to use the taxes as a credit against the tax on the accumulation distribution. Code §§ 667(b) and 667(d). For purposes of this rule, a distribution from a trust deemed to have been distributed on the last day of a particular preceding year will be disregarded unless it, when added to any previous distributions for such year, equals or exceeds $1,000. Code § 667(c)(2).

120 Code § 667(b)(1)(A).

121 Code § 667(b)(1)(C).


uses the default method of calculating her accumulations that the default method contains no instructions for her throwback tax using these 9 steps. The difficulty is dividing the sum of the three increases by three.126

Example 17: Assume that Michael’s income tax would have been increased by $15,200, $16,500, and $16,600 in each of the three calculation years.

Step 7 Determine the average tax increase by dividing the sum of the three increases by three.126

Example 18: Michael’s average tax increase is $16,100 ($48,300 divided by three).

Step 8 Multiply the average tax increase by the number of preceding taxable years in which the distribution is deemed to have been made as determined under Step 3.127

Example 19: Michael’s average tax increase, $16,100, is multiplied by 3. The product is $48,300.

Step 9 Subtract from the product obtained in Step 8 the amount of any U.S. income taxes that were added, in Step 2, to the amount deemed distributed to the beneficiary.128 The result is the amount of the beneficiary’s throwback tax.

Example 20: Assume that $25,000 of the total taxes added to Michael’s deemed distribution were U.S. income taxes. The $25,000 is subtracted from $48,300, leaving a throwback tax of $23,300.

(c) Use of the Steps With the Default Method

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, it is unclear how she would calculate her throwback tax using these 9 steps. The difficulty is that the default method contains no instructions for determining the number of years to which the distribution is to be thrown back. In the absence of detailed information, the appropriate approach might be to treat the distribution as having been thrown back in equal shares to onehalf the total number of years the trust has been in existence. This approach would be consistent with the method used to calculate the interest charge when the default method is used.

(6) Calculation of the Interest Charge

(a) In General

If a foreign nongrantor trust makes a distribution to a U.S. beneficiary that is subject to a throwback tax, the tax is increased by an interest charge determined under Code § 668.129

(b) Before the 1996 Act

Before the 1996 Act, the throwback tax imposed on distributions from foreign trusts was subject to a 6% simple interest charge.130 For purposes of the interest calculation, an accumulation distribution was deemed to have been made from the earliest period or periods with respect to which the trust had UNI. For example, if a foreign nongrantor trust made an accumulation distribution in 1992 of $25,000 and if its UNI for 1990 (after adjustment for any prior accumulation distributions) was $50,000, for purposes of the interest calculation the distribution would be deemed to have been made entirely from the income accumulated in 1990 and four years worth of interest would be charged. If the tax on the distribution was $10,000, the interest charge would have been $2,400. Code § 668(b) limited the total interest charge to the excess of the amount of the tax charged over the tax charged on such distribution. Thus, in this example, the interest charge could not exceed $15,000 ($25,000 (the amount of the distribution) reduced by $10,000 (the amount of the tax on the distribution).

(c) After the 1996 Act

Code § 668, as amended by the 1996 Act, modified the interest rate charged on the tax imposed on distributions of accumulated income by foreign trusts and completely changed the calculation method. The interest rate will be the floating rates applied under Code § 6621 to underpayments of tax (currently 8%).131 In addition, interest will be compounded daily and will be calculated over a specially calculated number of years rather than with reference to the length of time between the year of the earliest undistributed accumulations and the year of distribution.132 The number of years over which interest is calculated is

124 Code § 667(b)(1)(D).
125 Code § 667(b)(1).
126 Id. 127 Code § 667(b)(1).
128 Code § 667(b).
129 Code § 667(b)(1)(D).
130 Code § 667(b).
132 Code § 667(b)(1).
determined by the following rather complicated process designed to produce a “dollarweighted” number of years.

**Step 1** the undistributed net income for each year must be multiplied by the number of years between such year and the year of the distribution (counting the year of the accumulation but not the year of distribution).

**Step 2** all products calculated in the first step must be added together.

**Step 3** the sum of such products calculated in the second step must be divided by the aggregate amount of the trust’s undistributed income. The quotient is to be rounded to the nearest half-year.\(^{133}\)

For purposes of this calculation, an accumulation distribution is treated as having come proportionately from each year with respect to which there is undistributed net income (other than a year during which the beneficiary was not a U.S. person) rather than from the earliest accumulation years. This change has the effect of reducing the interest charge on earlier distributions but will prevent the trustees from arranging for distributions from earlier years to be made to beneficiaries who are likely to pay less tax and, therefore, less interest.

The process may be illustrated by the following example.

**Example 21:** FNT, a foreign trust, accumulated income of $100,000 in 1996 and $50,000 in 1997. On January 1, 2000, FNT distributed $25,000 to Tyler, a U.S. person. Tyler’s tax on this distribution was $10,000. The number of years over which interest will be calculated is 3.67 determined as follows:

**Step 1**

\[
100,000 \times 4 = 400,000
\]

\[
50,000 \times 3 = 150,000
\]

**Step 2**

\[
400,000 + 150,000 = 550,000
\]

**Step 3**

\[
550,000 / 150,000 = 3.67
\]

The 3.67 figure is rounded to the nearest half year, or 3.5.

The Code § 6621 rate was 9% in 1996, in 1997, and in 1998 until April 1, 1998, when it dropped to 8%.

Total interest, if the Code § 6621 rate remains 8% through 1999, will be $3,913. This can be calculated using the following formula:

\[
($10,000 \times (1+0.09/365)^{(1.75 \times 365)})
\]

\[
0.9000 = $1,706
\]

$1,706 is the interest charge through March 1998. The balance of the interest charge through December 31, 1999 can be calculated using the following formula:

\[
($11,706 \times (1+0.08/365)^{(1.75 \times 365)})
\]

\[
$11,706 = $1,759
\]

The total interest charge on the $10,000 income tax will be $1,706 plus $1,759 or $3,465.\(^{134}\)

For purposes of future interest calculations, 2/3 of the $25,000 distributions will be deemed to have come from 1996 accumulations and 1/3 from 1997 accumulations.

Code § 668(b) remains unchanged. Thus, total interest charges can never exceed the amount of the accumulation distribution reduced by the tax imposed on it.

If the interest calculation period includes any years before 1996, a possibility that will become increasingly unlikely given the peculiar method of determining the calculation period, the interest rate applicable to that period will be 6%. The interest will not be compounded except as to that portion of the interest calculation period after 1995.\(^{135}\)

**d) The Default Method**

If the U.S. beneficiary uses the default method of calculating her accumulation distribution, the period over which interest is calculated is one half the number of years the trust has been in existence as a foreign nongrantor trust.\(^{136}\)

The application of the new default interest rule can be draconian. If, for example, the interest rate on underpayments is 9% and if the U.S. beneficiary’s tax rate is 40%, the entire amount of the distribution from a trust that has been in existence for 20 or more years will be consumed by taxes and interest.\(^{137}\) Interest charges, however, can be reduced by spreading distributions over a number of years and using the default method rather than the exact method of calculating the amount of the accumulation distributions. As illustrated by Example 11, use of the default method will, with a pattern of equal annual distributions, eliminate accumu-

\(^{133}\) Line 54, Internal Revenue Service Form 3520 (1997).

\(^{134}\) The instructions to Internal Revenue Service Form 3520 (1997) contains a chart that can be used as a simpler method of calculating the interest charge.

\(^{135}\) Code § 668(a)(6).

\(^{136}\) Internal Revenue Service Form 3520, Line 44 (1997). A similar rule exists under Code § 666(d). It provides that, if adequate records are not available to determine the years within which income was accumulated, a distribution of accumulated income shall be deemed to have come from income accumulated in the first year of the trust’s existence. Presumably, the new rule in Code § 6048(c)(2)(B) supersedes Code § 666(d) for foreign trusts.

\(^{137}\) A 20 year trust requires that interest be calculated over a 10 year period. Interest calculated at a rate of 9% compounded daily on a tax of $40 (the assumed tax on a hypothetical distribution of $100) over a 10 year period will be approximately $60.
mulation distributions after a period of three years.

(e) Observation

For families who view their trusts as semi-perpetual arrangements, the interest charge is not likely to be significant. Their trustees are likely to be able to arrange investment and distribution patterns in order to avoid accumulation distributions. No matter how many years a foreign non-grantor trust is permitted to accumulate income free of U.S. income tax, its U.S. beneficiaries will never be subject to an interest charge unless they receive an accumulation distribution. Distributions that do not exceed current income will not be treated as accumulation distributions and, therefore, the income tax they attract will not be subject to an interest charge.

D. Loans Treated as Distributions

1. In General

Code § 643(i), which was added to the Code by the 1996 Act treats, except as provided in regulations, a foreign trust’s loans of cash (including foreign currencies and cash equivalents) or marketable securities to any U.S. grantor or beneficiary of the trust or to any other U.S. person who is related to such a grantor or beneficiary as a distribution.138 For this purpose, a person is related to another person if the relationship between them would result in loss disallowance under Code § 267 or Code § 707(b).

If the loan is made to a person who is not the grantor or a beneficiary, it is not treated as a distribution to the borrower, but, instead, is treated as a distribution to the grantor or beneficiary to whom the borrower is related.139 The logic of this provision is difficult to discern. It has the effect of separating the tax consequences from the economic enjoyment of the deemed distribution.

Congress apparently intended that Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.140 Although such regulations have yet to be issued, the Service signaled its thinking on this subject in Notice 97-34.141 The Notice states that the regulations will provide that a loan to a U.S. beneficiary (or a U.S. person related to a beneficiary) will be treated as a distribution unless it is a “qualified obligation.” An obligation is a qualified obligation only if:

“(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation’s maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. person extends the period for assessment of any income tax attributable to the loan and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation issued in consideration for the loan (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person’s taxable year and is paid within such period); when properly executed and filed, such an agreement will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d); and (vi) The U.S. person reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.”

2. Repayment of Loans

When a loan that has been treated as a distribution under Code § 643(i) is repaid, Code § 643(i)(3) disregards the repayment for all purposes of “this title.” More precisely,

“any subsequent transaction between the trust and the original borrower regarding the principal of the loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) shall be disregarded for purposes of this title.”

This is a curious provision. The “title” referred to includes not only the income tax provisions, but the estate, gift and generation-skipping transfer tax provi-

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138 Code § 643(i). An earlier version of the foreign trust legislation would also have treated the loan of tangible property, such as vacation homes, automobiles, and boats, as distribution. H.R. 981 § 207.
139 A person is related to a grantor or beneficiary if their relationship would result, under Code § 267, in a disallowance of losses for transactions between them. For this purpose, Code § 267(c)(4) is to be applied as if the family of an individual includes the spouses of her family members. Code § 643(i)(2)(B).
141 1997-1 C.B. 422.
142 Code § 643(i)(3).
sions as well. A literal application of this Code § 643(i)(3) would permit a foreign trust created by a U.S. person to make a loan to a grandchild beneficiary of the trust’s creator and to subsequently cancel that loan without any generation-skipping transfer tax consequences. The loan itself would not be treated as a taxable distribution since it is offset by a corresponding obligation running from the grandchild to the trust. The trust’s subsequent cancellation would not be treated as a taxable distribution because Code § 643(i)(3) requires that it be ignored. This provision should be amended to change its reference to “title” to “subtitle.”

3. Amount of the Distribution

In gauging the impact of the loan provision as it applies to loans of marketable securities, it is important to keep in mind how Code § 643(e) treats the distribution of property in kind. Under Code § 643(e), unless the trustee elects otherwise, the amount of a distribution other than cash is the lesser of the trust’s basis in the distributed property or its fair market value. The new rule does not seem to change this result. Thus, if a foreign trust lends marketable securities with a basis of 10 and a fair market value of 100 to a U.S. beneficiary, the amount treated as a distribution under Code § 643(i) would be 10, not 100, unless the trustee elects to recognize gain on the distribution.

E. Indirect Transfers From Foreign Trusts

1. Distributions Through “Intermediaries”

Code § 643(h), which was added by the 1996 Act, treats a U.S. person who receives property from a foreign person as having received the property directly from a foreign trust if the property she received was derived directly or indirectly from a foreign trust. This provision does not apply if the person from whom she received the property was the grantor of the trust. The intent of this provision is to prevent U.S. persons from avoiding income tax on their share of trust distributions by arranging for the distributions to be routed to them through a foreign beneficiary.

Since 1962 the Code has contained a rule intended to prevent the use of intermediaries as a means of circumventing the general rules which tax U.S. persons on distributions from foreign trusts created by U.S. persons. Former Code § 665(c) provided that:

“For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust.”

The language of former Code § 665(c) was broader than needed to accomplish the statutory objective. The Treasury, however, perhaps in recognition of the unnecessary breadth of the provisions, brought it within reasonable boundaries by regulation. Treasury Regulation § 1.665(c)-1 provided that the section would not apply:

“If the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 . . . was enacted.”

New Code § 643(h) extends the scope of the old rule (1) to amounts derived from trusts created by non-U.S. persons (other than amounts received from the grantor of certain foreign trusts that would have been so-called “grantor trusts” prior to the Act) and (2) to payments received from U.S. persons.

It provides as follows that,

“For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person.”

The expansion of the rule to trusts created by non-U.S. persons was presumably necessary to prevent what would otherwise have been a means of circumventing other provisions of the 1996 Act which enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts which are not taxed as grantor trusts under Code § 679 or otherwise.143

The reason for extending the rule to payments received from U.S. persons is less urgent. Foreign trust payments channeled through U.S. persons would, in the absence of new Code § 643(h), already have been exposed to U.S. taxation, and in the case of accumulation distributions, to the Act’s additional costs imposed on the receipt of such distributions.

Treasury has issued regulations under Code § 643(h).144 The regulations treat distributions from trusts as made through intermediaries only if the transaction has a principal purpose of avoiding U.S. tax. The regulations create a presumption of tax avoidance if all of the following factors are present:

(a) The U.S. person who received property from the intermediary is related to the grantor of the foreign trust or has another relationship with the grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the

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143 See Section 668.
144 Treas. Reg. § 1.643(h)-1.
U.S. person. For example, if the U.S. person is a child of the grantor of the foreign trust, this factor would be satisfied.

(b) An intermediary received a distribution from a foreign trust and within a four year period beginning two years before the distribution, transferred to a U.S. person; the same property; proceeds from the disposition of such property; or property “in substitution for” such property.

(i) Example 5 of Treas. Reg. § 1.643(h)-1(g) illustrates a transfer of property to a U.S. person in substitution for property distributed to an intermediary. The substitute property was shares of stock of equivalent value to shares distributed from the trust, but in different companies.

(ii) Example 6 of Treas. Reg. § 1.643(h)-1(g) demonstrates that a bank is viewed as an intermediary if it lends money to a U.S. person and the loan is secured by the trust’s deposit of funds in the bank if it can be shown that the bank would not have loaned funds to the U.S. person without the security interest in the trust’s deposit. Note that the bank has not received a “distribution” from a foreign trust, but rather a deposit. However, the loan is deemed made from the trust.

(c) The U.S. person cannot demonstrate to the satisfaction of the Service that:

(i) The intermediary has a relationship with the U.S. person that establishes a reasonable basis for concluding that the intermediary would also make a gratuitous transfer to the U.S. person;

(ii) The intermediary acted independently of the grantor and the trustee of the foreign trust;

(iii) The intermediary was not the agent of the U.S. person; and

(iv) The U.S. person properly reported the gift under § 6049F (required if the gift was made by a foreign person).

Examples in the regulations indicate that a U.S. person who receives property from a nonresident alien parent who received a distribution from a foreign trust funded by a grandparent will have to demonstrate more than a family relationship to the intermediary to avoid the nonresident alien parent being treated as an intermediary. If there is a pattern of giving and if the intermediary has other sources of income from which the transfer may have derived, that, plus the family relationship, apparently will be sufficient to avoid the parent being treated as an intermediary.145 Less evidence is required to show that a resident alien parent did not act as an intermediary.146

2. The Grantor Is Not an “Intermediary”

Under the Code, a grantor is never an intermediary. Treas. Reg. § 1.643(h)-1(b)(2) limits the exception to where “the intermediary is the grantor of the portion of the trust from which the amount is derived.” The regulations do not discuss how the portion rules are to be applied in this context.

The portion rules apply to determine what portion of a trust a grantor is deemed to own for income tax purposes. The rules do not explain how one determines who is the grantor of a portion of a trust. Consider, for example, a trust created by gift of community property. If a distribution is made to just one of the spouses, will the distribution qualify in full for the exception to the intermediary rule? If the trustee separately accounts for trust shares, presumably the answer is yes.

If a person creates or nominally funds a trust on behalf of another person, both are considered “grantors” but the nominal grantor is not treated as the owner of any portion of the trust.147 Although the intermediary regulations use the term “grantor” and not the term “owner”, if nominal grantors were able to serve as intermediaries, the intermediary rule would be simple to circumvent.

It is not clear whether the grantor must actively participate in the transfer of funds in order for the exception to the intermediary rule to apply. For example, if the trust makes a distribution to an account in the joint names of the grantor and a beneficiary and the beneficiary withdraws funds, it would be reasonable to treat the distribution as made through the grantor because the bank should not be treated as an intermediary in this situation.

3. Agency Principles Control Issue of Timing and Amount of Income

Under the regulations, if a distribution is treated as made through an intermediary, the intermediary is considered to be the agent of the trust unless the facts show that the intermediary was the agent of the U.S. person. Where the intermediary is considered to be the agent of the trust, the U.S. person includes the cash or property he or she receives from the intermediary in income in the year in which the U.S. person receives the cash or property, even if the distribution was made to an intermediary in an earlier taxable year. If the

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145 See Treas. Reg. § 1.643(h)-1(g) Ex. 3.
146 See Treas. Reg. § 1.643(h)-1(g) Ex. 7.
147 Temp. Reg. § 1.671-2T(c)(5).
property distributed from the foreign trust is worth more by the time the U.S. person receives it, the increased amount is included in income. If the property has declined in value, the U.S. person reports the lower value. If the intermediary has paid foreign taxes with respect to the cash or property distributed from the foreign trust, the U.S. person treats such taxes as if imposed on the trust for purposes of Code § 665(d)(2).

If the intermediary is the agent of the U.S. person, the U.S. person includes the cash or property distributed to the intermediary in the U.S. person’s income when her agent receives the distribution. Any income accruing on such cash or property between the time the intermediary receives it and the time the U.S. person receives it is also taxable to the U.S. person. If any foreign taxes were owed by the intermediary with respect to such cash or property, the taxes are creditable by the U.S. person as if the taxes were imposed on the U.S. person. Usual agency principles are applied to determine whether the intermediary is the agent of the U.S. person.

If a person who receives a distribution from a foreign trust is deemed to be an intermediary, the intermediary may exclude the distribution from gross income. The regulations fail to exclude from the intermediary’s gross income any income accruing on the property distributed from the foreign trust before it is transferred to the U.S. person, although presumably this was intended.

A de minimis exception applies where the aggregate amount of distributions to a U.S. person in one taxable year that are made from foreign trusts, either directly or through one or more intermediaries, does not exceed $10,000.

F. Treatment of Income of Controlled Foreign Corporations, Foreign Personal Holding Companies and Passive Foreign Investment Companies

1. In General

The U.S. beneficiaries of a foreign nongrantor trust may be subject to tax on income earned by controlled foreign corporations (“CFCs”), foreign personal holding companies (“FPHCs”) and passive foreign investment companies (“PFICs”) whose shares are held by the trust. The CFC, FPHC and PFIC rules, also called the “antideferral regimes,” eliminate the deferral of U.S. income tax that generally exists for U.S. shareholders of domestic corporations (i.e., shareholders are not subject to income tax on corporate income until dividends are paid to them). These antideferral regimes require that certain types of passive income of CFCs, FPHCs or PFICs be taxed to their U.S. shareholders currently, whether or not distributions are made to them.

2. The AntiDeferral Regimes

a. Controlled Foreign Corporations

A foreign corporation is a CFC if over 50% (by vote or value) of its stock is owned by “United States shareholders.” For purposes of this definition, a “United States shareholder” is a United States person who owns either directly, through one or more foreign entities, or through the application of certain constructive ownership rules, at least 10% of the total combined voting power of all classes of stock entitled to vote.

A U.S. person who owns directly or through a foreign entity shares of a CFC must include in gross income for each year her pro rata share of the CFC’s “Subpart F” income. A shareholder’s pro rata share of a CFC’s Subpart F income is that amount which would have been distributed with respect to the stock which such shareholder directly or indirectly (but not constructively) owns if, on the last day of the taxable year, the CFC had distributed all of its Subpart F income pro rata to its shareholders. Subpart F income includes insurance income, foreign base company income, international boycott income and foreign bribe/produced income. Special rules are provided for CFCs that have more than one class of stock with different dividend rights.

b. Foreign Personal Holding Companies

A foreign corporation is an FPHC if (i) at least 60% of its gross income for the taxable year is foreign personal holding company income (“FPHCI”) and (ii) at any time during the taxable year more than 50% (by

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146 Treas. Reg. § 1.643(h)-1(c)(1).
147 Treas. Reg. § 1.643(h)-1(c)(2).
148 Treas. Reg. § 1.643(h)-1(c)(3).
149 Code § 957(a).
150 Code § 957(a).
151 The term “United States person” generally has the same meaning assigned to it by Code § 7701(a)(30). It includes individuals who are citizens or residents of the U.S., domestic partnerships, domestic corporations, and estates or trusts other than foreign estates and trusts.
152 Code § 958(b).
153 Code § 958(b).
154 Code § 951(b).
155 Code § 951(a).
156 Code § 951(a).
157 Code § 951(a).
158 Code § 951(a).
159 Code § 951(a).
160 Treas. Reg. § 1.951-1(e)(2).
vote or value) of its stock is owned by not more than five individuals who are citizens or residents of the U.S.\textsuperscript{161} FPHCI is that portion of the corporation’s gross income which includes dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, personal service income from services performed by a shareholder, and rents (unless rents constitute 50\% or more of the gross income).\textsuperscript{162} For purposes of determining whether not more than five U.S. individuals own 50\% of the stock of a foreign corporation, an individual will be treated as owning her proportionate share of all stock owned directly or indirectly by a corporation, partnership, estate or trust in which she is a shareholder or partner or of which she is a beneficiary. She will also be treated as owning stock owned directly or indirectly by her family (siblings, spouse, ancestors, and descendants) and partners.\textsuperscript{163}

Each U.S. person who owns, directly or through a foreign entity, shares of a FPHC must include in her gross income, as a dividend, the amount she would have received as a dividend if, on the last day of the taxable year, the FPHC distributed all of its undistributed income for the taxable year.\textsuperscript{164} The CFC rules take precedence over the FPHC rules; that is, if a shareholder could be taxed under either set of provisions, she will be taxed under the CFC rules.\textsuperscript{165}

c. Passive Foreign Investment Companies

A U.S. shareholder who is not subject to current tax under the CFC or FPHC regimes may still be subject to the PFIC regime. A foreign corporation is a PFIC if (1) 75\% or more of its gross income for the taxable year is passive income or (2) the average percentage of assets (by value) held by the corporation for the production of income is at least 50\%.\textsuperscript{166} Passive income generally means income which would be FPHCI under Subpart F.\textsuperscript{167} Generally, a U.S. person who owns any interest in a PFIC will be subject to ordinary income tax on gain from disposing of PFIC stock and will be subject to an interest charge on the income tax imposed on such gain and on distributions from the PFIC.\textsuperscript{168} For purposes of this provision, a disposition of shares in a PFIC by a foreign nongrantor trust may be treated as a disposition of PFIC stock by the trust’s U.S. beneficiaries. Similarly, a distribution of property from a PFIC to the foreign nongrantor trust may be treated as a distribution to its U.S. beneficiaries.\textsuperscript{169} The specific tax consequences to a U.S. shareholder depends on whether or not she makes a “qualified electing fund” election.\textsuperscript{170}

3. The Attribution Indirect Construction Ownership Rules

The CFC and FPHC regimes contain indirect and constructive ownership rules that are used to determine both whether a corporation is a CFC or an FPHC and the extent to which U.S. persons will be taxed on its income.\textsuperscript{171} Similarly, the PFIC regime contains attribution rules that are used to determine the extent to which U.S. persons will be taxed on distributions and dispositions.\textsuperscript{172} These rules provide that stock in a foreign corporation owned by a foreign nongrantor trust will be considered as owned proportionately by its beneficiaries.\textsuperscript{173} When the beneficiaries of a foreign nongrantor trust have fixed interests in the trust, applying the constructive ownership rules is simple.

Example 22: A foreign nongrantor trust established in 1998 (FNT) has three beneficiaries, Michael, Isaac and Tyler. Each beneficiary is entitled to 1/3 of FNT’s income each year. At the end of FNT’s ten-year term, the trust fund will be distributed equally among the three beneficiaries. Michael and Tyler are U.S. persons; Isaac is not. The FNT holds 100\% of the stock of a foreign corporation (FC). In 1998, eighty (80\%) percent of FC’s gross income is FPHCI. Under the attribution rules discussed above, Michael, Isaac and Tyler will each be considered as owning 33 1/3\% of the shares of FC. As a result, in 1998 FC will be classified as a CFC and an FPHC. FC will also be a PFIC because of its percentage of passive income. Michael and Tyler, however, will be taxed only under the CFC regime, which takes precedence over the other two.\textsuperscript{174}

Matters are more complicated when beneficial interests are divided temporally. Suppose, for example, that in Example 22, on the death of the first of

\textsuperscript{161} Code § 552(a). The minimum FPHCI is 50\% of gross income after the first taxable year for which the corporation is a FPHC.
\textsuperscript{162} Code § 553(a).
\textsuperscript{163} Code § 554(a).
\textsuperscript{164} Code § 551(b).
\textsuperscript{165} Code § 951(d).
\textsuperscript{166} Code § 1297(a).
\textsuperscript{167} Code § 1297(b).
\textsuperscript{168} Code § 1291.
\textsuperscript{169} Code § 1298(b)(5)(A).
\textsuperscript{170} Code §§ 12931295.
\textsuperscript{171} Code § 958(a), and (b); Code § 554(a).
\textsuperscript{172} Code § 1298(a).
\textsuperscript{173} Code § 958(a)(2) (CFC attribution rules); Code § 554(a)(1) (foreign personal holding company attribution rules).
\textsuperscript{174} See Treas. Reg. § 1.958-1(d) Ex 3; Treas. Reg. § 1.554-1; Treas. Reg. § 1.552-3; Treas. Reg. § 1.544-2.
Michael, Isaac and Tyler to die, the FNT was to terminate and all of its property was to be distributed to Cathlyn, a non-U.S. person. Suppose further that the actuarial value of the income interests in the trust were equal to 30% of the value of the trust and the actuarial value of the remainder interest, 70%. Do each of Michael and Isaac, the two U.S. persons, now indirectly own only 10% of FC?

The regulations under the FPHC rules deal only with trusts the beneficiaries of which own both present and future interests in equal shares. The Service has ruled, however, that a beneficiary’s proportionate ownership is to be determined with reference to her proportionate actuarial interest in the trust. There are no final regulations interpreting the PFIC attribution rules. Proposed regulations suggest that the determination of a person’s indirect ownership should be made on the basis of all the facts and circumstances. And the CFC regulations establish two different approaches. The first construes Code § 958(a), the subsection that determines both whether the beneficiary will be subject to tax on a CFC’s income and whether the corporation whose shares are owned by the trust is a CFC. It states that the determination of a person’s proportionate interest in a foreign trust will be made on the basis of all of the facts and circumstances. The second construes Code § 958(b), the subsection that applies for purposes of determining whether a corporation is a CFC. It states that stock owned directly or indirectly by a trust will be considered as owned by its beneficiaries in proportion to the actuarial interests of such beneficiaries in the trust.

The Service provided some guidance on this issue recently in Field Service Advice 199952014. Without stating whether the actuarial allocation rule might simultaneously apply for purposes of Code § 958(b), it determined that, for purposes of Code § 958(a), the trust beneficiaries who were entitled to receive all current income should be treated as owning all of the stock owned by the trust. The remainder beneficiaries were treated as owning no stock.

In the personal holding company context, the Service has also provided some guidance as to discretionary trusts. Applying the attribution rules in the context of a foreign nongrantor trust becomes more difficult when the trust is a discretionary trust. The trustees of such a trust have complete discretion to distribute income and/or principal among the beneficiaries. The beneficiaries do not have fixed interests in the trusts that can be easily calculated.

In Private Letter Ruling 9024076, the Service described several relevant facts and circumstances to be considered in determining the actuarial interest of a beneficiary in a discretionary trust for purposes of Code § 544 (concerning personal holding companies). These facts include (1) the pattern of past distributions, (2) appropriate mortality assumptions, (3) the trustee’s fiduciary duties, and (4) the relationships among the trustees and beneficiaries. According to the Service, if it is possible to discern a pattern of past distributions, each beneficiary receiving distributions under such pattern will be deemed to own an income interest in the trust in the same proportion that the amount of distributions he receives bears to the total amount of the distribution. Each beneficiary’s income interest can then be determined on an actuarial basis with reference to the mortality tables as if the trustees were required to distribute the income to such beneficiary over the remainder of his life.

IV. TAX TREATMENT OF U.S. BENEFICIARIES OF GRANTOR TRUSTS WITH FOREIGN GRANTORS

A. Background

The 1996 Act limits the circumstances in which a person who is not a U.S. citizen or resident (“foreign person”) will be treated as the owner of a trust under the grantor trust rules.

Under prior law, a foreign person would be treated as the owner of a trust under Code §§ 673 through 678 of the Code to the same extent as a U.S. person, whether the trust was foreign or domestic. Only Code § 679 was limited to U.S. grantors. If a foreign person were treated as the owner of the income, then (i) the foreign grantor-owner was taxed on such income only under the limited rules for taxing nonresident alien individuals and foreign corporations; and (ii) distributions from the trust to U.S. beneficiaries were treated as gifts from the foreign grantor-owner. Such gifts generally were not taxable to the U.S. beneficiary as income. Gift tax would not be imposed so long as the subject matter of the gift was either intangible property or situated outside the United States.

B. Limitation on Grantor Trusts

The new rules are designed to prevent the avoidance of U.S. income tax by limiting the circumstances in which foreign persons will be treated as the owner of trust assets under the grantor trust rules. Generally,
under the new rules, the grantor trust rules will apply only to the extent the rules result in an amount (if the trust has any income) being currently taken into account in computing the income of a U.S. person.

C. Definition of “Grantor”

Temporary regulations define the term “grantor,” a term used extensively in relation to trusts but previously not the subject of much statutory or regulatory guidance. A grantor is defined as a person (which may include both an individual and a non-natural person) to the extent such person either creates a trust or directly or indirectly makes a “gratuitous transfer” of property to a trust.

1. Accommodation Grantor

If a person creates or funds a trust on behalf of another person, both persons are treated as grantors, but only the person making gratuitous transfers may be treated as the owner of the trust. A person who is reimbursed for a gratuitous transfer is not treated as an owner of any portion of the trust. For example, if an attorney is the settlor of a trust for the benefit of a client’s children, funds the trust with $5,000 and is later reimbursed for such contribution, the attorney is a grantor who may have an obligation to report the creation of the foreign trust and the transfer of funds to the trust for purposes of Code § 6048, but the attorney is not treated as the owner of any portion of the trust. If an accommodation grantor, such as the attorney in the above example, is treated as the grantor for purposes of the exception to the intermediary rule, the intermediary rule is easily circumvented. Distributions could be made from foreign trusts through accommodation grantors and such transfers would be tax-free gifts to the U.S. donees.

2. “Gratuitous Transfer”

A gratuitous transfer means a transfer other than a transfer made for fair market value or a distribution made by an entity, such as a corporation or partnership, in respect of an interest in such entity owned by a trust. For example, dividends received from a corporation in which a trust owns stock are not gratuitous transfers. A transfer for fair market value means a transfer in consideration for and equal to the value of (i) property received from the trust (other than an interest in the trust); (ii) services rendered by the trust; or (iii) the right to use property owned by the trust. A transfer may be gratuitous without regard to whether it is a gift for gift tax purposes and without regard to whether gain is recognized on the transfer.

3. “Grantor” Includes Purchasers

A grantor includes a person who acquires a beneficial interest in a trust from the grantor if the trust is one of the following—a fixed investment trust described in Treas. Reg. § 301.7701-4(c), a liquidating trust described in Treas. Reg. § 301.7701-4(d) or an environmental remediation trust described in Treas. Reg. § 301.7701-4(e).

4. Grantors Who Are Corporations or Partnerships

A corporation or partnership will be treated as the grantor of a trust established for a business purpose, such as to secure a legal obligation to an unrelated third party. However, if a corporation or partnership establishes a trust for a purpose other than a business purpose, the shareholder or partner on whose behalf the trust was deemed to have been established will be treated as constructively receiving the property and contributing it to the trust.

5. Trusts Established by Other Trusts

If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust unless a person with a general power of appointment over the transferor trust exercises the power in favor of another trust, in which case the power holder is treated as the grantor of the transferee trust. This rule applies even if the grantor of the transferor trust is treated as the owner of the transferor trust. This rule creates significant planning opportunities.

A power of appointment exercisable with the consent of a person who is not the grantor or an adverse party may be a general power. For example, suppose that A creates a foreign trust which is treated as owned by A. Further suppose that B, who is a nonresident alien individual, has a general power of appointment over the trust exercisable with the consent of a protector who is related to A but who has no beneficial interest in the trust. If B exercises the power to appoint the trust assets to a new trust, B is treated as the grantor of the trust to which the assets have been appointed. Although B will not qualify as the owner of the trust unless the requirements of Code § 672(f)(2) are met, distributions through B may satisfy the exception to the intermediary rule in Code § 643(h) even if B is not treated as the owner of the trust.

Code § 672(f)(5) does not apply to make A the owner of the trust (even assuming that A were a beneficiary of the transferee trust) unless B would otherwise be treated as the owner of the trust.

Code § 679 treats A as the owner of the foreign transferee trust if A has transferred property to the trust, directly or indirectly, and the trust has a U.S. beneficiary, unless the transfer was for value. Has A indirectly transferred property to the trust established by B’s exercise of B’s power of appointment? Does Treas. Reg. § 1.671-2T(e)(5) affect the analysis? That regulation makes B, and not A, the grantor of the transferee trust. Does this regulation preclude A from being
treated as the transferor of the transferee trust for purposes of Code § 679? If B’s power were a limited power of appointment, A would continue to be treated as the grantor of the trust to which the assets were appointed.

6. Code § 678 Powers

The regulations clarify that a person who has the right to withdraw assets from the trust is not a “grantor.” Although such a person would be treated as the owner of the trust under Code § 678 if he or she were a U.S. person, a foreign person who has an unexercised Code § 678 power will not be treated as the owner of a trust. If the person who has the Code § 678 power exercises the power to create a new trust, then he or she will qualify as the grantor. Even if he or she will not qualify as the owner of the trust, distributions may be made through the new grantor. The grantor is never treated as the intermediary.

Temp. Reg. § 1.671-2T(e)(5) provides that a person who funds a trust by exercising a general power of appointment is the grantor. The general power of appointment, but not the Code § 678 power, can be subject to limitations on exercise. Therefore, a power of appointment may be more useful for changing the grantor.

However, there is a risk that a nominal grantor will not be treated as the grantor for purposes of the intermediary rule. In some cases, the more conservative course may be to give the grantor control over assets before they are resettled in a new trust so that there is less argument for challenging his or her status as a real grantor.

D. Foreign Persons Not Treated as Owners

1. General Rule

Code § 672(f)(1) provides:

Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

a. Regulatory Test

Treas. Reg. § 1.672(f)-1 provides that there is a two-step process for determining whether Code § 672(f)(1) is applicable to limit a foreign person from being treated as the owner of a trust.

(a) First, the regular grantor trust rules are applied to determine whether the foreign person would be treated as the owner of the trust without regard to the rules of Code § 672(f).

(b) Second, if the person is a not a U.S. citizen or resident or a domestic corporation, the rules of Code § 672(f) prevent the person from being treated as the owner of the trust unless one of the exceptions to Code § 672(f) applies.

b. Transition Rule

If a trust that was a grantor trust before the enactment of the new rules becomes a nongrantor trust as of August 20, 1996, the trust is treated as if it were resettled on August 20, 1996. For example, if the trust had accumulated income as of that date, the accumulated income is deemed to be a contribution to a new trust as of August 20, 1996. The proposed regulations had an example that illustrated this point. Unfortunately, this example was not included in the final regulations. The same principles should apply where a grantor trust ceases to be a grantor trust after August 20, 1996. Only income accruing after the trust becomes a nongrantor trust should be treated as UNI and taken into account in determining the throwback tax.

2. Trusts Created by Certain Foreign Corporations

Code § 672(f)(3) provides that the rules of Code § 672(f)(1) do not apply to a CFC or a PFIC. This prevents such corporations from using foreign trusts to avoid U.S. tax. Treas. Reg. § 1.672(f)-2 extends these rules to FPHCs.

CFCs, PFICs and FPHCs are treated as domestic corporations for purposes of the grantor trust rules but are treated as foreign corporations for purposes of Code § 672(f)(4). Code § 674(f)(4) gives the Service the authority to recharacterize purported gifts to U.S. persons that are made directly or indirectly from foreign corporations. The regulations treat gifts to U.S. persons that are made from a trust funded by a foreign corporation as if made indirectly by such corporation if that incurs more U.S. tax.

The regulations further provide that the rules of Code § 672(f)(4) also will apply if the CFC, PFIC or FPHC is not the grantor of a foreign trust but is treated as the owner of such trust under Code § 678. Purported gifts to U.S. persons from the foreign trust over which a CFC, PFIC or FPHC has a Code § 678 power will be treated as indirectly made by such CFC, PFIC or FPHC.

For purposes of determining whether the character of income and assets of a corporation qualifies it to be classified as a PFIC, the rules of Code § 672(f) are ignored. That is, the assets held in the trust are treated...
as held directly by the PFIC.

Treas. Reg. § 1.672(f)-2 is effective for tax years of shareholders of CFCs, PFICs and FPHCs beginning after August 10, 1999 and taxable years of CFCs, PFICs and FPHCs ending with or within such taxable years of the shareholders.

3. Exceptions to General Rule

Code § 672(f)(2) provides three exceptions to the general rule of Code § 672(f) - certain revocable trusts, trusts that benefit only the grantor and the grantor’s spouse and compensatory trusts. In addition, certain trusts in existence on September 19, 1995 are grandfathered from the new rules.

a. Revocable Trust

A trust is exempt from Code § 672(f)(1) if it is revocable by the grantor alone or with the consent of a “related and subordinate party” as defined in Code § 672(c) who is subservient to the grantor. In the event of the grantor’s incapacity, the trust will continue to qualify as revocable if a guardian or other person has the power to revoke the trust on behalf of the grantor without the consent of any other person.

A related and subordinate party is a “nonadverse party” who is the grantor’s mother, father, issue, sibling, employee, a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. A nonadverse party is a person who does not have a sufficient beneficial interest in the trust to be adverse to the exercise of the power of revocation.

Persons within the category of related and subordinate are presumed to be subservient to the grantor unless shown by a preponderance of the evidence to be not subservient.

De facto control over the person who holds the consent power is not sufficient. Example 3 of Treas. Reg. § 1.671(f)-3(a)(4) provides that where an independent trustee has the power to vest assets in the grantor and the grantor has the power to replace an independent bank with a related and subordinate trustee, the nonresident alien grantor will not be treated as the owner of the trust. Example 1 reaches the opposite conclusion where the bank serving as trustee is owned and controlled by the grantor’s brother. The regulations are not consistent with the Service rulings concerning when trustee powers are imputed to the grantor.\footnote{See, for example, Rev. Rul. 79-353, 1979-2 C.B. 325; as modified by Rev. Rul. 95-58, 1995-2 C.B. 191.}\n
b. Grandfather Rule

Treas. Reg. § 1.672(f)-3(a)(3) provides that trusts in existence on September 19, 1995 and which were treated as owned by the grantor under Code § 676 will continue to be treated as owned by the grantor so long as they continue to qualify under Code § 676, subject to the requirement that any subsequent additions to the trust be separately accounted for. This adds a requirement not found in the legislation. The Act grandfathered trusts from Code § 672(f)(1) if they qualified as grantor trusts under either Code § 676 or Code § 677 (other than Code § 677(a)(3)) and were in existence on September 19, 1995. There was no requirement in the Act that the trust continue to qualify under the same grantor trust provision.

c. Trust for the Benefit of Grantor and Spouse

A trust that benefits only the grantor and his/her spouse during the lifetime of the grantor is exempt from Code § 672(f)(1). If any amount is distributable to another person, even temporarily, the trust will not be a grantor trust under this exception. For example, if
a trust benefits only the grantor except that distributions may be made to the grantor’s child during the period the child attends graduate school, the trust will not be a grantor trust even after the child graduates. 187

Amounts distributable to discharge a legal or support obligation of the grantor or his/her spouse are treated as distributable to the grantor or his/her spouse. The regulations define legal obligation and support obligation narrowly. An obligation to a related person, other than an individual who is legally separated from the grantor under a decree of divorce or separate maintenance is not a legal obligation unless it was contracted for full and adequate consideration. Amounts distributable to discharge a support obligation only include persons who would be dependents described in Code § 152(a)(1) through (9) without regard to the requirement that over half of the person’s support be received from the grantor or the grantor’s spouse who are either permanently and totally disabled or less than 19 years old. It is not clear whether a power to distribute “to or on the order of” the grantor will satisfy these rules.

Under the proposed regulations, a trust might cease to be a grantor trust after the grantor’s divorce (unless another exception to Code § 672(f)(1) applies), but was clear that it was not necessary that the trust provide ab initio that divorce terminates the spouse’s interest in the trust. 188 The final regulations do not address divorce except to say that distributions pursuant to a decree of divorce or separate maintenance are deemed to satisfy the legal obligations of the grantor. It is uncertain whether a trust which fails to terminate the interest of the grantor’s spouse upon divorce will qualify for this exception to Code § 672(f)(1).

The exception in Code § 672(f)(2)(A)(ii) also applies to certain business trusts established by a corporation or other business entity. For example, a trust established by a corporation to secure a loan to finance an airplane will be a grantor trust under this exception if distributions may only be made to satisfy the legal obligations of the corporate grantor arising out of its loan. 189

d. Limited Grandfathering for Trusts Funded as of September 19, 1995

Code § 672(f)(1) does not apply to trusts that are grandfathered. Grandfathered trusts are trusts to the extent funded as of September 19, 1995 that were either:

Treated as owned by the grantor because distributions could be made to the grantor or the grantor’s spouse without the consent of an adverse party; or

Treated as owned by the grantor because the trusts were revocable by the grantor without the consent of an adverse party. Unlike the exception in Code § 672(f)(2), the person whose consent is required to revoke can be independent and need not be related and subordinate.

According to the statute, grantor trust status continues as long as the trust otherwise would continue to be so treated under any of the basic grantor trust rules and only if any portion of the trust that is attributable to transfers to the trust that are made after September 19, 1995, are separately accounted for. The regulations clarify that physical separation is not required and give an extension of time to satisfy the separate accounting requirement. Separate accounting is satisfied if completed by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999. Such additions are not grandfathered. 190

The statute says that the new grantor trust rules of Code § 672(f) do not apply to grandfathered trusts, with no requirement that the grandfathered trusts continue to satisfy the reasons for which grandfathered status was allowed. However, Treas. Reg. § 1.672(f)-3(a)(3) provides that a trust which was treated as owned by the grantor under Code § 676 on September 19, 1995, will no longer be grandfathered if it thereafter ceases to satisfy Code § 676. Presumably, the trust would continue to be grandfathered if it also satisfied Code § 677 both on September 19, 1995 and thereafter. However, the regulation suggests that a trust would not be grandfathered if it satisfied Code § 677 when it ceased to satisfy Code § 676 unless it also satisfied Code § 677 on September 19, 1995. The regulations do not indicate whether a trust grandfathered under Code § 677 can change to qualify under Code § 676, for example, and cease to qualify under Code § 677.

e. Certain Compensatory Trusts

Compensatory trusts are exempt from Code § 672(f)(1). The final regulations clarify that compensatory trusts include those for self employed persons (independent contractors) as well as employees.

E. Shifting The Identity Of The Grantor

Code § 672(f)(5) provides that if a foreign settlor funds a trust which would be a grantor trust and a U.S. person who is a beneficiary made gratuitous transfers to such foreign settlor, the U.S. beneficiary will be

187 Treas. Reg. § 1.672(f)-3(b)(4) Ex. 3.
188 Treas. Reg. § 1.672(f)-3(b)(4) Ex. 4.
189 Prop. Reg. § 1.672(f)-3(b)(4) Ex. 4.
190 Treas. Reg. § 1.671(f)-3(d).
treated as the grantor-owner of the trust. The rule applies whether or not the beneficiary was a U.S. beneficiary at the time of the transfer to the foreign settlor, but only if the person making the gratuitous transfer to the foreign settlor is a beneficiary. For example, if A transfers assets to a foreign corporation before becoming a U.S. person and the foreign corporation establishes a revocable trust for A and A’s family, A will be treated as the grantor after he becomes a U.S. person.

Code § 672(f)(5) would not apply if A were not a beneficiary. For this purpose, however, the IRS views a person who may be added as a beneficiary as a “beneficiary.”

Code § 672(f)(5) does not by its terms contain any time constraints on applying this rule. Presumably, if a transfer to a foreign settlor can be shown to be unrelated to the funding of the trust, Code § 672(f)(5) should not apply.

Transfers not in excess of the amount not treated as taxable gifts under Code § 2503(b) are disregarded.191

F. Pre-immigration Trusts

1. Code §§ 679 and 6048 Extended to Immigrants

A foreign person who becomes a U.S. person will generally be treated as the owner, under the rules of Code § 679 of the grantor trust rules, of any property which he or she transferred to a foreign trust within the five-year period prior to his or her U.S. residency starting date. For purposes of both Code §§ 679 and 6048 - imposing reporting obligations on transfers to foreign trusts - the person will be treated as having transferred such property (together with any undistributed income, appreciation and gains thereon) to the trust on his or her U.S. residency starting date. Consequently, income accruing before the U.S. residency date will not be subject to U.S. tax (except to the extent that it is U.S. source income).

2. No U.S. Beneficiaries

Code § 679 will not apply, however, if the foreign trust does not have any U.S. beneficiaries after the grantor’s U.S. residency starting date. For this purpose, potential beneficiaries and future beneficiaries are counted. For example, if the trust can be amended to add a U.S. person as a beneficiary, the trust will be taxable to the grantor. However, if a foreign beneficiary becomes a U.S. person more than five years after the trust is funded, the trust is not treated as having a U.S. beneficiary for purposes of Code § 679.

3. Indirect Transfers

This rule applies to indirect as well as direct transfers.192 For example, if A gives assets to his brother before moving to the U.S. and A’s brother funds a trust for A and A’s family less than 5 years before A moves to the U.S., A will be treated as the owner of the trust unless A can show that the funding of the trust was unrelated to his gift to his brother.

4. Comparison of Code §§ 672(f)(5) and 679(a)(4)

Code § 679(a)(4) applies whether or not A’s brother would be treated as the owner of the trust and whether or not A is a beneficiary of the trust. Code § 672(f)(5) has no time limit, but Code § 679(a)(4) does not apply if the trust is funded more than five years before immigration to the U.S. It is not clear whether Code § 679(a)(4) applies if A’s transfer to his brother occurred more than 5 years before A moved to the U.S.

V. RECHARACTERIZATION OF PURPORTED GIFTS

A. Purported Gifts From Partnerships

Where a U.S. person receives a purported gift from a partnership (directly or indirectly), the entire amount must be included in the U.S. donee’s gross income as ordinary income without regard to the amount of partnership income.193

B. Purported Gifts From Corporations

Where a U.S. person receives a purported gift from a foreign corporation (directly or indirectly), the amount must be included in the U.S. donee’s income as if it were a distribution from the foreign corporation. The distribution will be taxed as a dividend to the extent of earnings and profits and as a redemption to the extent the amount exceeds earnings and profits. If the corporation is a PFIC, an interest charge may apply. If the distribution is taxed as a redemption, the donee’s basis will be deemed to be zero. The donee’s holding period for determining whether any gain is short or long term is equal to the weighted average of the holding periods of the actual shareholders. If the purported donee is a corporation, no “deemed paid” foreign tax credit will be allowed under Code § 902 to offset U.S. tax.

C. “Purported Gift”

A “purported gift or bequest” is any transfer, other than a transfer for fair market value, made from a corporation or a partnership to a person who is not a shareholder or a partner (or, if the purported donee is a shareholder or partner, a purported gift includes a distribution not consistent with the donee’s interest in the partnership or corporation).194

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191 Treas. Reg. § 1.672(f)-5.
192 Treas. Reg. § 1.672(f)-4.
193 Treas. Reg. § 1.672(f)-4(d).
D. Exceptions
There are the following exceptions to the above rules:

1. Donee has no Relationship to Partners or Shareholders. The purported gift rules do not apply if the U.S. person receiving the purported gift has no family or other relationship to a partner or shareholder that establishes a reasonable basis for concluding that the partnership or foreign corporation would make a gratuitous transfer to the U.S. donee.

2. U.S. Partnership Wholly Owned by U.S. Citizens or Residents or Domestic Corporations. If all beneficial owners of a U.S. partnership are U.S. individuals, the purported gift rules do not apply. This exception does not apply where the U.S. partnership has a trust as a partner and such trust has a foreign beneficiary.

3. A U.S. Citizen or Resident Individual Owning the Shares or Interests Reports the Distribution and Gift. If the donee can establish that a U.S. citizen or resident individual who directly or indirectly holds an interest in the partnership or foreign corporation treated the gift as a distribution to the U.S. partner or shareholder and as a subsequent gift by such partner or shareholder to the U.S. donee, then the gift will not be taxable to the donee. There is no similar exception where the owner of the interest is a non-natural person, such as a trust.

4. Foreign Individual Owning the Shares or Interests Reports the Distribution and Gift and U.S. Donee Reports the Gift. The final regulations add a similar exception for a nonresident alien individual partner or shareholder who reported the distribution from the entity and the gift for purposes of the tax laws of such individual’s country of residence and the U.S. donee timely reported the gift in accordance with Code § 6039F. Example 1 of Treas. Reg. § 1.672(f)-4(g) suggests that if reporting in the foreign country is “not applicable” under the laws of such country, the exception may still be available.

5. Capital Contributions. The purported gift rules do not apply to contributions to the capital of a U.S. corporation described in Code § 118.

6. Charities. The rule does not apply to payments made for an exempt purpose by donors who have received determination letters of tax exempt status or to donees that are charities described in Code § 170(c).

7. Gifts Through Trusts Funded by Gratuitous Transfers from Partnerships or Foreign Corporations. If a partnership or foreign corporation creates and funds a trust, whether or not it is the entity or the partners or shareholders who are treated as the grantors of the trust (see Treas. Reg. § 1.671-2T(e)(4) treating entities as the grantor of trusts established for business purposes and partners and shareholders as the grantor of trusts established for non-business purposes), and then the trust makes a distribution to a U.S. person
   a. The distribution is deemed made by the partnership or foreign corporation unless the rule in (2) applies.
   b. The distribution will be taxed as if it were made by the trust if the tax as so computed would be greater than the tax that would be imposed if it were treated as a distribution directly from the partnership or foreign corporation.195
   c. A distribution to a U.S. person from a trust funded by a foreign corporation or partnership will not be taxed as a purported gift by the entity or as a trust distribution if a U.S. donee demonstrates that the transfer has been taken into account for U.S. tax purposes by a U.S. citizen or resident or domestic corporation. No similar exception applies where a nonresident alien has reported the income. In Example 3 of Treas. Reg. § 1.672(f)-4(g), a purported gift to a U.S. person from a foreign trust funded by a foreign corporation is treated as subject to the accumulation distribution rules. The example does not mention whether a foreign shareholder reported the distribution and the gift. An inference can be drawn that the IRS considered this fact immaterial, since this information was mentioned in

195 Treas. Reg. § 1.672(f)-4(c)(2).
Example 1, where the distribution was made directly from the foreign corporation.

### E. Affirmative Use

Treas. Reg. § 1.672(f)-4(e) provides that a taxpayer may not use the rules under Code § 672(f)(4) affirmatively to reduce the taxpayer’s tax liability. The regulation purports to give the Service authority to “depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.”

### F. De Minimis Rule

The purported gift rules do not apply if during the taxable year of a U.S. donee, the aggregate amount of gifts and bequests received directly or indirectly (such as from trusts) from all partnerships or foreign corporations that are related does not exceed $10,000. The amount must include gifts or bequests from persons that the U.S. donee knows or has reason to know are related to the partnership or foreign corporation within the definition of “related” in Code § 643(i).

### G. Anti-Avoidance Rule – Check the Box

The purported gift rules cannot be avoided by electing pass-through treatment for a single member entity. A single member entity that elects to be taxed as a sole proprietorship under the check the box regulations will be treated as a corporation for purposes of Treas. Reg. § 1.672(f)-4. This rule gives the IRS latitude to recharacterize purported gifts made by such entities.

### VI. REPORTING OF DISTRIBUTIONS FROM FOREIGN TRUSTS AND GIFTS FROM FOREIGN PERSONS

#### A. Reporting by U.S. Beneficiaries of Foreign Trusts

Beginning with distributions received after August 20, 1996, the 1996 Act requires a U.S. person (including a grantor) who receives during any taxable year, directly or indirectly, any distribution from a foreign trust to report to the IRS information regarding the name of the trust, the amount of distributions received from the trust, and such other information as the IRS may require. Form 3520 is used to report distributions from foreign trusts.

In Notice 97-34, the Service describes the additional required information. Such information is to be set forth in either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement.

#### 1. Nontaxable Distributions Are Reportable

Reporting is required even if the foreign trust is a grantor trust and whether or not Code § 663(a) applies to the distribution.

#### 2. Only Gratuitous Transfers Are Reportable

All gratuitous transfers are reportable. Trustee fees, for example, are not reportable. However, if the trustee fees paid to a beneficiary/trustee are excessive, the distribution is reportable. The reporting obligation is waived if the payee reports the amount as taxable compensation for services rendered.

#### 3. Constructive Distributions

Notice 97-34 and the instructions to Form 3520 clarify that indirect and constructive distributions are reportable. For example, if a beneficiary uses a credit card and the trust guarantees or pays the invoice, the amount charged on the card is treated as a distribution. A beneficiary who draws a check on a trust account is in receipt of a distribution. A beneficiary who receives a payment for services or property in excess of the value of such services or property is deemed to have received a distribution.

#### 4. Knowledge That Trust Is Foreign

Notice 97-34 provides that reporting is required only if the U.S. beneficiary knows or has reason to know that the trust is a foreign trust.

#### 5. Information Required

##### a. Service Discretion to Determine Tax

Code § 6048(c) provides that if adequate records are not provided (by the beneficiary or some other person) to enable the Service to determine the proper tax treatment of any distribution received from a foreign trust, then the distribution will be treated as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax. For purposes of determining the interest charge on the throwback tax, the deemed accumulation period will be one-half of the years the trust has been in existence.

##### b. Appointment of Agent

To the extent provided in regulations, this rule will not apply if the foreign trust has appointed a U.S. agent for the purpose of responding to Service inquiries. Any U.S. person may serve as the agent of the trust, including a grantor or a beneficiary. While the appointment of a U.S. agent is not required, if an agent is not appointed the Service will have broad discretion to determine the amount of taxable income derived by the U.S. beneficiary from the trust. According to the “Blue Book” prepared by the staff of the Joint Committee on Taxation, Congress intended that the Service’s exercise of this authority will be subject to judi-
cial review under an “arbitrary and capricious” standard, which provides a high degree of deference to the Service. A foreign trust which appoints such an agent will not be considered to have an office or permanent establishment in the United States, or to be engaged in a U.S. trade or business, solely because of the activities of the agent under Code § 6048. Notice 97-34 provides a form for the appointment of an agent.

c. Beneficiary Statements

A U.S. beneficiary may avoid treatment of a distribution as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax, if with respect to the distribution, the beneficiary obtains from the foreign trust either (i) a Foreign Grantor Trust Beneficiary Statement to be attached to Form 3520, which would allow the beneficiary to treat the distribution as a nontaxable gift, (ii) a Foreign Nongrantor Trust Beneficiary Statement to be attached to Form 3520, or (iii) information regarding actual distributions from the trust for the prior three years (“default treatment”). Under the default treatment, a U.S. beneficiary will be allowed to treat a portion of the distribution as current income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution subject to the throwback tax. This rule is an adaptation of the rule for determining the interest charge on distributions from a passive foreign investment company.

d. Exceptions

Beneficiaries need not report (i) distributions from trusts taxable as compensation for services rendered that are reported as such on the recipient’s federal income tax return, or (ii) distributions from foreign trusts received by U.S. charitable organizations, provided that such organization has a determination letter from the Service (that has not been revoked) recognizing its tax-exempt status.

It is not clear whether loans from grantor trust are reportable. Notice 97-34 provides:

If a trust makes a loan to a grantor that causes the grantor to be treated as the owner of a portion of the trust under section 675(3), the loan will not be treated as a distribution under section 643(i) and will not be reportable under section 6048(c).

Code 643(i) treats loans as distributions for purposes of Subparts B, C and D. These Subparts do not apply to grantor trusts. Consequently, loans to any beneficiary from a grantor trust may not be reportable. However, Form 3520 does not “prompt” this result, and it is not clear why as a matter of policy an exception to the reporting requirements would be made for loans from grantor trusts when other distributions from grantor trusts are reportable.

e) Penalties for Nonreporting

The 1996 Act amends the penalty provisions of Code § 6677 to provide that a U.S. beneficiary who fails to report distributions from a foreign trust under Code § 6048(c) will be subject to a penalty equal to 35 percent of the amount distributed.

Additional penalties can be imposed for continuing noncompliance; however, the total penalties may not exceed the reportable amount. Under Code § 6677(e), the IRS is authorized to assess and collect these penalties without prior judicial review.

Under Code § 6677(d), the IRS is permitted to waive any penalty if the failure to file was due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on any person for failing to disclose the required information will not be considered a reasonable cause for failure to file. Notice 97-34 clarifies that “reasonable cause” does not include refusal on the part of a foreign trustee to provide information. This is true whatever the reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of information.

These penalties generally apply to distributions received after August 20, 1996.

Notice 97-34 provides that if penalties for nonreporting could apply under both Code §§ 6677 and 6039F, then the Code § 6677 penalty will be assessed and will reduce any penalty otherwise imposed under Code § 6039F.

B. Reporting of Foreign Gifts

The 1996 Act imposes information reporting requirements on any U.S. person (other than certain tax-exempt organizations) who after August 20, 1996 receives, in the aggregate, foreign gifts in excess of $10,000 in any taxable year. This $10,000 threshold is indexed for inflation after 1996. The 1997 threshold is $10,276; for 1998 the threshold is $10,557; for 1999 the threshold is $10,735.

1. Form 3520

Part IV of Form 3520 requires only a brief description of the property received, the fair market value of the property and the date of the gift where the donor is an individual or an estate. Form 3520 does not ask for the name and address of the donor except where a foreign donor is a corporation or a partnership. The

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200 See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS-12-6), December 18, 1996, at 276.

201 See Code § 1291(b).

202 Code § 6039F.
identity of a foreign donor who is a corporation or a partnership must be disclosed. The form also asks whether the filer has any reason to believe that the foreign donor is acting as a nominee or intermediary for another person. Form 3520 does not indicate that a gift from a grantor should not be treated as gifts by an intermediary. Even though the identity of donors is not required in the case of donors who are individuals, it is important to note that upon request, the U.S. person may be required to provide additional information, including the identity of the donor.

2. Exceptions

Qualified tuition and medical payments are not taxable gifts under Code § 2503(e) and will not have to be reported. Distributions made from a foreign trust to a U.S. beneficiary, and which are reported by the U.S. beneficiary under Code § 6048(c), do not have to be reported again by the U.S. beneficiary under Code § 6039F.

3. Interaction of Codes §§ 6039F and 6048

U.S. beneficiaries who receive distributions from foreign trusts should report the amounts under the trust reporting rules Code § 6048(c) rather than the gift reporting rules of Code § 6039F. This is true even if the trust is grantor trust and the distribution is treated as a gift under principles of substantive law.

4. Gifts to Trusts

U.S. beneficiaries are not required to report contributions by foreign persons to trusts in which the U.S. beneficiaries have an interest, unless the U.S. beneficiaries are treated as receiving the contribution in the year of transfer (i.e., a U.S. beneficiary has a Code § 678 power). A domestic trust that receives a contribution from a foreign person must report the gift unless the trust is treated as owned by a foreign person (e.g., a foreign person creates a U.S. revocable trust). According to Notice 97-34 and the instructions to Form 3520, a U.S. beneficiary who receives a distribution from a domestic grantor trust owned by a foreign grantor must report it under Code § 6039F as a gift from a foreign person (i.e., the deemed foreign owner of the domestic trust).

5. Reporting Thresholds

a. Individuals and Estates

Notice 94-38 increases the statutory threshold for reporting gifts received from foreign individuals and foreign estates. The annual reporting threshold for the aggregate amount of gifts from a foreign individual or foreign estate is $100,000 with respect to that individual or estate. Once the $100,000 threshold is met, Form 3520 requires the U.S. donee to separately identify each gift in excess of $5,000; however, the U.S. donee is not be required to identify the donor unless the Service requests this information.

b. Corporations and Partnerships

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of gifts from all such entities exceeds $10,000 (as adjusted for the cost of living under Code § 6039F(d)) in the taxable year. Once the $10,000 threshold is met, Form 3520 requires the U.S. donee to separately report all purported gifts from such entities, including the identity of the donor entity. Such purported gifts are subject to recharacterization under new Code § 672(f)(4).

c. Aggregation Rules

In calculating the threshold amounts with respect to a particular foreign person, a U.S. donee must aggregate gifts from foreign persons that he or she knows, or should know, are related (under Code § 643(i)(2)(B)). If the relevant reporting threshold is exceeded, Form 3520 will require that the donee separately report each aggregated gift in excess of $5,000 from a foreign individual or foreign estate without identifying the donor, and (ii) separately report each aggregated purported gift from a foreign corporation or foreign partnership, including the identity of the donor.

d. Examples. Notice 97-34 provides two examples:

Example 14. If a U.S. person, A, receives $90,000 from his or her nonresident alien spouse, B, and the following amounts from the spouse’s siblings:

- Sibling C: $40,000
- Sibling D: two gifts, $4,000 and $3,000
- Sibling E: $4,000

The total of gifts from related foreign individuals is $141,000. Reporting is required because the total exceeds $100,000. A must separately identify the gifts from B and C. A must identify the receipt of $7,000 from D but is not required to separately list information about each transaction. A is not required to separately identify information about E’s gift. None of the donors need be identified.

Example 15. If U.S. citizen, A, receives a gift of $6,000 from his or her nonresident alien spouse, B, and a purported gift of $8,000 from a foreign corporation wholly owned by B, A must report the gifts because A has reason to know that the donors are related and the aggregate amount, $14,000, exceeds the $10,000 threshold for gifts from foreign corporations. A must separately identify each gift.

6. Penalties for Nonreporting

A U.S. person who fails to report such foreign gifts will be subject to penalties equal to five percent of each gift for each month of noncompliance (not to exceed 25 percent of the aggregate foreign gifts). The
Service is also authorized to determine the tax consequences of any unreported gift based on the information available to it. The Conference Report to the 1996 Act states that the Service’s exercise of this authority will be subject to review under an “arbitrary and capricious” standard. These sanctions will not apply if the failure to file was due to reasonable cause and not due to willful neglect.

C. Unified Reporting Forms

1. In General

Form 3520 (“Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts”) allows U.S. persons generally to use a single form to comply with all the new foreign trust and foreign gift reporting requirements. Form 3520-A is to be filed by U.S. grantor-owners of foreign trusts to report trust income.

Generally, to avoid the penalties for nonreporting under Code §§ 6039F or 6677, taxpayers must file Form 3520 as an attachment to their income tax return by the due date (including extensions) of the return with a copy of Form 3520 sent to the Philadelphia Service Center by the same date.

Form 3520-A must be filed in the Philadelphia Service Center by the fifteenth day of the third month following the end of the taxpayer’s taxable year (i.e., by March 15, in the case of a calendar year taxpayer) or later if an extension is granted. A separate form is required for each trust.

2. Transition Rules

a. Form 3520

For the taxable year that includes August 20, 1996 (the “transition year”), a taxpayer may avoid penalties for nonreporting by filing Form 3520 either (i) on or before November 15, 1997 with the Philadelphia Service Center, or (ii) by the due date (including extensions) for the taxpayer’s income tax return for the first taxable year beginning on or after January 1, 1997, but only if the taxpayer’s return for the transition year reflects the information contained in the Form 3520.

b. Form 3520A

For 1996, the U.S. grantor-owner may avoid penalties for nonreporting by filing Form 3520-A either (i) on or before October 15, 1997 or (ii) by the due date (including extensions) for the return for the year beginning on or after January 1, 1997 provided that the U.S. owner reflected the information contained in the 1996 Form 3520-A on the owner’s 1996 return.
Working with a Family Office

by Lynn Wintriss*
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To read the current financial press, it seems that every high net worth family might need a family office. Yet at a recent ACTEC meeting, few Fellows were able to describe just what a family office is and does. The purpose of this discussion is to explain the history and functions of family offices, and the important roles that other professionals may develop with them.

Since the Industrial Revolution in this country, and perhaps longer in Europe, wealthy entrepreneurial families have formed family offices to preserve their large fortunes. When, through the profits of an operating company, a sufficient amount of liquid wealth is accumulated or created among members of a family, someone needs to manage and administer the assets that have accrued outside the structure of the business itself. Without this management, family assets tend to dissipate. Often the operating company will have had an accounting department, which provided investment, record keeping, and tax planning and preparation services to the members of the family who owned the enterprise. When the family business is sold, transferred to the next generation, reorganized, or disposed of, the family may decide to establish a family office to handle the services no longer provided by employees of the business.

Typically, many family offices start with a focus on investment management, accounting, and tax services—aspects of wealth management that few people are interested in handling themselves. More established offices may offer a wider range of services, including bill-paying, handling the payroll for various family employees, real estate management, estate planning, trust administration, estate administration, insurance assessment and claims processing, providing seminars on various financial, tax, and legal topics, and private foundation administration, to name just a few.

By hiring non-family members to administer a family’s affairs, a high level of professionalism can be achieved at a relatively reasonable cost. Often as a matter of tradition, family offices employ members of the family as well as “outsiders,” or nonfamily members. One of the advantages of a family office is that a greater degree of confidentiality may result from careful selection of the individuals who work in the family office. A family office also ensures some degree of control over personnel turnover.

A typical family office will be managed by an executive with a high level of expertise in one of more of investment management, accounting, taxes, or estate planning. Depending on the amount of wealth involved, the number of families and family members served, and the number of trusts or foundations to be administered, the size of a family office will range from 1 or 2 employees to 20 or more, although the average office has 5 to 10 people, usually balanced between professional and support staff. Family office personnel may provide professional services themselves, or those services may be out-sourced, with the family office overseeing and coordinating the activities of outside professionals. To achieve greater economies of scale, some family offices serve two or more unrelated families. Examples include the multi-client family offices administering the Pew, Phipps, Pitcairn, Rockefeller, and Whittier fortunes.

The Family Office Exchange (FOX) is an advisory group and affiliation of hundreds of family office managers and their advisers. The Institute for Private Investors, many of whose members have family offices, is another affiliation based in New York that focuses largely on the investment issues of very high net worth families and individuals. FOX, based in Chicago, estimates that there may be more than 3,000 family offices in the United States, and that the minimum amount of liquid assets necessary to justify establishing a family office is $50 million. During 1999, FOX conducted a survey on trends in the family office industry. Preliminary results of the survey provide some interesting general information. Over 70% of the 93 family offices responding had fewer than 11 employees, and those offices served an average of 25 family members. The average operating budget of a family office was $2.1 million, and 54% of the responding offices managed assets of $500 million or less. Over 60% of the families with family offices had sold their core business, and more than 50% of the family offices had been in existence for 10 years or less.

Family offices offer unique solutions to a variety of problems, yet they are not without problems themselves. Few family offices are run like businesses, in that there is rarely, if ever, a profit motive or opportunity. On occasion, family offices may experience firmly entrenched outside employees or family employees. Although low personnel turnover is a great advantage of a family office, it can also be a liability in that the family may be unwilling or unable to remove or replace employees. The loyalty of individuals, regardless of

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their performance, often makes it difficult to ensure that a particular office has the best people for critical roles. It also can result in a failure to modernize practices and to keep abreast of developments in the various service areas the office provides. In fact, change can be one of the greatest challenges to a family office.

On the other hand, the well-run and well-motivated family office may be the change agent itself. As one would expect, these corporate family offices may be the change agent itself. As family history and politics may often stand in the way of change from within, outside employees of a family office can be in a position to recommend innovation. Particularly where family office personnel has successfully avoided the appearance of loyalty to any one branch of the family or family member, the family will be more receptive to their suggestions, and the family office may become the catalyst for change.

Many family offices work closely with “public” trust companies. As one would expect, these corporate fiduciaries tend to be those with outstanding reputations for exceptional service. In such situations, the family office tends to provide more strategic services than administrative services. Bessemer Trust Company, Mellon Private Asset Management, Morgan Guaranty Trust Company, and Northern Trust Company are among those who have strong relationships with several family offices. For the right family office, a sophisticated trust company may be a perfect complement.

An alternative to a family office or an alternative to using a “public” trust company is for the family to form its own private trust company. Forbes magazine estimates that there are now over 50 such trust companies across the country, including those founded by the Cargill, Houghton, Perry, Pratt, and Ziff families. Phenomenal growth in this industry has occurred over the last 10 years or so, although it will be years before the number of private trust companies catches up with the number of family offices. Because many states have recently relaxed their capital requirements for trust companies, it is now easier to establish a private trust company than it was just a few years ago.

Part of the impetus for a family to form its own trust company may be the difficulty in finding good corporate trustees, who will give appropriate weight to the decisions of any given family. Many corporate trustees are unwilling to hold a closely-held business without some degree of participation in the management of the business, which is anathema to most families. If the family wealth is highly concentrated, a corporate trustee may be reluctant to administer an undiversified pool of assets, or to follow the family’s schedule for diversifying. The level of responsibility that the corporate trustee is expected to assume may often be greater than that trustee is willing to take on.

Another reason to establish a private trust company is that the new trust company itself will be liable if there is any breach of fiduciary duty, rather than the individuals who might serve as trustee. Having the family own and control the trust company will provide individual family members a greater degree of protection from litigation, and should limit the amount of exposure to the (relatively fewer) assets of the trust company.

Corporate trustees have always provided a level of permanence, which is why many grantors have named them as trustees and personal representatives over the years. Having one’s own private corporate trustee allows the accomplishment of other goals, while preserving the stability and endurance of the trustee.

On the other hand, a corporate trustee of any sort (private or not) is subject to state and federal regulation and oversight. Compliance issues add an extra level of complexity that a family may be unwilling to assume.

Over generations, family ancestors may have named a corporate trustee when they created various trusts. When a family is faced with the necessity of using a corporate trustee, creating the family’s own captive trust company may make much sense. As well as being able to accept exposures that “public” trust companies may not, the private trust company will likely offer greater confidentiality, improved responsiveness, and customized investment choices. Even if corporate trustees have not been specified in trust documents, if the individuals who act as trustees have not performed their duties effectively, a private trust company may provide an attractive alternative to searching out other individuals or public corporate trustees to assume the role of trustee.

What does a family that has its own family office want from its advisors? Most will look for experts who understand the family’s unique situation, and who have dealt with similar issues in analogous circumstances. The professionals in a family office will feel most comfortable with outside professionals who speak the same language, and who respond to requests promptly. In addition, advisors who are proactive, who bring solutions either to the family office professionals or to the family members themselves, will be most appreciated. As most wealthy families treasure their privacy, they expect the utmost confidentiality from their advisors. Because of the initial “investment” that each advisor must make to become fully familiar with the family’s complex circumstances and history, these families prize long-term relationships. As there is usually a panoply of advisors involved with any family, they will appreciate experts who work well in teams.

Working with a family office as an outside adviser is a role that requires great client cultivation, or sheer good luck. It can be personally and professionally rewarding in that over the long term, much can be accomplished with very tangible results.
Bibliography