Official Publication of the State Bar of California
Trusts and Estates Section

California Trusts and Estates Quarterly

Volume 8, Issue 4 • Winter 2002

Inside this Issue...

By Ellen H. Whelan, Esq. and Kristopher E. Storti, Esq.

What A Long Strange Trip It's Been: The Past, Present and Future of Equity Collateral Split-Dollar 5

With Notice 2001-10, Notice 2002-8 and new proposed regulations, the IRS has developed a new system of rules governing the taxation of life insurance purchased under split-dollar arrangements. The authors explain the chronology of these recent developments, analyze the law today and recommend planning strategies for practitioners and their clients.

By Frayda L. Bruton, Esq.

A Practitioner's Guide to the Change in Ownership Rules .12

In 1978, the California property tax rules changed dramatically with the adoption of Proposition 13. Since then these rules have been revised considerably by subsequent voter-approved propositions, enabling legislation and litigation. The author provides a comprehensive review of the current state of the law.

By Terence Mulligan and Chris Nicholson

The Community Foundation Value Proposition: An Introduction to Community Foundations and the Services they Provide to Estate Planners and their Clients 26

The subject of charitable giving has changed profoundly in recent years. The authors review recent changes in the charitable giving marketplace, provide a background on the community foundation field in California and illustrate the services that these organizations offer to estate planners and their clients.

By Kay E. Henden, Esq.

Mediation in Trust and Probate Practice 33

The author reviews the use of mediation in the various court systems and administrative agencies serving trust and probate practice in California. The author reports the results of a recent survey of courts, agencies and practitioners regarding the success of mediation today.

By William H. Soskin, Esq.

Early Termination of Irrevocable Trusts 40

Given the 2001 Tax Act, estate planners must consider methods for the future termination of otherwise irrevocable trusts. The author examines: (1) how our clients can take advantage of existing California statutes that permit early termination of trusts; and (2) drafting ideas to facilitate the termination of an irrevocable trust by an independent or independent trustee.

From the Chair 2

From the Editor 4

Litigation Alert 50

Federal Tax Alert 53

© 2003 State Bar of California,
Trusts and Estates Section

The statements and opinions herein are those of the contributors and not necessarily those of the State Bar of California, the Trusts and Estates Section, or any government body.

From the Chair

*By Marshal A. Oldman, Esq.**

When I joined the Executive Committee of the Estate Planning Trust and Probate Section in 1995, I managed to find myself thrust into the then raging controversy over the suggested introduction of informal probate in California. During the prior couple of years, a task force of the Section's Executive Committee had been reviewing the Uniform Probate Code with a view of replacing California's formal probate process with one that required little court supervision. By the middle of 1995 a draft of the proposal was being circulated and became the basis of an article that I wrote for my regular column in the *Daily Journal*. The article became a basis of a broadening level of discussion about the merits of informal probate and created a level of unhappiness among those who were supporting it on the Executive Committee. It was by a trick of timing that the article was published almost simultaneously with my appointment to the Executive Committee. At the my first meeting, some of the members were happy to see me and treated me as a new ally while others were wishing that the earth might swallow me up so I might never be seen again.

Over time, informal probate was dropped by the Executive Committee once it became clear that neither most of the probate and estate planning attorneys nor the judges would support the concept. Eventually, the divisions within the Executive Committee caused by informal probate began to heal. However, an underlying division of purpose continued to lie just below the surface. The desire to enact an informal probate procedure was fueled by a belief that such a system would be good for the public, the debate often centered on the question of the public interest. Consequently, the question of the needs of the practitioner was often muted and at times the interests of the Section's basic constituency seemed secondary.

At the annual retreat of the Executive Committee in 1998, the role and mission of the Executive Committee became the topic of discussion for the Saturday session. The debate focused on an item of legislation that would have made it illegal for attorneys to sell insurance or other financial products to their own clients. Previously, the Committee had endorsed the legislation as good for the public. However, during the Saturday session, a consensus grew that the Committee's endorsement of the bill might be regarded as contributing to a climate of attorney bashing and not in the interests of the practitioners who comprise our membership. Very often, the practitioner is the best person to suggest such products and should be able to engage in such activities with the proper disclosures to the client. The members also reviewed the activities of the Section to determine whether we were serving the needs of our constituency. In the main, we were satisfied that our high quality education programs, our greatly informative Quarterly publication, and our legislative program were enormously helpful to our members. The result of the debate was that the Section not only decided to continue with its basic activities but also to consider in general the interests of the probate and estate planning practitioner in making its recommendations. Ultimately, if the Executive Committee did not attempt to speak for the interests of its members a fair question might arise over need for our continued existence.

In the years following, the Executive Committee has been able to balance the twin missions of advancing the interests of the practitioner while fostering to the needs of the public that we all serve. Since the 1998 retreat, the Chairs of the Section have each typified and promoted the dual mission, and the Executive Committee's effectiveness has grown accordingly. None of leaders of our section have been more successful than our outgoing chair, Warren Sinsheimer. Quietly and firmly, Warren guided the section and the committee through the last year in his inimitable and faultless fashion which has left a daunting standard for me to match during the upcoming year. People have been kind enough to congratulate me on my accession to the leadership role. However, any success that I might enjoy in the coming months will be based on the solid foundation that Warren and our predecessors have left for the Executive Committee and its many programs. Not being a person to argue with success, I foresee little change in style, substance, or organization in the year to come. I will also have the advantage of having Warren's experience and suggestions for my guidance as he will continue to be active as the immediate past chair, our representative on the Council of Sections, and chair of the Nominating Committee.

As with any person taking on the stewardship of a group, I hope for a quiet time when controversy is minimized and the talents and energy of the section can be focused on our usual projects. The educational programs that will be featured at the Section Education Institute, the State Bar Convention, and the annual road show will continue in their fashion, and we will all benefit from high quality programs and updates to keep ourselves current with latest developments and concepts. The *Quarterly* will continue with the same management that has brought us one of the highest quality publications in the field. Our legislative program and monitoring will continue to receive the advocacy of Larry Doyle, our lobbyist, and of the Legislation Committee. The various substantive committees will continue to meet and discuss topics of improvement and change in the areas of estate planning, litigation, administration ethics, and taxation. Improving membership and benefits will also be given the same priority that has brought section membership to record numbers during the last year. Our liaisons with CEB and other sections and groups will also continue to give us the broadest possible prospective for our consideration and action. In particular, our liaison with CEB has helped considerably with membership growth and helped to improve programs for everyone practicing in our area, while our liaison with the Judges Association has helped to improve the legislation that the committee has sponsored during the last year.

The issue that will attract much attention is the changing relationship between the State Bar and its sections. Under recent dues legislation, the work of the sections must be entirely supported by voluntary dues. The Trust and Estates Section has continued to build on its programs and has a healthy surplus to support its activities and to help it plan for the future. Some of the sections are small and cannot survive without being subsidized. For its services, the State Bar creates an assessment that the sections must pay. The amount of the contribution to the State Bar is determined by the State Bar and assessed with little explanation to the sections. The calculation of the annual contribution and the allocation of the contribution among the sections will be an area of continuing controversy for the next year and probably for some time thereafter. In addition to the financial question is the question of State Bar oversight of section activity. The members of the Executive Committee are recruited by the committee, but the selection must be approved by the Board of Governors. Legislation offered by a section must also be similarly approved. The State Bar holds section funds and also provides for day to day administration. Accordingly, the sections are caught in the odd position of being entirely self-supporting while not being entirely self-governing. Balancing the needs of the sections with the policies of the State Bar has created friction in the past and may be an area of some controversy as the year progresses.

On top of these issues, the Conference of Delegates, which meets at the State Bar Convention, has become an entirely independent organization during the last year as a result of legislation. It has its own corporate organization, it own officers, its own treasury, and makes it own policies independently of the State Bar. Aside from contractual agreements between the Conference and the Bar, the State Bar cannot withhold approval of its legislation, pick its officers, control its expenditures, or dictate any policies. My partner, Marc Sallus, is the chair elect of the Conference and has frequently extolled these virtues as a model for the sections to follow. However, I have not come to the point of endorsing any such move because the sections gain greatly from their formal association with State Bar. Of course, the progress of the Conference and the manner employed by the State Bar in working with the sections will be matter of continuing observation and discussion among the section leadership.

I will look forward to the opportunity to write and communicate with the membership during the course of the year to come. Our section and its executive committee is one of the important institutions active in our area of practice. Nothing makes me prouder than having been designated as its leader until the next bar convention that will meet in Anaheim. I hope that I can maintain and continue the improvements left by Warren and the past chairs and will feel fortunate to leave such an organization to my successor, Randy Godshall, when it is his turn to be chair.

Finally, I must close on a sad note. Jim Chisholm, one of our members, along with others was killed in a tragic accident while driving in Mexico. Jim was important to the Section and will be missed. We could always depend on him for advice in trust and estate administration and taxation. We all looked forward to seeing him at the meetings and working with him in committee. His death has brought home all too painfully what we as practitioners often deal with abstractly. Our hearts go out to his wife, family, friends, and colleagues.

* *Oldman, Cooley, Leighton & Sallus, LLP, Encino, California*

Published Quarterly by the Trusts and Estates Section of the state Bar of California

California
Trusts and Estates Quarterly

Warren A. Sinsheimer III
Chair
San Luis Obispo

Marshal A. Oldman
Vice-Chair
Encino

Barry C. Fitzpatrick
Executive Editor
Rancho Santa Fe

George F. Montgomery II
Editor
Friedman McCubbin et al.
San Francisco
(415) 433-2300
george@fomlaw.com

Albert G. Handelman
Assistant Editor
Santa Rosa

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered and is made available with the understanding that the publisher is not engaged in rendering legal or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

Please direct any inquiries regarding republication of any article in the *Quarterly* to the editor. Such permission is generally granted on the condition that initial publication attribution be given to the *Quarterly*.

From the Editor

*By George F. Montgomery II, Esq.**

We are excited to bring you this issue of the *Quarterly*. We have a broad range of articles that offers something for everyone.

The Internal Revenue Service has been extremely active in the last two years in developing new rules governing split-dollar insurance. Several articles already have been published on this subject, but most of them make the subject incomprehensible. But the article by Ellen Whelan and Kris Storti explains these developments in a straight-forward and concise manner.

Frayda Bruton has been a close observer of the Proposition 13 rules for many years. In this issue, she provides an overview of where we are today with California property tax in light of the original Proposition 13 and the numerous developments that have been generated by subsequent propositions, the California legislature and the courts.

The technical rules regarding charitable giving are complex, and there are numerous articles that have addressed these. But we have read little on the subject of donor-advised funds and the historic sponsors of donor advised funds, which are the California community foundations. In this issue, Terence Mulligan and Chris Nicholson share their experiences with two California community foundations to describe the types of services these organizations provide and how they may help us in advising clients about charitable giving.

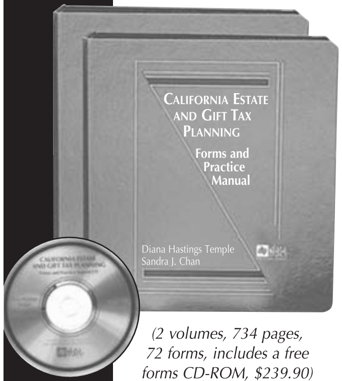
For those readers who handle estate and trust disputes, Kay Henden has written a though-provoking report concerning the use of mediation. Kay reports on the availability of mediation in various courts and with the IRS and describes the results of a recent survey concerning reactions to mediation and generally the positive response and advantages perceived in the use of mediation.

Will the estate tax exemptions and even the existence of the estate tax change in the future? Yes, although we cannot say today in what manner. Given this uncertainty, Bill Soskin suggests that we may wish to start planning today for the early termination of trusts that might cease to have any purpose depending on how the estate tax rules change. In his excellent article, Bill reviews the existing California statutes that provide a foundation for a trust termination and suggests drafting language to be included in new trust instruments to facilitate early terminations in the future.

We publish the *Quarterly* four times per year, but sometimes we don't quite manage to publish it "quarterly." The Fall issue came out three months late, and for that we apologize. You hold in your hands the Winter issue, which has been published about one month late, so we are getting back on track.

This Winter issue marks the end of the current editorial team at the *Quarterly*. We extend our heartfelt thanks to Barry Fitzpatrick, who has volunteered on the *Quarterly* for three years now and will move on to other assignments with the Executive Committee of the Trusts and Estates Section. George Montgomery and Albert Handelman move up one rung on the masthead, and we are pleased to report that John Hartog will be joining us as an editor. John has an active private practice but nevertheless has found time to write regularly for the *Quarterly*, both his regular column on useful internet sites and articles on a variety of other subjects.

* *Friedman, McCubbin, Spalding, Bilter, Roosevelt, Montgomery & Worth, San Francisco, California*


California Estate and Gift Tax Planning
Forms and Practice Manual
Diana Hastings Temple
Sandra J. Chan

INCLUDES 2003 SUPPLEMENT!

CALIFORNIA ESTATE AND GIFT TAX PLANNING:
Forms and Practice Manual
By Diana Hastings Temple and Sandra J. Chan

Save 10% when you mention this ad!

(2 volumes, 734 pages, 72 forms, includes a free forms CD-ROM, $239.90)

This newly updated, authoritative forms and practice manual will allow you to determine the optimum estate planning strategies for your clients and to prepare the appropriate wills and trusts. Use this step-by-step guide to simplify the planning and drafting procedure. For your convenience, all of the forms are also included on a free CD-ROM.

TO ORDER:
Online: **www.datatrace.com/legal**
By email: **info@datatrace.com**
By phone: **800-342-0454**
By fax: **410-494-0515**
By mail: Data Trace Publishing Company, PO Box 1239, Brooklandville, MD 21022-9978

dtp data trace PUBLISHING COMPANY

LACE33

WHAT A LONG STRANGE TRIP IT'S BEEN:

The Past, Present and Future of Equity Collateral Split-Dollar

By Ellen H. Whelan, Esq. and Kristopher E. Storti, Esq.**

In 1964 the Internal Revenue Service ("IRS") issued Revenue Ruling 64-328, which governed the taxation of all split-dollar arrangements for approximately 37 years. After the issuance of Notice 2001-10, Notice 2002-8 and the split-dollar proposed regulations, it appears that the sleeping giant has awoken. The IRS now has scrapped the all-inclusive taxation regime of Revenue Ruling 64-328, opting instead for complex mutually exclusive tax regimes saturated with new definitions, exceptions and unanswered questions.

The proposed regulations appear to apply to any and all versions of split-dollar arrangements (i.e., private split-dollar, reverse split-dollar, equity compensatory split-dollar, non-equity compensatory split-dollar etc.). This article focuses almost exclusively on the most prevalent of split-dollar arrangements, the compensatory equity collateral assignment split-dollar arrangement ("equity collateral split-dollar"), discussing "how we got here," the new rules as set forth in the proposed regulations and several future options for existing arrangements.

I. EQUITY COLLATERAL SPLIT-DOLLAR

In the employment context, the typical equity collateral split-dollar arrangement involves a split of the premium payments between an employee (or the trustee of the employee's irrevocable life insurance trust) and the employer. The employee contributes the portion equal to the current value of the straight term life insurance protection (i.e., the "economic benefit") and the employer contributes the balance of the premiums. The employer's payments are secured by a collateral assignment in the policy which entitles the employer to reimbursement for an amount equal to the lesser of: (a) the cash value of the policy; or (b) the value of the premiums advanced by the employer. Thus, if there is not enough cash value built up in the policy to repay the employer for all premiums advanced (a typical scenario in the early years of the arrangement), the employer is reimbursed the amount of cash value that exists.

Under most projections, a "cross-over point" will occur within the first 10 years of the arrangement when the cash value of the policy exceeds the premiums advanced by the employer. This additional "equity build-up" in the policy following the cross-over point stays with the owner of the policy (i.e., the employee or the trust established by the employee). Upon the subsequent termination of the split-dollar arrangement (i.e., "roll-out"), the trust reimburses the employer only for its portion of the premiums paid and the employer then releases its assignment. If the employee dies prior to termination, the employer is reimbursed its portion of the premiums from the proceeds, releases its assignment, and the balance of the proceeds is then paid to the policy owner.

Many employees establish an irrevocable life insurance trust ("employee's trust") to own the policy to keep the life insurance proceeds out of the employee's taxable estate for estate tax purposes. In such a circumstance, the employee annually gifts an amount equal to the economic benefit to the trust, and the trust pays this portion of the premium to the carrier with the employer paying the balance.

II. REVENUE RULING 64-328: TRADITIONAL TAX TREATMENT

In 1964, the IRS released Revenue Ruling 64-328, which addresses the Federal income tax treatment of split-dollar life insurance arrangements.[1] The Ruling established the tax treatment for split-dollar arrangements that has been followed for almost four decades ("traditional tax treatment"). The Ruling describes two split-dollar methods. The first is the collateral assignment method, under which the employee is the designated owner of the policy, the employer's premium payments are similar to loans from the employer to the employee, and the employee assigns an interest in the policy to the employer as collateral for the employee's obligation to repay the employer's payments. The second is the endorsement method, under which the employer is the designated owner of the policy and the employer endorses the contract in amounts equal to the portion of the proceeds payable to the employee's beneficiary. The Ruling provides that a split-dollar arrangement should not be characterized as a loan because the employee is not expected to make repayment except out of the proceeds "or funds available to the employee by reason of the surrender or loan value of the policy." The Ruling concludes that any economic benefit contributed by the employer and not the employee constitutes gross income to the employee. The table of one-year premium rates (referred to as the "P.S. 58" rates) is used to determine the current value of the life insurance protection.[2] Revenue Ruling 64-328 provides that the determination of the economic benefit is unaffected by the split-dollar method adopted.

As applied to the typical collateral assignment arrangement, no amount is taxable to the employee per Revenue Ruling 64-328 because the employee or the employee's trust is responsible for payment of the economic benefit. When the arrangement is terminated on the death of the insured, the employer is repaid the aggregate amount of premiums advanced.[3] If the arrangement is terminated prior to the death of the insured, the employer is typically repaid the lesser of the cash surrender value of the policy or aggregate premiums advanced. Termination under both scenarios is a nontaxable event to the employee or the employee's trust.

In substance, then, a split-dollar arrangement is very similar to an interest-free loan from the employer to the employee or the employee's trust. However, the 1964 Revenue Ruling specifically negates the loan characterization and treats split-dollar arrangements as described above.

III. TECHNICAL ADVICE MEMORANDUM 9604001

Revenue Ruling 64-328 defined the tax structure of all split-dollar arrangements and remained essentially unchanged until 1996.[4] In 1996, the IRS released Technical Advice Memorandum 9604001 ("TAM 96"). In TAM 96, the IRS first attempted to tax the difference between the cash value and the amount of premiums owed to the employer (i.e., the equity build-up). The IRS claimed that such equity was taxable to the employee and was to be reported in the year that it accrued. According to TAM 96, any amount of the cash surrender value that was in excess of aggregate premiums paid by the employer was taxable to the employee in that year of accrual.

In practice, because the language of TAM 96 was confusing, most practitioners and commentators considered it inapplicable. As a result, the TAM was usually cited as a risk but ignored in most situations.

IV. NOTICE 2001-10

On January 10, 2001, the IRS released Notice 2001-10.[5] The IRS announced that Notice 2001-10 was to "provide taxpayers with interim guidance regarding the treatment of split-dollar arrangements pending publication of further guidance." (As described below, such future guidance came a year later in the form of Notice 2002-8.) The IRS announced that Revenue Ruling 64-328, while valid, was not intended to apply to equity split-dollar arrangements. The Notice offered the taxpayer of an existing equity arrangement one of two mutually exclusive ways to characterize and tax split-dollar: (a) the taxpayer could characterize the arrangement as a loan; or (b) the taxpayer could characterize the arrangement as a transfer of property related to services and subject any equity build-up to tax upon roll-out. The IRS indicated that it would generally accept the parties' characterization of a split-dollar arrangement so long as: (a) it was not clearly inconsistent with the substance of the arrangement; (b) the parties consistently adhered to the chosen tax treatment from inception of the arrangement; and (c) the parties fully accounted for all economic benefits conferred on the employee in a manner consistent with the characterization. As for the timing of taxing the equity, the IRS indicated that it would not treat it as having been transferred to the employee until a subsequent taxable event (i.e., roll-out). In addition, the Notice provided that for taxable years beginning after December 31, 2001, the rates set forth in P.S. 58 would no longer be accepted to value the economic benefit. The Notice provided a new table (Table 2001) to determine the value of the current life insurance protection.

V. NOTICE 2002-8

On January 3, 2002, the IRS released Notice 2002-8 which: (a) revoked Notice 2001-10; (b) announced that new regulations would be published providing guidance for the federal tax treatment of split-dollar arrangements; (c) outlined rules expected to be included in the regulations as well as the effective date of the regulations; and (d) provided guidance for the valuation of current life insurance policies under a split-dollar arrangement.[6]

Essentially, the Notice proclaimed a new tax regime and stated that an equity collateral split-dollar arrangement would be taxed as an interestfree loan under the forthcoming regulations. Notice 2002-8 eliminated the ability to choose between the two tax treatments provided in Notice 2001-10.

The Notice also provided guidance in the form of "transition rules" for: (a) plans existing *before* January 28, 2002; and (b) plans put into place *before* the publication of final regulations. There are four transition rules which are pertinent to existing equity collateral split-dollar arrangements, all of which are "safe-harbors." There is also a "no inference" clause. The four "safe-harbors" and "no inference" clause are discussed below.

A. Safe-Harbor No. 1: Standards for Valuing Economic Benefit[7]

As discussed above, Notice 2001-10 prohibited the use of the P.S. 58 rates in determining the value of the economic benefit. While acknowledging the prohibition, Notice 2002-8 provided a safe-harbor whereby an employer and employee could use the P.S. 58 rates to determine the value of the economic benefit so long as: (a) the arrangement was entered into prior to January 28, 2002; and (b) the arrangement provided for use of the P.S. 58 rates to value the economic benefit.

The Notice also provided that an employer and employee who entered into an arrangement prior to January 28, 2002, may use the insurer's lower published premium rates for all standard risks for one-year term insurance to measure the employee's annual contribution (the economic benefit).[8] Generally, this safe-harbor is only beneficial when the life insurance in the split-dollar plan is issued on the life of the employee alone and not both the employee and the employee's spouse.

Finally, for any arrangement entered into prior to the issuance of final regulations, Notice 20028 allows use of Table 2001 (with appropriate adjustments where an insurance policy is insuring the lives of two persons instead of just one) to calculate the economic benefit.

B. Safe-Harbor No. 2: Continued Protection for Arrangements in Place

The second transition rule provides that so long as the employee continues to contribute (or be taxed on) the economic benefit (the amount of the premium equal to the straight annual term cost) and the employer pays the balance of the premium, the IRS will not attempt to tax the policy's equity build-up. Thus, so long as an arrangement continues in place, the IRS will not challenge the traditional tax treatment of the arrangement. The Notice, however, does not address the tax treatment of the arrangement upon roll-out. The concern of taxpayers is that this omission leaves the door open for the IRS to challenge the arrangement upon roll-out, at which time the IRS may argue that the arrangement should have been treated as an interest-free loan or that the equity build-up is subject to tax. While the Notice does not indicate that the IRS will, in fact, challenge the arrangement upon roll-out, the option to do so has arguably been retained by the IRS' silence on this point.

Some commentators propose that arrangements be left in place until the death of the insured. Then, there would be no equity buildup to tax upon termination of the plan; rather, there would be insurance proceeds which are income-tax free. Under this approach, the insured would have to recognize the economic benefit as ordinary income each year until death. For example, if the insurance policy had built up enough cash value by the end of year 15 to reimburse the employer and not need any additional premium payments to maintain its death benefit, the insured (or the trustee of the trust established by the insured) could pay back the employer all but a "de minimus" amount (e.g., $100) and then leave the remaining $100 obligation in place and not terminate the agreement until following death. The insured would no longer have to annually pay the economic benefit as the premiums would have been paid up in full; however, that economic benefit (which annually increases in amount due to the aging of the insured) would be imputed to the insured as taxable income (as well as a taxable gift where an irrevocable life insurance trust is in place) through to death.

C. Safe-Harbor No. 3: Availability of Interest-Free Loan Treatment

The third transition rule provides that the employer and the employee may choose to tax an existing plan as an interest free loan. While the date of treating the arrangement as a loan is at the discretion of the taxpayer under this safeharbor, all earlier premium payments by the employer must be included and treated as loans entered into at the beginning of the first year that loan treatment is implemented. Understandably, there is little to no incentive to pursue this option as it simply accelerates the unappealing tax treatment to be imposed on equity collateral split-dollar arrangements entered into after issuance of the final regulations.

D. Safe-Harbor No. 4: Existing Arrangement Terminated Before January 1, 2004

The fourth transition rule provides that the IRS will not challenge the treatment of equity for any arrangement entered into before January 28, 2002, and terminated before January 1, 2004. In this instance, equity in the arrangement will be retained by the policy owner tax-free. For tax purposes, this is an extremely advantageous rule for existing "mature" split-dollar arrangements containing large equity build-up. It does not, however, provide a significant benefit for an arrangement that has yet to reach the cross-over point.

At the same time, this rule does provide an "escape hatch" that allows the employer and/or an employee to unravel an arrangement before January 1, 2004 without adverse tax ramifications. In essence, it allows a "wait-and-see" approach through December 31, 2003, for employers and the employees. If within the next year the IRS' treatment of existing arrangements becomes more clear through the publication of final regulations and that treatment is not desirable, the arrangement may be terminated prior to January 1, 2004 with no adverse tax consequences. This option facilitates flexibility as the only requirement is having an arrangement in place prior to January 28, 2002.[9] At best, existing arrangements may be able to proceed with the traditional tax treatment with no challenge from the IRS.

E. "No Inference" Clause

This provision of the Notice, referred to as the "no inference" clause, is not a safe-harbor, but does potentially provide protection to taxpayers choosing to proceed with the traditional tax treatment for existing split-dollar arrangements. The clause provides that the IRS is not able to challenge the treatment of an existing arrangement by citing Notices 2001-10 or 2002-8. Thus, the primary authorities supporting a challenge by the IRS regarding the treatment of an arrangement as an interest-free loan or subjecting the equity build-up to taxation have been revoked or cannot be used by the IRS as direct authority.

Some have interpreted this clause to provide complete protection for existing arrangements from an IRS challenge. This position is based on the belief that, without being able to use Notices 2001-10 and 2002-8, the IRS has no authority to argue against traditional tax treatment. Some commentators have construed the Notice as providing "a window of opportunity" for split-dollar arrangements which are put into place any time up to publication of final regulations.

However, such a reading of the Notice treats the "no inference" clause as the equivalent of a grandfathering provision giving complete protection to existing split-dollar arrangements. Typically, grandfathering protection is clearly stated as such in the effective date provisions of a change in the law. The "no inference" clause is not drafted in this manner and does not have these characteristics. Further, such a reading of the Notice is inconsistent with the safeharbor provision allowing loan treatment to be affirmatively elected. Notices 2002-8 and 2001-10 lay out the IRS' argument should it decide to challenge the tax structure of an existing arrangement not terminated before January 1, 2004. While the "no inference" clause prevents an argument directly based on such authority, there appears to be no reason that the IRS could not challenge an arrangement predicated on the theories outlined in those authorities.

While the taxation of existing equity collateral split-dollar arrangements are at issue, the combination of the above-mentioned safe-harbors and "no inference" clause may be used strategically to provide protection to existing plans until the IRS' intentions (as expressed in Notice 2002-8 and the final regulations) become more clear. At best, taxpayer's with existing arrangements may be able to proceed with the traditional tax treatment with no challenge from the IRS. At worst, if the IRS determines to challenge traditional tax treatment of existing split-dollar arrangements, the parties may terminate the arrangements before January 1, 2004.

VI. SUMMARY OF PROPOSED SPLIT-DOLLAR REGULATIONS

Exactly six months to the date following release of Notice 2002-8, the IRS issued proposed regulations on split-dollar arrangements. In pertinent part, the proposed regulations may be found at sections 1.61-22 and 1.7872-15 of the Treasury Regulations.[10]

The preamble to the proposed regulations provides that the regulations only apply to split-dollar arrangements entered into after the date the final regulations are issued. Arrangements entered into before or on the date final regulations are issued are governed by Notice 2002-8.[11]

Substantively, the proposed regulations are generally consistent with the outline in Notice 2002-8 of what rules the regulations would contain. As such, the proposed regulations reinforce Notice 2002-8 for arrangements existing prior to the issuance of final regulations. The proposed regulations include: (i) the definition of a "split-dollar arrangement;" (ii) the segregation of split-dollar arrangements into two categories, endorsement and collateral assignment; and (iii) the mutually exclusive tax regimes of each arrangement.

A. Definition of Split-Dollar Arrangement

The proposed regulations broadly define a split-dollar arrangement as: (a) any arrangement between an "owner" and "non-owner" of a life insurance contract (other than group term life insurance); (b) in which either party pays (directly or indirectly) all or a portion of the premiums on the contract, including a payment by means of a loan to the other party that is secured by the contract; and (c) one of the parties paying the premiums is entitled to recover all or a portion of such premiums from the proceeds or cash surrender value of the life insurance contract.[12] In the event a particular arrangement falls outside of the definition, the proposed regulations also contain a definition of a general split-dollar arrangement.[13]

The concept of "owner" and "non-owner" is a marked departure from the traditional treatment of split-dollar arrangements. Revenue Ruling 64-328 provided that the owner of the policy was irrelevant because, notwithstanding who owned the policy, the tax treatment remained the same. For purposes of the proposed regulations, though, the tax regime applicable to a particular arrangement hinges on the determination of "owner" and "non-owner." The person named as the policy owner on the contract is generally treated as the "owner."[14] A "non-owner" is anyone who has a direct or indirect interest in the policy who is not the owner.[15] In the context of a compensation collateral assignment split-dollar arrangement, the employee (or the trustee of the employee's irrevocable life insurance trust) is the "owner" and the employer is the "non-owner."

However, there is a special rule for non-equity compensatory collateral assignment arrangements, providing that the employer is the deemed owner (regardless of the owner on the contract) if the only economic benefit provided to the employee is the current life insurance protection (i.e., the employer is entitled to the *greater* of the premiums paid or cash surrender value).[16] Since the employer is the deemed owner, the effect of the special rule is that all non-equity compensatory collateral assignment arrangements are taxed pursuant to the "economic benefit" regime (described below).

B. Differentiation of Split-Dollar Arrangements Into Categories - Endorsement and Collateral Assignment

Traditionally, the IRS did not differentiate between endorsement and collateral assignment split-dollar arrangements. Although the terms "endorsement" and "collateral assignment" were used to describe the structure of split-dollar arrangements, both types of arrangements were treated identically for income and gift tax purposes. The proposed regulations differentiate between endorsement split-dollar arrangements and collateral assignment split-dollar arrangements and subject each respective arrangement to a mutually exclusive tax regime.[17] Collateral assignment split-dollar arrangements are subject to the "loan" taxation regime and endorsement split-dollar arrangements are subject to the "economic benefit" taxation regime.

Briefly, the newly enacted economic benefit regime annually taxes the employee on the cash value build-up in a policy in excess of the aggregate premiums advanced by the employer – to the extent of the employee's ownership interest in the policy under the endorsement split-dollar arrangement. (The use of the term "economic benefit" in this context should not be confused with the traditional use of this term to identify that portion of an annual premium payment equal to the cost of straight term life insurance.)[18] As noted in the introduction, this article does not address the endorsement/economic benefit regime; rather, it focuses on the much more prevalent equity collateral split-dollar arrangements between employers and employees and the new loan regime.

C. Loan Regime in the Context of Compensatory Collateral Assignment

Generally, a split-dollar arrangement includes a "split-dollar loan," and will be subject to loan treatment if: (a) payment is made (directly or indirectly) by the employer to the employee (or insurance company); (b) it is reasonable for the employer to expect repayment;[19] and (c) the repayment is to be paid from or secured by the policy's death benefit or cash surrender value.

Each premium paid by the employer (directly or indirectly) for the benefit of the employee is treated as a separate loan from the employer to the employee.[20] Each loan is tested for adequate interest in accordance with general "below market loan" rules.[21] This rule may create administrative complexities as each deemed loan may have its own interest rate and provisions. A loan bears adequate interest if the stated interest is at or above the applicable federal rate ("AFR"). If a loan bears adequate interest, it is subject to the general tax rules regarding loans.[22] If the loan does not bear adequate interest, it is deemed a "below market loan." Under the below market loan rules, the amount by which interest under the AFR exceeds the stated interest (if any) is deemed to have been paid by the lender to the borrower, and then paid back from the borrower to the lender.[23] The proposed regulations make clear that the $10,000 de minimus exception set forth in Internal Revenue Code § 7872(c)(2) and (3) does not apply in the context of split-dollar loans.[24]

The proposed regulations recognize that many split-dollar arrangements involve insurance trusts, and treat such arrangements as "back-to-back" loans.[25] For instance, if an employer made premium payments and did not charge adequate interest where the policy is owned by the trustee of an employee's insurance trust, the proposed regulations tax the transaction as if: (a) the employer made a below market loan to the employee; and (b) the employee took the premium payment and made a second below market loan to the employee's life insurance trust.[26]

The timing and recognition of taxation of a loan depends on whether it is classified as a demand loan or term loan.

Demand Loan – A split-dollar demand loan is any split-dollar loan that is payable in full at the demand of the lender.[27] A demand loan is tested for adequate interest in each year that the loan is outstanding.[28] A demand loan is deemed to have adequate interest if the interest rate is equal to or greater than a special averaged AFR.[29] If a demand loan does not have adequate interest, the foregone interest is deemed to be transferred to the employee and retransferred to the employer on the last day of each calendar year the loan is outstanding.[30]

Term Loan – Any loan that is not a split-dollar demand loan is a split-dollar term loan.[31] Rather than being payable upon demand, a term loan is payable after a fixed term. A split-dollar term loan is deemed to be a below market loan if the discounted present value of all payments under the loan is less than the loaned amount.[32] The full amount of the discounted foregone interest is included in the employee's income in the year the loan is first made, and included in the employer's income only ratably as the interest accrues over the term of the loan.[33] Other than the acceleration of timing and recognition of the foregone interest, the nature of the deemed transfers is the same as described above regarding demand loans.

Although existing equity collateral assignment arrangements are governed by Notice 2002-8, the proposed regulations fill in the gaps left by Notice 2002-8 regarding the operation of loan treatment. The proposed regulations are particularly instructive in the following two respects: (a) they set forth the taxation of split-dollar arrangements should an employer choose to enter into such an arrangement after the issuance of final regulations; and (b) they set forth the taxation of a split-dollar arrangement should an employer decide at a future date to treat any of its already existing arrangements as a loan (pursuant to the safe harbor described above in Notice 2002-8).

VII. SARBANES-OXLEY ACT OF 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the "Act").[34] Its primary purpose is to reform certain corporate accounting and governance practices. The Act includes a provision which prohibits a public company from making personal loans to its officers and directors. Specifically, section 402 of the Act makes it unlawful for any public company, "directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof)." The Act does not apply to loans maintained prior to July 30, 2002, provided that "there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after [July 30, 2002]." However, the Act does not provide guidance as to what actions may constitute a "material modification" of an existing loan.

Because the language prohibiting loans is broad with no definitional terms, the question has arisen as to whether it applies to equity collateral split-dollar arrangements. It is important to note that equity collateral split-dollar arrangements entered into prior to the issuance of final regulations are neither taxed or accounted for as loans, nor entered into and maintained as loans under current law. The possible application of the Act to split-dollar arrangements has arisen, however, because the typical documents structuring equity collateral arrangements are similar to loan documents, and the proposed split-dollar regulations provide that equity collateral arrangements entered into after the issuance of final regulations will be taxed as loans.

Many in the insurance industry as well as commentators do not believe the Act applies to premiums advanced by an employer in the context of split-dollar arrangements and are requesting clarification to this effect. There have been articles in the general press, however, speculating that the Act's loan prohibition may apply to equity collateral split-dollar.

VIII. OPTIONS FOR EXISTING ARRANGEMENTS

While the issuance of the final regulations may curb the prevalence of equity collateral split-dollar on a going forward basis, there are still several options for already existing arrangements, including the four alternatives described below. No course of action, necessarily including the four below, should be undertaken without a detailed analysis and quantification of the costs, tax and otherwise, on a going forward basis.

A. Option No. 1: "Wait and See"

What has become known as the "wait and see" safe-harbor provided by Notice 2002-8 (described above) provides that the IRS will not attempt to tax the equity build-up of any arrangement that is entered into prior to January 28, 2002 and terminated before January 1, 2004. This safe-harbor provides a short window of continued risk-free maintenance of equity collateral split-dollar arrangements.

The downside to this alternative is that a portion of the premium payments made by the employer during this interim period may not be recovered. (Again, under most equity collateral arrangements, the employer is entitled to the lesser of the cash surrender value of the policy and the aggregate advanced premiums upon termination of the arrangement.) This "lost" premium recovery is the direct cost to the employer for pursuing a "wait-and-see" approach.

B. Option No. 2: No Inference Clause

Another option is to continue to operate existing split-dollar arrangements "business-as-usual," relying on the "no inference" clause contained in Notice 2002-8 (described above). It is arguable that the "no inference" clause is the equivalent of a "grandfathering clause" providing complete protection to existing splitdollar arrangements. The potential downside to this alternative is that it is not known how broadly courts will interpret the "no inference" clause and it is possible that the IRS may challenge an arrangement predicated on the theories outlined in Notice 2001-10 and Notice 2002-8.

C. Option No. 3: "Switch-Dollar"

There has been some discussion among commentators regarding the opportunity to implement a strategy known as "switch-dollar."[35] The basic premise of "switch-dollar" is to treat an existing equity arrangement as a traditional collateral assignment split-dollar arrangement until the "cross-over" year (i.e., the year the cash value of the policy is greater than the aggregate value of the premiums paid by the employer) and then "switch" to the loan treatment (as referenced in Notice 2002-8 and described in the proposed regulations). The thought is that by switching to loan treatment in the year that equity actually accrues, the IRS is unable to come back upon roll-out and argue that the equity should be taxed because the arrangement will have been treated as a loan pursuant to Notice 2002-8. Certain costs are imputed to the employee (i.e., imputed income and gift tax liabilities from the loan) upon switching to loan treatment. Additionally, the aggregate amount of premiums paid by the employer from the initiation of the arrangement are treated as a loan made in the year that the arrangement is switched to loan treatment. While this option is less beneficial than the traditional treatment of equity collateral split-dollar arrangements, "switch-dollar" continues to provide an opportunity to transfer wealth from an employee to beneficiaries (or an insurance trust) at an amount less than that of the regular cost.

That being said, the Sarbanes-Oxley Act may be interpreted to prohibit the "switch-dollar" technique. If so, switch-dollar will not be available to employers that are public companies (as defined in the Act).

D. Option No. 4: Terminate Certain Split-Dollar Arrangements and Provide Basic Term Insurance

Another option is to evaluate existing split-dollar arrangements and terminate some on a case by case basis. As an alternative, the employer may provide increased term life insurance coverage as a benefit to the employees whose arrangements are terminated. For arrangements that are not terminated, the employer can proceed with the no inference option, or keep the arrangement in place until the executive's death by continuing to treat the value of the current life insurance protection as an economic benefit (as described in the Summary of Notice 2002-8 above). Also, the switch-dollar technique may be a viable alternative (unless the employer is a public company and the Sarbanes-Oxley Act's loan prohibition is determined to apply to switch-dollar).

The advantage of switching some or all policies to term insurance is simplicity. By providing basic term life insurance, the employer will no longer have to deal with the complexities and continuing changes in the law regarding the taxation of split-dollar. The disadvantage to this option is that the employer will have to pay the premium for each year the basic term life insurance is provided (unlike the split-dollar arrangements where the employer advances the premiums for a fixed number of years and is ultimately reimbursed the total amount advanced or the cash value of the policy).

IX. CONCLUSION

After years of relative inaction, the IRS has now focused its attention on the regulation of split-dollar arrangements. The journey to the present split-dollar taxation system has been convoluted, and the current situation is complex and murky. While opportunities remain for arrangements entered into prior to the issuance of the final regulations (particularly for arrangements entered into prior to January 28, 2002), it appears that the Service has effectively taken action to eliminate most of the traditional advantages of the equity collateral split-dollar arrangement by subjecting it to loan treatment.

** Gray Cary Ware & Freidenrich LLP, San Diego, California*

ENDNOTES

[1] Rev. Rul. 64-328, 1964-2 C.B. 11.

[2] Revenue Ruling 64-328 provides that the economic benefit may be measured using the rates set forth in the table contained in Revenue Ruling 55-747, 1955-2 C.B. 228, which are commonly referred to as the "P.S. 58" rates.

[3] While the insured is identified in the singular for simplicity in this summary, many compensation collateral assignment policies cover two insureds (husband and wife).

[4] The IRS did issue subsequent rulings that refined the traditional taxation of split-dollar (e.g., Rev. Rul. 66-110, 1966-1 C.B. 12, Rev. Rul. 67-154, 1967-1 C.B. 11, Rev. Rul. 78-420, 1978-2 C.B. 67).

[5] Notice 2001-10, 2001-5 I.R.B. 459.

[6] Notice 2002-8, 2002-4 I.R.B. 398.

[7] Special thanks to Mr. James E. Whistler and Mr. Eric Gardiner of Northwestern Mutual for their assistance regarding the measurement of the economic benefit in accordance with the P.S. 58 rates and Table 2001 rates.

[8] This safe-harbor is also available to an arrangement entered into after January 28, 2002, and before the effective date of future guidance. However, to use the lower published rates during that time period, it must be established that: "(i) the insurer generally makes the availability of such rates known to persons who apply for term insurance coverage from the insurer, and (ii) the insurer regularly sells term insurance at such rates to individuals who apply for term insurance coverage through the insurer's normal distribution channels."

[9] It should be noted that the language of the Notice creates a slight ambiguity regarding availability of the right to terminate pre-January 1, 2004. The Notice states that this provision applies when the employer "is entitled to receive full repayment of all its payments." Under immature arrangements, the policies will not have enough cash value prior to January 1, 2004 to repay the employer in full for its premiums advanced. Rebecca Asta of the Office of Associate Chief Counsel (one of the two contact persons listed on the Notice) advised that the safe-harbor should still be available under these circumstances – even taking into consideration the language of the Notice.

[10] 67 Fed. Reg. 45414-01 (July 9, 2002).

[11] An arrangement entered into before final regulations are issued which is later "materially modified" is deemed to have been entered into on the date of the modification. Thus, if an arrangement entered into prior to the issuance of final regulations is materially modified prior to the issuance of final regulations, the arrangement will continue to be governed by Notice 2002-8. If an arrangement entered into prior to the issuance of final regulations is materially modified after the issuance of final regulations, the arrangement will be governed by the final regulations.

Notice 2002-8 provided certain limited safe-harbors for arrangements entered into prior to January 28, 2002. Notice 2002-8 is silent as to the effect of a material modification. Questions arise as to whether an arrangement would lose the pre-January 28, 2002, status (and safe-harbors) if the arrangement were materially modified. Neither Notice 2002-8 nor the proposed regulations define the standard "materially modified."

[12] Prop. Treas. Reg. § 1.61-22(b)(1).

[13] Prop. Treas. Reg. § 1.61-22(b)(2)(ii).

[14] Prop. Treas. Reg. § 1.61-22(c)(1)(i).

[15] Prop. Treas. Reg. § 1.61-22(c)(2).

[16] Prop. Treas. Reg. § 1.61-22(c)(1)(ii).

[17] An endorsement split-dollar arrangement is generally described as any arrangement whereby the employer is the owner of the insurance policy. A collateral assignment split-dollar arrangement is defined as any arrangement whereby the employee (or the trustee of the employee's irrevocable life insurance trust) is the owner of the insurance policy.

[18] Ironically, the proposed regulations reference the employee's receipt of the economic benefit, but do not provide guidance with respect to its valuation. One may assume that Table 2001 continues to provide an appropriate means of valuation until further guidance or a new valuation table is released.

[19] Most split-dollar arrangements are "nonrecourse" in relation to the employee (e.g., upon default of repayment of premiums, beyond the cash value or proceeds of the policy, the employer has no recourse against the employee individually). The proposed regulations provide that an arrangement that is nonrecourse is treated as a "contingent payment." Prop. Treas. Reg. § 1.7872-15(d)(1). Generally, contingent payments are tested for adequate stated interest by using unfavorable assumptions. The proposed regulations include an exception which provides that a nonrecourse arrangement will not be treated as a contingent payment so long as: (a) the loan provides for adequate stated interest; (b) the parties to the arrangement represent in writing that a reasonable person would expect that the borrower will repay all payments made by the lender; and (c) the writing is attached to the parties income tax return for the year the payment of the first split-dollar loan is due. Prop. Treas. Reg. § 1.7872-15(d)(2).

[20] Prop. Treas. Reg. § 1.7872-15(a)(2).

[21] Prop. Treas. Reg. § 1.7872-15(a)(2).

[22] Interest paid by the borrower is treated as taxable income to the lender, and the borrower is not allowed a deduction for the interest paid. Prop. Treas. Reg. § 1.7872-15(a)(2).

[23] I.R.C. § 7872(a). The tax liability would play out as follows: (a) the "transfer" from the lender to the borrower would generate ordinary income to the borrower; and (b) the "transfer back" from the borrower to the lender would create interest income to the lender (and no interest deduction for the borrower).

[24] Prop. Treas. Reg. § 1.7872-15(a)(3).

[25] Prop. Treas. Reg. § 1.7872-15(e)(2).

[26] Prop. Treas. Reg. § 1.7872-15(e)(2). Note that each loan is treated independently for tax purposes. Thus, the initial transfer from the employer to the employee is taxed as described in footnote 23 above. The transfer from the employee to the employee's insurance trust would play out as follows: (a) the transfer from the employee to the trustee of the employee's insurance trust is deemed a gift, generating gift tax liability payable by the employee; and (b) the transfer back from the trustee of the insurance trust to the employee would create interest income to the employee (and no interest deduction for the trustee of the insurance trust).

[27] Prop. Treas. Reg. § 1.7872-15(b)(2).

[28] Prop. Treas. Reg. § 1.7872-15(e)(3)(ii).

[29] Prop. Treas. Reg. § 1.7872-15(e)(3)(ii). The averaged AFR is called the "blended annual rate" which is an average of the short-term AFR from the previous January and July. The blended annual rate is published in June of each year and is 2.78% for 2002.

[30] Prop. Treas. Reg. § 1.7872-15(e)(3)(iii)(B)(1).

[31] Prop. Treas. Reg. § 1.7872-15(b)(3).

[32] Prop. Treas. Reg. § 1.7872-15(e)(4)(iii). The present value of all payments due is discounted using the appropriate AFR based on the term of the loan. The short-term AFR is used for loans with a term of three or less years, the mid-term AFR is used for loans with a term of at least three but not more than nine years and the long-term AFR is used for loans with a term of more than nine years.

[33] Prop. Treas. Reg. § 1.7872-15(e)(4)(iv) and (v). The interest included in the employer's income is recognized ratably over the term of the loan using "original issue discount" accounting principles.

[34] Sarbanes-Oxley Act of 2002 (H.R. 3763).

[35] The person generally credited with developing the switch-dollar technique is Michael D. Weinberg of the Weinberg Group, Inc. in Denver, Colorado. Mr. Weinberg may be contacted at (303) 692-9599, or via email at mweinberg@theweinberggroup.com

A PRACTITIONER'S GUIDE TO THE CHANGE IN OWNERSHIP RULES

*By Frayda L. Bruton, Esq.**

Prior to enactment of Proposition 13 in 1978, all real property was assessed at market value each year.[1] The only certainty a property owner had was that each year the local government would prepare its budgets for the upcoming fiscal year, and each year the tax bill would indicate whether the county had a surplus or deficit. In its 1977-78 Annual Report, the State Board of Equalization found that assessed values in California tripled in the 16 years prior to 1978 and that tax rates increased 51%.[2] Much of the burden fell on homeowners. Home prices escalated to nearly double the national average.[3]

Taxpayer revolt was inevitable. In 1978, angry voters enacted Proposition 13 that added Article XIIIA to the California Constitution. Real property values were rolled back to their 1975-76 assessed values in the absence of new construction or a "change in ownership." Article XIIIA also provided for a reassessment in the event of a purchase, which the Legislature defined as a "change in ownership for consideration."[4]

This article reviews the current state of law in view of the original proposition, subsequent voter-approved propositions, enabling legislation, rulings by the State Board of Equalization, and litigation.

I. FUNDAMENTAL CONCEPTS

In general, real property that is not entitled to special assessment treatment or exemption is valued for property tax purposes at the lower of (1) fair market value on the lien date of the year in question, or (2) a base year value determined under Proposition 13 guidelines adjusted for inflation.[5] The tax rate is 1% of "assessed value," which cannot be increased by more than 2% per year.[6] The method of calculation is determined with reference to the date of acquisition by the owner of the interest in the property. The critical event and inquiry becomes when a "change in ownership" (or "CIO") occurs.

California Revenue & Taxation section 60 defines a "change in ownership" by setting out a three-part test:

- a transfer of a present interest in real property, *including*
- the beneficial use of the (real) property,
- the value of which (the real property transferred) must be substantially equal to the fee (value of the interest).

Sections 61 through 69.5 set out various transactions which the Legislature determined do or do not meet the basic definition

Afghanistan
Bangladesh
Cambodia
China
Hong Kong
India
Indonesia
Japan
Korea
Malaysia
Mongolia
Nepal
Pakistan
Philippines
Sri Lanka
Taiwan
Thailand
Vietnam

Give2Asia

Philanthropic Solutions for You and Your Clients

Give2Asia's services can help your clients fulfill their charitable goals in Asia. Whether they are interested in a specific charitable organization or a particular cause, we make international giving convenient and effective. • Established by The Asia Foundation, Give2Asia draws on 50 years of experience and eighteen regional offices, offering your clients a direct link to charitable opportunities overseas. Our solutions to cross-border giving challenges help ensure impact, accountability, and tax-deductibility. • The Give2Asia Donor Advised Fund is one convenient tool for your clients, and we can also work with other funds and private foundations.

Contact Give2Asia to join a community of advisors with similar interests.

Michael Rea, *Managing Director*
mrea@give2asia.org (415) 743-3336

465 California Street, 14th Floor
San Francisco, CA 94104-1832 USA

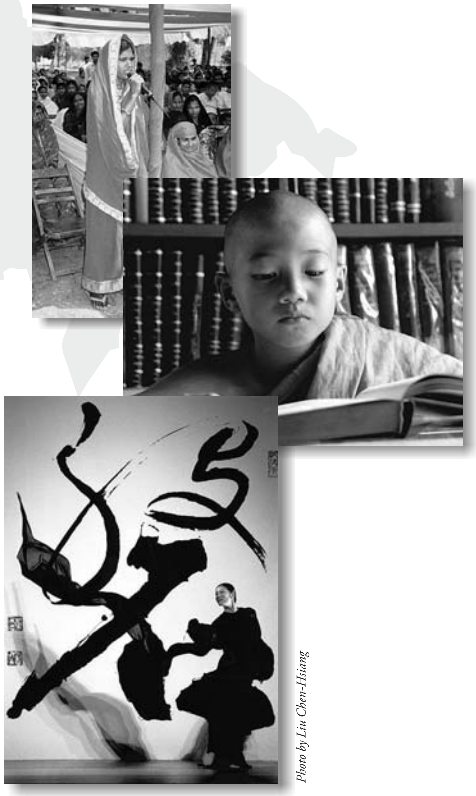


Photo by Liu Chen-Hsiang

of a CIO. The State Board of Equalization further explains those legislative choices in Property Tax Rules 462.001.[7] Some of the statutory provisions reflect particular change in ownership exclusions, e.g., parent-child and grandparent-grandchild transfers and over-55 base year exclusions that were added to the base set of rules by subsequent voter-approved propositions amending Article XIIIA.

The following is a list of the most common transfer types that are excluded or contain excluded variations and the relevant section from the Revenue & Taxation Code:

Section 62: Transfers where "owners" remain the same have the same percentages of "ownership" interests before and after the transfer:

- A partitioning of co-ownership interests.
- Proportional ownership interests remaining the same before and after the transfer.
- Perfecting title to property.
- Creation, assignment, termination or reconveyance of a security interest.
- Trust transfers.
- Life estates.
- Joint tenancies.
- Leases.

Section 63: Interspousal transfers (excludes all transfers between spouses).

Section 63.1: Transfers between parent-child or child-parent; grandparent-grandchild or grandchild-grandparent transfers (limited to personal residence plus $1,000,000 "full cash value" of other property).[8]

Section 64: Transfers of ownership interests in legal entities.

Section 65: Joint tenancy transfers among original joint tenants

Section 65.1: "De minimis" transfers

Section 69: Base year transfers (including calamity base-year value transfers under § 69 and replacement dwelling base-year value transfers under § 69.5).

II. PRELIMINARY CONSIDERATIONS

A. Date of Change in Ownership

Rule 462.260 provides that if a deed is recorded, the change in ownership is rebuttably presumed to be the recording date. If a deed is unrecorded, the change in ownership date is rebuttably presumed to be the date on the document. The presumptions can be rebutted by evidence showing that all the escrow instructions for all parties involved were met on another date, or the agreement of the parties was specifically enforceable on another date.

B. Deed Presumption Regarding Ownership

Rule 462.200 provides that when more than one person's name appears on a deed, there is a rebuttable presumption that all persons listed on the deed have an ownership interest. The presumption can be rebutted one of the following ways:

- A written document executed prior to or at the time of the conveyance in which all parties agree that one or more of the parties do not have equitable ownership interests.
- A judicial finding, order or judgment.
- Declarations made under penalty of perjury accompanied by such written evidence as may be available.

C. Death of an Owner

The death of a property owner is a change in ownership unless there is a statutory exclusion that applies.[9]

D. Transfers to Trust

For property tax purposes, ownership and CIO analysis depends on the identification of the trust *beneficiaries*, who are treated as owners of real property held in trust.[10] NOTE: Transfers to or among trusts are changes in ownership *unless* the trust is revocable, or the trustor-transferor is the sole beneficiary, or the trustor-transferor retains a reversion and the beneficial interests of others do not exceed 12 years (e.g., so-called Clifford Trusts before they became rarely effective after changes to the grantor trust rules), or the transfer qualifies as an interspousal transfer, or there is no change in the proportional interests.[11]

E. Reporting Requirements

1. *In General*

Whenever a transfer of title to real property or manufactured home subject to property tax occurs, the transferee is required to file a signed change in ownership statement in the county where the real property or manufactured home is located.[12] The change in ownership statement may be attached to or accompany the deed or other document filed for recording.

If the change in ownership statement is not filed at the time the deed is recorded, then the statement shall be filed with the Assessor within 45 days from the date the change in ownership occurs. If the change in ownership occurs due to the death of the owner, the statement shall be filed within 150 days after the date of death or shall be filed at the time the inventory and appraisal is filed if the estate is probated.

2. *Legal Entities [Sections 480.1 and 480.2]*

When there is a change in control or change in ownership of any corporation, partnership, limited liability company or other legal entity, a signed change in ownership statement shall be filed with the State Board of Equalization ("SBE") within 45 days from the date of a written request by the SBE.[13]

The Legal Entity Ownership Program ("LEOP") is a cooperative arrangement between the Franchise Tax Board ("FTB") and the SBE to aid in the discovery of legal entity changes in control or ownership. A question is included on the franchise tax return sent to legal entities that asks if there has been a change in control/ownership of the entity in the past year. If the entity answers in the affirmative, the FTB informs the SBE, which sends a change in control/ownership statement to the entity. The SBE then determines if the change in control/ownership is subject to reappraisal. Each county is sent a report monthly identifying any properties in the county owned by a legal entity that have undergone a change in control/ownership with a copy of the change in control/ownership statement filed by the entity.

3. *Preliminary Change of Ownership Report ("PCOR") [Sections 480.3 and 480.4]*

The PCOR is the primary document used in determining:

- if a transfer of title is a change of ownership;
- if any change of ownership exclusions apply;
- if any adjustments to the nominal sales price need to be considered in determining market value.

Section 480.3 prescribes that, except for the case of an intermediate transferee, the PCOR must be filed with the Recorder at the time any document evidencing a transfer of title to real property is recorded, except a "straw man" transfer. Section 480.4 prescribes the format of the PCOR as follows:

Part I: Transfer Information. Part I provides information with respect to the transfer that can help determine if the transfer of title is a change in ownership for property tax purposes. Affirmative answers to particular questions will result in the mailing of appropriate exclusion forms to the grantee.

Part II: Purchase Information. Part II provides information regarding the purchase that may be used by the appraiser to develop the market value for posting to the assessment roll.

Part III: Signature. Part III requires the signature of the new owner, corporate officer or legal representative certifying that the information contained on the PCOR is true, correct and complete.

III. CHANGE OF OWNERSHIP ANALYSIS WHEN TITLE IS HELD AMONG MULTIPLE OWNERS

Analysis of whether a CIO occurs becomes more complicated when title to real property is not held by a single owner. The Legislature and SBE have adopted numerous rules to address: (1) concurrent ownership, when real property is simultaneously owned by more than one person or entity; and (2) successive ownership, when real property is owned by life estate and remainder beneficiaries or by trusts.

A. Concurrent Ownership: Tenancy in Common [Sections 61(f), 63.1, 65.1, Rule 462.020]

A tenancy in common exists when more than one person or legal entity is owner of an undivided interest, i.e., each owner owns a percentage of the whole *viz*. owning a specific piece of the property. Under a tenancy in common:

- Interests can be unequal or equal.
- The document specifies tenancy in common or specifies no vesting at all.
- Any tenant is free to sell, convey or mortgage the tenant's own interest.
- Generally, the creation, transfer or termination of any tenancy in common interest is a change in ownership requiring reappraisal of the *interest transferred.*

Thus, various owners may own any percentage so long as the total ownership interests total 100%. The document may state that ownership is held as tenants in common or may be silent. Each owner or tenant may transfer or mortgage the owner/tenant's interest as the owner/tenant wishes. When an owner dies, the decedent-owner's interest passes to the decedent-owner's heirs. The new owner who succeeds to the decedent-owner's interest then becomes a tenant in common with the remaining owners of the property. The percentage transferred is considered a change in ownership.

> *Example*: Blackacre is owned by X, Y and Z where X owns 30%, Y owns 35% and Z owns 35%. Z sells her 35% interest to A, an unrelated third party. A CIO occurs as to an undivided 35%, and because no exclusion applies to the transfer, 35% of the property will be revalued.

B. Concurrent Ownership: Joint Tenancy [Sections 61(e), 62(a)(1), 62(f), 63, 63.1, 65, Rule 462.040]

A joint tenancy exists when there are two or more owners of undivided interests where, similar to tenancies in common, each owner owns an undivided percentage of the property as a whole (*viz*. owning a specific piece of the property). Joint tenants have equal interests acquired by the same conveying instrument, acquired at the same time with equal right to possession, i.e., the four unities: interest, title, time and possession. If any element is lacking, a tenancy in common exists. Thus, in a joint tenancy:

- The interests of each owner are equal.
- The interests of the owners are acquired at the same time.
- The owners have right of survivorship.
- The document must specify joint tenancy vesting.
- Generally, the creation, transfer or termination of any joint tenancy interest is a CIO and requires reappraisal of the *interest transferred.*

Thus, all owners holding title in joint tenancy hold the same percentage interest in the property which they acquired in the same instrument. In addition, the document must specify that the method of holding title is in joint tenancy, either by using a joint tenancy deed or stating "as joint tenants" following the listing of the owners' names. At the death of a joint tenant, the decedent-joint tenant's interest is divided equally among the surviving joint tenants. Joint tenancy property passes to the surviving joint tenants by operation of law; it cannot be disposed of by will, nor is it includible in the decedent-joint tenant's probate estate. To transfer the property to the surviving joint tenant(s), an Affidavit of Death of Joint Tenant is recorded.

Section 65(a) defines a CIO of a joint tenancy interest as the "interest or portion which is transferred from one owner to another owner." A newly created joint tenancy, e.g., C conveys to A and B as joint tenants, results in a CIO because C *is not among the joint tenants.*

1. *Joint Tenants and the Original Transferor Exclusion [Sections 65(b), 65(c), 65(d); Rule 462.040]*

Section 65(b) creates an exception "upon the creation or transfer of a joint tenancy interest if *after such creation or transfer* the transferor or transferors are among the joint tenants." When the transfer is excluded from being a CIO under this provision, the interest(s) of the transferor(s) is (are) known as "original transferor's interest(s)." Any interests held by persons added to title (other than those held by original transferors) are known as "other than original transferors." Original transferor interests are created only when the transfer is to the transferor(s) in joint tenancy.

Example 1: Greenacre, owned by A and B, is transferred to A, B, C and D, all as joint tenants. Because all the transferors, i.e., A and B, are among the joint tenants, the transfer is excluded from CIO. A and B are now "original transferors," and C and D are "other than original transferors."

Example 2: X sells Blueacre to A and B, unrelated third parties, who acquire title as joint tenants. Since X did not remain on title, and A and B are "other than original transferors," 100% reappraisal.

If the spouse of an original transferor acquires an interest in the joint tenancy property, either during the period that the original transferor holds an interest or by a transfer from the original transferor, the spouse is also considered an original transferor.[14]

Example 3: Following example 1, E is A's spouse. A, B, C and D now transfer to A, B, C, D and E. E also becomes an original transferor. If A, B, C and D transferred to B, C, D and E as joint tenants, E would also become an original transferor as well.

Section 65(d) provides that upon termination of a joint tenancy interest held by any joint tenant other than the original transferor, there is no reappraisal under subdivision (b) if the entire joint tenancy interest is transferred either to an original transferor or to all remaining joint tenants; provided, however, that one of the remaining joint tenancy is an "original transferor."

Example 4: Following example 1 above, D transfers his interest to A, B and C as joint tenants. The transfer is excluded because the interest granted to the remaining joint tenants and A and B are "original transferors." If D transfers his interest to E or just to C, the property would be revalued as to 25%.

2. *Other CIO Exceptions [Sections 62(a), 63(d) and 65(e)]*

a . For Properties Acquired As Joint Tenants

Section 62(a)(2) provides for a transfer terminating the joint tenancy and creating a tenancy in common of equal interests.

Example 5: E and F acquire property as joint tenants. They then transfer the property to themselves as tenants in common as to an undivided 50% each. The transfer is excluded from CIO because E and F each had an undivided 50% interest in the property *before and after the transfer.*

Section 65(e) creates a "rule of convenience" for joint tenancies created on or before March 1, 1975, which creates a rebuttable presumption that each joint tenant holding an interest in the property as of March 1, 1975, shall be an "original transferor." This applies only if there is no supporting evidence to the contrary.

Section 62(a)(2) provides for a transfer terminating the joint tenancy and creating or transferring to a legal entity when the interests of the transferors and transferees remain the same after the transfer.

Example 6: A and B acquire property as joint tenants and subsequently transfer to AB LLC, whose members are A and B as to 50% each. The transfer is excluded because the proportional ownership interests held by A and B remained the same after the transfer. If the proportional interests were not exactly the same, the *entire* interest transferred is subject to reassessment (not just the difference).

b. For Any Joint Tenancy Transfer

- Section 63(d) applies, i.e., the transfer is one to which the interspousal exclusion applies.

  Example 7: H and W are married and acquire property as joint tenants. The property is excluded from CIO if one party transfers to another.

- Section 65.1 provides an exception if the transfer is of a joint tenancy interest of less than 5% (accumulated during any one assessment year) and has a value of less than $10,000.
- Section 63.1 provides for a transfer is one in which the parent/child or grandparent/grandchild exclusion applies and for which a timely claim has been filed.

C. Partition of Concurrent Ownership [Section 62(a)(1)]

A partition is a division of property giving separate title to those previously holding undivided interests. For example, an appraisal unit owned by tenants in common or by joint tenants is split into two or more separate parcels with each original owner taking possession of a new parcel. If the proportional interests do not change, there is no CIO.

Example: A 60 acre vacant parcel held as a single appraisal unit is owned equally by D and E. The parcel is split into two 30 acre parcels, each of equal value, with D owning 100% of parcel 1 and E owning 100% of parcel 2. Because the proportional interests do not change, there is no CIO.

D. Life Estate and Estate For Years [Sections 61(g) and 62(e); Rule 462.060]

In general, a life estate is created by a testamentary document or deed of conveyance which grants the holder the total right of use, occupancy and control during the holder's lifetime. The creation of a life estate is a CIO at the time of the transfer unless the instrument creating the life estate reserves the life estate in the transferor or the transferor's spouse.

Example 1: H and W transfer Blackacre to C, their youngest child, reserving a life estate in themselves. Because the owners (H and W) have the present interest and beneficial use of the property prior to and subsequent to the reservation, there is no CIO. At the death of the surviving life tenant, a CIO occurs which can be excluded from reappraisal if C files a "PT-58," a Claim for Reassessment Exclusion for Transfer Between Parent and Child.

If a property owner grants a life estate to someone other than the owner's spouse, a change in ownership occurs upon the grant of the life estate. A second change in owner occurs when the life estate terminates and the present interest and beneficial use transfer to a third person (the remainderman).[15] NOTE: The remainderman's interest comes from the trustor who created the future interest, and not from the holder of the life estate who has the present interest and beneficial use of the property.

Example 2: M's will provides that upon her death, Greenacre will be distributed to her brother Z for life, remainder to M's child. Upon M's death, there is a CIO when the property is transferred to Z for life. Upon Z's death, a second CIO occurs which can be excluded from reappraisal if M's child files a PT-58 since the property came from M.

An estate for years differs from a life estate inasmuch as the term is specified. The creation or transfer of an estate for years for *less than* 35 years is not a change in ownership. The creation of an estate for years for a term of 35 years or more is a change in ownership at the time of the transfer unless the estate is reserved to the transferor or to the transferor's spouse.[16] The vesting of the right to possession or enjoyment to the remainderman (other than the transferor or the transferor's spouse) upon the termination of any reserved estate for years is a change in ownership.[17]

E. Trusts [Sections 60, 61(h), 62(d), 63, 63.1 and 64; Rule 462.160]

For property tax purposes, trust beneficiaries are treated as the owners of real property held in trust. Transfers to or among trusts are changes in ownership unless the trust is revocable, the trustor-transferor is the sole beneficiary, the trustor-transferor retains the reversion and the beneficial interest of others does not exceed 12 years, or the transfer qualifies as an interspousal transfer, or there is no change in the proportional interests.

For property tax purposes, the trustee is never viewed as the "owner" of the trust property even though the trustee has legal title and the power to sell.[18] A change in ownership occurs when (1) the trustor-transferor of a revocable trust dies, and the trust becomes irrevocable, or (2) the trust is irrevocable at the time of its creation, and the beneficiaries receive present beneficial use of the property or present income from the property.[19]

1. Revocable Trusts [Section 62(d); Rule 462.260]

Most transfers to or from trusts involve revocable trusts in which the trustor, the trustee and the beneficiary are the same person. The transfer of real property by the trustor-transferor to a trust revocable by the trustor-transferor is not a change in ownership because for property tax purposes, the present interest is not transferred. If the trustor-transferor revokes the trust, no reappraisal occurs for the same reason — the present interest has not transferred.

At the death of the trustor-transferor, either (1) the trust terminates, and the property is transferred to the remainder beneficiary, or (2) the trust continues but becomes irrevocable. In the case of (1) or (2), there is a change in ownership subject to reappraisal unless the remainder beneficiary or the beneficiary of the trust that has become irrevocable qualifies for an exclusion, e.g., a surviving spouse or child.[20]

Example 1: X transfers real property to the X Revocable Trust in which X is the sole beneficiary. Upon X's death, the trust becomes irrevocable for the benefit of X's brother, J,

> during J's lifetime. At the death of X, there is a CIO, and the property will be reappraised because someone other than X (the trustor-transferor) is the beneficiary (has a present interest), and J does not qualify for an exclusion.[21]
>
> *Example 2*: H and W transfer real property interests to the HW Family (Revocable) Trust. The trust provides that upon the death of either H or W, the deceased spouse's assets shall be distributed to the "H [or W] Exemption Trust" for the benefit of the surviving spouse, their children and a favorite nephew. The assets of the surviving spouse shall be retained in a "Survivor's Trust" in which the surviving spouse is the sole beneficiary. H dies, and the H Exemption Trust becomes irrevocable. Since the H Exemption Trust holds assets for the benefit of W, their children, and favorite nephew, a CIO occurs to the extent of the interest passing to favorite nephew if a PT-58 is filed. NOTE: If nephew disclaims his interests and as a result of the disclaimer, no beneficiary of the H Exemption Trust is a person who does not qualify for an exclusion, no CIO will occur provided the PT-58 is filed.

2. *Irrevocable Trusts [Section 61(h); Rule 462.160]*

When a trust-transferor transfers real property to an irrevocable trust, a change in ownership occurs unless:

- There is no reappraisal either on creation or termination of the trust if the trustor-transferor retains the reversionary interest and the beneficial interest of others does not exceed 12 years in duration.[22]
- There is no change in ownership if the trustor-transferor is the sole present interest beneficiary of the trust, e.g., a QPRT.[23]
- Persons other than the trustor-transferor who may otherwise qualify for an exclusion from change of ownership, e.g., interspousal, parent-child, grandparent-grandchild, are present interest beneficiaries.[24]

3. *Charitable Trusts*

Real property transferred to charitable remainder trusts will not result in a change in ownership if the trustor-transferor retains the present right to income. On the contrary, a transfer to a charitable lead trust is a change in ownership on the date of the transfer. NOTE: Upon the termination or distribution of the property from the CLT, a change in ownership would be excludable if the beneficiaries are a spouse, children, or eligible grandchildren, provided that a PT-58 is timely filed.

4. *Personal Residence Trusts*

A personal residence trust (including a qualified personal residence trust) is an irrevocable trust in which the trustor-transferor retains the present interest (right to possession and beneficial interest) for a term of years with a gift of the remainder interest in his or her personal residence or vacation property to children or other beneficiaries. For reassessment purposes, there is no change in ownership upon the creation and transfer into the personal residence trust or qualified personal residence trust. However, at the expiration of the term (or at the death of the trustor-transferor prior to the expiration of the term if the property is transferred to the named beneficiaries *viz*. to the trustor-transferor's estate), there is a change in ownership of the real property unless there is an exclusion that applies.[25]

F. Trusts as Owners: Special Trust Terms

1. *Sprinkle/Spray Power [Rule 460.160]*

Where a trustee has discretion to distribute income and principal to a number of potential beneficiaries (a "spray" power or a "sprinkle" power), unless *all* potential beneficiaries have an available exclusion, the property is subject to reappraisal because the trustee could potentially distribute income or principal to a non-excludable beneficiary.[26]

2. *General v. Special Powers of Appointment*

Under certain circumstances, the determination of whether a beneficiary has a "general" or a "special" power of appointment[27] over trust property can make a difference for property tax purposes. When a beneficiary has a general power of appointment, the beneficiary can exercise the power in his or her favor and is considered to have absolute ownership of the property that is the subject of the power of appointment. On the other hand, if the beneficiary has a special power of appointment and may not exercise it in his or her favor, the beneficiary is not considered to have an ownership interest.

> *Example 1*: Father (F) established a trust in which his child, D, was given a testamentary power of appointment over her share of F's Trust property in the event she died before the trust terminated. Later, D specified in her trust that her right, title, and interest in F's Trust would transfer to her husband and children. D's husband had children of a prior marriage. D died and her stepchildren filed a Claim For Reassessment Exclusion For Transfer Between Parent and Child.

The exclusion applies for two reasons. First, the power of appointment was general in that D could exercise it in favor of herself or her children as if she owned the property. As D exercised the power of appointment, she effectively transferred her share of F's Trust directly from herself to her stepchildren. Second, D's stepchildren qualify as her "children" under section 63.1(c)(3)(B) because the stepparent-stepchildren relationship is deemed to exist at the date of death which is the date of the transfer. NOTE: If D's husband died first, the stepparent-stepchildren relationship is deemed to exist until D remarries.

> *Example 2*: H and W own several valuable income properties with a full cash value of $3,000,000. They transfer title to these properties to their revocable trust. Following the death of W, the properties are distributed to Trust A (the Survivor's Trust), Trust B (the Exemption Trust) and Trust C (the Marital

Trust). H is the income beneficiary of all three trusts. C, the son of H and W, is the remainder beneficiary of all three trusts. When H dies, the question is whether C can receive the benefit of H's $1M exclusion under Trust A and W's $1M exclusion under Trusts B and C.

If H had a general power of appointment over Trust C at any time during his lifetime, ownership of the assets are considered to be vested in H. Therefore, any transfer of property from Trust C would be considered to be a transfer from H and would not be eligible for W's $1M exclusion.

PRACTICE TIP: If Trust C is a QTIP Trust, H cannot have a general power of appointment by definition. If, on the other hand, Trust C is a 2056(b)(5) power of appointment trust, W's $1M could only be used for property funding Trust B.

3. *Disclaimer By a Beneficiary*

The effect of a qualified disclaimer is as if the beneficiary had predeceased the trustor, and the date of the disclaimer relates back to the trustor's date of death, not the date the disclaimer is filed.[28]

Example 1: Trustor A dies leaving three properties to his two children, S and D, in equal undivided interests. D files a qualified disclaimer as to Property 3, and under the terms of the trust, D's 50% interest in Property 3 passes directly to D's son, M. The 50% interest that passes to D in Property 3 effectively on A's death is a CIO because the grandparent-grandchild exclusion will not apply (D is still alive).

Example 2: Trustor M dies leaving a testamentary trust with provisions that allow the trustee to sprinkle income and principal to M's child, B, and B's children, GC1 and GC2. M's trust is funded with three properties. GC1 and GC2 each file qualified disclaimers as to their interests in Property 2 and Property 3 upon discovering that the grandparent-grandchild exclusion will not apply. Under the terms of the trust, Property 2 and Property 3 will pass to B. Thus, B is treated as the owner of Property 2 and Property 3 as the of date of M's death, and the parent-child exclusion would apply assuming all requirements are met. However, because GC1 and GC2 did not disclaim their respective interests in Property 1, Property 1 will be reassessed 100% since some members of the designated group will not qualify for exclusion.[29]

IV. EXCLUSIONS FOR WHICH NO CLAIM IS REQUIRED

A. Interspousal Exclusion [Section 63; Rule 462.220; L.A. 81/152, 86/92]

Change in ownership does not include any interspousal transfer, whether of real property or interests in legal entities holding real property. The exclusion extends to former spouses in connection with a property settlement agreement, including a post-dissolution amendment, and transfers upon the death of a spouse. NOTE: Interspousal transfers of interests in legal entities are not counted toward a change in control or transfers of original co-owners under sections 64(c) or 64(d).[30]

Example 1: W transfers a 30% interest in HW, LLC to H who already owns a 30% interest in the LLC. There is no CIO.[31]

Example 2: H and W are "original co-owners" of HW, LP, a California limited partnership. Each originally owned a 2.5% general partnership interest and 47.5% limited partnership interests. Each has transferred 20% of their respective limited partnership interests to Y, an unrelated third party. No CIO occurs when H transfers his 2.5% general partnership interest and 27.5% limited partnership interests to W because the interspousal transfer is not counted in determining whether more than 50% of the "original co-ownership" interests have transferred. The interest transfer from H to W retains its "original co-ownership" character in the hands of W.[32]

B. Five Percent/$10,000 De Minimis Rule [Section 65.1; Rules 462.020(b)(2) and 462.040(b)(6)]

The transfer or transfers during any one assessment year of a joint tenant or tenant in common interest is not a change in ownership if, *in the aggregate*, the undivided interest has a market value of less than 5% of the total property and if the market value of the interest(s) transferred is less than $10,000. However, a transfer of 5% or more would result in a reappraisal of the interest transferred. NOTE: During any one assessment year (January 1 through December 31), all transfers shall be cumulated for purposes determining the total percentage and the market value of the interest(s) transferred. Each interest shall be reappraised as of the date of the transfer if the 5%/$10,000 threshold is met or exceeded.[33]

V. EXCLUSIONS FOR WHICH A CLAIM MUST BE FILED

A. Parent-Child Exclusion (Proposition 58) [Section 63.1; CAV 92/05; Letters to Assessors 86/92, 87/72, 88/10. 89/16, 89/79, 90/03, 91/08, 91/23, 91/76, 92/15, 94/21, 94/59, 96/40, 98/23, 98/35, 99/25, and 00/05]

1. *History*

Proposition 58 amended Article XIIIA of the California Constitution to provide that effective November 6, 1986, the terms "purchase" and "change in ownership" do not include the purchase or transfer of:

- a principal residence between qualified parents and children; and
- the first $1,000,000 of other real property between qualified parents and children.

Only unrestricted transfers are eligible for the parent-child exclusion.

> *Example*: A as the transferor creates a life estate in C (A's child). At the time of the transfer, A has gifted a present interest to an excluded person, C; therefore, the parent-child exclusion applies. At C's death, however, the transfer of the property from C to GC is the result of A's original gift of the present interest and the remainder interest; thus, the transfer from C to GC occurs by operation of law. A is the transferor of a future interest to GC; therefore, unless all of GC's parents are deceased [for property tax purposes, step-parents have the same status as parents], no parent-grandchild exclusion is available, and because C is the not transferor, no parent-child exclusion is available, either. *See infra* section V.B.

2. *Effective Date Exception*

In *Larson v. Duca*, 213 CA 3d 324 (1989), the court held that where the decedent died before November 5, 1986 (the date of passage of Prop 58), and the estate is probated after November 5, 1986, the change in ownership for purposes of section 63.1 occurs *as of the date of the decree of distribution*. Thus, the eligible transferee acquired the property by a decree of distribution and as of the decree's date rather than the date of death. NOTE: If the estate is distributed other than by probate, e.g., by operation of law or distribution from a trust, the holding in *Larson v. Duca* does not apply.[34]

3. *Defined Terms [(Section 63.1]*

"Principal Residence" refers to a dwelling for which a homeowners' exemption or disabled veterans' exemption has been granted in the name of the eligible transferor.

"Purchase or Transfer Between Parents and Children" refers to any transfer of real property from parent(s) to child(ren) or from child(ren) to parent(s). The date of death is the date of the transfer unless *Larson* applies.

"Children" refer to: (1) any child born of the parent(s); (2) any statutorily adopted child who is adopted by the age of 18; (3) any stepchild or spouse of that stepchild while the relationship of stepparent and stepchild exist, which means until the relationship is terminated by divorce or, if terminated by death, upon remarriage; and (4) any son-in-law or daughter-in-law of the parent(s) while the in-law relationship exists, which means until the relationship is terminated by divorce or, if terminated by death, upon remarriage.

"Full Cash Value" refers to the taxable value on the (property tax) roll just prior to the date of transfer. [35]

"Eligible Transferor" refers to the parent or the child of an eligible transferee.

"Eligible Transferee" refers to the parent or child of an eligible transferor.

"Third Party Transfer" refers to any person or entity that is not a transferor or transferee in the transfer for which a claim is filed. A transfer to a third party occurs only when all of the real property is transferred. Effective January 1, 2000, "a transfer of real property to a parent or child of the transferor shall not be considered a transfer to a third party," e.g., Child D transfers to Parent P who later transfers to Child S. The transfer from P to S is not considered a "third party transfer" for purposes of this exclusion.[36]

"Real Property" as defined in section 104 does not include any interest in a legal entity.

4. *"Share and Share Alike" (Non-Prorata Allocations) [L.A. 91/08]*

Distributions from a trust or an estate are not always made on a pro rata basis as to each and every property. Probate Code section 16246 provides in pertinent part: "The trustee has the power to effect distribution of property and money in divided or undivided interests and to adjust resulting differences in valuation. A distribution in kind may be made pro rata or non pro rata."

Trustees and executors may be granted broad discretion under the instrument (or rely on the default rule under the Probate Code) to distribute property on a non-prorata basis, i.e., allocate specific assets to individual beneficiaries or heirs. Thus, Child S may, for example, receive Blackacre and Child D may receive stocks and bonds (or Whiteacre). For property tax purposes, the threshold question is whether the testamentary instrument specifically *prohibits* non-prorata allocations. If there is no prohibition in the testamentary document, it is assumed that the fiduciary, i.e., trustee or personal representative, has broad discretionary powers. Thus, for example, if the testator-trustor specifically devises his personal residence to S and his rental property to D, the fiduciary has no discretion to alter the distribution scheme.

If the instrument is silent, or the fiduciary has the discretion to allocate assets on a non-prorata basis to beneficiaries who are to receive equal shares, i.e., "share and share alike," the fiduciary has a duty to assure that each beneficiary receives an equal share.

> *Example 1*: M died leaving three children, C1, C2, and C3. At the time of M's death, M's residence was worth $350,000 with an encumbrance of $100,000. M also owned a 50% interest in a warehouse valued at $250,000 and a portfolio of stocks and bonds with a value of $250,000. The executor proposes to distribute the residence to C2, the portfolio to C1, and the 50% interest in the warehouse to C3. Since each child is receiving an equal share of M's estate, none of the real property interests will be reappraised at the time of the distribution provided that a timely PT-58 is filed.

Example 2: H and W establish a revocable trust that provides upon the death of surviving spouse, the remaining trust estate will be distributed in equal shares to C1 and C2. C1 wants the family residence; C2 wants the office building. The Trustee has discretion to distribute assets in cash or in kind, pro rata or non-prorata and distributes the residence valued at $400,000 to C1 free of encumbrance and the office building to C2 valued at $700,000 subject to a debt of $100,000 (equity of $600,000). Because C2 is receiving more equity than C1 (each child should have received $500,000 equity in the real property), the office building will be reassessed as to 16.67% calculated as follows:

(Equity minus child's share in Trust) ÷ Equity)

(600,000 - 500,000) ÷ 600,000 = 0.1667 or 16.67%

NOTE: The 16.67% is a transfer between the siblings which does not qualify for the parent-child exclusion since it exceeds the trust's "equal shares" provisions.

5. *Filing Requirements*

For transfers occurring *prior* to September 30, 1990, a Claim For Reassessment Exclusion For Transfer Between Parent and Child (or "PT-58") must be filed within three years of the date of the change in ownership or, for *Larson* situations, within three years of the date of the decree of distribution. *See supra* section V.A.2.

For transfers occurring *after* September 30, 1990, a PT-58 must be filed before the earlier of:

- three years from the date of the change in ownership (or for *Larson* situations, within three years of the date of the decree of distribution), or
- a transfer of real property to a third party.

A PT-58 may still be timely even though these dates have passed if the PT-58 is filed within six months from the mailing date of the Notice of Supplemental Assessment or Notice of Escape Assessment. NOTE: If both are mailed, use the later of the two dates of mailing.

PRACTICE TIP: If PT-58s are not filed by the dates indicated, the assessee might still be eligible for the exclusion *prospectively* when property has not transferred to a third party. In this case, a qualified PT-58 filed on January 1, 1998, or after shall be allowed beginning with the lien date of the year in which the PT-58 is filed. Thus, for example, a qualified PT-58 filed on August 15, 1999, shall be allowed for the January 1, 1999, lien date or the 1999-2000 roll year. A PT-58 is considered complete only when all of the minimum information required by Section 63.1(d) has been provided. Thus, for example, if it is realized 10 years after a transfer and reappraisal by the assessor that the exclusion was available, a PT-58 could be filed. No refund of taxes would be made, but the prior base year value of the property would be reinstated.

B. Grandparent-Grandchild Exclusion [Proposition 193] [Section 63.1; L.A. 96/40, 97/32, 98/23, and 98/35]

1. *History*

Proposition 193 amended Article XIIIA of the California Constitution to provide that the parent-child exclusion shall be extended to include certain (limited) transfers from grandparents to grandchildren. The effective date for such transfers is March 27, 1996.

The grandparent-grandchild exclusion is much more limited than the parent-child exclusion. Such limitations include:

- Transfers may only be from grandparent(s) to grandchild(ren), not from grandchild(ren) to grandparent(s).
- The parents of the grandchild(ren) who qualify as children of the grandparent(s) must be deceased.
- The transfer of a "principal residence" from grandparent(s) to grandchild(ren) may only be allowed if the grandchild(ren) never received a "principal residence" that was eligible for exclusion from the parent(s). NOTE: The property must only have been *eligible* for the exclusion from the parent(s); a Claim need not have been filed.
- "Other real property" being transferred is tracked under the Social Security Number of the deceased *parent* who is the natural child of the grandparent(s) and therefore is applied to the *parent's* $1,000,000 exclusion.

2. *Filing Requirements*

Filing dates are the same as those for the parent-child exclusion.

C. Transfer of Base Year Value [Proposition 60] [Section 69.5; L.A. 86/92, 87/71, 88/10, 89/53, 91/31, 91/80, 97/02]

1. *History*

Proposition 60, which was adopted by the voters and became effective on November 5, 1986, amended Article XIIIA of the California Constitution to provide that the base year value[37] of an original dwelling may be transferred to a replacement property.

2. *Requirements*

- Both the original property and the replacement property must be located in the same county.
- As of the date of the transfer of the original property, the claimant must be at least 55 years old.
- The replacement dwelling must be eligible for the homeowners' exemption as of the date the claim is filed. The original property must have been eligible for the homeowners' exemption at the time of sale or within 2 years of the purchase or new construction of the replacement dwelling. NOTE: The homeowners' exemption need not have been claimed on the property; it need only be eligible for the exemption.

- The replacement dwelling in its entirety must be purchased or newly constructed within 2 years of the sale of the original property.
- The claimant or the claimant's spouse (if a record owner of the replacement dwelling) must not have been granted this property tax relief previously.
- The claimant must file a claim for this relief within 3 years from the date the replacement dwelling (defined as land and improvements) was purchased or that the new construction of the replacement dwelling was completed.

D. Other Base Year Transfers

1. *Intercounty Transfer of Base Year Value [Proposition 90].*

Proposition 90, approved by the voters on November 8, 1988, allows the Legislature to authorize the Board of Supervisors in each county to adopt an ordinance granting base year value relief to replacement dwellings located in their county when the original property was located in another county within the State.

2. *Transfer of Base Year Value for Severely Disabled Persons [Proposition 110]*

Proposition 110 extends existing base year value transfer provisions available to person over the age of 55 to severely disabled persons.

3. *Transfer of Base Year Value for Displacement by Governmental Action [Proposition 3; Section 68; Rule 462.500]*

Proposition 3 excludes from change in ownership acquisition of replacement property as a result of eminent domain or inverse condemnation proceedings. Comparable replacement property may be located in any county in the State and does not require an ordinance to be passed by the Board of Supervisors.

VI. LEGAL ENTITIES

A. Transfers To, From, and Between Legal Entities [Sections 62(a)(2), 64(b); Rule 462.180]

The general rule is that transfers of interests in real property to a legal entity or by a legal entity is a change in ownership, subject to two major exceptions.

Exception 1: There is no CIO if the proportional interests of the transferors and the transferees are exactly the same before and after the transfer. If the proportional interests are not exactly the same, the entire interest transferred is subject to reappraisal. (Section 62(a)(2)).

> *Example 1*: If D transfers real property to Corporation V and D is the sole shareholder, there is no CIO. [Section 62(a)(2); Rule 462.180(b)(2), Ex. 5]

> *Example 2*: E and Z, as equal co-tenants, each transfer an undivided 50% interest in Whiteacre to the EZ Partnership, each taking a 50% interest in the partnership. There is no CIO. Section 62(a)(2); Rule 462.180(b)(2), Ex. 2 and 3.

NOTE: When the transfer is excluded from reassessment under section 62(a)(2), the holders of the ownership interests in the transferee legal entity shall be defined as "original co-owners" for purposes of determining whether a change in ownership has occurred upon the *subsequent* transfer of ownership interests in the legal entity. In the above examples, D, E, and Z would be considered "original co-owners."

PRACTICE TIP: The proportional transfer of real property must be proportional as to "each and every piece of real property transferred" or a change in ownership of the disproportionally transferred property results.[38]

Section 62(a)(2) does not apply to a statutory conversion or a statutory merger of a partnership into a limited liability company or other partnership (or a limited liability company into a partnership) when the law of the jurisdiction of the converted or surviving entity provides that such entity remains the same entity or succeeds to the assets of the converting or disappearing entity without other act or transfer, and the partners or members of the converting or disappearing entity maintain the same ownership interest in profits and capital of the converted entity that they held in the converting or disappearing entity. Rule 462.180(d)(4).

Exception 2: There is no change in ownership when real property is transferred among affiliated corporations (parent corporation owns 100% of all subsidiaries either directly or indirectly) including those made to achieve corporate reorganization if (i) the voting stock of the corporation making the transfer and the voting stock of the transferee corporation are each owned 100% by one or more corporations related by voting stock ownership to a common parent and (ii) the common parent corporation owns directly 100% of the voting stock of at least one corporation in the chain of related corporations.[39]

> *Example 3*: Corporation A is owned 100% by Corporation P. Corporation B is owned 50% by P and 50% by A. Corporation C is owned 50% each by A and B. If B (wholly owned by A and P) acquires property owned by C (wholly owned by A and B), there is no CIO because C and B are owned 100% by corporations related to a common parent and P owns 100% of A.[40]

B. Transfers of Ownership Interests In Legal Entities [Sections 64(a) and 64(c) and (d); Rule 462.180(c) and (d)]

Generally, transfers of interests in legal entities do not result in changes in ownership of the underlying real property. The general rule is equally true for transfers of interests in partnerships regardless of whether the partnership is a continuing or dissolved partnership. There are two main exceptions to the general rule: (1)

transfers resulting in any person obtaining, directly or indirectly, majority ownership of a legal entity; and (2) transfers resulting in cumulatively more than 50% of "original co-ownership" interests having been transferred.

Rule 462.180 reflects statutory changes adopted in the wake of *Zapara v. County of Orange*, 26 CA4th 464 (1994). In *Zapara*, the taxpayer owned 68% of the partnership interests and acquired the other 32%. Several months later, he formally dissolved the partnership and distributed the real property to himself. The court held there was a 100% CIO of the property when Zapara acquired the minority interests because the partnership was automatically dissolved as that time under state law. Had the partnership been a corporation, a different result would have obtained (subject to the appropriate application of the step-transaction or the substance-over-form doctrines.) Section 62(c)(2) was added in 1996 to reverse the specific holding of *Zapara*. After January 1, 1996, a majority partner who acquires the minority partnership interests does so without triggering a reassessment. CAVEAT: The step transaction could possibly void such a result.

Section 64(a) was also amended to state that the general rule applied to transfers of partnership interests regardless of whether the partnership was continuing or dissolved. NOTE: When property did not change ownership for property tax purposes at the time it was acquired by the legal entity (because there was no change of proportionate ownership), a change of ownership will occur once *cumulatively* more than 50% of the original interests in the legal entity have transferred.[41] The Rule makes clear that there is a change in ownership of 100% of the real property previously excluded from change in ownership, not the percentage equal to the percentage of interests in the legal entity that had cumulatively been transferred.

> *Example 1*: A and B (unrelated parties) hold equal interests as tenants in common in Blackwood Acres, a parcel of unimproved real property. A and B transfer Blackwood Acres to the Blackwood Acres LLC and in exchange A and B each receive 50% member interests. No CIO. (Section 62(a)(2)). Under section 64(d), A and B become "original co-owners". A transfers 30% of her member interests to A's child, S; B transfers 25% of his member interests to B's grandchild, N. There is a CIO upon B's transfer to N. (Section 64(d)). NOTE: Neither parent-child nor grandparent-grandchild exclusions are available for transfers of interests in legal entities. However, if S and N were the respective spouses of A and B, there would be no CIO under section 63 and Rule 462.220.[42]

> *Example 2*: Property was purchased by the JK Partnership with partners J and K each owning a 50% partnership interest. K obtains 5% from J and now owns a 55% partnership interest. K now has control of JK partnership, and there is a CIO of the real property.[43]

PRACTICE TIP: When "original co-owners" in a legal entity cumulatively transfer more than 50% of the interests in that entity, three different exclusions apply which prevent the Assessor from "counting" certain transfers within the entity for section 64(d) purposes:

- If the transfer is from an original owner to his or her spouse, the transfer is excluded from section 64(d) under section 63;
- If the transfer is from an original co-owner into his or her trust (revocable or irrevocable when excluded under section 62(d)), the transfer is excluded from section 64(d); or
- If the transfer is from an original co-owner to a legal entity and the proportional ownership interest remains exactly the same, the transfer is excluded from section 64(d) under section 62(a)(2).

C. Parent-Child and Grandparent-Grandchild Transfers.

Insofar as transfers of interests in legal entities involves transfers to children or grandchildren,[44] the Legislature expressly stated its intent that the parent-child exclusion be liberally construed.[45] Nevertheless, as *Penner v. Santa Barbara County*, 37 CA4th 1672 (1995), demonstrates, care must be taken to strictly observe the requirements of the exclusion. In *Penner*, Joyce Penner transferred real property she owned to a limited partnership wholly owned by herself and her children. The transaction was nominally the same as if she had transferred interests in real property to her children and they all had then transferred their interests in the real property to the limited partnership. However, the appellate court held that the parent-child exclusion did not apply because the limited partnership was not Mrs. Penner's child.

CAVEAT: Notwithstanding the Legislature's express statement of intent, some county assessors may still attempt to apply the step-transaction doctrine to refuse parent-child exclusions when property is subsequently transferred to an entity.

PRACTICE TIP: Many practitioners find that county recorders are imposing documentary transfer taxes to transfers into and out of legal entities although such transfers are not subject to reassessment under section 62(a)(2). Arguments against the imposition of documentary transfer tax become exercises in futility. Counties may impose documentary transfer tax on otherwise exempt (from reassessment) transfers. Rather than argue against the taxes, attempt to argue that the value for transfer tax purposes should be the "full cash value" for property tax purposes.

D. Step-Transactions and Substance-Over-Form [L.A. 92/69, 95/33]

The Legislature established technical rules to govern change in ownership determinations. Technical rules enhance predictability and ease of administration. However, the

Legislature has acknowledged the availability of doctrines such as the step-transaction and substance-over-form in determining whether a change in ownership for property tax purposes has in fact occurred.[46] The two doctrines have been applied to disregard the form of a transaction where the courts thought it appropriate to do so.

For example, in *Pacific Southwest Realty Co. v. County of Los Angeles*, 1 Cal. 4th 155 (1991), the Supreme Court held that a change in ownership had in substance occurred even as to the portion of the real property, as more particularly described in a long-term lease document, that had been reserved from the title passing to a third party in the deed. Rather than first reviewing the specific technical exclusions from change in ownership on which Pacific Southwest relied, the Court analyzed the transaction under section 60's general definition and found there had been a transfer of a present interest, coupled with the beneficial use thereof, in real property that was substantially equivalent to the fee value. The Court then interpreted the statutory and regulatory exclusions that appeared to apply in a manner consistent with its conclusion under section 60.

In an early property tax annotation, the State Board of Equalization legal staff stated that an intermediate step in a transaction should be ignored when taken solely for the purpose of avoiding a reassessment. "Change in Ownership B Step Transaction," *Property Taxes Law Guide,* V. 3 (Property Tax Annotations) at 5410 (State Board of Equalization Staff Correspondence, Dec. 24, 1981).

In *Shuwa Investments Corporation v. County of Los Angeles* 1 Cal. App. 4th 1635 (1991), the court articulated the step-transaction doctrine. Where a partnership is owned equally by Corporations A and B, and Corporation A sells its 50% partnership interest to Corporation C, after which the partnership is dissolved and its real property distributed pro rata to Corporations B and C, followed by a sale of Corporation B's 50% tenancy in common interest in the real property to Corporation C, the court found a change in ownership of 100% (not 50%) of the property even though the transaction was structured to mitigate the significant adverse federal income tax consequences that would be suffered by Corporation A if the property itself were sold by either Corporation A or the partnership. If the separate steps were respected, there would have been only a 50% change in ownership.[47] There were business purposes independent of avoiding property taxes for the individual steps. However, when the transaction was complete, a third party had acquired 100% of the property in its own name. Relying on federal case law, the *Shuwa* court described three separate tests for determining whether separate transfers should be stepped together or collapsed into a single transfer so that the property tax result could be based on "what actually occurred."

- "Under the '*end result test*,' purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." *Shuwa, supra*, at 1650 (emphasis added).
- "The second test is the '*interdependence test*' which requires an evaluation of 'whether on a reasonable interpretation of objective facts the steps [are] so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." *Ibid*. at 1651 (citations omitted; emphasis added).
- The "*binding commitment*" test "is the most restrictive test and generally forbids the use of the step-transaction doctrine unless 'if one transaction is to be characterized as a "first step" there [is] a binding commitment to take the last steps." *Ibid*. at 1652 (citations omitted; emphasis added).

The *Shuwa* court found that under any of the three tests, the transfers should be stepped together and viewed as a purchase of 100% of the property by C. The court also rejected C's claim that the existence of independent business purposes supporting the separate transfers or steps prevented the application of the doctrine to collapse the transaction. The court was not persuaded that the business purposes presented by C justified upholding the form of the transaction over its substance.[48]

After *Shuwa*, county assessors were advised that independent business purposes for the various steps in a transaction are not necessarily a defense to application of the step-transaction doctrine and that they should review transactions to determine whether their substance is within the intent of the change in ownership statutes.[49] A letter opinion issued in connection with the Shuwa transaction stated that the steps in a transaction that could have been accomplished in fewer steps should be respected where they are supported by independent business purposes.[50]

In *McMillan-BCED/Miramar Ranch North v. County of San Diego*, 31 Cal. App. 4th 545 (1995), *modified* 32 Cal. App. 4th 264a, *rev. denied*, the Fourth District Court of Appeal applied the step-transaction doctrine in ruling that a change in ownership of real property owned by a partnership had occurred. The facts were such that neither the end result test nor the binding commitment test was satisfied. Indeed, the court described the various steps as "discrete business and real property transfers" and each was supported by a business purpose independent of avoiding reassessment. Nevertheless, the court found that a 100% change in ownership had occurred.

NOTE: L.A. 95/33 notes "[t]he two most important features of the [McMillan] decision" as being:

"(1) the existence of an independent business purpose for each of the various steps, while of significance, does not prevent the application of the step-transaction; and (2) the step-transaction doctrine may be applied where only one test, in this case, the interdependence test, is satisfied."

In *Munkdale v. Giannini* 35 Cal. App. 4th 1104 (1995), the First District Court of Appeal discussed the step-transaction doctrine in connection with a transaction which itself fell within the express terms of section 61(i). Two brothers dissolved a partnership in which they were equal partners and divided the partnership's 11 parcels or real property between them. Five parcels were deeded to one brother, five to the other, and the last one to both as equal tenants-in-common. The first 10 parcels were reassessed as having changed ownership 100% for property tax purposes under section 61(i). The remaining parcel was not reassessed since section 62(a)(2) excluded the transfer to the brothers as equal tenants-in-common from being a change in ownership. Asserting that they could have structured the transaction in two steps — deeding each property from the partnership to themselves as equal tenants-in-common and then each deeding his half tenancy-in-common interests in five parcels to the other — the brothers unsuccessfully contended there in substance had been only a 50% change in ownership with respect to each parcel. The court concluded that the end result, binding commitment, and interdependence tests all would have been satisfied had the brothers chosen the two-step structure.

VII. STATUTES OF LIMITATIONS FOR SUPPLEMENTAL AND ESCAPE ASSESSMENTS FOR CHANGES IN OWNERSHIP [SECTIONS 75.11 AND 532; L.A. 2001/035]

S.B. 2170 (Ch. 647 of Stats. 2000) amended sections 75.11 and 532 to revise the statutes of limitations for supplemental and escape assessments involving changes in ownership. A *supplemental assessment* is the difference between a new base year value established for a CIO or completion of new construction and the taxable value on the assessment roll. An *escape assessment* is a retroactive assessment intended to rectify an omission or error that caused taxable property to be underassessed or not assessed at all. Once such an omission or error occurs, the property escapes assessment each year thereafter until the underassessment is discovered and corrected.

Effective January 1, 2001, the limitations periods are as follows.

A. Supplemental Assessments [Section 75.11]

- Where an individual files a change in ownership statement ("COS") for a CIO (or the death of the property owner) under section 480, a change in control of a legal entity under section 480.1, a change in ownership of a legal entity under section 480.2, or a PCOR was filed under section 480.3, the statute of limitations for supplemental assessments is four years.
- Where a COS or PCOR is filed under sections 480, 480.1, 480.2, or 480.3 which is subject to a penalty assessment under section 504 (concerning tangible property), the statute of limitations for supplemental assessments if six years.
- Where no COS or PCOR were not timely filed under sections 480 or 480.3, the statute of limitations for supplemental assessments is eight years. NOTE: This section does not apply to unreported changes in control and ownership of legal entities.
- Unlimited statute of limitations in cases of fraud under section 503.
- An unlimited period in cases of changes in ownership involving property owned in a legal entity if a COS required by sections 480.1 or 480.2 has not been filed.

B. Escape Assessments [Section 532]

- If any document evidencing a change of title or ownership is recorded, regardless of whether a COS or PCOR is filed, the statute of limitations on escape assessments is four years.
- If the penalty provided for in section 504 is added to the assessment, the statute of limitations on escape assessments is six years.
- If a COS under section 480 or a PCOR under section 480.3 is not timely filed and no document evidencing a change of title or ownership is recorded, the statute of limitations on escape assessments is eight years.
- No limitations period in escape assessments in cases of fraud under section 503.
- No limitation period in escape assessments in cases of changes in control and ownership of properties held in a legal entity if a COS required by either sections 480.1 or 480.2 has not been filed.

* *California Trust & Estate Counselors LLP, Sacramento, California*

ENDNOTES

1. Sean Flavin, Taxing California Property (3rd ed.), § 1.03.
2. *See* Serrano v. Priest, 18 Cal. 3d 728 (1976).
3. *See Summary of Legislation Implementing Proposition 13 for Fiscal Year 1978-79*, Assembly Revenue and Taxation Committee, October 2, 1978.
4. Cal. Const. art. XIIIA, § 2(a); Calif. Rev. & T. Code § 67. Primary legal sources for property tax issues are the California Constitution, art. XIIIA, Chapter 2 of the Revenue and Taxation Code including sections 60 through 69.5, Title 18, Public Revenue, California Code of Regulations include the Property Tax Rules, advisory opinions of the State Board of Equalization in the form of Letters to Assessors and other correspondence and case law. Unless otherwise stated, all references to sections are to the California Revenue and Taxation Code and all references to Rules are to the Property Tax Rules under Title 18, Public Revenue, California Code of Regulations.

[5] Calif. Rev. & T. Code § 110, §§ 50-51. "Base year" value is defined as the value of real property on March 1, 1975, or the fair market value on a later date when a present interest in the property is transferred or when improvements are newly constructed. Calif. Rev. & T. Code § 110.1.

[6] Calif. Rev. & T. Code §51(a)(1)(B).

[7] 18 Cal. Code Regs. § 462.001 *et seq*.

[8] *See* Calif. Rev. & T. Code § 110 for definition of "full cash value."

[9] The authority for this is found in Rule 462.001, which states that "[e]very transfer of property qualified as a change in ownership shall be so regarded whether the transfer is voluntary, involuntary, by operation of law, by grant, gift, devise, inheritance, trust...." If the death of a property owner is a change in ownership, the date of the ownership change is the date of death of the decedent. Rule 462.260(c).

[10] Rule 460.160.

[11] Calif. Rev. & T. Code §§ 61(h), 62(d).

[12] Calif. Rev. & T. Code § 480 *et seq*.

[13] Calif. Rev. & T. Code §§ 480.1, 480.2.

[14] Calif. Rev. & T. Code § 63; Rule 462.040.

[15] Calif. Rev. & T. Code § 61(g); Rule 462.060.

[16] Calif. Rev. & T. Code § 62(e); Rule 462.060.

[17] Calif. Rev. & T. Code § 61(g).

[18] *See* Annotation No. 220.0761; Rules 462.160 and 462.240.

[19] Allen v. Sutter County Board of Equalization, 139 Cal. App. 3d 887 (1983); *see also* Calif. Rev. & T. Code § 61(h).

[20] *See* Calif. Rev. & T. Code §§ 61(h), 63, 63.1.

[21] Calif. Rev. & T. Code §§ 60, 61(h), 62(d); Rule 462.160(b)(1)(A). *See also* Empire Properties v. Los Angeles County, 44 Cal. App. 4th 781 (1996).

[22] Calif. Rev. & T. Code § 62(d); Rule 462.160(b)(1)(B).

[23] Calif. Rev. & T. Code § 62(d)); Rule 462.160(b)(1)(A).

[24] Rule 462.160(b)(4).

[25] Calif. Rev. & T. Code § 62(d); Rule 462.160(c)-(d).

[26] *See* Rule 462.160(b)(1)(A), Ex. 1 and 2.

[27] Probate Code section 611(a) provides that "[a] power of appointment is 'general' only to the extent that it is exercisable in favor of the donee, the donee's estate, the donee's creditors, or the creditor of the donee's estate, whether or not is exercisable in favor of others." Probate Code section 611(d) provides that "[a] power of appointment that is not 'general' is 'special.'" Under (b) and (c) of section 611, the power to invade trust principal or income is "special" if: (i) it is for the benefit of some person whom the donee is obligated to support or is limited by an ascertainable standard (such as "health, education, support, or maintenance") or (ii) it is exercisable by the donee in conjunction with a person having an interest that is adverse to the donee.

[28] Probate Code § 282(a)).

[29] *See* Annotation No. 625.0090; L.A. 98/23.

[30] Rule 462.220(b) and (c).

[31] Calif. Rev. & T. Code § 63(e); Rule 462.220(a).

[32] Calif. Rev. & T. Code § 63(d); Rule 462.220(c), Ex. 2.

[33] Rules 462.020(b)(2), Ex. 2, 3, 462.040(b)(6).

[34] L.A. 99/25.

[35] If the taxable value of the property has been reduced for the lien date immediately prior in accordance with Section 51, the lower value is the taxable value. In the case of property assessed under the provisions of the Williamson Land Conservation Act, the excluded value will be the base year property value factored by the appropriate California Consumer Price Index, not the restricted value. Calif. Rev. & T. Code § 63.1(c)(5); *see also* Calif. Rev. & T. Code § 110.0.

[36] L.A. 00/05.

[37] *See supra* note 5.

[38] *See* Munkdale v. Giannini, 35 CA4th 1104 (1995).

[39] Calif. Rev. & T. Code § 64(b); Rule 462.180(b)(1).

[40] Rule 462.180(b)(1), Ex. 1.

[41] Calif. Rev. & T. Code § 64(d); Rule 462.180(d)(2).

[42] Rule 462.180(d)(2), Ex. 7.

[43] Calif. Rev. & T. Code § 64(c); Rule 462.180(d)(1).

[44] The exclusions for parent-child and grandparent-grandchild transfers have been discussed extensively earlier in this article. *See supra* section V.B.

[45] "It is the intent of the Legislature that the provisions of Section 63.1 of the Revenue & Taxation Code shall be liberally construed in order to carry out the intent of Proposition 58 on the November 4, 1986, general election ballot to exclude from change in ownership purchases or transfers between parents and their children described therein. Specifically transfers of real property from a corporation, partnership, trust, or other legal entity to an eligible transferor or transferors, where the latter are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, shall be fully recognized and shall not be ignored or given less than full recognition under a substance-over-form or step-transaction doctrine, where the sole purpose of the transfer is to permit an immediate retransfer from an eligible transferor or transferors to an eligible transferee or transferees which qualifies for the exclusion from change in ownership provided in Section 63.1. Further, transfers of real property shall also be fully recognized when the transfers are immediately followed by a transfer from the eligible transferee or eligible transferees to a corporation, partnership, trust, or other legal entity, where the transferee or transferees are the sole owner or owners of the entity or are the sole beneficial owner or owners of the property, if the transfer between eligible transferors and eligible transferees satisfies the requirements of Section 63.1. Except as herein provided, nothing in this section shall be construed as an expression of intent on the part of the Legislature disapproving in principle the appropriate application of the substance-over-form or step-transaction doctrine."

Stats. 1987, Ch. 48, § 2 (uncodified statutory note to section 63.1).

[46] *See supra* note 45; section 64(c)(2); Stats. 1995, Ch. 48, § 40 (uncodified statutory note to section 64).

[47] Sections 64(a) and (c) excluded A's sale of its 50% partnership interest to C from being a change in ownership because C did not obtain a majority of the partnership interests. Section 62(a)(2) excluded the partnership dissolution and property distribution pro rata to B and C because there was a change merely in the method of holding title and not in the proportional ownership interests. Section 61(e) included B's sale of its 50% tenancy-in-common interest to C as a change in ownership of that portion of the property.

[48] The court speculated that the transaction might have been accomplished in fewer steps. The court's proposed two-step transaction — a sale of A's partnership interest to B followed by a sale of the real property by the B to C — may in fact add up to more than two steps and may not have met all the parties' concerns. The court also thought certain of the expressed business concerns for the form of the transaction could have been and were addressed by measures other than the transaction's structure. *Shuwa, supra* at 1656-1657. It was probably not helpful that the history of the transaction and the documents evidenced property tax planning. *Ibid*. at 1641-1642.

[49] L.A. 92/69.

[50] *Shuwa, supra*, at 1649 and fn. 15.

How can I recommend charity without recommending *a charity?*

Talk to your clients about giving through their local community foundation.

It's a delicate dilemma. Estate planners, financial planners, and other professional advisors are often faced with a delicate dilemma: You want to discuss the many benefits of charitable giving with your clients, but you want to avoid recommending specific charitable causes or organizations.

Fortunately, there's a simple solution. It's your local community foundation. A community foundation is a single, trusted vehicle your clients can use to address the issues they care about most, while gaining maximum tax benefit under state and federal law. We offer a variety of giving options — including the ability to set up a Donor Advised Fund in your client's name. It's just one way we can help you help your clients achieve their charitable goals.

community foundations℠

For **good.** For **ever.**℠

There's so much more we'd like you to know.

toll-free (877) 899-5555 ~ forgoodforeverCA.org

cf℠

This symbol identifies community foundations that achieve national standards of excellence.

© 2003 League of California Community Foundations

THE COMMUNITY FOUNDATION VALUE PROPOSITION:

An Introduction to Community Foundations and the Services they Provide to Estate Planners and their Clients

By Terence Mulligan and Chris Nicholson ***

I. A BRAVE NEW WORLD

Philanthropy isn't what it used to be. In the last 10 years, the field of charitable giving has changed so profoundly that new words and phrases have been born into our language to describe trends and activities reshaping the independent sector. These include venture philanthropy, social capital, giving circles, social return-on-investment and the intergenerational transfer of wealth.

During this time, a network of organizations with several decades of experience has come of age, engineering many of the recent developments in the field of giving. These organizations are called community foundations and they are playing an increasingly prominent role in both charitable giving and the estate planning process, especially in California. This article surveys recent changes in the charitable giving marketplace, provides a background on the community foundation field in California and illustrates the services that these organizations offer to estate planners and their clients.

A. Philanthropy In The Age Of Enron

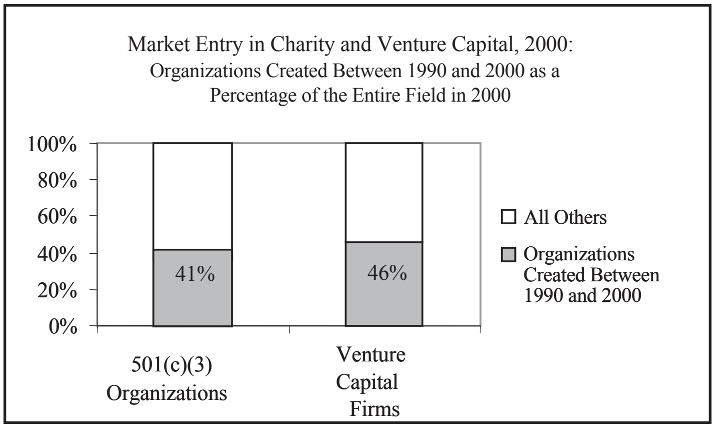
Philanthropy is still alive and well. Despite the recent downturn in the capital markets, the growth in Americans' wealth over the last 40 years has been staggering. The recently released 2002 World Wealth Report created by Merrill Lynch and Cap Gemini Ernst & Young reveals that in the U.S., there were 2.1 million high net worth individuals at the end of last year — just slightly higher than the findings in the last report — whose combined wealth grew 1.7 percent to $7.6 trillion. Meanwhile, the wealth of ultra-high-net-worth individuals in the U.S., individuals who have financial assets over $30 million, saw a 3 percent increase, to a total net worth of $8.37 trillion. Although total giving by Americans declined slightly last year on an inflation-adjusted basis to $212 billion, this number just about matches the total global sales in 2002 of Wal-Mart, Inc., the largest company in the world.[1]

By the middle of this century, the much discussed intergenerational transfer or wealth (or IGTW) will have shifted between $41 trillion and $136 trillion from one group of people to another group of people and institutions in the United States.[2] This massive future transfer of assets to heirs, government tax coffers and charitable organizations is a product of powerful economic and demographic forces that will take several decades to play out.

However, in the near term, there are two things that can be said about it with some certainty. First, although IGTW has become useful shorthand for attorneys, wealth managers and nonprofit executives, it captures only the rough outlines of a much larger object, like the first explorers' maps of the New World. Despite all the journal articles and conference seminars, we may not really comprehend the dimensions of IGTW until it more completely surrounds us. For example, equities have lost nearly $8 trillion in value since March 2000, but one-half to two-thirds of the wealth of U.S. individuals is held in *non-financial* assets like houses, property and family businesses — and the assumptions underneath the IGTW figures cited above are very conservative.[3] Second, just as above-average profits attract new entrants to a particular industry or sector in the world of business, we will continue to see new charitable giving platforms and new philanthropic service providers arrive on the scene in the years ahead, lured by the tremendous promise of acquiring social capital and earning fees on a scale never before seen.

B. Market Entry and the Choices Facing Your Clients

Indeed, the challenge for planners in this evolving landscape is to help clients clear a thoughtful path through a dense forest of alternatives — some of them old but many of them new. A brief review of the numbers shows just how tricky this challenge has become. Between 1990 and 2000, the Internal Revenue Service registered more than 500,000 new tax-exempt organizations, including 332,000 entities registered under Internal Revenue Code § 501(c)(3).[4] As the following table demonstrates, these new arrivals accounted for a very significant percentage of the overall nonprofit sector in 2000, even when viewed in comparison to the field of venture capital, cited by many as one of the most dynamic industries in the for-profit sector over the same period of time.[5]



The nonprofits that flooded into the philanthropic marketplace between 1990 and 2000 include: private foundations established by families and corporations; supporting organizations created in connection with community foundations and other nonprofits; direct service agencies like food banks and health care clinics; educational institutions like charter schools; environmental and arts groups; and a slew of commercially-branded entities that exist chiefly to provide "donor advised funds" (or DAFs, discussed extensively in the balance of this article) to the burgeoning retail market for charitable giving.

Growth in this last category of nonprofit enterprise — commercial firms providing donor advised funds, sometimes termed "commercial gift funds" — has been especially impressive. The Fidelity Charitable Gift Fund was launched in 1992 and attracted $2.6 billion in assets by 2001. The four next-largest providers comprise a second tier that, while smaller in the aggregate than Fidelity in terms of asset size, is still large and growing fast. These second tier players are Vanguard, Schwab, the National Philanthropic Trust (or NPT, which provides private label donor advised funds to several large financial service companies) and Ayco Charitable Foundation. Together, they controlled assets of about $1 billion in 2001, up from $168 million in 1999, an increase of nearly 500 percent. All other participants in the commercial gift fund market controlled less than $150 million by year-end 2001.[6]

Notwithstanding a major correction in the capital markets and a sharp decline in the number of individuals who own highly appreciated, publicly-traded securities, new providers continue to trickle into the commercial gift fund market, and dozens of organizations are developing new services targeted at high net worth families. Several financial service companies, for example, have recently chosen to buy private label donor advised fund programs from the likes of NPT rather than build their own charitable subsidiaries.

In our view, this is a smart move. Many financial service companies are struggling to sustain growth and profitability in core business operations like investment banking, brokerage services and wealth management. These firms have watched their clients' assets migrate to commercial gift funds at Fidelity and elsewhere; they know these assets are not coming back; and they want to have their own gift fund programs in place to prevent future philanthropic assets from taking flight. But instead of investing in proprietary charitable programs at a time of economic uncertainty, they have decided to acquire gift fund capabilities from third party providers like NPT. Firms that have entered the commercial gift fund market in this fashion over the last two years include Morgan Stanley, Goldman Sachs, Salomon Smith Barney, Credit Suisse First Boston, American Express, Legg-Mason Trust and JP Morgan Chase.

Large universities like Harvard and Yale, and national nonprofits like the United Way and Rotary International, have also begun to offer donor advised funds to alumni, donors and members.[7] These institutions recognize that the benefits of a DAF program to clients — simplicity, cost effectiveness, and flexibility — are too compelling to ignore. However, the DAF market is not the only source of innovative ideas these days. Just this year, when it seemed as if philanthropy would be hard pressed to become any more like a Target store than it was already, a new company called Foundation Source introduced a software solution that aims to simplify the process of setting up private foundations. To quote from its website:

> Using traditional methods, it can take up to several months and $10,000 to $20,000 to create a new private foundation. Foundation Source dramatically reduces both the time frame and the cost. The information gathering process takes about 15 minutes. Once Foundation Source has the information, it can deliver the foundation in less than three business days, and at a cost of under $5,000.[8]

We suspect that planners (and their "traditional methods") will not be replaced by software programs any time soon. On the contrary, the amount of noise in the charitable giving marketplace will only enhance the need for well-informed, preferably human counsel. But where can planners themselves go for assistance in this shifting environment? There are more nonprofit agencies to choose to support — directly or indirectly — than ever before, and more charitable giving platforms designed to organize clients' giving. Is a donor advised fund an appropriate solution? If so, which of the many providers does it make sense to work with? What about supporting organizations and private foundations? Or venture philanthropy and giving circles?

The purpose of this article is to suggest a solution for your clients' giving requirements that is better, faster and cheaper than many of the other alternatives available. This solution is the group of community foundations located throughout California. If you are already familiar with your local community foundation (CF), it may be helpful to skip the following section, which provides a brief background of the field in California for those who may not have had the opportunity to work with a CF. Section III provides specific examples of the benefits you and your clients may receive by working with community foundations, as well as a few case studies from our own work with attorneys and other professional advisors at Peninsula Community Foundation and the East Bay Community Foundation.

II. CALIFORNIA COMMUNITY FOUNDATIONS

A. Definition

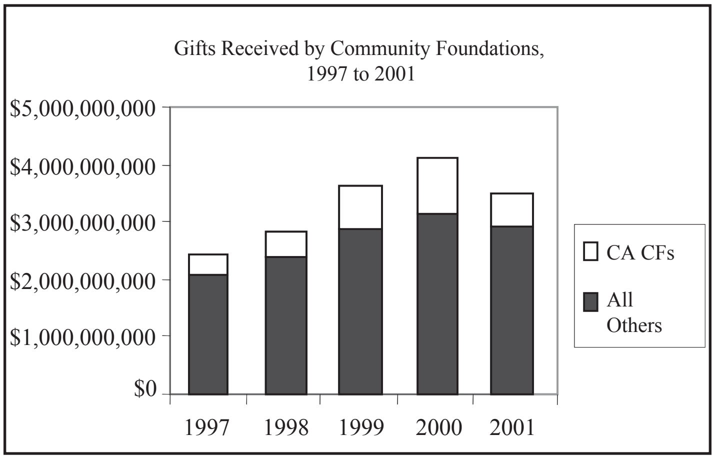
A community foundation is a nonprofit entity organized as a collection of component funds for the long-term benefit of a specific geographic area. Community foundations are tax-exempt under Internal Revenue Code § 501(c)(3) and meet the public support test under § 170(b)(1)(A). Gifts made to community foundations, like gifts made to other public charities for which tax deductions have been secured, are irrevocable. [9]

However, community foundations differ from most charities in that they resemble a mutual fund, not a particular stock. In other words, community foundations address a broad range of issues that affect the quality of life in your neighborhood, your city and your community — from education to the environment to the arts. They are not focused on one mission, like building homes for low-income families. They typically do not offer direct services, like providing meals to the hungry. Instead, they are focused on promoting effective philanthropy and on helping your clients connect to high quality nonprofit agencies and programs. Very often, community foundations serve as a kind of philanthropic private bank for individuals, families and corporations. People open up a charitable giving account (like a donor advised fund or a scholarship fund), then work with the staff of the community foundation to identify programs of interest and establish a plan for grantmaking.

B. Recent Growth

Community foundations are perhaps the best-kept secret in trust, tax, estate and charitable planning. This is a curious thing, because much of the innovation that has taken place in the philanthropic sector in recent years has its roots in the work of these local organizations. For example, the market for donor advised funds, which was propelled to celebrity status by the late 1990's capital market boom, was pioneered by community foundations (and also by the national network of Jewish Community Federations). Whereas the most recent entrants into the DAF business (the commercial gift funds discussed above) had combined assets in 2001 of $3.75 billion, community foundations based in California had assets of more than $4.5 billion and are the fastest growing subset of a national community foundation field comprised of some 650 individual nonprofit trusts and corporations with roughly $32 billion in assets under management.[10]

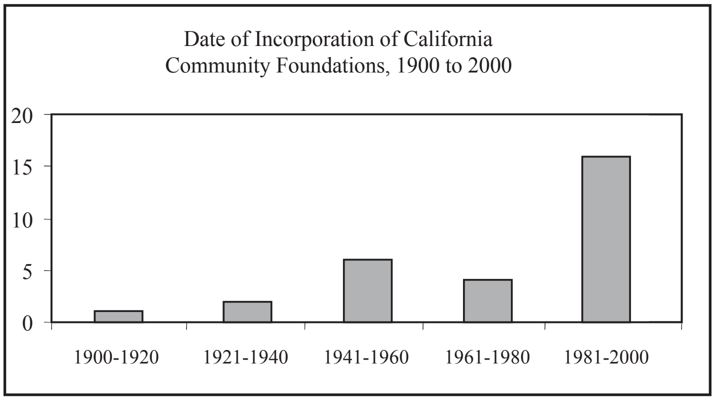
As the following table illustrates, California community foundations have been remarkably successful in attracting social capital in the last five years, serving as the engine of growth for the larger field and increasing gifts received (or contributions) at a compound annual rate of 12 percent. Between 1997 and 2001, California community foundations received more than $3 billion in gifts, a number that represents nearly 20 percent of all contributions received by community foundations in the U.S. over that time period.[11] Most of these donations were from living individuals and families who established donor advised funds and supporting organizations with appreciated, publicly traded securities.



However, a significant percentage of the gifts received by California community foundations in recent years were either: 1) more complicated assets such as real estate, privately held securities, limited liability corporation or limited liability partnership shares; or 2) used to create other types of giving vehicles, such as scholarship funds, testamentary and inter-vivos endowment funds and corporate advised funds.[12]

C. History

In historical terms, the recent surge in contributions to California community foundations has been exceptional. So, too, has been the sheer growth in the total number of CFs that exist in the Golden State. During the first half of the 20th century, only a handful of CFs were incorporated here. The California Community Foundation, which serves the Los Angeles area, is the oldest in the state. It was established in 1915 in a broom closet in the Security Pacific Bank, and it operated without full-time professional staff until 1946.[13] As the table below points out, the California Community Foundation in Los Angeles also operated without a peer group large enough to fill a broom closet until the post-WWII years. In fact, a majority of the 29 community foundations that serve California today were established after 1980.



As you might expect, the age of a community foundation tends to be positively correlated with its asset levels. The older the foundation, the deeper its roots in the community and the bigger its base of donors — both living and deceased. But there are exceptions to this rule. The Marin Community Foundation was founded in 1986 with the assets of a trust created by the Buck family. This large testamentary gift effectively jump-started Marin's asset growth, and today the foundation is the largest CF in the state with $1.15 billion in assets as of 2001.[14]

Overall, there are seven CFs in California with assets greater than $100 million; ten with assets between $10 million and $100 million; and twelve with assets below $10 million. The larger CFs support more staff members, from development officers that work with professional advisors on gift transactions to program officers that conduct due diligence on foundation-directed and donor-directed grantmaking. However, all community foundations share essentially the same mission — to develop resources for the common good in a particular geographic area like a metropolitan area or a specific county. There are certainly differences among foundations at the margins, but as discussed more fully in Section III, we all have staff ready to help your clients give back to their communities, or to charities anywhere in the U.S. (and sometimes abroad).

Some CFs, like Peninsula and East Bay, have invested heavily in supporting a large base of donor advisors, while continuing to grow unrestricted endowment via planned gifts. Others have focused more narrowly on either the advised fund or the unrestricted endowment approach. But minor philosophical or strategic differences among foundations of similar asset sizes are probably less noticeable from the planners' perspective than the differences that exist across CFs of varying asset sizes. Even here, there is good news for you and your clients. California community foundations, no matter what their size, are all equipped to deliver something that commercial gift funds can not: high touch, personalized local service; knowledge about nonprofit agencies and programs that are having a positive impact on the communities where your clients live; and, in many cases, an ability to comprehend and often accept complicated gift assets that the commercial funds can not.

A Bay Area financial planner recently summarized the advantages of a donor advised fund at a community foundation thusly:

> Starting a private foundation is like buying a GulfStream II. You get full control, but a lot of responsibility. Opening a charitable check writing account at Vanguard is like flying coach on a major airline. It's cheap but they don't feed you anything. Working with a community foundation is the best of both worlds. It's like fractional ownership of a private jet![15]

D. Legal Issues

Other than the use of the phrase "fractional ownership," we think the testimonial above is a reasonable metaphor to use when thinking about the charitable giving options available to your clients. From a legal perspective, your clients will probably need some help to understand three basic but critical issues related to community foundations. First, the irrevocability of donations made to such an entity. Second, the tax-exempt status of CFs under § 501(c)(3), which enables donors to receive significant tax benefits when making contributions. Third, the important distinction between "recommending" grants in the advised fund context and controlling grantmaking as the principal in a private foundation. Here, briefly, is a discussion of these issues.

1. *Irrevocability*

Although this point may seem self-evident, in an era of retail philanthropy and do-it-yourself investment management, it probably bears repeating for some clients: a gift transaction is an immutable event. Once an asset has been transferred to a community foundation, it is no longer the property of the donor. It cannot be given back to the donor's family or transferred by grant to a private foundation under the donor's control (or to any private foundation, for that matter). Instead, the donation can be held in a donor advised fund (or another type of fund) that bears the donor's name, and the asset or its proceeds distributed to § 501(c)(3) organizations based on the recommendations of the donor (or his or her family).

2. *The Joys of Ceding Control*

In exchange for making an irrevocable gift to a community foundation and giving up legal control of donated assets, your clients receive significant tax benefits. Cash gifts to a CF qualify for the maximum income tax deduction — 50% of "adjusted gross income" (AGI) in the year of the gift, with five-year carry over. Gifts of appreciated property avoid capital gains tax and are deductible at fair market value at up to 30% of AGI, with five-year carry over. This compares to the 30% and 20% AGI limitations, respectively, for gifts of cash or publicly traded securities to a private foundation.

Perhaps more important than the higher deductible ceiling for a community foundation is the issue of fair market value versus cost basis for a wide range of potential gift assets. Any asset other than cash or publicly traded stock donated to a private foundation will be deductible only at its cost basis. Thus, real estate and closely held family business shares and venture capital shares, to name a few, may not be appropriate for funding a client's private foundation. Even with the recent passage in the California State Legislature of AB 1122 and SB 657, which brought California into harmony with Federal rules allowing a tax deduction based on FMV for gifts of publicly traded stock to private foundations, community foundations continue to offer a dramatically better alternative for charitable clients with less liquid assets. Giving up slight control may be a very worthwhile tradeoff for such clients.

3. Ask, But Don't Insist

Suppose Ms. Garcia creates a donor advised fund at Peninsula Community Foundation (PCF) with 100 shares of IBM. Her broker transfers the shares to a PCF account, where they are sold tax-free by PCF, resulting in proceeds of $8,750 for the "Garcia Family Fund."

But the assets in the fund belong to Ms. Garcia in name only. As a legal matter, she has given up sovereignty over the $8,750 transferred to PCF. This protects the tax deduction she garnered in making the donation and the tax-exempt status of the entity that received her gift. She can recommend how charitable dollars in her fund are spent, but she cannot give binding directives. Ultimate control rests with the tax-exempt sponsor of the DAF, in this example PCF.

This is an important point of distinction between a DAF and a private foundation. If your client is the chairman of her family's private foundation, he or she has full control of grantmaking and investment decisions. If the client instead created a DAF, this would not be the case. As a practical matter, however, many donors find the difference between a recommending role and a directing role insubstantial. They are happy to give up control in exchange for the simplicity, cost-effectiveness and flexibility of a donor advised fund. In fact, they sometimes recommend the "recommending" approach of DAFs to others.

III. THE COMMUNITY FOUNDATION VALUE PROPOSITION: GIVING ADVICE AND PROVIDING FLEXIBILITY, SIMPLICITY AND CONVENIENCE

Community foundations are attractive partners because of the special role they play in the philanthropic process as well as the unique benefits they provide to both donors and their estate planning advisors. The term "giving advisor" probably best captures the unique role community foundations play in the philanthropic process. Community foundations play this role because of the substantive and procedural advice about charitable giving that they provide to donors and their advisors.

A. Giving Substantive Advice to Clients/Donors

Community foundations provide substantive advice to clients/donors by helping them to identify and evaluate potential grant recipients. In August 2001, PCF received a call from a local estate planner. His client, "Mrs. Jackson," was a retired schoolteacher whose late husband had built a successful business in Burlingame over the course of 40 years. Mrs. Jackson had no children; she owned two homes that had appreciated significantly in value since they were purchased in the mid-1960's; and she wanted give back to her community through her estate plan, with an emphasis on children and education.

The challenge for the estate planner was twofold. First, his client did not have a list of specific charities that she wanted to support. She planned to leave a sizeable gift to the school district where she had taught for almost two decades, but wanted to "hedge her bets" by including other programs that helped children. Second, the estate planner was not sure whether local charities could accept complex gift assets like real estate — assuming he could identify and recommend such agencies.

PCF solved both of the estate planner's problems. First, by deciding to establish a testamentary "Field of Interest Fund" for education at PCF named after her late husband, the client was able to support effective charitable causes without picking one or more specific charities. PCF will steward her charitable fund, hire professional money managers to grow the fund corpus, conduct due diligence on charitable organizations, and make grants in Mr. Jackson's name to nonprofit agencies that help educate and enrich children. Second, when the fund is created through Mrs. Jackson's estate, PCF can quickly comprehend and absorb these unique assets, residential real estate. Indeed, as the capital markets continue to face challenges, the ability of community foundations to accept thoughtfully planned inter-vivos and testamentary gifts of real estate is becoming a key value add.

Community foundations are also capable at helping people who already have significant philanthropic experience. When "Mr. Johnson," one of the East Bay Community Foundation's (EBCF) most recent donors, was referred to the Foundation, he was already an established philanthropist. An East Bay native with over forty years of investment management experience, Mr. Johnson was a firm believer in the value of education. He was an annual giver to not only his alma maters but to numerous other colleges and universities. Yet, when the year 2000 rolled around, Mr. Johnson found himself reevaluating his philanthropy. "I just wasn't convinced that I was helping the most disadvantaged of people. I wanted to find a way to broaden the scope of my philanthropy beyond what I already knew." It was a friend who suggested EBCF as a potential solution. From EBCF's donor services staff, Mr. Johnson received a detailed orientation to critical areas of need in the East Bay and guidance on evaluating nonprofit organizations. He developed a new philanthropic focus in youth development and education and economic empowerment, goals deeply rooted in his own values.

By giving through EBCF, Mr. Johnson's gifts could be made anonymously, an option many donors choose. "You give people the tools to succeed and they will respond," said Mr. Johnson. "I'm not interested in recognition from my contributions. I'm just inclined to help where I can. The people at the East Bay Community Foundation, in helping me to analyze and focus my interests, were the means for me accomplishing that goal."

There are two things worth noting about these examples. First, donors like these are becoming more and more common. Individuals are increasingly seeking giving advice from organizations like community foundations. The traditional approach to philanthropy, making year-end contributions to the same list of mainstream organizations, is being supplemented or replaced by a goal-oriented or issue-focused style of giving.

Second, the process used by each community foundation to work with the client is conceptually very similar to the approach financial advisors take in working with clients. Donors view their contributions as investments, not gifts, and, as with their investments, seek results.

Community foundations are uniquely positioned to provide substantive advice about giving, helping to connect people with causes they care about. They possess more collective intellectual capital about giving opportunities than any other organization in the United States. This intellectual capital consists of the collective grantmaking experiences of more than 650 community foundations, a total of $9.5 billion in grants over the last five years.[16] Community foundations readily share information with one another, which makes it possible for individuals working with a CF in California to obtain information about grantmaking opportunities anywhere in the country.

B. Giving Procedural Advice to Clients/Donors

In addition to helping people figure out *who* to give to, community foundations help people determine *how* they want to give. Community foundations can help individuals with procedural issues related to giving: assist with framing charitable intent, developing mission statements and grantmaking guidelines, identifying and evaluating giving strategies, discussing approaches to involve children in philanthropy. Recent studies suggest that clients want this sort of help from their advisors.[17] Estate planners can help clients who want assistance with some of these procedural issues by referring them to a community foundation.

The estate planning as well as the financial planning fields have shifted in recent years to a greater focus on values-based planning. Community foundations are a great resource for any values-based planner as, through the procedural services discussed above, they can help a client develop and implement a values-based estate plan. Parents who want to transfer values to the next generation or teach children about the importance of giving back can do so through establishing a donor advised fund at a local community foundation.

C. Giving Advice to Advisors

Community foundations also serve as giving advisors to estate planners themselves. Many community foundations in California offer free charitable gift planning expertise to professional advisors, including consultations, illustrations, projections and sample documents. Many of the larger community foundations in California employ attorneys to deliver this advice. Community foundations frequently sponsor continuing education presentations on charitable giving topics. Recent Bay Area presentations dealt with: supporting foundations, gifting real estate, gifting stock options, gifting S-corp stock, and planning strategies for clients with concentrated equity positions. In addition, the Bay Area community foundations sponsor *www.GiftPlan.org*, an internet site which provides tax planning information and advice to professional advisors. This site is a comprehensive resource with information about tax rules and gifting vehicles and provides a summary of recent key tax court rulings.

Estate planners will find that community foundation staff can be particularly helpful with particular gifting issues/questions related to private foundations and their alternatives (principally donor advised funds and supporting foundations), charitable trusts and leaving a legacy.

D. Flexibility

Whatever the client's situation or philanthropic desire — current year tax planning, a large capital gain, leaving a legacy, establishing a family foundation — a community foundation can help to create a giving plan to meet the client's need. Community foundations are vehicles for both current as well as planned giving and offer a range of fund options to suit the needs of donors: donor advised funds, designated funds, field-of-interest funds, and organizational endowment funds.

Community foundations can receive a broad variety of assets and make grants to a range of charitable causes and organizations. As a general rule, a community foundation will accept any type of asset as long as it is marketable and does not have a liability attached. For example, last year Peninsula Community Foundation received real estate, limited partnership interests, closely held and restricted stock, in addition to cash and publicly traded securities.

Community foundation donors have tremendous grantmaking flexibility. As a general rule, community foundation donors can make gifts from their funds to support any organization or program, as long as the gift is furthering a charitable purpose. It is a common misperception that community foundations require their donors to make gifts to organizations in a specific geographic region or to a pre-approved list of nonprofits. That is simply not the case. A donor with the San Diego Foundation, for example, could make gifts from their donor advised fund to environmental organizations in the Florida Keys. Five years ago, the East Bay Community Foundation helped Sarunas Marciulionis, then a member of the Golden State Warriors, build a children's center in Lithuania with gifts from his donor advised fund. More recently, Peninsula Community Foundation and Community Foundation Silicon Valley have helped their donors support a range of international charities.

E. Simplicity and Convenience

Community foundations make the process of giving both simple and convenient. Donors can establish their own fund in a single day and avoid the cost and complexity of a private foundation. Most California community foundations have draft fund agreements on their websites, which can be downloaded and revised as needed for specific donors. These agreements are typically two page plain-English agreements between the community foundation and the donor or donors. They only require three pieces of information: the donor’s name, a description of the donor’s charitable goals, and a name for the fund. With that donor-specific information, the template agreement is revised accordingly, and, when signed by both the donor and a representative from the community foundation, a fund is established. It’s that simple.

Once a fund has been established, community foundations make the process of giving very convenient. The community foundation handles all of the record keeping and reporting required for charitable contributions. For individuals who made a significant number of gifts, this can be an especially attractive benefit. For tax reporting purposes, donors are provided with a gift acknowledgment letter from the community foundation for the gift to their fund. Donors are not responsible for obtaining gift acknowledgement letters from all of the charities they are supporting through their fund. Community foundation staff conducts due diligence on all grants for the donor.

In addition, operating a fund at a community foundation is easier than operating a private foundation because the private foundation excise taxes do not apply to funds at community foundations. Community foundation donors need not worry about tax in investment income, minimum payout requirements, self-dealing and excess business holding rules.

IV. CONCLUSION

Community foundations are great partners for estate planning professionals in the arena of charitable giving, a field which is becoming increasingly competitive, complex, service-oriented and values-based. They can help estate planners offer a greater variety of charitable options to clients in ways that complement the underlying plan. California community foundations can provide personal client service, giving advice on procedural and substantive levels, and a channel for turning a range of assets into charitable capital. In short, they are a very effective means to an important end — helping your clients accomplish their charitable goals. To learn more about community foundations, or to locate the one nearest to you, please visit *www.forgoodforeverca.org.*

* *Peninsula Community Foundation, San Mateo, California*
** *East Bay Community Foundation, Oakland, California*

ENDNOTES

[1] Wal-Mart’s revenues for the fiscal year ending January 31, 2002 were just under $218 billion. Wal-Mart Annual Report, 2002. This revenue figure is higher than that of any other company in the world.

[2] John J. Havens and Paul G. Schervish, Millionaires and the Millennium: The Forthcoming Transfer of Wealth and the Prospects for a Golden Age of Philanthropy, (Boston: Boston College Social Welfare Research Institute, 1999). Of note: In January 2003, Havens and Schervish announced that they are standing by their numbers, despite the three year slide in the equity markets. “Our principle conclusion remains that it is not whether $41 trillion will be transferred, but how much more than $41 trillion will be transferred,” the authors said in the Boston College Social Welfare Research Institute Newsletter, January 2003. For a complete report, see: http://www.bc.edu/bc_org/avp/gsas/swri/wcvol3.htm.

[3] Kelly Greene, *Market Victim: Your Inheritance*, Wall Street Journal, August 6, 2002; John J. Havens and Paul G. Schervish, *“Introduction to Wealth Transfer,”* Boston College Social Welfare Research Institute (August 6, 2002) available at http://www.bc.edu/bc_org/avp/gsas/swri/swri_features_wealth_transfer_report.htm

[4] Sources are: the National Center on Charitable Statistics at the Urban Institute’s Center on Nonprofits and Philanthropy in Washington, D.C.; Michael O’Neill, Nonprofit Nation: A New Look at the Third America, (San Francisco; 2002). The Urban Institute data is available on their website at http://nccs.urban.org/factsht.htm.

[5] Data is from the National Venture Capital Association Yearbook, 2001 and Venture Economics.

[6] Harvey Lipman, *Survey Finds Rapid Rise in Assets and Grants of Donor advised Funds*, Chronicle of Philanthropy, May 31, 2001; Debra E. Blum, *Tailor-Made for Charity: Private-label Gift Funds are Growing in Popularity*, Chronicle of Philanthropy, May 30, 2002.

[7] Chronicle of Philanthropy, 2002.

[8] Foundation Source Philanthropic Services, Inc., *Foundation Source*, at https://www.foundationsource.com/ about (July 22, 2002).

[9] Christopher R. Hoyt, Legal Compendium for Community Foundations, (Washington, D.C.; Council on Foundations, 1996).

[10] *Community Foundation’s Assets, Gifts and Grants in 2001*, Chronicle of Philanthropy, September 19, 2002.

[11] Data source is the 2001 Columbus Foundation Community Foundation Survey. Over the five-year time period cited above, gifts received by California CFs accounted for 18.7% of total gifts received by the community foundation field nationwide.

[12] For example, real estate, privately held business shares and other complex assets accounted for about 20% of the value of the gifts received by Peninsula Community Foundation in 2001.

[13] California Community Foundation, *Inside CCF/CCF History*, http://www.calfund.org/3/ccf_history_3.5.php.

[14] League of California Community Foundations; Marin Community Foundation website, http://www.marincf.org/foundation/mission_history.html.

[15] Authors’ conversation with a Bay Area financial planner, spring 2002.

[16] Columbus Foundation Community Foundation Survey, 2001. Community foundations made $9.5 billion in grants between 1997 and 2001.

[17] *Doing Well by Doing Good—Improving Client Service, Increasing Philanthropic Capital: The Legal and Financial Advisor’s Role* at www.tpi.org; *The Donor Advisor: The Critical Role of the Advisor in Family Philanthropy”* at http://www.ncfp.org/publications-passages-donoradvisor.pdf.

MEDIATION IN TRUST AND PROBATE PRACTICE

*By Kay E. Henden **

The early promise of mediation was that disputes would be resolved more quickly, less expensively, and with better closure for the litigants. Within the last five years, that promise has been largely realized.

This article outlines mediation's present status in the various court systems and administrative agencies serving trust and probate practice in California. It also describes the results of its use as reported by the courts, agencies and practitioners in the area.

Three primary systems are involved:

- The state court system[1] (both trial court and appellate levels), handling all types of disputed trust and probate[2] matters.

- The federal court system (both trial court and appellate levels), handling similar disputed matters when diversity and/or other federal issues are involved.

- The Internal Revenue Service, handling lifetime income taxes, fiduciary taxes, transfer taxes (gift, estate, and generation skipping), and other miscellaneous tax matters.

I. PRESENT STATUS

A. California Courts

In the California state court system, there are only two formal statewide requirements relating to court-annexed mediation programs.

First, effective July 1, 2002, the California Rule of Court requiring plaintiffs in civil actions to serve information relating to alternative dispute resolution ("ADR") on defendants as part of the opening documentation has been moved to the rules relating to civil service in general.[3] Originally adopted as part of the ADR rules,[4] this rule was sometimes overlooked by litigants and was moved to its new location to insure compliance and promote public knowledge and awareness of the ADR process. The ADR materials produced for the general civil program in compliance with this rule are often shared with the probate divisions of the county.

Second, new standards of conduct for mediators in court-connected cases were adopted effective January 1, 2003 in California,[5] which more clearly define the responsibilities of the mediator and codify the confidentiality of the process.

Only two statewide mediation programs exist. First, in 1986 the Dispute Resolution Programs Act ("DRPA")[6] was passed, providing matching-fund grants for ADR programs in the community and allowing an increased filing fee in civil actions to cover funding. Although some restrictions apply, the intent is to promote pre-litigation resolution of disputes.

Second, a formal statewide pilot mediation program is now underway in the general civil divisions of five test counties.[7] Favorable results could prompt future legislation expanding mediation availability or providing more uniform programs statewide or both.[8]

In addition to these statewide programs, however, ADR and particularly mediation has been implemented to some degree in nearly all courts in the state.[9]

1. *California Trial Courts*

In general, four primary approaches are used:

a. In a few counties, alternative dispute resolution is offered, but is limited primarily to settlement conferences utilizing either the assigned judge, or volunteer judges from other divisions in the same county. In these counties, the general civil and probate ADR programs are combined, and court resources are shared between them.

b. In the majority of counties,[10] comprehensive general civil programs encompassing arbitration and mediation are available (in addition to the settlement conference option). In the smaller of these counties, contested probate cases are often assigned to general civil judges for disposition, resulting in continued overlap between civil and probate administration. Court staff administers the ADR program for both civil and probate divisions, and probate and family law courts sometimes develop methods of mutual support based on similarity of issues in their cases.

c. In the most populous counties, ADR programs become more sophisticated, and it is common to see a professionally staffed general civil ADR program. Formal mediation training is provided to mediation panel members at no cost or on a reduced fee basis. A separate program for probate staffed primarily by volunteers often arises, though still utilizing some of the infrastructure established for the general civil program. Counties such as Los Angeles and San Diego[11] have developed separate mediation panels with specific trust and probate expertise. The panel lists are generally kept at the court, although in some counties (such as Alameda) the county bar association maintains the court panel roster.

d. Finally, in the most complex mediation models available at the state trial court level,[12] the probate and trust program is further subdivided into probate and trust litigation, on the one hand, and conservatorship and guardianship matters on the other. Moreover, one or more separate mediation programs are maintained by the bar association in addition to the court-annexed program.[13]

2. California Appellate Courts

As with the trial courts, the six appellate districts (encompassing eight divisions, including the three separate divisions of the Fourth Appellate District) have different levels of staffing and complexity in their ADR programs.

In the Fourth Appellate District (Division Two, Riverside), one of the oldest organized ADR programs has been highly successful in reducing court backlog and improving efficiency. This program evolved from a more traditional settlement conference type model using an all-volunteer panel of mediators to its current mediation program conducted in a dedicated ADR conference facility.

In the Second Appellate District, the program was developed from earlier test programs and has been in its present form for about six years. It originally used the settlement conference model as well, but in the last year has begun training its volunteer attorney settlement officers in mediation, and both techniques are used as appropriate. All referrals to the program are voluntary but occur immediately upon intake.

In the First Appellate District, one of the newest programs has emphasized mediation from inception; it also refers early in the process, but pre-screens referrals to the program. Extensive materials are available, and comprehensive statistics are being maintained.

Most of the remainder of the appellate level courts have differing if less intensive programs; two courts (Fifth Appellate District, Fresno, and Sixth Appellate District, San Jose) report no formal mediation program.

B. Federal Court System

In the federal court system, the impetus for adoption of mediation came first at the appellate level and from there expanded into the trial courts.

1. Ninth Circuit Court of Appeals

Alternative dispute resolution, including arbitration and assisted settlement conferences, has been in place at the appellate court level in the federal system since 1978; early neutral evaluation was added to the program in the 1980s. In the Ninth Circuit, the mediation program has been in its present form since 1992. The program is extremely well developed, and employs nine full-time staff mediators, rather than a volunteer panel.

2. U.S. District Courts

In 1998, Congress passed the Alternative Dispute Resolution Act of 1998,[14] which stated:

> "Congress finds that the continued growth of Federal appellate court-annexed mediation programs suggests that this form of alternative dispute resolution can be equally effective in resolving disputes in the Federal trial courts; therefore, the district courts should consider including mediation in their local alternative dispute resolution programs."[15]

Although all four[16] of the California districts employ ADR programs, each has a different focus. The Northern District has a well developed mediation program, encompassing comprehensive training for their panel of outside mediators, on-line mediator profile listings, assignment of specialized mediators to given subject-matter cases, and regular procedures for selection of ADR process. The Central District has a similarly comprehensive program, the Eastern District is next most active, and the Southern District has a less complex approach.

C. Internal Revenue Service

The IRS now has two permanent mediation programs in place, the Fast Track Mediation Program (addressing disputes pre-appeal), and the appeals program (available after an appeal is filed).

1. Appeals Level

The appeals section of the IRS first introduced mediation as a resolution tool in 1995;[17] the program was expanded in 1998.[18] In 2002, a permanent mediation program with expanded coverage for wider range of taxpayers[19] was put into place, which eliminated the minimum dollar requirement and applied to all issues with few restrictions.

2. Fast Track Mediation Program

The "Fast Track Mediation Program," a pre-appeals version of the older appeals mediation program, began in 2000 as a pilot program in four areas of the country.[20] The program was rolled out nationwide in 2002 and is available for virtually all disputes.[21]

Both programs utilize the same panel of in-house mediators, who are trained by the Federal Mediation and Conciliation Service. But at the appellate level the taxpayer may employ a private co-mediator in addition to the IRS mediator. As with other mediation programs, the IRS mediators are bound by strict confidentiality requirements.[22]

While both programs are to be offered to all eligible taxpayers, not all IRS personnel may yet be aware of their availability. Practitioners should be prepared to request submission to the programs if the process is not initiated by the IRS agent in charge.

II. RESULTS OF THE PROGRAMS

A. Positive Results

Initial results from the mediation programs in the state, federal, and tax areas have been extremely positive. Reports on the programs mention three primary benefits: (1) reduced time required to settle the case, (2) cost savings to both the participants and the court, and (3) participant satisfaction with the process.

Programs in all arenas are of relatively short duration, and in many instances, no statistics are maintained. Even where numerical data is available, the criteria for determining various rates are different from one jurisdiction to another. For these reasons, the numerical results given below and in Table 1 at the end of this article should be viewed as approximate ranges, rather than as precise values.

Further, overall settlement rates and other statistical results for the courts as a group could be biased in favor of positive results, since unsuccessful programs may have been discontinued. For this reason, the author conducted a survey of all certified estate planning, trust and probate specialists in California,[23] both to verify court-reported and agency-reported results and to obtain a broader perspective on the process. The results reported by both the agencies and the specialist-respondents correlated closely. A summary of those results are set forth in Table 1.

1. *Settlement Rates*

Although most cases settle before trial (estimates range from 95% in the state system to 97% in the federal), mediated cases in general settle at a much earlier point in the proceedings. Assuming similar settlement terms, a settlement occurring earlier than in the absence of mediation results in savings of both time and money for the courts and the litigants.

Settlement rates (for cases settled between assignment to mediation and close of the mediation itself) as reported by the courts, agencies, and participants themselves average from 40-65% at the trial court level to 46-90% percent at the appellate level. In those courts where separate statistics are kept, settlement rates range from 11 to 28 percentage points higher for probate and trust matters than for general civil cases in the same courts.

2. *Dollar Savings*

Surveys conducted by the courts themselves following final disposition of the actions indicate significant dollar savings for those litigants using mediation. In one survey,[24] for example, the litigants and/or their attorneys estimated a savings of over $20,000 each. The specialist survey conducted for this article also returned similar results; average dollar savings ranging from a few thousand dollars up to $100,000 were reported, with most respondents claiming a $20,000-$40,000 savings.

At the appellate level, cost savings estimates were similar. Two additional elements unique to the appellate process were noted but not quantified by the responding courts. First, a case resolved by agreement at this level may also resolve related or ancillary cases, creating additional savings attributable to but not directly reported under the primary case. In addition, final settlement may save the parties a retrial after appeal, for substantial additional cost savings.

3. *Time Savings*

The specialist survey returned an estimated time savings for trial-level mediated cases over unmediated ones of several months to two years or more. Most responses clustered around the six-month range, which conformed closely to reported court statistics.

As with dollar savings, no attempt was made to quantify savings at the appellate level for time associated with related cases or retrial of the primary case.

4. *Participant and Attorney Satisfaction*

Even more significant than time or cost savings, however, was the satisfaction with the result of the process as reported by the participants themselves. Although the requested criteria varied from court to court, the participants were asked generally to evaluate the mediation process in terms of (1) perceived fairness, (2) efficiency of process, and (3) sense of finality, resolution or closure.

In the state system, participant satisfaction ranged from 75% to 95% at the trial level, up to 97% at the appellate level. Even where the case failed to settle in mediation, participants reported that the mediation process was beneficial in settling some if not all issues or in helping to focus those issues remaining.

In the federal system, returns from participants in court proceedings indicated a 90% to 95% percent satisfaction level at the trial level, and 98% at the appellate level. In tax cases, results indicated an overall satisfaction rate of 4.2 on the scale of 5.0 in the Fast Track (lower level) program;[25] no statistics are available for the appeals level program.

The trial attorneys involved with the mediated cases also reported a high level of satisfaction with the results of mediation. Many responded that the mediation process, when successful, made more efficient use of their time (particularly in contingency cases), and promoted greater client satisfaction (thereby reducing the risk of formal client complaints).

B. Negative Results

Although courts, participants, and attorneys generally reported very positive results from mediation, they also mentioned a few negatives:

- While mediation is intended to promote candid, informal and confidential disclosure of facts and issues, some respondents expressed concern that opposing counsel viewed the process only as a discovery tool rather than as a vehicle for settlement.

- Cost of the mediation session, if unsuccessful, was also frequently cited, as was delay caused by it.
- "Buyer's remorse" was occasionally raised. In some cases, the mediation settlement was repudiated based on post-mediation reconsideration of the result by one or both parties.
- Untrained or ineffective mediators were sometimes cited as a source of dissatisfaction, particularly in cases where knowledge of probate or trust law was a requisite.[26]
- In cases where one party was heavily invested in vindication, lack of public pronouncement of "guilt" or "innocence" was also cited as a negative to the mediation process.

Several additional and somewhat surprising negative facets to the increased use of mediation in the judicial system were raised:

- Several attorneys expressed concern that availability of mediation encouraged litigants to proceed with weak cases despite lack of legal foundation, on the theory that mediation would produce at least some recovery.
- Some attorneys contended that mandatory mediation discouraged meaningful settlement discussions prior to mediation.
- Several courts commented that, with a substantial percentage of cases being settled through mediation prior to trial, a large and increasing percentage of trials were difficult and extended.[27]
- One interviewee also expressed concern that, with increased use and standardization of the mediation process in the court system, the unique informality and creativity of the mediation process would be lost or compromised.

III. THE FUTURE

The courts and specialists surveyed uniformly projected more estate and trust litigation in the foreseeable future. Reasons given were an aging population, wide availability and usage of trusts, and a movement by the general population toward "self-help" in the field of drafting and administering testamentary documents.

Increased use of alternative dispute resolution was also forecast, as a result of the overcrowding of courts due to the increased litigation, mandates for faster resolution of litigated cases, and/or restricted financial resources.

As the result of the convergence of these two trends, the legal system is moving strongly and with astonishing speed toward alternative dispute resolution, particularly mediation, as an effective alternative to trial and traditional pretrial preparation. In the main, this trend appears to be a positive one, but the negatives experienced by some participants point up a need for improved education at all stages of the process.

In addition, increased standardization and regulation of the process, at least in court-annexed programs, appears inevitable. While mediators are not yet licensed as such, court-connected programs now routinely require formal mediation training as a pre-requisite for panel membership. New statewide standards of conduct for mediators in court-connected cases were adopted effective January 1, 2003, and the parameters of confidentiality for the process are still being tested and refined in all systems.[28]

The courts have taken the first step in encouraging the use of mediation in the justice system, but ongoing commitment to development of the process on the part of all participants is critical if this promising field is to reach its full potential.

* *Larkspur, San Francisco and Los Angeles, California*

ENDNOTES

1. The state trial court system handles trust and probate matters in two separate areas, the probate division (primarily involved in specific trust and probate matters) and the general civil division (handling more general issues involving the affairs of the decedent or trust and estate entities per se, such as contract cases, real estate matters, and the like).
2. As used in this article, "probate" refers to the separate probate division of the court system where appropriate; "probate and trust" or similar phrases include all facets of living trust administration as well as at-death transfers of property, whether litigated in the probate or general civil divisions.
3. Cal. Rules of Court 201.9, effective 7/1/02.
4. Cal. Rules of Court 1590.1, effective 1/1/01.
5. Cal. Rules of Court 1620-1620.9 and 1622.
6. Dispute Resolution Programs Act, Cal. Bus. & Prof. Code § 465 *et seq.*
7. In 1999, the Early Mediation Pilot Program, or EMPP, was initiated in four test counties, later expanded to five with the addition of 10 departments from downtown Los Angeles. As with the earlier Civil Action Mediation Pilot Program, Cal. Civ.Proc. Code § 1775 *et seq.*, probate and certain other areas were not covered by the program.

   The EMPP is still ongoing, with a status report due in January 2003. The report is required to provide information on the rate of settlement, timing of resolution, cost to the courts and litigants, and litigants' satisfaction. This program will end on January 1, 2004 unless extended, and is expected to cover the same five courts through its termination.
8. On August 16, 2001, a new Uniform Mediation Act was promulgated by the National Conference of Commissioners on Uniform State Laws, providing a standardized framework for possible future legislation nationwide.
9. In a few counties, such as Modoc and Imperial, no alternative dispute resolution program applicable to probate is available at present.
10. El Dorado and Nevada counties are examples of this model.
11. With a total population of 9,802,780 as of January 2002, Los Angeles County contains over 28 percent of California's population. The next most populous county, San Diego, is a third its size, and constitutes only 8.3 percent of the population.
12. San Francisco uses this model.
13. *See, e.g.*, the Dispute Resolution Service ("DRS") program maintained by the Los Angeles County Bar with funding from DRPA or the Bar Association of San Francisco mediation panel in San Francisco.
14. 28 U.S.C. § 651 *et seq.*, effective October 30, 1998
15. *Ibid.*

16. *Central*: Los Angeles, Orange, Riverside, San Bernardino, San Luis Obispo, Santa Barbara, Ventura. *Eastern*: Alpine, Amador, Butte, Calaveras, Colusa, El Dorado, Fresno, Glenn, Inyo, Kern, Kings, Lassen, Madera, Mariposa, Merced, Modoc, Mono, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Stanislaus, Sutter, Tehama, Trinity, Tulare and Tuolumne, Yolo, and Yuba. *Northern*: Alameda, Contra Costa, Del Norte, Humboldt, Lake, Marin, Mendocino, Monterey, Napa, San Francisco, San Mateo, Santa Clara, Santa Cruz, San Benito, Sonoma. *Southern*: Imperial, San Diego.

17. Mediation was first introduced in 1995 for Coordinated Examination Program (CEP) cases (Ann. 95-86, 1995-44 IRB 27, Doc 95-9424 (23 pages) 95 TNT 201-6), and the program was eventually extended through 2000 to cover most cases with factual issues involving adjustment of $1 million or more (Ann. 98-99, 1998-2 C.B. 650, Doc 98-32219 (14 pages), 98 TNT 211-13).

18. Section 3465 of the Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, adding § 7123 to the Internal Revenue Code.

19. Rev. Proc. 2002-44, 2002-26 I.R.B. 10.

20. Hartford, Connecticut; Jacksonville Florida; Houston, Texas; and Denver, Colorado.

21. See Internal Revenue Service Publication 3605.

22. Note, however, federal confidentiality standards are different than those of California; see IRC § 6103, with exceptions at 5 U.S.C. § 574.

23. Nearly 1/3 of the certified specialists in the state responded to the survey. The author would like to thank the specialists and their firms for their time and generosity not only in responding to the survey, but for their thoughtful comments and keen insight as well.

24. Los Angeles, preliminary responses, 10 divisions.

25. News Release IR-2002-80.

26. Only 30 certified probate specialists statewide responded that they both conducted mediations and had been formally trained as mediators.

27. One appellate court reported that the average size of the record on appeal had nearly doubled in a fifteen year period.

28. See Foxgate Homeowners' Assn. v. Bramalea California, Inc. (2001) 26 Cal.4th 1 (2001); IRC § 6103, with exceptions at 5 U.S.C. § 574.

TABLE 1
SETTLEMENT AND SATISFACTION RANGES REPORTED

COURT	SETTLEMENT RATE		TIME SAVINGS	DOLLAR SAVINGS	PARTICIPANT SATISFACTION
	All Civil	Probate			
California Trial Courts	40%-62%	80%-90%	approx. 6 months	$20,000 to $40,000	75%-95%
California Appellate Courts	46%-80%	72%	8 to 9 months	$21,000 to $45,000	89%-97%
Federal District Courts	60%-65%	N/A	N/A	N/A	90%-95%
Federal Circuit Court of Appeals	75%-90%	N/A	3 to 18 months (avg 15)	N/A	98%[1]
IRS Fast Track	N/A	N/A	N/A	N/A	4.2 on scale of 5.0
IRS Appeals Section	70%-85%	N/A	months to years	N/A	N/A

[1] Favorable rating on "efficiency of process, accomplish objectives of litigation"

EARLY TERMINATION OF IRREVOCABLE TRUSTS

*By William H. Soskin, Esq.**

All estate planners realize that a major problem with drafting irrevocable trusts is relying on estate tax laws that may well change. Until recently, however, few drafters felt the need to include provisions in irrevocable trusts to facilitate termination or modification in the event of significant changes in the tax law. The 2001 Tax Act radically changed the analysis.[1] Because of future substantial increases in the applicable credit amount and at least temporary abolition of the estate tax, drafters are now struggling to provide mechanisms for early termination of tax motivated irrevocable trusts.

In California, there are two very different approaches to facilitate early termination. One approach is to utilize existing California Probate Code provisions to terminate trusts. The second approach, which can be used concurrently with the first approach, is to draft provisions in the trust instrument to allow an independent trustee to terminate a TMIT. This article examines: (1) how our clients can take advantage of the California statutes that permit early termination of trusts; and (2) drafting ideas to facilitate the termination of an irrevocable trust by an independent or independent trustee.

I. IDENTIFICATION OF TAX-MOTIVATED IRREVOCABLE TRUSTS

The first question a drafter must ask is why an irrevocable trust has been or is being established. If the only reason is to save estate taxes, then termination techniques must be examined. But many irrevocable trusts will have important non-tax considerations and therefore should not be drafted to facilitate termination. Qualified terminable interest property marital trusts, bypass trusts (or, as they are often called, exemption or credit trusts), disclaimer trusts and irrevocable life insurance trusts ("ILITs") may be created to allow the creator to control the ultimate distribution of trust assets. In addition, they allow the first spouse to die to determine the extent of benefits to be

Attention California estate planners!

Now there's a firm development tool made specifically for *you*.

Maximize *your* referrals with the . . .

California Estate Planning FaxLetter

From Your Firm

Street Address, Suite #
City, CA Zip Code

Telephone: 000-000-0000

Facsimile: 000-000-0000

"Your Slogan Goes Here."

A Complementary Review of Estate Planning, Asset Protection, & Elder Law Issues

October 28, 2002 Edition

ESTATE TALK

Charitable Deduction Denied for Improperly Operated CRAT

The 11th Circuit recently held that the charitable deduction for a charitable remainder annuity trust (CRAT) m... be denied because the trust fail...

"It is not sufficient to establish a trust under CRAT rules, then completely ignore the rules during the trust's administration."

Source: Estate of Atkinson v. Commr., (CA 11th Cir., No. 01-16536, 10-16-02)

TAX TID-BITS

In 1998, Robert and Sara Helm converted their IRAs to Roth IRAs, realizing over $85,000 of conversion income. They elected to report the income on a 4-year ratable basis, and reported about $21,400 on their income tax returns. They did not report their Social Security benefits,

Call 1-800-853-0799 Today!

Baird's Publishing Company, Inc.

www.bairdspublishing.com

conferred on a surviving spouse. Many ILITs have the non-tax goal of creating trusts for children if one or both parents die. Nevertheless, a significant number of irrevocable trusts are created solely to defer, reduce or eliminate estate or inheritance taxes. The following are examples of trusts that often are tax motivated irrevocable trusts ("TMITs").

A. Bypass and Disclaimer Trusts

Assume a couple has a community property estate of $3 million. They have been married 50 years and have two grown children. The marriage is very strong and each spouse prefers to leave his or her assets outright to the surviving spouse. Each is comfortable that the other spouse will leave all assets to their children and they do not want the complexity, cost and limitations of a trust where assets of the first-to-die spouse are held for the benefit of the surviving spouse. In this situation, the drafter will not create a QTIP trust; there will be an outright marital deduction to the surviving spouse. However, an estate planner will normally suggest either a bypass trust or a disclaimer trust to take advantage of the applicable credit amount of the first spouse to die. Under these circumstances, the drafter will want to create a trust that can be terminated if the estate tax is abolished or if the estate tax exemptions are sufficiently high that there will be no estate tax when the surviving spouse dies.

B. ILITs and QPRTs

Assume the couple described above has a $1 million insurance policy on the life of the husband. But for estate tax considerations, the proceeds would be distributed outright to the wife if she survives the husband or, if not, to their two children. To save estate taxes, such client often will create an ILIT will that confers lifetime benefits on the surviving spouse with the remainder interest passing to the children. If the estate tax is abolished, continuation of the trust will no longer be necessary and the couple presumably would prefer to have the policy ownership revert to the couple, or the survivor of them.

This same couple might have a second-to-die insurance policy. If an ILIT was created solely to save estate taxes and the estate tax was abolished, the couple would clearly prefer having ownership of the policy revert to both spouses or the survivor of them. Similarly, a single grantor may create an ILIT so that the life insurance proceeds will pass to his or her children free of estate tax. Again, if the estate tax is abolished while the grantor is still alive, he or she would clearly prefer having the policy ownership revert to the insured grantor.

Qualified personal residence trusts ("QPRTs") are always going to be TMITs.[2] Not only will the QPRT be unnecessary in the event of abolition of the estate tax or significantly increased estate tax exemptions, but there can be an income tax disadvantage if the QPRT continues to exist. This is because QPRT property does not receive a step-up in basis upon the death of the grantor. If it turns out there was no reason to create a QPRT, but there is still a loss of income tax basis, there is even more motivation to terminate the QPRT before the death of the grantor.

C. Generation Skipping Trusts

Wealthier taxpayers also frequently create generation-skipping trusts for children and grandchildren so that estate taxes which would otherwise be incurred when a child or grandchild dies are avoided. If estate tax savings are no longer a consideration, the grantor would prefer to have trust assets distributed outright to the then living descendants.

II. STATUTORY TOOLS AVAILABLE IN CALIFORNIA

Several provisions of California law may authorize the early termination of a trust: (A) California Probate Code section 15403 allows all beneficiaries to compel termination or modification on petition to a court if certain conditions are present; (B) section 15404 allows the settlor and all beneficiaries to compel modification or termination of a trust; and (C) section 15409 allows a court to modify or terminate a trust to accomplish the purposes of the trust as a result of newly discovered and unanticipated circumstances. Each of these statutory approaches is analyzed below.

A. Unanimous Beneficiary Consent to Termination (Probate Code Section 15403)

There are three requirements for terminating a trust pursuant to California Probate Code section 15403.[3] First, all beneficiaries must agree to terminate the trust. Second, the parties have to obtain court approval. Section 15403(b) indicates that if a court concludes the continuation of the trust is not necessary to carry out a material purpose, the court shall approve termination. But, if a court concludes that continuation is necessary to carry out a material purpose of the trust, then no termination can occur unless the court determines that the reason for doing so "under the circumstances outweighs the interest in accomplishing the material purpose of the trust." Third, the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of a beneficiary's interest (i.e., a spendthrift provision).

There are substantial impediments to relying on section 15403 to terminate or modify a TMIT. First and foremost, if *any* beneficiary refuses to consent to the termination or modification, this statutory remedy is unavailable. One can easily envision a disgruntled child, angry at a surviving spouse's remarriage, refusing to consent to termination of a TMIT and distribution of trust proceeds to the spouse. Also, there is no certainty a court is going to rule favorably. One could include provisions in a TMIT indicating that the sole material purpose of the trust is to minimize or avoid estate taxes. However, a court might disregard or look behind such a statement to find other reasons for the trust. In addition, stating that the material purpose in creating the trust is to avoid taxes may be an invitation to an IRS challenge that the trust should be ignored. Compare the many instances in which estate planners buttress the existence of limited partnerships and trusts with all types of business purposes to avoid an IRS attack that such a vehicle should be ignored because its sole purpose is to avoid tax.

Just as significantly, however, many clients and tax planners will be reluctant to eliminate spendthrift provisions. Spendthrift provisions are legitimate and important tools. Most clients do not want a remainder beneficiary selling or borrowing against a future interest. One could draft a spendthrift provision which is expressly inapplicable in the event a petition to modify or terminate under section 15403 is filed. However, beneficiaries could then circumvent a spendthrift provision by filing a Section 15403 Petition. Alternatively, one could empower an independent trustee to negate a spendthrift provision as a prerequisite to filing a Section 15403 Petition. However, if the drafter is going through the trouble of creating an independent trustee to deal with spendthrift provisions, why not (as discussed *infra* in section III of this article) give an independent trustee full power to simply terminate or modify the ILIT?

A Section 15403 Petition will also usually create the added burden of having a guardian at litem appointed for unborn, unascertained and minor beneficiaries. In theory, a child's interest and that of his or her parent will be identical and a parent can act as guardian ad litem for his or her child. They will both be adverse to termination. But a court may require appointment of a third party guardian ad litem, which will increase termination costs. Probate Code section 15405 does allow a guardian at litem to rely on "general family benefit accruing to living members of a beneficiary's family as a basis for approving a modification or termination of a trust." But whether general family benefit will be accepted as justification for approval by a guardian at litem depends on what a court thinks is appropriate. There is no guarantee a court will make a favorable ruling.

The challenge of obtaining consents from multiple remainder beneficiaries might be mitigated by creating a special power of appointment to limit the class of beneficiaries. See the sample language at Exhibit A at the end of this article. Careful attention has to be paid in selecting the person holding the unusual power. The grantor should not be the power-holder because the trust would then be included in the grantor's estate by virtue of IRC § 2036(a), which prohibits retained powers to designate who will enjoy the trust corpus. If the trust is funded with one spouse's separate property, then the grantor's spouse is a possible candidate so long as he or she does not have the power to eliminate all other beneficiaries and make the spouse himself or herself the sole beneficiary, which would cause the spouse to be treated as having a general power of appointment under IRC § 2041(b). A remainder beneficiary, such as a child, should not have a power to limit the class of beneficiaries if it could result in increasing the share of the trust corpus which could pass to the power-holder. The power of appointment clause should also include language allowing the power holder to reinstate the beneficiaries in case a court refuses to approve the Section 15403 Petition.

Allowing the grantor or a "nonadverse party" (as defined in IRC § 672(b)) to change beneficiaries will also cause the trust income to be taxed to the grantor. See the discussion *infra* at section III.E of this article. This might not be a significant problem if there is little trust income, or if there are Crummey beneficiaries, or if it is considered advantageous to have the grantor pay income taxes on trust income.

Another section 15403 issue is the question of to whom the trust principal should be distributed in the event of termination. Probate Code section 15410(d) provides that trust property shall be disposed of "as provided in the trust instrument or in a manner directed by the court that conforms as nearly as possible to the intentions of the trustor as expressed in the trust instrument." Therefore, anticipating possible use of section 15403, a drafter might include specific directions stating who should receive the trust principal in the event of a section 15403 termination. For example, when the surviving spouse is a beneficiary in an ILIT, the grantor could specify that all proceeds shall be distributed to the surviving spouse in the event of termination under section 15403. However, there is some risk in specifying that ILIT trust assets revert to the grantor in the event of termination because, under Treas. Reg. § 20.2042-1(c)(3), the "possibility" that the policy or its proceeds may return to the insured constitutes an incident of ownership under IRC § 2042. It may be better to include a provision in the agreement among the beneficiaries that trust assets revert to the grantor, although there is no statutory authority in Probate Code section 15410 allowing this decision to be made by the beneficiaries.

Another problem is that an agreement by all beneficiaries to terminate a TMIT and transfer the corpus to the grantor or surviving spouse is a gift by the beneficiaries of their remainder interests to the grantor or surviving spouse. If the estate and gift taxes have been abolished, there will be no negative consequence to the beneficiaries arising out of their gift to the surviving spouse. However, if the gift tax remains in effect or if the estate tax exemptions merely have been increased but not eliminated, these gifts by the remainder beneficiaries may create transfer tax complications for them that risk having them refuse to consent to the termination.

B. Termination and/or Modification by Grantor and Beneficiaries (Probate Code Section 15404)

If the grantor and all beneficiaries of a trust agree, they can compel termination or modification of a trust pursuant to California Probate Code section 15404.[4] Court approval of such an agreement is not required.[5] Unlike section 15403, the presence of a spendthrift provision will not preclude termination by the grantor and all beneficiaries.

The section 15404 approach, unfortunately, also has significant drawbacks. First, and obviously, it is available only while the grantor is living. After the grantor's death, the section 15404 mechanism is no longer available. Unlike section 15403, discussed *supra*, the consent of all beneficiaries is not mandatory. However, if any beneficiary does not agree to termination and/or modification, court approval is required and can be granted only if the court concludes "a modification or a partial termination" will not substantially impair the interest of the beneficiaries who do not consent. It would seem in almost any circumstance, a beneficiary's interest would be impaired. Furthermore, the language of section 15404 does not discuss what happens if there is no unanimous agreement to a complete termination. A literal reading of section 15404(b) is that if one beneficiary disapproves of a complete termination, the court has no right to approve the petition.

Section 15404 does have a helpful provision not included in section 15403. Section 15404(c) states that when the trust includes "heirs" or "next of kin" or other words describing a class of persons who take under the rules of intestacy, the court can limit the class of beneficiaries whose consent is needed to those who are reasonably likely to take under the circumstances. Still, many TMITs include numerous contingent beneficiaries, such as siblings and issue, and the consent of all of those persons will still be required (or their interests considered if they refuse to consent).

As with the section 15403 approach, if there are numerous beneficiaries, the effort to obtain their consent may be time consuming and problematic. The number of beneficiaries whose consent must be obtained can be reduced by giving someone a lifetime power of appointment to limit the beneficiaries of the trust. See *supra* the discussion of section 15403 in section II.A of this article and Exhibit A. Still, there will often be the impediment of appointing guardians ad litem for unborn, unascertained and minor beneficiaries and securing their consent to a termination petition. Like section 15403 termination procedures, under Probate Code section 15405 the guardian ad litem may rely on general family benefit accruing to living members other than the beneficiaries' family as a basis for approving a modification or termination of the trust.

Even though court approval of the agreement by all beneficiaries and the grantor is not required, the involvement of a court will be necessary for appointment of guardians at litem. Once appointed, guardians at litem can, in theory, consent to an agreement to terminate the trust without seeking court approval of their actions. However, many guardians at litem will insist on court approval to protect them from future challenges from a beneficiary who does not agree that a guardian was justified in approving a termination or modification of an ILIT.

Trustees may also insist on court approval of a termination agreement to protect them from liability. Probate Code section 17200(b)(13) permits a trustee to request court approval of a termination agreement. Including language within a trust document stating that termination is desirable if there will no longer be estate tax savings if the trust is continued may increase the likelihood a court will approve a petition by a guardian ad litem or trustee for court approval of termination. However, such a provision does not address the question of whether termination is beneficial to a remainder beneficiary who will no longer have the possibility of receiving trust corpus.

To facilitate agreement by a disabled grantor or beneficiary under section 15404 (or agreement by all beneficiaries under a petition pursuant to section 15403), a durable power of attorney for financial matters might include an express provision authorizing an agent to take action under sections 15403 and 15404. Probate Code section 4264(a) requires a power of attorney to expressly authorize the agent to create, modify or revoke a trust. Also, the trust instrument should include a provision expressly permitting an agent to modify or revoke the trust in order to comply with Probate Code section 15401(c).

The agreement by the grantor and beneficiaries should specify to whom the trust principal will be distributed. Probate Code section 15410(b) provides that the property shall be transferred upon termination as is agreed to by the trustor and all beneficiaries. However, as is the case with section 15403, agreeing to transfer property to the grantor or surviving spouse will constitute a gift by the remainder beneficiaries. This may not be important if the estate and gift taxes have been abolished but can be a problem if termination is occurring by virtue of substantially increased estate tax exemptions or if the gift tax is retained.

C. Changed Circumstances (Probate Code Section 15409)

California Probate Code section 15409 permits termination or modification if, owing to circumstances not known to the grantor or anticipated by the grantor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust.[6] The existence of a spendthrift provision does not bar a section 15409 termination, but the statute directs that the court specifically consider the inclusion of such a clause in making its evaluation.

The changed circumstances approach can be used whether the grantor is alive or deceased. It has the advantage over a termination or modification under sections 15403 or 15404 that there is no requirement to obtain the consent of all beneficiaries.

The grantor can increase the likelihood of court approval by including language in the trust which states that elimination of estate taxes is not anticipated by the trustor and if there will be no estate tax savings, continuation of the trust would defeat the purpose of the trust. See sample language at Exhibit B at the end of this article.

Still, the Section 15409 approach has some of the drawbacks that the other statutory approaches have. Court approval is required and one can never rely with certainty on a court approving a Section 15409 Petition. The likelihood of a court rejecting a Section 15409 Petition is increased if any beneficiary objects to the petition, and court approval is always in doubt given that most trusts do include spendthrift provisions.

To be certain that trust principal will be distributed in accordance with the grantor's wishes, language (as is also the case with section 15403) can be included indicating to whom assets are distributed in the event of termination. If the grantor is alive, trust principal is distributed back to the grantor. If the surviving spouse is the current beneficiary of the trust, then trust principal is distributed to the surviving spouse. However, as noted earlier, there is some risk in specifying that ILIT trust assets revert to the grantor in the event of termination because, under Treas. Reg. § 20.2042-1(c)(3), the "possibility" that the policy or its proceeds may return to the insured constitutes an incident of ownership under IRC § 2042. But, if the trust document is silent in this regard, how will the court follow the edict of Probate Code section 15410(c) that trust property shall be disposed of by the court "…in a manner…that conforms as nearly as possible to the intention of the settlor *as expressed in the trust instrument*" (emphasis added)?

III. TERMINATION BY AN INDEPENDENT TRUSTEE

Disgruntled beneficiaries, a non-cooperative court, paying for and obtaining the approval of guardians at litem, and searching for trust beneficiaries are obstacles that limit our clients' ability to rely on the California statutes. In drafting documents for prospective termination in the future, therefore, the drafter should consider avoiding these risks by including in the trust document a power authorizing a trustee to terminate the trust under certain circumstances.[7] In general, the person holding this power should be an independent trustee,[8] whether the power-holder is the regular trustee or a special trustee who acts only with respect to this specific power.

The drafter must use great care in drafting the language that empowers an independent trustee to terminate a trust. See the sample language at Exhibit C at the end of this article. The grantor should clearly set forth the reasons for creating an independent trustee and a general statement as to the circumstances when the trustee should exercise the termination power. To hinder a beneficiary from challenging the independent trustee who decides to terminate the trust, the trustee should have sole and absolute discretion. To further discourage a challenge to the independent trustee, a provision indemnifying and holding harmless the independent trustee for all damages and costs should be included. If the grantor wants additional protection against challenges, a no-contest might require a beneficiary to forfeit his or her beneficial interest (and possibly that of his or her issue) if the beneficiary challenges the independent trustee's decision to terminate, or not to terminate, the trust. The provisions should specify to whom trust assets are to be distributed in the event of termination. Language should also be included which provides the independent trustee with the ability to exercise power only if the current beneficiary is either the grantor or the grantor's spouse; if the grantor's spouse is deceased and there are trusts established for younger beneficiaries, there are presumably non-tax reasons for continuing the trust.

A. Termination Versus Modification

Should the independent trustee have the power to modify and change the provisions of the TMIT as well as having the power to terminate the trust? While the decision to terminate will be relatively easy if the estate tax is abolished, it becomes much more difficult if the estate tax exemptions are increased but it is not clear whether the net worth of the grantor, when augmented by including the trust assets, will be significantly less than the estate tax exemption at the time of the grantor's death. The question of modifying the trust, however, seems to be an entirely different magnitude of difficulty. Even before the 2001 Tax Act, there was still a possibility (and likelihood) that estate tax laws would change and what once appeared to be a brilliant estate tax saving device would no longer be appropriate or beneficial. Trying to define standards under which the independent trustee should act to modify an irrevocable trust to respond to future changes in the estate tax laws is a monumental task. Many grantors will not going to want to give an independent trustee power to modify trust terms because of changed tax laws, and many drafters will be wary of the challenges in drafting such language. For this reason, most drafters will empower the independent trustee solely to terminate the TMIT in whole or in part.

B. Selection of Independent Trustee

Appointment of an independent trustee with the power to terminate the trust is not problem-free. The independent trustee will have substantial discretion, particularly if the estate tax exemptions are increased but the estate tax is not abolished. So a major challenge is finding an appropriate independent trustee. This may not be a problem if the grantor has adult, obedient and responsible children who will carry out the grantor or the grantor's spouse's desires if there is no longer a tax justification for continuing the trust. But many taxpayers are not going to have a suitable candidate for appointment as an independent trustee. One can easily imagine a situation in which the surviving spouse is remarried and the adult children are not particularly anxious to terminate the trust and redistribute all of the assets to the surviving spouse, letting their wishes be clearly known to the independent trustee. The fear of disinheritance may not dissuade a more remote potential beneficiary from threatening or filing a lawsuit against the independent trustee for abuse of discretion.

C. Reliance on California Statutory Provisions

Drafters may be tempted to include enabling language to facilitate petitions under sections 15403 or 15409 as backup alternatives in case the independent trustee refuses to act. But this can be a double-edged sword. Including language in a trust to facilitate the use of the statutory solutions may provide a convenient justification for the independent trustee refusing to use his or her powers. Conversely, if there is an independent trustee provision as well as language in the trust to facilitate the use of sections 15403 and 15409, a court may justify a refusal to permit termination of the trust on the grounds that there was an independent trustee who had such power and refused to exercise the power. For these reasons, there should be language to facilitate the use of a statutory solution or there should be provisions providing for an independent trustee, but not both. Of course, if an independent trustee refuses to act, one or more beneficiaries may seek the trust's termination under either or both of sections 15403 and 15409.

D. Creditor Problems

Creditors of the grantor may have access to the TMIT if, upon a termination, the trust property is or may be returned to the grantor. California Probate Code section 15304(d) provides that if the trustee has the discretion to distribute any property to the grantor, a creditor of the grantor may reach the maximum amount that the trustee could pay to the grantor. However, creditor access should occur only if and after the independent trustee makes the determination that the trust should be terminated. Until that time, the independent trustee would not have the discretion to distribute assets to the grantor. Also, the creditor access problem only exists in the context of distributing assets back to the grantor as opposed to the surviving spouse or grantor's children.

E. Grantor Trust Problems

Another problem unique to the independent trustee approach is dealing with the so-called "grantor trust rules" of IRC §§ 671-679. One or more of these rules might be applied to a trust that includes trust termination provisions.

1. Power To Control Beneficial Enjoyment (IRC § 674)

IRC § 674(a) provides that the grantor is the owner of the trust property when the grantor or any *non-adverse party*[9] retains the right to change the disposition. Unless the independent trustee is an "adverse party," the trust may be deemed a grantor trust with any income taxed to the grantor during his or her lifetime. However, § 674 includes a couple of exceptions that might help avoid grantor trust status:

- Under § 675(b)(5)(A), the trust is not a grantor trust if the power to distribute corpus is limited by a reasonably definite standard that is set forth in the trust instrument. The question then becomes whether the power to terminate the trust and distribute assets to the grantor in the event there is no estate or inheritance tax benefit from continuing the trust is a reasonably definite standard.
- Under § 674(c), the trust is not a grantor trust if the trustee is not the grantor and is not a "related or subordinate party" to the grantor (as defined under § 672(c)).

A drafter or client may not wish to rely on winning the ascertainable standard argument. But §674 is avoided if the independent trustee selected is not a "related or subordinate party."

2. Power To Revoke (IRC § 676)

Under IRC § 676, a power to revoke may trigger grantor trust status, even if the power is held by an independent trustee (unless the independent trustee is an adverse party). If the independent trustee is a non-adverse party and has the power to return the trust property to the grantor, then it appears that the trust should be treated as a grantor trust. Query whether this status would only arise after the independent trustee has made the determination that the trust should be terminated or whether this status arises immediately upon the trust's creation.

3. Crummey Trusts and the Beneficiary's Status (IRC § 678)

An analysis of the grantor income tax rules because more complicated when Crummey withdrawal powers are involved. Most ILITs include Crummey withdrawal powers so that the grantor's contributions qualify for the gift tax annual exclusion. The beneficiary holding the Crummey withdrawal power is generally deemed the grantor of the trust and is taxable on the trust income. However, IRC § 678(b) provides that the Crummey power holder will not be considered the grantor under IRC § 678(a) if the grantor is otherwise treated as the owner of the trust income. When the grantor is considered to be the grantor because of a power to revoke or a power to change the disposition of the trust under IRC § 676 or § 674, then income will be taxed to the grantor instead of to the Crummey withdrawal power holder. However, IRC § 678(b) is silent with respect to who is the grantor over trust principal.

4. Grantor Trust Status May Not Be Significant

The fact that income is taxed to the grantor may not be a substantial problem in most instances. TMITs, such as ILITs and QPRTs are not going to generate substantial income during the life of the grantor. Moreover, from an estate planning perspective, the family obtains a benefit by "using up" the grantor's assets rather than the trust's assets in paying any income tax liability. Still, this is an issue which should be analyzed and discussed with the client.

F. Estate Tax Problems

The use of an independent trustee with the power to return principal to the grantor[10] may trigger horrendous estate tax consequences in California. The problem is that the grantor is considered to retain the possession and enjoyment of corpus placed in an irrevocable trust under IRC § 2036 when the grantor's creditors can reach trust income to pay the grantor's debts.[11] If the independent trustee can return trust corpus if continuation of the trust is not needed to save estate taxes then, under section 15304, the creditors, as pointed out *supra*, can reach the maximum amount that the trustee can pay to the grantor. In theory, so long as there continues to be estate tax benefits resulting from continuing the trust, one can argue the independent trustee cannot distribute the assets to the grantor and therefore during such period the grantor's creditors do not have access to the trust assets, and the trust assets are not includable in the estate of the grantor under IRC § 2036(a)(1) and 2038(a)(1). This result is more likely if the independent trustee does not have sole and absolute discretion but instead must exercise "reasonable" discretion. But who wants to be the first IRS test case!

Another approach to avoid estate tax inclusion would be to give the power to terminate the trust to somebody in a non-fiduciary capacity. Then, one could argue that section 15304 does not apply because a non-fiduciary has the power to return corpus to the grantor. But, again, this is an extremely gray area and most drafters will not want to use an independent trustee provision as a mechanism to return corpus to the grantor.

III. CONCLUSIONS

Irrevocable trusts which are created solely to minimize or avoid estate taxes should not be continued when estate and inheritance taxes are no longer an issue. Both in drafting instruments and advising clients about TMITs, the lawyer should consider the range techniques available to terminate trusts if appropriate under the now-changing gift and estate tax laws. The lawyer first should determine whether the goal is to return the trust assets to the grantor or to distribute the trust assets to other beneficiaries.

A. TMIT Termination: Distribution Back to Grantor

When the goal is to return trust assets to the grantor, the independent trustee approach has several problems, including the ability of creditors to reach the trust and the potential grantor trust status for income tax purposes. But the most substantial problem is the possibility that the entire corpus will be included in the grantor's taxable estate — even if the trust has not been terminated — because creditors have potential access to the trust corpus and the grantor therefore may be considered to have the continued right to possession and enjoyment of the corpus. For this reason, the easiest solution is to rely on one of the California statutory methods to terminate the trust.

Of the California statutory solutions, the easiest probably is an agreement between the grantor and all beneficiaries under section 15404. This approach is facilitated by giving someone other than the grantor a special power of appointment to restrict the number of beneficiaries whose consent has to be obtained, although this may result in trust income being taxed to the grantor. If beneficiaries cannot be eliminated or their consent cannot be obtained, then a petition to terminate the trust under section 15409 (because of changed circumstances) may be considered. If a statutory approach is envisioned, the trust should include statements by the grantor under what circumstances he or she wants the trust terminated (although this creates a minimal risk with an ILIT that the grantor has retained an incident of ownership). To further preclude dissent, a drafter can provide that any beneficiary challenging an agreement between the grantor and beneficiaries or a petition to terminate because of changed circumstances is disinherited.

B. TMIT Termination: Distribution To A Beneficiary Other Than The Grantor

If the goal of a TMIT is to transfer assets to someone other than the grantor (e.g., the spouse or children), appointment of an independent trustee will be the best solution (assuming that the grantor trusts some person sufficiently to grant this power). A no-contest clause can be expanded to include anyone challenging the act (or failure to act) of the independent trustee.

If there is no suitable candidate to act as independent trustee, then the drafter will have to rely on a petition to terminate because of changed circumstances. To facilitate the Secton 15409 Petition, the trust instrument should include a statement describing the grantor's intent so as to justify a court's approval of a changed circumstances petition as well as provisions disinheriting anyone who challenges the petition. Trying to terminate under section 15403, whereby all beneficiaries consent to termination, will not generally be available because almost all irrevocable trusts will have spendthrift provisions.

* *Law Offices of William H. Soskin, Monterey, California*

ENDNOTES

1. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 107th Cong., 1st Sess. (2001) ("The 2001 Tax Act").
2. Reg. 25.2702-5(c).
3. Probate Code section 15403 provides as follows:

"*Modification or Termination of Irrevocable Trust by All Beneficiaries.*

(a) Except as provided in subdivision (b), if all beneficiaries of an irrevocable trust consent, they may compel modification or termination of the trust upon petition to the court.

(b) If the continuance of the trust is necessary to carry out a material purpose of the trust, the trust cannot be modified or terminated unless the court, in its discretion, determines that the reason for doing so under the circumstances outweighs the interest in accomplishing a material purpose of the trust. Under this section the court does not have discretion to permit termination of a trust that is subject to a valid restraint on transfer of the beneficiary's interest as provided in Chapter

2 (commencing with Section 15300)."

4. Section 15404 provides as follows:

"Modification or Termination by Settlor and All Beneficiaries.

(a) If the settlor and all beneficiaries of a trust consent, they may compel the modification or termination of the trust.

(b) If any beneficiary does not consent t the modification or termination of the trust, upon petition to the court, the other beneficiaries, with the consent of the settlor, may compel a modification or a partial termination of the trust if the interests of the beneficiaries who do not consent are not substantially impaired.

(c) If the trust provides for the disposition of principal to a class of persons described only as "heirs" or "next of kin" of the settlor, or using other words that describe the class of all persons who would take under the rules of intestacy, the court may limit the class of beneficiaries whose consent is needed to compel the modification or termination of the trust to the beneficiaries who are reasonably likely to take under the circumstances."

5. See Law Review Commission comment to section 15404, 1990 enactment.

6. Section 15409 provides as follows:

"Modification or Termination of Changed Circumstances.

(a) On petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust or terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust. In this case, if necessary to carry out the purposes of the trust, the court may order the trustee to do acts that are not authorized or are forbidden by the trust instrument.

(b) The court shall consider a trust provision restraining transfer of the beneficiary's interest as a factor in making its decision whether to modify or terminate the trust, but the court is not precluded from exercising its discretion to modify or terminate the trust solely because of a restraint on transfer."

7. At least two other drafting solutions exist: (1) the grantor may retain the power to terminate the trust; or (2) the instrument may direct trust termination upon the occurrence of specific external events.

If the grantor retains the right to terminate the trust, the trust corpus will be subject to estate tax on the grantor's death, under both IRC § 2036(a)(2) and § 2038, because the grantor had retained the right to designate persons who would enjoy the trust property. The estate tax problem can also plague the surviving spouse. If the surviving spouse has the power to redirect the trust corpus to himself or herself and that power is not limited by an ascertainable standard, trust corpus will be included in the surviving spouse's estate under IRC § 2041.

The problem with automatic termination is the difficulty of precisely delineating under what circumstances the trust should be terminated under objective criteria. For example, if the estate tax exemptions are increased significantly, one still has to decide whether it is likely that by the time the surviving spouse or grantor dies, a taxable estate of the grantor or surviving spouse will exceed the exemption.

8. If the grantor or the surviving spouse is the independent trustee, the trust will automatically be dragged back into the grantor's estate or the surviving spouse's estate under IRC § 2036 or IRC § 2038. If the grantor or the grantor's spouse want to retain the right to appoint successor independent trustees, such potential successor trustees should not be related or subordinate to the grantor or the grantor's spouse within the meaning of IRC § 672(c). Rev. Rul. 95-58, 1995-2 C.B. 191.

9. If a contingent beneficiary, such as a grantor's child, is appointed independent trustee, the child is probably an adverse party and IRC § 674 does not apply. Query whether, if the grantor or the grantor's surviving spouse has a special power of appointment to eliminate the child as a beneficiary, does the result change. If the independent trustee is not a remainder beneficiary, then IRC § 674 becomes more of a problem.

10. The same rules, however, do not apply to a surviving spouse. Therefore the independent trustee provision remains appropriate as a mechanism to return trust assets to the surviving spouse or others.

11. Rev. Rul. 77-378, 1977-2 C.B. 347; Rev. Rul. 76-103, 1976-1 C.B. 293; Outwin v. Commissioner 76 TC 153 (1981). *See* Horn, "Estate Planning and Drafting for the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")," 27-2 ACTEC Journal, Fall 2001, 130-133.

Exhibits on the following page ➢

Before using the language of any of these Exhibits, the attorney must make an independent determination as to whether the language is appropriate for his or her client and whether it needs to be modified to meet any special circumstances and/or objectives. The author does not guarantee that the language of these Exhibits effectively accomplishes their purpose and assumes no responsibility for the language or their use.

Exhibit A: Special Power of Appointment to Limit Beneficiaries

So long as either Trustor is living, the individual(s) designated in this Paragraph (the "Power Holder") shall have the power to eliminate and reinstate any beneficiary to whom all or a portion of the Trust estate could be distributed, other than a child of the Trustors. An action by the Power Holder shall be by means of a written instrument that specifically refers to the powers granted under this Paragraph, signed by the Power Holder, and delivered to the Trustee(s).

_______________________________ is designated the Power Holder who may appoint (a) successor Power Holder(s), which appointment(s) may be revoked without cause; provided, however, such appointee may not be a Trustor or any person or entity related to or subordinate to a Trustor within the meaning of Internal Revenue Code Section 672(c).

The Trustors' purpose in appointing a Power Holder with the powers granted under this Paragraph is to facilitate modification or termination of this Trust under California Probate Code Section 15404 by limiting the number of beneficiaries whose consent must be obtained to compel modification or termination of this Trust under California Probate Code Section 15404 or any successor section.

Exhibit B: Trust Purpose and Changed Circumstances

The Primary purpose of this Trust, during the lifetime of the Grantor and the Grantor's spouse, is to eliminate or substantially reduce estate taxes that will be otherwise imposed upon the assets placed in this Trust upon the death of the Grantor and/or the Grantor's spouse. There are no circumstances known to or anticipated by the Grantor which would defeat or substantially impair the accomplishment of the aforesaid Trust purpose. Even though the Grantor does not now know or anticipate a statutory framework whereby the continuation of this Trust would not result in eliminating or substantially reducing estate taxes, if such were to occur, continuation of this Trust under its terms would defeat or substantially impair the accomplishment of the aforesaid purposes of this Trust, and this Trust should be terminated.

Exhibit C: Appointment of Special Trustee

The Grantor has created this Trust to minimize estate and inheritance taxes which would otherwise be due upon the death of the Grantor or the Grantor's spouse. But for the likelihood, under existing law, of reducing or eliminating estate and inheritance taxes, the Grantor would not have established this Trust.

The Grantor would like to facilitate termination of this Trust, during the lifetime of the Grantor's spouse, in the event that continuation of this Trust is not necessary to reduce estate or inheritance taxes otherwise due upon the death of the Grantor's spouse. Accordingly, the Grantor appoints _______________________ as Special Trustee (the "Special Trustee"), who shall have the power in his (her) sole and absolute discretion to determine if this Trust shall be completely or partially terminated because it is very likely that its existence is no longer necessary, because of changes in federal estate and/or inheritance tax laws, to reduce or eliminate estate and/or inheritance taxes which would otherwise be incurred upon the death of the Grantor's spouse. The Special Trustee may exercise his or her discretion even if continuation of the Trust would avoid a minimal amount of estate and/or inheritance taxes on the death of the Grantor's spouse. Nevertheless, this Special Trustee may not exercise the power to terminate all or a part of this Trust unless the Grantor's spouse is a current beneficiary of this Trust.

In the event the Special Trustee determines that all or a part of this Trust shall be terminated, the Special Trustee shall notify, in writing, the then acting Trustee, who shall then immediately terminate that portion of the Trust directed to be terminated and distribute such assets, including accumulated income, to the Grantor's surviving spouse. The Trustee shall incur no liability to any beneficiary of the Trust or to any other person for following such written directions from the Special Trustee to terminate all or a part of this Trust.

The Special Trustee shall incur no liability to any beneficiary of this Trust or to any other person for determining or not determining that all or a part of this Trust should be terminated. The Special Trustee's responsibilities are limited to the exercise of discretion under this Article, and the Special Trustee should not be concerned with or liable for other aspects of trust administration. In the event the Special Trustee has a current or potential conflict of interest with respect to the power granted to the Special Trustee, the Grantor nevertheless requests the Special Trustee to carry out his (her) duties under this document and that the Special Trustee shall not be liable to any beneficiary or any other third person for any act or failure to act under this Paragraph.

If _________________________ is unable or unwilling to act as Special Trustee, ________________________ shall act as Successor Special Trustee. No bond shall be required of a Special Trustee for the faithful performance of his or her duties under this Article. A Special Trustee may resign without cause at any time by written notice to the Successor Special Trustee and to the Grantor, if then living, and otherwise to the Grantor's spouse if he or she is then living.

Except as provided below, a Special Trustee for whom there is no appointed successor may designate a Successor Special Trustee to act if he (she) is unable or unwilling to serve as Special Trustee and revoke or change such designation by a signed and dated document. Notwithstanding the above, the Grantor (or the Grantor's surviving spouse if the Grantor is incapacitated or deceased) may name successor and replacement Special Trustees other than the Grantor and the Grantor's spouse and may remove without cause any person otherwise nominated to act as Special Trustee by a signed writing delivered to such person; provided, however, in no event may a Special Trustee appointed by the Grantor or the Grantor's surviving spouse be related or subordinate to the Grantor or the Grantor's spouse within the meaning of Internal Revenue Code Section 672(c) or any successor statute.

Richard Aiello
Law Offices of Richard Aiello, Concord

Alan Leigh Armstrong
Law Office of Alan Leigh Armstrong, Huntington Beach

James R. Birnberg
Loeb and Loeb LLP, Los Angeles

Frayda Bruton
Law Offices of Frayda Bruton, Sacramento

Richard Burger
Law Office of Richard Burger, Petaluma

Theodore E. Calleton
Law Offices of Theodore E. Calleton, Pasadena

Sandra J. Chan
Sandra J. Chan, PC, Santa Barbara

Monica Dell'Osso
Burnham Brown, Oakland

Jeffrey A. Dennis-Strathmeyer
CEB, Oakland

Erik Dryburgh
Silk, Adler & Colvin, San Francisco

Jon J. Gallo
Greenberg Glusker Fields Claman Machtinger & Kinsella LLP, Los Angeles

Steven M. Goldberg
Friedemann O'Brien Goldberg & Zarian LLP, Santa Rosa

Leah V. Granof
Law Office of Leah V. Granof, Encino

Richard S. Kinyon
Morrison & Foerster, LLP, San Francisco

Susan T. House
Hahn & Hahn LLP, Pasadena

CEB would like to congratulate all of the authors of ***California Estate Planning*** for their outstanding contributions to this distinguished new practice book.

From the basics of estate planning law office management to sophisticated trusts, complex tax issues, and the difficult subjects of planning for incapacity and health care, this new CEB core title is essential to any estate planning practice.

A Job Well Done.

Beth L. Kramer
Kramer Law Group, San Francisco and San Rafael

Genevieve M. Moore
Morrison & Foerster, LLP, San Francisco

Ruth E. Ratzlaff
Law Offices of Ruth E. Ratzlaff, Fresno

Joel A. Levine
Law Office of Joel A. Levine, Los Angeles

Lisa K. Y. Nakahara
Kramer Law Group, San Francisco and San Rafael

Peter Spero
Law Offices of Peter Spero, Santa Monica

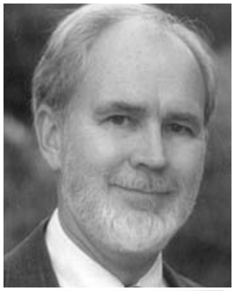
Robert J. Lowe
O'Melveny & MyersLLP, Los Angeles

Maria E. Nuñez
Baker & McKenzie, San Diego

Robert E. Temmerman, Jr.
Temmerman & Cilley, LLP, San Jose

Kim Marois
Law Offices of Kim Marois, Santa Rosa

Marshal A. Oldman
Oldman Cooley Leighton & Sallus, Encino



Donald R. Travers
Law Offices of Donald R. Travers, Paradise

John M. Milgate
Law Office of John Milgate, Walnut Creek

Kenneth G. Petrulis
Goodson & Wachtel, Los Angeles

California
ESTATE
PLANNING
2

Approx. 1100 pages, 2 looseleaf volumes, 2002, ES-33460, $189

For more infomation on our authors, visit our website at ceb.com and go to our "An Authors' Who's Who *California Estate Planning*."

California Estate Planning

To order, call 1-800-232-3444 or go to ceb.com

CEB®

By and For California Lawyers

5424

LITIGATION ALERT

*By Mary F. Gillick, Esq.**

I. BENEFICIARY'S ATTEMPT TO PROBATE WILL WHICH HE PROCURED THROUGH UNDUE INFLUENCE VIOLATED NO-CONTEST CLAUSE OF EARLIER WILL

In *Estate of Gonzalez,* 102 Cal.App.4th 1296 (2002), the Sixth District Court of Appeal affirmed a trial court decision finding that a beneficiary had violated a no-contest clause by attempting to probate a later Will which the beneficiary had procured through undue influence.

Decedent executed a Will dividing his property equally among four of his children. The Will contained a no-contest clause. Decedent gave the youngest son a general power of attorney. In the last several years of his life, decedent was increasingly ill. Shortly before decedent's death, the youngest son had a new Will drafted which left him the entire estate, and he procured his father's signature. After his father's death, the youngest son sought admission of the later Will for probate. The other siblings contested the Will, and at trial the judge found that the Will was procured by the youngest son's undue influence. The other children then filed a petition alleging that in seeking admission of the later Will to probate, the youngest son had violated the prior Will's no-contest clause. The trial court agreed, holding that the youngest son had no reasonable cause to seek probate of the later Will.

The Court of Appeal affirmed. A no-contest clause is generally enforceable. However, pursuant to Probate Code § 21306, it is not enforceable against a beneficiary who has "reasonable cause" to bring a contest on the grounds of forgery or revocation. Here, the youngest son claimed that he had reasonable cause to believe that the prior Will had been revoked. The Court of Appeal disagreed, noting that "reasonable cause" was an objective standard which requires that the person filing the action has possession of facts that would cause a reasonable person to believe that the allegations of the pleading could be proven. Relying on the extensive evidence which formed the basis of the trial court's finding of undue influence, the Court of Appeal noted that the youngest son did not have "reasonable cause" to believe the later Will was valid. As a result, the Court of Appeal affirmed the trial court's ruling that the younger son had violated the no-contest clause.

II. PLAINTIFF CANNOT SEEK EQUITABLE REMEDY FOR BREACH OF CONTRACT WHERE ADEQUATE LEGAL REMEDY WAS AVAILABLE

In *Wilkison v. Wiederkehr,* 101 Cal.App.4th 822 (2002), the Second District Court of Appeal held that plaintiff could not bring suit seeking equitable remedies for breach of contract where he had an adequate legal remedy.

The plaintiff's father had entered into a contract with plaintiff's grandparents and other relatives. The contract provided that plaintiff's father would purchase plaintiff's aunt's interest in the grandparents' home, and that the grandparents would leave the home to the father by Will. The father paid the aunt the required sum, and the grandparents created a Will leaving the home to the father. The father's Will effectively left his entire estate to plaintiff. The grandfather and father died before the grandmother. The grandmother later revoked her Will and executed a Will leaving the home to plaintiff's aunt. Shortly before her death, the grandmother decided to sell the home. She died before escrow closed. By agreement of the aunt and plaintiff, the house was sold and the proceeds placed into a bank account. The aunt was appointed as the executor, and plaintiff failed to file a timely creditor's claim for breach of contract. Several months later plaintiff filed a claim for breach of contract seeking the imposition of a constructive trust on the sale proceeds. The trial court ruled in favor of plaintiff, imposing a constructive trust on the proceeds and ordering the aunt to pay the proceeds to plaintiff.

The Court of Appeal reversed. The Court of Appeal relied on the legal principle announced by the Supreme Court in *Morrison v. Land,* 169 Cal. 580 (1915), which provides that equitable remedies are available only if there is no adequate legal remedy. Here, plaintiff could recover only the sale proceeds, essentially a monetary bequest. Equitable relief was not available where an adequate legal remedy clearly existed. Therefore, plaintiff should have filed a creditor's claim for breach of contract, and the action for imposition of a constructive trust was barred. The Court expressly did not decide if a creditor's claim is a necessary prerequisite to a suit for constructive trust if the contract involved real property which was still in the estate at the time the action was filed.

III. PLAINTIFF'S PROPOSED COMPLAINT ASSERTING BREACH OF ORAL CONTRACT VIOLATES NO-CONTEST CLAUSE OF TRUST

In *Nairne v. Jessop-Humblet,* 101 Cal.App.4th 1124 (2002), the Fourth District Court of Appeal ruled that plaintiff's proposed complaint alleging breach of an oral contract violated a trust's no-contest clause.

Decedent and his wife created a revocable trust which contained a broad no-contest clause. Among the properties listed on the trust schedule was real property in Borrego Springs. The trust provided that trust property would be divided into a survivor's trust and a bypass trust on the first death, and property remaining in both trusts on the surviving spouse's death would be distributed to the trustors' issue. Plaintiff, wife's child by a previous marriage, lived at the Borrego Springs property with the permission of his mother and stepfather. Upon the stepfather's death, plaintiff asserted that he was entitled to the Borrego Springs property pursuant to an oral agreement. His mother, the surviving settlor, disagreed and requested that plaintiff pay rent if he wished to continue to reside at the property. Plaintiff sought a ruling that his proposed complaint asserting breach of an oral contract would not violate the no-contest clause of the trust. The trial court, relying upon *Varney v. Superior Court,* 10 Cal.App.4th 1092 (1992), held that because the claim was based upon an oral agreement independent of the trust, plaintiff's proposed complaint would not violate the no-contest clause.

In reversing, the Court of Appeal noted that there is no categorical rule that a claim based upon an agreement independent of a Will or trust can never be a contest. Relying upon the fact that the Borrego Springs property was listed on the trust schedule and that the trust provided for distribution to the settlors' issue only upon the death of the surviving spouse, the Court of Appeal held that plaintiff's proposed complaint would violate the no-contest clause.

IV. STATUTE OF LIMITATIONS NOT TOLLED FOR MINORS WHO FAILED TO BRING CLAIM AGAINST DECEDENT'S TRUST WITHIN ONE YEAR OF DECEDENT'S DEATH

In *Levine v. Levine,* 102 Cal.App.4th 1256 (2002), the Second District Court of Appeal upheld a trial court ruling which found that the one year statute of limitations for actions against a decedent was not tolled while plaintiffs were minors.

Plaintiffs' grandfather established investment accounts for plaintiffs under the Uniform Transfers to Minors Act. Several years before his death, the grandfather improperly removed the funds from the accounts. More than a year after the grandfather's death the plaintiffs brought suit against the grandfather's widow who was the beneficiary of a revocable trust created by the grandfather which became irrevocable upon his death. The complaint alleged breach of fiduciary duty by the grandfather for removing the funds. There was no proceeding to administer the grandfather's estate and the trustee of his trust did not file a notice to creditors under Probate Code § 19003. The widow demurred on the grounds that plaintiffs' complaint was barred by the one-year statute of limitations contained in Code of Civil Procedure § 366.2. The trial court dismissed the complaint without leave to amend.

The Court of Appeal affirmed. In the absence of a pending creditors' claim, either in an estate proceeding or against a trust, the one-year statute of limitations period contained in CCP § 366.2 applies to any claim for recovery based upon a liability of a decedent. This is true even though there has been no notice to creditors. In reaching its ruling, the Court of Appeal relied upon the language of CCP § 366.2 and the need for finality in the administration of estates. The Court of Appeal also held that the statute of limitations is not tolled due to minority or incapacity.

V. CLAIM FOR BREACH OF ORAL AGREEMENT FILED MORE THAN ONE YEAR AFTER DECEDENT'S DEATH WAS NOT BARRED BY ONE-YEAR STATUTE OF LIMITATIONS BECAUSE CAUSE OF ACTION DID NOT EXIST UNTIL WILL WAS INVALIDATED

In *Estate of Roberson,* 102 Cal.App.4th 1201 (2002), the Sixth District Court of Appeal ruled that a claim for breach of oral contract brought more than one year after the death of decedent was not barred by the one-year statute of limitations.

Decedent promised his companion of twenty years that he would provide for her support for the rest of her life and that he would leave her their shared home in his Will. Decedent executed a Will leaving his entire estate to his companion. Upon decedent's death the Will was submitted for probate but was eventually found to be invalid because it had not been properly witnessed. The companion then brought suit to enforce the oral agreement, but because of the time taken to resolve the Will contest her claim was not filed until more than one year after decedent's death. Relying upon Code of Civil Procedure § 366.2, the trial court held that the companion's claims were barred.

The Court of Appeal reversed. The Court of Appeal held that CCP § 366.2 applied only to causes of action existing at the death of a decedent. Decedent had executed a Will in fulfillment of his promise. Therefore, no cause of action existed at death because there had been no breach of the promise to provide for the companion. The Court of Appeal also held that even if the statute of limitations were to apply, the companion's actions in filing the Will and resisting the Will contest were sufficient to invoke the doctrine of equitable tolling. Accordingly, the companion's clams for breach of an oral contract were not barred.

VI. EQUITABLY ADOPTED CHILD WAS NOT A MEMBER OF THE CLASS OF "ISSUE" IN HER STEPFATHER'S MOTHER'S WILL

In *Estate of Furia,* 103 Cal.App.4th 1 (2002), the First District Court of Appeal held that a child who is not entitled to inherit from her stepfather under Probate Code § 6455 or Probate Code § 6454 does not meet Probate Code § 26's statutory definition of "child" and consequently is not a member of the class of "issue" under the stepparent's mother's Will.

When she was two, petitioner's parents divorced and her biological father severed all ties with her. When she was four, her mother remarried and she took her stepfather's last name. Her stepfather began adoption proceedings shortly thereafter but these proceedings were discontinued when the child's biological father could not be located. The stepfather raised petitioner as his daughter and they continued to treat each other as father and daughter in all respects until his death over 30 years later. When her stepfather died, petitioner shared equally in his estate with his biological children. Similarly, petitioner was treated as the granddaughter of decedent, the stepfather's mother. When decedent died, her Will left her assets to her five children, including petitioner's stepfather. If any of her children predeceased the decedent, that child's share passed to "the surviving issue of the deceased devisee." The trial court denied petitioner's unopposed heirship petition.

In affirming, the Court of Appeal first held that since there was no extrinsic evidence to show what decedent meant by the word "issue," the statutory or common law meaning governs. The court concluded that there was no material difference in the law as it existed in 1960, when the Will was drafted, and 2000, the year decedent died, and therefore did not resolve the question of which law applied to interpretation of the word "issue." Probate Code § 50 defines "issue" as a person's "lineal descendants of all generations, with the relationship of parent and child at each generation being determined by the definitions of child and parent."

Petitioner did not meet the requirements of Probate Code § 6454, which governs intestate succession by and through a stepparent, because the legal impediment to adoption ceased to exist when petitioner attained her majority. Petitioner next argued that she was equitably adopted under Probate Code § 6455. The Court of Appeal assumed that petitioner met the requirements of Probate Code § 6455 and had been equitably adopted by her stepfather. Even so, the court concluded that while this may have given her a contractual right to a portion of her stepfather's estate, it did not bestow on her the status of "heir" and did not give her the right to inherit from or through her stepfather. Thus, she did not meet the definition of "child" under Probate Code § 26 and did not qualify as an "issue" under decedent's Will.

The Court of Appeal expressed sympathy to petitioner's situation but reiterated the need for brightline tests in determining entitlement to distribution of estates.

* *Luce, Forward, Hamilton & Scripps LLP, San Diego, California*

TRUST AND ESTATES SECTION EXECUTIVE COMMITTEE

Chairs Of Section Subcommittees (2002-2003)

The Trusts and Estates Section Executive Committee accomplishes much of its work by its subcommittees.
The following are the chairs of the subcommittees of the Executive Committee.
Comments and suggestion concerning matters in their respective substantive areas can be directed to them.

CALIFORNIA LAW REVISION COMMISSION (CLRC)
Christopher M. Moore
(310) 540-8855

COMPUTER/INTERNET
Albert Handelman
(707) 521-2800

CONFERENCE OF DELEGATES
Robert J. Gomez, Jr.
(626) 573-1100

EDUCATING SENIORS
Paul J. Barulich
(650) 595-0444

EDUCATION
Carol Kao
(619) 699-2540

ESTATE PLANNING
William E. Beamer
(619) 235-6800

ETHICS
Charles P. Wolff
(415) 421-0288

FAMILY LAW SECTION LIASON
Christopher M. Moore
(310) 540-8855

INCAPACITY
Neil A. Harris
(530) 893~2882
Peter S. Stern
(650) 326-2282

INCOME AND TRANSFER TAXES
James M. Allen
(415) 957-1800

LEGISLATION
J. Keith George
(805) 528-3394

LITIGATION
Kenneth S. Wolf
(310) 470-6010

MARKETING AND SALES
Janet Anne Reese
(805) 988-8324

MEMBERSHIP
Carmen Alberio
(310) 222-8877

NCCUSL, UNIFORM TRUST ACT
Terence Nunan
(310) 286-1700

NO CONTEST TASK FORCE
John A. Hartog
(925) 253-1717

QUARTERLY
George F. Montgomery II
(415) 433-2300

TRUST & ESTATE ADMINISTRATION
John A. Hartog
(925) 253-1717

FEDERAL TAX ALERT:

Selected Federal Tax Legislation, Cases & Rulings

*By James M. Allen, Esq.**

This article will provide a summary of selected developments in federal taxation since the Fall Quarterly of particular interest to trust and estates attorneys.

I. FEDERAL LEGISLATIVE ACTIVITY

A. Charity Aid, Recovery and Empowerment Act of 2002

In the Fall issue of the Quarterly, it was reported that the Charity Aid, Recovery and Empowerment (CARE) Act 2002 (H.R. 7) had been passed by the House of Representatives by the Senate Finance Committee. The Bill still has not been voted upon by the full Senate and is being resubmitted.

B. Retirement Savings Security Act of 2002

In the Fall issue of the Quarterly, it was reported that the House of Representatives had passed the Retirement Savings Security Act of 2002 (H.R. 4931) which would make permanent the pension and income retirement arrangement provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001. This Bill has not been considered by the full Senate.

C. Permanent Death Tax Repeal Bill of 2002

On September 19, 2002, the House of Representatives, on a largely party line vote of 242 – 158, agreed to a Republican sponsored "Sense of the House" resolution that Congress should complete action on the Permanent Death Tax Repeal Bill of 2002 (H.R. 2143). This Bill, which passed the House on June 6, 2002, failed to gain approval in the Senate.

II. FEDERAL REGULATORY ACTIVITY

A. Notice 200259, 200236 IRB 481

The Internal Revenue Service has made it clear that it will not respect split-dollar life insurance arrangements (including so-called "reverse" split dollar arrangements) where the parties attempt to avoid taxes by using inappropriately high current term insurance rates, prepayment of premiums or other techniques to understate the value of taxable policy benefits.

B. Form 706

The Internal Revenue Service has released the 2002 version of Form 706, United States Estate(and Generation-Skipping Transfer) Tax Return. This new version of the Form 706 reflects the numerous law changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 and is applicable only for decedents dying in 2002.

III. FEDERAL CASES AND RULINGS – ESTATE TAX

A. Definition of Gross Estate (I.R.C. § 2031)

1. *Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002)*

The value of a decedent's 62.9% interest in the stock of a family-owned, closely-held corporation was determined by applying an 85:15 ratio in valuing the corporation with a rate of 85% assigned to its earning based value and a weight of 15% assigned to its asset-based value. In addition, in calculating the corporation's value under the asset-based approach, it was necessary to reduce the value of the company's assets by 34% on account of built-in capital gain.

2. *Estate of Glover v. Commissioner, T.C. Memo. 2002186*

For federal estate tax purposes, the value of a decedent's interest in a malpractice claim against a law firm, settled out of court, did not include the portion of the settlement amount that was allocable to attorney's fees that were ordered to be returned to the estate. The Court so ruled because the attorney's fees related to conduct that occurred after the decedent's death.

B. Alternate Valuation (I.R.C. § 2032)

Priv. Ltr. Rul. 200234037 (Aug. 23, 2002)

The IRS granted an extension pursuant to Treas. Reg. §§ 301-9100-1 and -3 to make an alternate valuation election. Apparently a misunderstanding between the executor and the accountant resulted in a timely-filed estate tax return which did not contain the election.

C. Adjustments for Certain Gifts Made Within Three Years of Decedent's Death (I.R.C. §2035)

Estate of Armstrong v. Commissioner, 119 T.C. No. 13 (2002)

Pursuant to I.R.C. § 2035(c), the decedent's gross estate included approximately $4.5 million in gift taxes paid by or on behalf of the decedent. The section does not violate the due process clause of the Fifth Amendment, nor does it violate the equal protection requirements of the Fourteenth Amendment.

D. Transfer with Retained Life Estate (I.R.C. § 2036)

1. *Estate of Thompson v. Commissioner, T.C. Memo. 2002246*

A decedent's gross estate included the date of death fair market value of assets that the decedent had transferred to two limited partnerships because the decedent retained the enjoyment of the contributed property until his death. The Tax Court held that the family limited partnerships had sufficient substance to be recognized for estate and gift tax purposes. However, in reviewing the circumstances surrounding the creation of the family limited partnerships, the court ruled that there was an implied agreement that the decedent would retain the economic benefit of the contributed property. The court observed that because the decedent transferred to the family limited partnership assets that would have been required for his support, there had to be an implied understanding that his children would agree to his requests for money.

2. *Priv. Ltr. Rul. 200240018 (Oct. 4, 2002)*

Several years prior to the death of the decedent, funds had been recovered on a lawsuit brought against a hospital with respect to care provided the decedent. These funds were transferred to an irrevocable supplemental needs trust. The Internal Revenue Service noted that the funds contributed to the trust were awarded the to decedent as compensation for his personal injuries and were contributed to the trust by the decedent's guardian acting on his behalf. Thus, for the purposes of I.R.C. § 2036, the decedent was the transferor of the funds. Because the funds were utilized to reimburse the state for costs of public assistance, the value of the trust corpus was included in the decedent's estate under I.R.C. § 2036.

3. *Priv. Ltr. Rul. 200229013 (July 19, 2002)*

The power held by trust beneficiaries to remove and appoint members of a trust company's board of directors, which in turn was responsible for appointing the persons with the authority to make distribution decisions, did not cause the trust assets to be includable in the beneficiaries' gross estates. In so concluding, the Internal Revenue Service noted that the trust company's bylaws prohibited any person who was an employee of the trust company, had any beneficial interest in the trust, or was a "related or subordinate party" from possessing the authority to make distributions.

E. Joint Interests (I.R.C. § 2040)

Estate of Concordia v. Commissioner, T.C. Memo. 2002-216

A decedent's estate was entitled to exclude half the value of a residence held by the decedent and her niece as joint tenants in calculating the decedent's gross estate because the consideration furnished by the niece for her interest was adequate to support the estate's claim that one-half was excludable. The decedent had entered into an agreement with her niece and the niece's husband pursuant to which the decedent deeded the residence to herself and the niece as joint tenants. In exchange for receiving the joint interest, the niece and her husband permitted the decedent to live with them in the home they already owned, and the husband agreed to manage a separate rental property owned by the decedent. The court concluded that the rental value of the niece's home allocable to the decedent's rent-free residency there was slightly more than half of the joint-tenancy residence's fair market value.

F. Certain Property for Which Marital Deduction Was Previously Allowed (I.R.C. § 2044)

Priv. Ltr. Rul. 200236021 (Sept. 6, 2002)

An election to treat a trust as a qualified terminable interest property (QTIP) trust was disregarded for federal transfer tax purposes because the election had not been necessary to reduce the predeceased spouse's tax liability to zero.

G. Expenses, Indebtedness and Taxes (I.R.C. § 2053)

Estate of O'Neal v. United States, 228 F. Supp.2d 1290 (N.D. Ala. 2002), 2002-2 U.S.T.C. (CCH) ¶60,448

The decedent's estate was entitled to an estate tax deduction for the value of restitution claims made by the decedent's descendants on whom the Internal Revenue Service had imposed transferee tax liability in connection with gifts the decedent had made to them during her life. After the statute of limitations on the gift tax apparently had run against the decedent, the Internal Revenue Service asserted a transferee tax liability of over $9.4 million against the descendants. The court determined that the value of the descendants' claim was greater than the value of the decedent's estate, that the claim was fully deductible by the estate and that the deductible claim thus reduced the decedent's estate – and estate tax liability – to zero.

H. Charitable Deduction (I.R.C. § 2055)

1. *Estate of Bradford v. Commissioner, T.C. Memo. 2002-238*

The method of apportionment of federal estate and state inheritance taxes adopted by the decedent in his will and trust was controlling. Under this method, such taxes, as well bequests, debts and expenses that were paid from the decedent's residuary estate, had greatly reduced the residuary estate; as a result, far fewer assets were available for allocation to a residuary charitable gift. The Tax Court agreed with the Internal Revenue Service in determining that the estate tax charitable deduction would be allowed only as to amounts actually passing to charity after the reduction of the residue for death taxes and other expenditures under the terms of the decedent's estate plan.

2. *Estate of Atkinson v. Commissioner, 309 F.3d 1290 (11th Cir. 2002), 2002-2 U.S.T.C. (CCH) ¶60,449*

The decedent's estate is not entitled to deduct a charitable remainder interest in a trust intended to be a charitable remainder annuity trust because of the failure to pay required annual distributions and the improper payment of corpus to benefit a non-charitable secondary beneficiary. Two years before her death, the decedent placed stock worth $4 million in a charitable remainder annuity trust. The trust was to pay the decedent five percent of the fair market value of the assets per year. However, no payments were actually made during the decedent's lifetime. Later, a non-charitable beneficiary entered into a settlement with the decedent's estate resulting in a payment from the trust which further violated the terms of the trust and the rules governing the operation of a charitable remainder annuity trust. The court has held that no charitable deduction is allowable because I.R.C. § 664(d) requires that minimum payments be distributed annually and that no portion of the purported charitable remainder annuity trust could be paid to anyone other than designated non-charitable beneficiaries in a manner consistent with the statute or to statutorily accepted charitable entities.

3. *Priv. Ltr. Rul. 200230018 (July 26, 2002)*

The Internal Revenue Service has ruled favorably on the effect of a proposed testamentary transfer of an individual retirement account to an exempt organization in exchange for its promise to pay an annuity to the individual retirement account owner's survivor. The Internal Revenue Service has ruled that the charity's exempt status will not be adversely affected and that it will not receive taxable income from its receipt of the IRA. The taxpayer's estate will not have income from the IRA and may claim a charitable deduction for the value of the IRA less the value of the annuity.

4. *Priv. Ltr. Rul. 200223013 (June 7, 2002) and Priv. Ltr. Rul. 200223014 (June 7, 2002)*

These two private letter rulings hold that an estate tax charitable deduction is allowable for art work bequeathed to a museum even though the museum's use of the art work was subject to certain conditions under a gift and loan agreement entered into during the decedent's lifetime. The allowable amount of the deduction was the fair market value of the art work determined without regard to the existence of the gift and loan agreement.

I. Marital Deduction (I.R.C. § 2056)

1. *Tech. Adv. Mem. 200234017 (Aug. 23, 2002)*

A surviving spouse did not have a qualifying income interest for life in a trust for marital deduction purposes because the spouse possessed a lifetime limited power of appointment over the trust assets. The surviving spouse had the power either during lifetime or at death to appoint trust income and principal to the decedent's descendants. The Internal Revenue Service observed that the spouse did not have the required qualifying income interest for QTIP purposes because the spouse had the lifetime ability to appoint trust property to persons other than herself. A savings clause contained in the will did not extinguish this power because such clauses can operate effectively for transfer tax purposes only when the power to be voided by the savings clause is ambiguous; here, the power was unambiguously described.

2. *Priv. Ltr. Rul. 200240020 (Oct. 4, 2002)*

A decedent's transfer of a leasehold interest to his spouse constituted a taxable gift that did not become part of the estate and therefore was not subject to I.R.C. §§ 2056(d) and §2056A. After the decedent moved to a foreign country, he purchased a 50-year leasehold interest in a residence. About two months prior to his death, he transferred his entire leasehold interest to his non-citizen spouse but continue to live in the residence until his death. The IRS also concluded that I.R.C. § 2036 would not apply even though the decedent continued to live in the residence because this was an interspousal transfer. (See *infra* Part IV.E., for gift tax effect.)

J. Family-Owned Business Interests (I.R.C. § 2057)

1. *Priv. Ltr. Rul. 200234004 (Aug. 23, 2002)*

A decedent's estate was granted an extension of time to make an I.R.C. § 2057 election under Treas. Reg. § 301.9100-3 because the executor, in relying on a tax professional, acted reasonably and in good faith. Even though the estate's law firm and accounting firm possessed the information to conclude that a deduction was available to the estate, neither the law firm nor the accounting firm advised the executor of the existence of a qualified family owned business interest election.

2. *Chief Couns. Adv. 200234055 (Aug. 23, 2002)*

The Internal Revenue Service has concluded that if an estate elects to claim the estate tax deduction for qualified family owned business interests, but fails to provide all required information or signatures, the executor has 90 days after notification by the Internal Revenue Service to provide the information.

IV. FEDERAL CASES AND RULINGS – GIFT TAX

A. Valuation of Gifts (I.R.C. § 2512)

Okerlund v. United States, 53 Fed. Cl. 341 (2002)

The value of closely held stock transferred by sibling donors to trusts for the benefit of their respective children was determined by using a combination of market and income approaches and applying discounts for lack of marketability and voting rights. The donors and their respective spouses transferred non-voting shares to newly created trusts for the primary benefit of their children. The court adopted the Internal Revenue Service's expert's pre-discounted valuation which weighted the income approach at 70% and the market approach at 30%. The court then found that the appropriate lack of marketability discount was 40% and that in addition, a 5% discount for lack of voting rights was appropriate, thereby resulting in a combined 45% discount.

B. Disclaimers (I.R.C. § 2518)

Priv. Ltr. Rul. 200225015 (June 21, 2002)

The Internal Revenue Service has privately ruled that a beneficiary's disclaimer of a specific number of shares of stock that comprised one-half of his one-sixth interest was a qualified disclaimer for purposes of I.R.C. § 2518. The IRS found that the disclaimer was in writing and made within nine months of the decedent's death. Moreover, the beneficiary did not receive or accept any benefits from the trust. The Internal Revenue Service noted that both applicable state law and the regulations under I.R.C. § 2518 permit a partial disclaimer of severable property such as shares of corporate stock.

C. Dispositions of Life Estate in QTIP Trust (I.R.C. § 2519)

Priv. Ltr. Rul. 200230017 (July 26, 2002)

A surviving spouse's sale of her qualifying income interest in one of seven separate trusts created by the severance of a qualified terminable interest property ("QTIP") trust does not result in a taxable transfer of any property in the other six trusts. The QTIP trust was created from the residue of the husband's estate for his wife's lifetime benefit. Following the wife's death, the trust property was to be distributed to seven of the husband's descendents. In order to resolve disagreements among the trustees and the beneficiaries over investment strategies, the QTIP trust was divided into seven separate trusts, one for each of the remainder beneficiaries. Following the severance, the wife sold her qualifying income interest in one of the trusts to the designated remainder beneficiary.

D. Charitable Gifts (I.R.C. § 2522)

Priv. Ltr. Rul. 200240027 (Oct. 4, 2002)

Both a husband and wife who created three charitable lead unitrusts ("CLUTs") were allowed gift tax charitable deductions for the present value of the unitrust amounts in the CLUTs. The Internal Revenue Service also ruled that the CLUTS were not includable in either spouse's gross estate for federal estate tax purposes because the couple retained no interest or reversion in the trust assets; had no right to alter, amend or revoke the trusts; were not eligible to receive any payments from the trusts during their lifetimes; and had no general power of appointment in connection with the trusts.

E. Marital Deduction (I.R.C. § 2523)

Priv. Ltr. Rul. 200240020 (Oct. 4, 2002)

A decedent's transfer of a leasehold interest in a residence to his wife did not qualify for a gift tax marital deduction because the wife was not a U.S. citizen. Although the Internal Revenue Service concluded that the residence in question was not subject to inclusion in the donor's estate under I.R.C. § 2036, it also concluded that the value of the leasehold interest was subject to gift tax because the transfer failed to qualify for a marital deduction under I.R.C. § 2523(i). (See *supra* Part III. I.2. for estate tax effect.)

V. FEDERAL CASES AND RULINGS – GENERATION-SKIPPING TRANSFER TAX

A. Tax Imposed (I.R.C. § 2601)

Once again, there are numerous private letter rulings which deal with the issue of modification of a generation-skipping trust that was grandfathered by the Tax Reform Act of 1986. Two are worthy of mention.

1. Priv. Ltr. Rul. 200234062 (Aug. 23, 2002)

Distribution of interests in a limited liability company pro rata to shareholders of an 'S' Corporation, including grandfathered generation-skipping trusts, will not constitute additions to or distributions from the trusts.

2. Priv. Ltr. Rul. 200231011 (Aug. 2, 2002)

Modification of a grandfathered generation-skipping trust to cash out charitable remaindermen will not deprive the trust of grandfathered exemption from the generation-skipping transfer tax. However, the transaction will result in a taxable exchange since the proposed agreement will cause a material difference in the beneficiary's entitlement under the trust.

B. Special Rules (I.R.C. § 2654)

Priv. Ltr. Rul. 200226026 (June 28, 2002)

The severance of a qualified terminable interest property (QTIP) trust into two separate trusts was recognized for generation-skipping transfer tax (GSTT) purposes and the two trusts were treated as separate trusts under I.R.C. § 2654(b)(1). The Internal Revenue Service determined that under Treas. Reg. § 26.2654-1(b)(1)(ii), the severance of the QTIP trust should be recognized for GSTT purposes because (1) the separate trusts in the aggregate provided for the same succession of interests and beneficiaries as the original trust; (2) the reformation proceeding was commenced prior to the timely filing of the decedent's estate tax return; and (3) the new trusts were severed on a fractional basis and were funded in a manner that fairly reflected the net appreciation or depreciation of assets between the valuation date and the date of funding.

VI. FEDERAL CASES AND RULINGS – SPECIAL VALUATION RULES

Special Valuation Rules For Transfers of Interests in Trusts (I.R.C. §2702)

Priv. Ltr. Rul. 200241039 (Oct. 11, 2002)

The taxpayer plans to transfer a vacation property to a trust that is intended to meet the Treas. Reg. § 25.2702-5(c) requirements for a qualified personal residence trust (QPRT). The property is forested with a cleared area containing a vacation residence, a guesthouse, a barn, a boathouse, 2 sheds and a large pier and dock. During some summers, the property has been used as a campsite for high school students for which consideration of $1.00 per year was received. Additionally, the property is subject to a perpetual conservation easement. The Internal Revenue Service found that the size of the property is comparable to that of nearby properties used for residential purposes and accordingly found that the property includes adjacent land not in excess of what is reasonably appropriate for residential purposes. The Internal Revenue Service therefore concluded that the property qualifies as a personal residence for QPRT purposes.

VII. FEDERAL CASES AND RULINGS – INCOME TAX & MISCELLANEOUS

A. Charitable Contributions and Gifts (I.R.C. § 170)

1. *Rauenhorst v. Commissioner, 119 T.C. No. 9 (2002)*

A couple's transfers of stock warrants to four charitable institutions were not anticipatory assignments of the proceeds from the sale of the warrants. Mr. and Mrs. Rauenhorst owned stock warrants in NMG, Inc. After World Color Press, Inc. sent a letter to NMG regarding its intention to buy all of the issued and outstanding stock in NMG, the Rauenhorsts assigned their warrants to four charitable institutions. The charitable institutions were under no legal obligation and could not be compelled to sell the warrants. The donees, however, sold the warrants soon after the contributions. In a summary judgment proceeding, the court ruled that the anticipatory assignment of income doctrine does not apply where donees are not legally obligated and cannot be compelled to sell the contributed property.

2. *Priv. Ltr. Rul. 200241044 (Oct. 11, 2002)*

The taxpayer has entered into a funding agreement calling for an annual funding commitment by the taxpayer to a tax-exempt university. To secure the funding agreement, the taxpayer made a non-recourse pledge of securities to be used by the university under a pledge agreement. The pledge agreement provides that in the event of a material default by the taxpayer of the taxpayer's obligation under the funding agreement, the university will have the right to transfer the number of pledged shares that are substantially equal in value to the amount of the defaulted obligation. This ruling, among other things, holds that the transfer of shares under the pledge agreement will be treated as a transfer under the funding agreement and will be eligible for a charitable deduction pursuant to I.R.C. § 170.

B. Stock Redemptions to Pay Death Taxes (I.R.C. § 303)

Priv. Ltr. Rul. 200242025 (Oct. 18, 2002)

When the decedent died, the executor elected to deduct the value of the decedent's qualified family owned business interests under I.R.C. § 2057 and claimed the maximum allowable amount. It is proposed that shares of the qualified family owned business be redeemed pursuant to I.R.C. § 303 for the payment of taxes. Assuming that the requirements of I.R.C. § 303 are otherwise met, the redemption of stock will not be treated as a disposition of any portion of the qualified family owned business interests under I.R.C. § 2057 and the proposed redemption will not trigger the imposition of additional estate tax. If, however, after the redemption, the corporation reissues the redeemed shares or issues new shares to a person other than a family member, a recapture tax will be triggered by the transaction.

C. Individual Retirement Accounts (I.R.C. § 408)

1. *Ancira v. Commissioner, 119 T.C. No. 6 (2002)*

No taxable distribution from a taxpayer's self-directed IRA resulted from taxpayer's actions when faced with the custodian's refusal to invest in a desired stock because it was not publicly traded. Taxpayer arranged for a check to be issued by the custodian payable to the stock issuer and forwarded the check in exchange for the stock issued in the IRA's name. The taxpayer had requested that the custodian of his IRA invest $40,000 in the stock of a non-publicly traded company. The custodian informed the taxpayer that although the stock could be held as an asset in the IRA, as a matter of policy the custodian would not purchase the stock since it was not publicly traded. The taxpayer therefore arranged for the custodian to issue a check drawn on the IRA account and payable to the stock issuer. The custodian sent the check to the taxpayer, who in turn forwarded the check to the issuer. This ruling holds that no distribution from the IRA to the taxpayer occurred because the taxpayer was merely a conduit for the IRA custodian.

2. *Priv. Ltr. Rul. 200228023*

The Internal Revenue Service has privately ruled that an IRA beneficiary had to pay tax on a mistaken cash-out and rollover of an inherited IRA because the transaction did not constitute a valid trustee-to-trustee rollover. The beneficiary, however, would not have taxable distributions from the IRA which received the invalid rollovers if the contributed amounts were timely returned to him.

D. Tax on Unrelated Business Income (I.R.C. § 511)

Priv. Ltr. Rul. 200230004 (July 26, 2002)

A couple intends to create a valid charitable remainder trust and transfer shares of a wholly-owned corporation to the trust. This ruling holds that dividends paid on the shares will not constitute unrelated business income to the trust under I.R.C. § 512 because the income from the stock will be characterized as dividends which are not treated as unrelated business income under I.R.C. § 512(b)(13)(C).

E. Income In Respect of a Decedent (I.R.C. § 691)

Priv. Ltr. Rul. 200234019 (Aug. 23, 2002)

The Internal Revenue Service has privately ruled that an estate's assignments of the decedent's retirement accounts to charities which were entitled to a specific percentages of the estate but were not named as beneficiaries of the accounts would not trigger taxable income to the estate or to the charities. The decedent died possessing four annuity contracts and three individual retirement accounts. He had named his estate as the beneficiary on all these accounts. The decedent's will left a percentage of his estate to various named charities. The amounts to be distributed to the charities roughly equal the value of the retirement accounts. The executor proposes to assign the estate's beneficial interests in the retirement accounts to the charities in satisfaction of their respective shares of the estate. The Internal Revenue Service has ruled that the proposed assignment would not cause either the estate or any of the individual beneficiaries to have taxable income and would not be taken into account in the computation of the estate's distributable net income for the tax year in question. The ruling also concluded that the charities would realize income in respect of a decedent by reason of the distributions to them, but that it would not be taxable because of the charities' exempt status under I.R.C. § 501(c)(3). (See *supra* Part III.H.3. for tax consequences to account owner.)

* *Leland, Parachini, Steinberg, Matzger & Melnick, LLP, San Francisco, California*

California
Trusts and Estates Quarterly

California Trusts and Estates Quarterly

is accepting advertisements from sponsors for upcoming issues.

For guidelines and further information, please contact:

Richard Burger
(707) 765-6926

THE STATE BAR OF CALIFORNIA
LEX
JULY 29, 1927

NOTES

Enrollment Form

Trusts and Estates Section of the State Bar of California

To join the section, please complete this form and return it with your check (payable to the Trusts and Estates Section, State Bar of California) or credit card authorization to Section Enrollments, State Bar of California, 180 Howard Street, San Francisco, CA 94105-1639.

Date . . . .

Name . . . .

Address . . . .

City . . . . Zip . . . .

State Bar Number (if applicable) . . . .

Telephone/E-Mail . . . .

I authorize the State Bar of California to use my credit card for enrollment in the Trusts and Estates Section.

□ MasterCard □ Visa

Account Number ______________________________

Exp. Date ______________________________

Cardholder's Name ______________________________

Cardholder's Signature ______________________________

□ Attorney Member – $60

□ Subscriber (Non-attorney or attorney licensed outside of California interested in Section work, publications, and programs) – $60

□ Law Student Member – $20

Non-Profit Org.
U.S. Postage
PAID
Permit No. 2066
Eau Claire, WI 54701

California
Trusts and Estates Quarterly

State Bar Education Foundation
• 180 Howard Street •
San Francisco, CA 94105-1639