NEWSLETTER
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Message from the Chair

C. Arthur Robinson, II, Chair

On behalf of the Board of Governors of the Virginia State Bar Trusts and Estates Section, I am happy to introduce the Spring 2015 edition of the T&E Section Newsletter. In this issue we have four very interesting articles which speak to current topics and concerns for all of us.

In this issue Kathleen A. Kelley identifies The Top Five Mistakes in Drafting Limited Liability Company Agreements. LLCs are extremely flexible and powerful vehicles which can be used to do any number of things and accomplish significant estate planning objectives. As we all know, however, the devil is in the details. Kathleen's article identifies five common mistakes in drafting LLC agreements which when not corrected can lead to significant problems with this otherwise very powerful planning tool.

Thomas D. Yates and Alvi Aggarwal have produced a thoughtful piece which discusses the process of maximizing basis for difficult-to-value assets in the case of non transfer taxable estates. As several authors have recently pointed out in a wide variety of publications, the focus of our planning has changed in recent years. We are now spending considerable time dealing with income tax efficiency which, in the context of inherited assets, means maximizing the basis of assets. This article walks through the landscape of how to value hard-to-value assets, the proper use of appraisals, and the pitfalls and concerns where the process of valuation is not properly documented with sufficient evidence to withstand the scrutiny of the Internal Revenue Service.

Melinda Merk explores joint revocable trusts and discusses the ins and outs of using these vehicles in common law property states. Given that in many cases transfer taxes are no longer a significant concern for our clients, the emphasis on simplification is greater than ever. One potential technique that allows for this simplification is the use of a joint revocable trust. However, as Melinda's article points out, joint revocable trusts carry with them a series of complexities that have to be appropriately dealt with in order to ensure that an otherwise simple instrument does not create significant complications. Her article is a thorough and thoughtful examination of both the pros and cons of joint revocable trusts and will make an excellent reference with respect to this area going forward.

Finally, Joanne Marcus has provided a planning suggestion for special needs trust planning which will be useful in many instances. As she points out, a freestanding special needs trust may often times be impractical based on the amount of assets a family seeks to retain in trust. Depending on the availability of resources, a pooled special needs trust run by an experienced charitable organization can be a viable alternative in this planning area.

We would like to thank our newsletter editor C. Daniel Vaughan and assistant newsletter editor Lauren Jenkins for their work in producing this Spring Newsletter. As I am sure you are all aware, in February, an issue of the Virginia Lawyer dedicated to trust and estate issues was provided and our editors worked tirelessly to make that publication a credit to our Section. Please visit our website at http://www.vsb.org/site/sections/trustandestates for additional information. Please feel free to contact me or any other member of the Board of Governors with any ideas or inputs of Section activities and let us know if there is any way that we can improve the offerings of our Section.

As a final note, it has been my pleasure to serve as Chair of the Trusts and Estates Section for fiscal year 2014/2015 and I am confident that our incoming Board will continue to make the Section relevant and valuable to its members. ⚜

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The Top Five Mistakes in Drafting LLC Agreements You Will Never Guess How to Keep Charlie Sheen out of Management!

By Kathleen A. Kelley

Trusts and estates lawyers form limited liability companies (individually, an "LLC") for a variety of reasons: liability reduction, the consolidation of estate assets, a mechanism in the event of incapacity, contractual dispute resolution, and the ability to transfer interests with a minority discount are just some examples. A successful lawyer will use the LLC form to provide all of these benefits and more for the estate; however, for the unwary, drafting the LLC Operating Agreement can thwart some of the best laid plans and resemble a Kardashian wedding banquet.

This article focuses primarily on typical mistakes made in drafting Operating Agreements, but the issues considered herein also translate to the corporate, partnership, or limited partnership arenas.

1. Not Defining a "Unit" – Three and a Half Units?

In Virginia, members of an LLC own membership interests in the company.[1] Under the Virginia Limited Liability Company Act (the "Virginia LLC Act"), a membership interest is defined as "a member's share of the profits and the losses of the limited liability company and the right to receive distributions of the limited liability company's assets."[2] A member's membership interest consists of the member's entire bundle of rights with respect to the LLC. Each member owns a membership interest - one membership interest, not several membership interests. Unlike Virginia corporations in which shareholders own shares of stock, a membership interest is not divided into separate shares or units; the division of membership interests must be done through the terms and conditions of the LLC's Operating Agreement.

Frequently, the terms of the Operating Agreement provide that the LLC will only issue a certain number of "Units," similar to the restrictions on corporations. A common mistake found in Operating Agreements is the omission of a definition of "Units." Either the definition is missing entirely (the drafter believing Unit is the term for ownership of the LLC) or provides some definition that Units are membership interests in the LLC (but each member only has one).

The savvy drafter will provide a definition of Units, such as "a representation of a fractional part of all of the Membership Interests (as defined in the Statute) owned by all of the Members in the LLC." This way, the definition refers back to the statutory definition, provides for an understanding of one hundred percent of the membership interests in the LLC, and then further divides those membership interests. With a good definition of Units, the drafter can provide for Non-Voting Units, Voting Units, Class A Units and so forth, further delineating the rights of ownership in the LLC.

2. Exit Strategies – Celebrity Break-Ups.

After reading popular articles on the Internet, clients may be well aware of the numerous celebrity couples that are no longer together, however, that does not always translate into the realization that a business relationship may not last happily ever after. While this may not appear to be an issue for trusts and estates lawyers, lawyers must counsel their clients on exit strategies should the LLC have more than one member or have the possibility of more than one member.

Many clients have heard of "Buy-Sell" Agreements – an arrangement in which one of the parties buys out another party for a pre-determined price at a pre-determined time. The concept is that while everyone gets along the parties agree how they are going to break up. The pre-determined price need not be a set price; a formula or mechanism to determine the value is all that is needed. The pre-determined time can be the death or incapacity of one of the parties, but it could also be at a deadlock. A typical drafting strategy would be that a "Deadlock" is called at the point when the parties have been at an

impasse for two consecutive manager meetings, or sixty days, whichever is shorter. Upon a Deadlock, one of the parties ("Gwyneth") can then purchase the other party's ("Chris") interests for a named price, or Chris can buy Gwyneth's interests for that named price. The plan is to provide conscious uncoupling, in a smooth process.

Trusts and estates lawyers may think: "but my client will be the sole owner of this business, I don't need to worry about disagreements!" This is true, but you must also analyze the ultimate end of the business. If the LLC is intended to continue past the death of the client and pass to the client's children or to multiple parties while remaining an LLC, a properly drafted exit strategy is essential.

3. Management Issues - Who's The Boss?

Many times when a client asks you to transfer assets or real property into an LLC, the intent is that the client will control the business or assets while he or she is alive and upon the death of the client, the LLC is no longer needed. The LLC is then dissolved, the assets liquidated, and the proceeds go to a trust or directly to descendants. If the intent is that someone other than the client manages the business, or if the LLC is intended to continue past the death of the client, consideration must be provided to management.

Corporations are relatively easy to manage: they will have shareholders which elect a Board of Directors, and then the Board sets long-range plans and elects officers to implement those plans. Additionally, the Virginia Stock Corporation Act and Virginia's case law protects minority shareholders against (some) oppression from majority owners or directors.[3] In contrast, LLCs typically have a single manager or a board of managers to make decisions and may have officers to implement day-to-day business, but the management structure is not set by statute. The Virginia LLC Act is heavily deferential to the contractual language in the Operating Agreement.[4] Case law setting forth guidance on LLC management is still sparse in Virginia.

With the Operating Agreement, the first question is who will manage the LLC: a single manager or a board of multiple managers? (Of course, the LLC can be member-managed or grand-poobah-managed, but for the sake of this article, that is considered management by a single manager.) With a single manager, that manager must be trusted implicitly by the other parties. With several managers on a board, there is a much greater possibility of a deadlock in any decisions. Additionally, who will choose the manager(s) and how is a manager removed? With this open-ended structure, the drafter must think through and anticipate all of these variables.

One solution to these problems is to keep as much of the power and management as possible with the client for as long as possible: issuing "voting" units to the client and "non-voting" units to the other members, and providing that the managers may only be elected or removed by the client for as long as the client is living and competent, and upon the client's death that power passes to a pre-selected individual. Alternatively, if the drafter is working with a family consisting of multiple generations, it is possible to draft language providing that the individual descendent starts out with a "non-voting" interest, but can then receive "voting" interests upon the death of one or more ancestors or upon the attainment of a certain milestone. Of course, as with the problem of a fertile octogenarian, this can get tedious and more and more remote for drafting.

4. Missing Transfer Restrictions – Charles is Not in Charge.

Many times assets are placed into an entity so the client can obtain various "discounts" on the LLC ownership and gift more ownership than if the assets were all reduced to cash. Discounts can be provided for lack of marketability (who would want to buy 2% of a business) or lack of control (that 2% right won't change anything). Ownership of the entity may be disbursed throughout many individuals. Each of those individuals may then want to gift or possibly sell the interest to others. At that point, the client could find himself or herself operating a business or managing an LLC with Charlie Sheen.

A well drafted Operating Agreement will include provisions allowing certain types of transfers (typically defined as "Permitted Transfers"), and disallowing all other transfers. Normally, transfers for the owner's own estate planning or transfers approved by the manager (which would be controlled by the client or client's representative), will be allowed.

Regardless of the restrictions in the Operating Agreement, transfers may occur by operation of law: death, bankruptcy, or divorce are examples. In that case, the member's ownership interest will then pass automatically to the member's estate, to the trustee in bankruptcy, or through a court proceeding.

In order to fix this problem, the drafter should include language in the Operating Agreement that should these "involuntary transfers" occur, what is transferred is solely the economic interest, not a "membership" in the LLC, and that the LLC has a right of first refusal in the interest before it is formally transferred. This language would allow the manager to admit the new holder, if the new holder is an appropriate member, or to purchase the subject membership interest for a pre-determined price, if the new holder is not an appropriate member. Regardless of the actions taken, with an effective Operating Agreement, at no point would Charlie Sheen be able to participate in management, unless the client is Mr. Sheen, of course.

5. Failure to Consider Fiduciary Duties – Law and Order: LLC Manager Edition.

Probably the most discussed issue with respect to LLCs within the legal community in the past few years has been the fiduciary duties that managers, members, and officers of an LLC owe to the LLC. Delaware's judiciary spent many years arguing about the existence of "default" fiduciary duties and the ability of members to contract out of those default duties. Eventually, Delaware's legislature acted so that it is clear that for a Delaware LLC, "[fiduciary] duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."[5]

Under Virginia law, directors of a corporation are subject to two fundamental fiduciary duties: the duty of care and the duty of loyalty.[6] The traditional duty of care requires that managers or directors be attentive to the business and inform themselves of all material facts regarding a decision before taking action. The traditional duty of loyalty requires that managers or directors act in the best interests of the corporation and not further their personal gain at the expense of the corporation.

In contrast to the corporate statute, the Virginia LLC Act only expressly provides for a duty of care: "A manager shall discharge his or its duties as a manager in accordance with the manager's good faith business judgement of the best interests of the limited liability company."[7] There is no provision in the Virginia LLC Act similar to that found in the corporate statute, requiring that managers avoid transactions involving a conflict of interest. Additionally, the United States Bankruptcy Court for the Western District of Virginia recently refused to impose a duty of loyalty on a manager of an LLC, finding that no such duty existed under the statute or the common law.[8]

With this (and the dearth of Virginia LLC case law) in mind, the careful drafter should consider what fiduciary duties are appropriate in the situation and include the standard in the Operating Agreement. Clients who desire to have the managers of the LLC subject to fiduciary duties, should state those fiduciary duties in the Operating Agreement. Drafting such provisions can even be as simple as "The Managers [and Officers] shall owe the same fiduciary duties to the Company that directors of a Virginia corporation owe to a corporation."

Conversely, there may be situations where the client desires to modify or eliminate fiduciary duties owed to the LLC. In the case of a family owned LLC, the specific member serving as manager or on a board of managers may have other business lines or opportunities, and presenting each opportunity he or she wants to pursue independently may be unreasonable. In another case, a manager may serve at the appointment of a specific family branch, and want his or her loyalties to go to that family branch rather than to the LLC as a whole.

There are several possible approaches to addressing these situations. First, consider forming a Delaware LLC rather than a Virginia entity for the certainty. Second, consider narrowly focusing the "Business" or "Purpose" of the LLC. For an example, if the purpose of the LLC is to develop and manage real property located in X neighborhood, it is unlikely a manager would be subject to a breach of loyalty claim for developing real property located

in Y neighborhood. Third, careful drafting of what would not be considered a breach, along with robust exculpation and indemnification provisions, may work, although this approach still involves risk.

Although far from all the considerations that must be evaluated when drafting or reviewing LLC Operating Agreements, this article attempts to highlight some of the important points. The most frequent mistakes come from not thinking through the possibilities and planning for the "what-ifs." With the proper counsel, your client can stay out of the entertainment pages and stay comfortably in the "Business" section. ✤

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Ms. Kelley received her Juris Doctorate, cum laude, from Washington & Lee University School of Law, and received her Bachelor's degree from the University of Virginia in History and Middle East Studies. Ms. Kelley lives in Falls Church with her husband and two sons. Should Mr. Charlie Sheen desire representation in forming or managing an LLC, Ms. Kelley would welcome the call.

(Endnotes)

1. VA. CODE ANN. §13.1-1002.
2. *Id*.
3. *See* VA. CODE ANN. §13.1-747; Colgate v. The Disthene Group, Inc., 85 Va. Cir. 286 (2012), *appeal granted* 2013 Va. LEXIS 60 (Apr. 25, 2013).
4. VA. CODE ANN. § 13.1-1023(A)(1) ("An operating agreement may contain any provisions regarding the affairs of a limited liability company and the conduct of its business to the extent that such provisions are not inconsistent with the laws of the Commonwealth or the articles of organization.").
5. DEL. CODE ANN. tit. 6, § 18-1101(c).
6. *See* VA. CODE ANN. § 13.1-690(A); Willard *ex rel*. Moneta Bldg. Supply, Inc. v. Moneta Bldg. Supply, Inc., 258 Va. 140, 156 (1999) (noting the common law as opposed to statutory origin of the duty of loyalty); Simmons v. Miller, 261 Va. 561 (2001); *Colgate*, 85 Va. Cir. at 292 ("The statute sets the standard by which a director is to discharge those duties [*i.e*., the duty of care and duty of loyalty].").
7. VA. CODE ANN. § 13.1-1024.1(A).
8. *In re* Virginia Broadband, LLC, 521 B.R. 539 (Bankr. W.D. Va. 2014).

Maximizing the Basis of Difficult-to-Value Assets in Non-Taxable Estates without Getting into Trouble[1]

By Thomas D. Yates and Alvi Aggarwal

1. The Changing Picture (Purpose & Scope)

The tax picture associated with the administration of a decedent's estate has changed. In most cases, the focus now is away from minimizing estate taxes and toward obtaining the highest defensible step-up in the tax basis of capital assets owned by the decedent at death.[2]

Because of the increased federal estate tax exemption (currently $5.43M), which is indexed for inflation[3] and the new portability rules (which, if elected, permit aggregation of the decedent's exemption with that of the decedent's surviving spouse),[4] most estates now escape the imposition of estate tax altogether.

In this new environment, increases in the value of an estate asset may be available at little or no estate tax cost. Because the tax basis of a decedent's capital asset is equivalent to its estate tax value, and any valuation is not exact but generally accurate within a range of numbers, there is a premium on obtaining a higher-side value which is defensible from an audit point-of-view and protectable from penalties. This premium is enhanced by the current income tax climate where capital gains bear higher income taxes. This article will briefly review certain elementary concepts of basis and valuation, provide an overview of potential penalties, and then address how a fiduciary may obtain the highest defensible value.[5]

2. Valuation & Basis

An estate's (or beneficiary's) basis in property acquired from a decedent is generally the "fair market value of the property at the date of the decedent's death," or, at the alternate valuation date, if applicable.[6] The fair market value is deemed to be the value as finally determined for federal estate tax purposes or as determined for state death taxes if no federal estate tax return is required.[7] If no federal or state estate tax return is required to be filed, fair market value would, of course, not be reported initially, but would still be ascertained using federal estate tax valuation principles.

For estate tax purposes, the fair market value of an asset is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[8] This is the "willing buyer/willing seller" test, which is the cornerstone of the valuation process. The Treasury Regulations (the "Regulations") provide some fairly specific guidance as to certain types of assets, including promissory notes and closely held business interests.[9] The valuation of real estate is not addressed in-depth in the relevant Regulations.

The fair market value of an interest in a business "is the net amount which a willing purchaser whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[10] This is just a slight variation on the general test for determining fair market value. Relevant facts may include an appraisal of the business's assets, the business's earning capacity, and the additional factors set forth in the Regulations.[11] The instructions to Form 706 require that the decedent's estate include "complete financial and other data used to determine value, including balance sheets (particularly the one nearest to the valuation date) and statements of the net earnings or operating results and dividends paid for each of the 5 years immediately before the valuation date" with the estate tax return. Generally, business valuations may be based on asset values, earnings, or a combination of both.

The fair market value of real estate is determined under the general willing buyer/willing seller test.[12] Appraisals typically reflect closed sales of comparable properties and may be inaccurate in an improving market. By way of circular reasoning, the Regulations assert that "[p]roperty shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date."[13] Case

law provides additional guidance, including "highest and best use" where the real estate is reasonably subject to development.[14]

3. The Risk of Overenthusiasm: Penalties

The most significant risks in maximizing basis are potential penalties to the taxpayer, return preparer, and appraiser.

3.1 Taxpayer Penalties: IRC § 6662

The Internal Revenue Code of 1986, as amended, (the "Code") imposes an accuracy-related penalty on taxpayers for the underpayment of tax.[15] An underpayment might result from an overstatement of an asset's basis, from the reporting of improper depreciation deductions, or from an incorrect calculation of gain or loss upon the asset's sale. The accuracy-related penalty is typically 20% of any underpayment.[16] The penalty may be imposed if the underpayment is attributable to one or more of the following acts of misconduct: (i) "[n]egligence or disregard of [the] rules or regulations"; (ii) "substantial understatement of income tax"; or (iii) "substantial valuation misstatement under chapter 1 [of the Code]."[17] This penalty does not apply if a taxpayer has "reasonable cause" and acts in "good faith," or meets the criteria for any additional exceptions.[18]

3.1.1 Negligence or Disregard

The imposition of penalties for negligence[19] or disregard[20] require analysis of the taxpayer's conduct, such as whether the taxpayer made a reasonable attempt to comply with the provisions of the Code and exercised ordinary and reasonable care in the preparation of the tax return.

There is a special exception to the negligence and disregard penalties: if a position contrary to a rule or regulation is adequately disclosed on a return[21] and represents a good faith challenge to the validity of the Regulation, the position will not give rise to a negligence or disregard penalty.[22]

3.1.2 Substantial Understatement

Another activity that can trigger an accuracy-related penalty for an individual taxpayer is the taxpayer's overstatement of basis in an asset which results in the "substantial understatement" of income tax.[23] For individuals, an understatement is not substantial unless it "exceeds the greater of (i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) $5,000."[24] The amount of the understatement is the amount of tax that should have been reported reduced by the tax that was shown. The understatement calculation effectively excludes any item for which: (i) the taxpayer had "substantial authority" for its tax treatment; or (ii) "the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return" and the taxpayer had a "reasonable basis for the tax treatment of such item."[25]

3.1.3 Misstatement

Finally, a "substantial valuation misstatement" can trigger an accuracy-related penalty for a taxpayer in this context. Similar to the substantial understatement penalty, the substantial valuation misstatement penalty has a threshold for individuals: the penalty does not apply "unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 [of the Code] exceeds $5,000."[26] Also, an underpayment of income tax is attributable to a "substantial valuation misstatement" only if "the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 [of the Code] is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis."[27] The determination of whether a misstatement has occurred is made on a property-by-property analysis, not on the basis of the entire return.[28] Unlike the other accuracy–related penalties to which taxpayers can be subject, a valuation misstatement can be "gross" and the penalty increased to 40% of the deficiency amount if the asset's value or adjusted basis is 200% or more of the correct amount.[29]

3.1.4 Exception: Reasonable Cause and Good Faith

There is an exception that applies to the penalties for "negligence or disregard," "substantial understatement of income tax," and "substantial valuation misstatement": "[n]o penalty shall be imposed under section 6662…with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion."[30]

The relevant Regulations, which are fairly extensive but somewhat uninformative, impose a "facts and circumstances" test for whether a taxpayer acted in good faith and with reasonable cause.[31]

Although the Regulations state that "[r]easonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property," it is clear that an independent professional appraisal provides a measure of protection as an important part of the facts and circumstances.[32] In considering an appraisal, the Regulations indicate the court or the Internal Revenue Service should look at "the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used."[33] Case law suggests that a reasonable reliance on an appraiser with proper qualifications is generally very helpful in determining reasonable cause and good faith.[34]

As to whether a taxpayer relied in good faith on professional advice, certain threshold requirements must be met:[35] (i) "[t]he advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances";[36] (ii) "[t]he advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person";[37] and (iii) "[a] taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately disclosed, in accordance with Section 1.6662-3(c)(2), the position that the regulation in question is invalid."[38] Even if these threshold requirements are met, it is not necessarily established that a taxpayer acted with reasonable cause and a good faith.[39]

3.2 Preparer Penalties

Code Section 6694 imposes certain penalties on a tax return preparer who prepares a return or claims a refund involving an understatement of tax. One penalty is imposed if the underpayment is attributable to an unreasonable position, and the preparer "knew (or reasonably should have known) of the position."[40] The penalty in that case is "the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim."[41] Another penalty is imposed if the understatement is attributable to "(A) a willful attempt in any manner to understate the liability for tax on the return or claim, or (B) a reckless or intentional disregard of rules or regulations."[42] In those cases, the penalty is higher: the greater of "(A) $5,000, or (B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim."[43] This potentially higher penalty amount is reduced by any penalty attributable to an unreasonable position of which the preparer knew or should have known.[44] It is possible that an attorney could be considered a nonsigning tax return preparer under certain circumstances.[45] Practitioners are also subject to Circular 230 requirements under certain circumstances.[46]

3.3 Appraiser Penalties

Code Section 6695A imposes certain penalties on "a person [who] prepares an appraisal of the value of property" and "knows, or reasonably should have known, that the appraisal would be used in connection with a return…[if the valuation] results in a substantial [or gross] valuation misstatement."[47] The term "appraisal" is not defined in the relevant Code Section, and its meaning may be broad enough to reach a return preparer's estimate of an asset's value reported on the return. Substantial and gross valuation misstatements have the same meanings as in Code Section 6662.[48] The amount of the penalty is the lesser of: (i) 125% of the gross income received by the appraisal preparer for the preparation of the appraisal; and (ii) the greater of $1,000 or 10% of the amount of the underpayment attributable to the misstatement.[49]

Code Section 6695A provides one exception to the appraiser penalty: no penalties are imposed if the person who prepares the appraisal establishes that the appraisal value "was more likely than not the proper value."[50]

4. How Do We Value Assets to Maximize Value/Basis?

4.1 Working with Appraisers

Valuation of hard-to-value assets (such as real estate and closely-held business interests) is more art than science, and most hard-to-value assets will reasonably fit into a range of values.

In spite of our objective of maximizing basis, we should interact with the appraiser just as we would in situations where estate tax would have been due. So, although we give information and input, it is with the understanding that the final appraisal is peculiarly the professional, independent work product of the appraiser. Within that framework, we should consider taking the following steps:

1. Notifying the appraiser of the purpose of the appraisal, including a description of estate tax exposure or lack thereof;
2. Reviewing the draft report prior to finalization in order to correct factual inaccuracies and provide proper input; and
3. Providing the appraiser with true facts and attributes which point to a higher valuation or to lower valuation discounts:
   a. For lack of control discounts, we can bring to the appraiser's attention attributes which could limit the scope of the discount, i.e., the power to direct the management and policies of a business enterprise. Factors generally could include positive characteristics relating to business governance in terms of the interest to be valued, history of cash distributions, history of strong cash flow, history of or anticipation of sales of assets, ease of dissolution/liquidation of entity, day to day management, and history of and ability to refinance/leverage assets.
   b. Likewise, for lack of marketability discounts, we should emphasize attributes which limit the extent of the discount, i.e., the potential to quickly convert an asset to cash with an emphasis upon the liquidity of the asset. Factors generally could include cash flow distributions, historical cash flow from the underlying assets, relative size of investment, lack of restrictions on transferability in governing instruments, low loan to value ratios, existence of diversification, lack of prepayment penalties, lack of phantom income, lack of a portfolio discount, favorable debt or debt terms, lack of market absorption issues, low vacancy rates, lack of loans to related parties, lack of title problems, lack of litigation, limited extent of potential capital improvements, limited historical or potential capital calls, limited liability risks, lack of development risks, and existence of multiple tiers of entities. The key factors appear to be cash flow and cash distributions.
   c. For fractional interest in land, we should focus on attributes which limit the potential discount, including, but not limited to, history of cooperative decision-making by co-owners, history of undivided use and possession, historical and potential cash flow, lack of debt, small size of investment, and impending sale of the property.
4. Emphasize with the appraiser, as the Internal Revenue Service does in transfer tax cases, the lower end of valuation discounts from reported case law where relevant and appropriate, including (i) *Knight v. Comm'r*, 115 T.C. 506 (2000), involving a partnership with securities and real estate, and a combined effective discount of 15%; (ii) *Holman v. Comm'r*, 130 T.C. 12 (2008), dealing with a partnership with a concentrate stock position, and a discount of 22.5%; (iii) *Ludwick v. Comm'r*, 99 T.C.M. (CCH) 1424 (2010), regarding a fractional interest in land, and a discount of 17.5%; (iv) *Astleford v. Comm'r*, 95 T.C.M. (CCH) 1497 (2008), involving a real estate limited partnership, and discounts of 15% and 22%; and (v) *Estate of Heck v. Comm'r*, 83 T.C.M. (CCH) 1181 (2002), involving an S Corporation that produced champagne and owned land, and a discount of 25%.
5. For real estate, we may want to stress lease terms favorable to the lessor, strong sales of comparable properties, upward trends in the marketplace, and the good condition and convenient location of the property.

In addition, because estate planning objectives may be to foster higher values, entity documents in the future should be drafted (or amended) with lower discounts in mind.

4.2 Working Without Appraisers

In some cases, obtaining professional appraisals might not make economic sense or might not seem worthwhile to the client.

For federal estate tax purposes, an appraisal is required for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000."[51] No other requirement for an appraisal appears in the Regulations, although the federal estate tax return instructions require an explanation of how the values of certain types of assets were determined. As noted previously, an appraisal can help avoid imposition of penalties described above. Accordingly an attempt at estimating values may trigger penalties, including possibly the Code Section 6695A penalty.

Real estate tax assessments may not be sufficient for estate tax purposes.[52] Traditionally, tax assessments are periodic, not immediate, and thus lag behind value in markets trending up and could exceed value in markets trending down. Some assessments are not done yearly. Generally, a realtor's letter or a Zillow valuation will not excuse or avoid the imposition of penalties.

4.3 Not Bound by Probate Values, Unless Duty of Consistency Applies

Nothing in the Code requires a taxpayer to use "probate" values as the taxpayer's basis. The estate probate inventory form may require a listing of the "fair market value" of each asset and permit the use of tax assessments for real estate. Probate documents, if sworn, might be unfavorable evidence and should be amended if the taxpayer wishes to take a later valuation position different from what was reported in the probate documents.

5. Conclusion

For years the government has been taking positions to increase the value of taxpayer's assets for federal estate tax purposes. In this new climate, taxpayers will be taking positions consistent with that approach. ⚜

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(Endnotes)

1. The authors thank Munford R. Yates, Jr. (Yates, Campbell & Hoeg, LLP) and Craig Stephanson (Valuation Services, Inc.) for their valuable contributions to this article. For other sources, the authors recommend consulting the following: JOHN A. BOGDANSKI, FEDERAL TAX VALUATION (Thomson Reuters 2015) (1996); Howard M. Zaritsky & Lester B. Law, *Fundamentals Program: Basis – Banal? Basic? Benign? Bewildering?* (Focus Series), 49 INST. ON EST. PLAN. CH. 1 (2015); COMMERCE CLEARINGHOUSE, IRS VALUATION GUIDE FOR INCOME, ESTATE AND GIFT TAXES: VALUATION TRAINING FOR APPEALS OFFICERS (CCH 1994).

2. There is an analogous concern in estate planning for clients whose assets do not exceed their available exemption(s). *See* Paul S. Lee, *Run the Basis and Catch Maximum Tax Savings—Part 1*, EST. PLAN., Jan. 2015, at 1; Paul S. Lee, *Run the Basis and Catch Maximum Tax Savings—Part 2*, EST. PLAN., Feb. 2015, at 2; Michael A. Yuhas & Carl C. Radom, *New Estate Planning Frontier: Increasing Basis*, 122 J. TAX'N 4 (2015).

3. I.R.C. § 2010(c)(3)(B).

4. *Id*. §§ 2010(c)(2)(B), 2010(c)(4).

5. The consideration of any additional limitations arising from fiduciary duties under state law is beyond the scope of this article.

6. I.R.C. § 1014(a).

7. Treas. Reg. § 1.1014-3(a).

8. *Id*. § 20.2031-1(b).

9. *See, e.g.*, Trea. Reg. §§ 20.2031-4 (regarding valuation of promissory notes), § 20.2031-3 (regarding valuation of interests in businesses).

10. Treas. Reg. § 20.2031-3.

11. *Id*. §§ 20.2031-2(f), (h), 20.2031-3.

12. *Id*. § 20.2031-9.

13. *Id*. § 20.2031-1(b).

14. The appropriate method for valuing real estate depends on the type of real estate (undeveloped land, commercial, residential, etc.). *See* Estate of Pattison v. Comm'r, 60 T.C.M. (CCH) 471 (1990); Estate of Necastro v. Comm'r, 68 T.C.M. (CCH)

227 (1994); Rev. Proc. 79-24, 1979-1 C.B. 565.
15. I.R.C. § 6662.
16. *Id*. § 6662(a).
17. *Id*. § 6662(b). There are additional circumstances, listed in Code Section 6662(b), under which the Code Section 6662(a) penalty can be triggered.
18. *See* I.R.C. § 6664(c).
19. "Negligence" is not precisely defined in the Code or the Regulations. The Code provides "the term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of this title." I.R.C. § 6662(c). The Regulations clarify that "[n]egligence is strongly indicated where—(i) [a] taxpayer fails to include on an income tax return an amount of income shown on an information return, as defined in [I.R.C. §] 6724(d)(1); or (ii) [a] taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit or exclusion on a return which would seem to a reasonable and prudent person to be 'too good to be true' under the circumstances." Treas. Reg. § 1.6662-3(b)(1). The negligence standard has a special exception: "A return position that has a reasonable basis…is not attributable to negligence." *Id*. There are other circumstances that "strongly indicate" negligence described in the Regulations, though they generally apply in the corporate and partnership contexts. *Id*. A "reasonable basis" is a "high standard," though it is not as high as the "substantial authority" required to avoid certain other penalties. *Id*. § 1.6662-3(b)(3).
20. "Disregard" refers to disregard of "rules or regulations," which encompass the "provisions of the Internal Revenue Code, temporary or final Treasury regulations issued under the Code, and revenue rulings or notices (other than notices of proposed rulemaking) issued by the Internal Revenue Service and published in the Internal Revenue Bulletin." Treas. Reg. § 1.6662-3(b)(2).
21. In accordance with the requirements of Treas. Reg. § 1.6662-4(f).
22. *See* Treas. Reg. § 1.6662-3(c). Importantly, the adequate disclosure exception to these penalties will not apply if the taxpayer "fails to keep adequate books and records or to substantiate items properly." *Id*. § 1.6662-3(c)(1).
23. I.R.C. § 6662(b)(2).
24. *Id*. § 6662(d)(1)(A).
25. *Id*. § 6662(d)(2)(B).
26. *Id*. § 6662(e)(2).
27. *Id*. § 6662(e)(1)(A).
28. Treas. Reg. § 1.6662-5(f)(1).
29. I.R.C. § 6662(h).
30. *Id*. § 6664(c)(1).
31. *See* Treas. Reg. § 1.6664-4(b)(1).
32. *See Id*.
33. *Id*.
34. *See, e.g*., Estate of Thompson v. Comm'r, 499 F.3d 129 (2nd Cir. 2007); Bergquist v. Comm'r, 131 T.C. 8 (2008). Reliance on an accountant (or perhaps a lawyer) who is not a "certified appraiser" or without an assessment of the appraiser's approach, on the other hand, may not be sufficient. *See, e.g*., Estate of Richmond v. Comm'r, T.C. Memo 2014-26.
35. *See* Treas. Reg. § 1.6664-4(c)(1).
36. *Id*. § 1.6664-4(c)(1)(i).
37. *Id*. § 1.6664-4(c)(1)(ii).
38. *Id*. § 1.6664-4(c)(1)(iii).
39. *Id*. § 1.6664-4(c)(1). There is a notable exception to the availability of the reasonable cause and good faith defense: reasonable cause and good faith will not prevent the application of Code Section 6662 penalties in a case where the underpayment is attributable to a "disallowance of claimed tax benefits by reason of a transaction lacking economic substance (within the meaning of section 7701(o)) or failing to meet the requirements of any similar rule of law." I.R.C. §§ 6662(b)(6), 6664(c)(2).
40. *See* I.R.C. § 6694(a).
41. *Id*. § 6694(a)(1)(B).
42. *Id*. § 6694(b)(2).
43. *Id*. § 6694(b).
44. *Id*. § 6694(b)(3).
45. *See* Treas. Reg. § 301.7701-15(b).
46. 31 C.F.R. Subtitle A, Part 10 (Rev. 6-2014).
47. I.R.C. § 6695A(a). Additional conditions can trigger this penalty, but only the valuation misstatement trigger is relevant in this context.
48. *Id*. § 6695A(a)(2).
49. *Id*. § 6695A(b).
50. *Id*. § 6695A(c).
51. Treas. Reg. § 20.2031-6(b).
52. *Id*. § 20.2031-1(b). ⚜

Joint Revocable Trusts: Call Me Maybe?[1]

By Melinda Merk

Throughout my career, I have frequently encountered and urged caution regarding the use of joint revocable trusts (JRTs) for married couples in common law property states.[2] Admittedly, it has become increasingly more difficult to advise clients (particularly those in "long-term stable" marriages with a total net-worth under the combined estate tax exemption) that JRTs should not be considered or that their existing JRT should be unwound.[3] Given the lack of case law, rulings, and other supporting authority concerning JRTs, this seemingly less complicated planning technique can create unintended pitfalls and complexity, and may not be suitable for every client.[4] Most married clients prefer the idea of using a JRT compared to creating and dividing their assets between separate revocable trusts for each spouse, particularly if most of their assets are titled jointly; however, the administration of a JRT during the spouses' joint lifetime and upon the first spouse's death can be more cumbersome and result in potential adverse estate, gift, and income tax consequences if the JRT is improperly drafted, administered, and/or funded. In addition, for couples with significant separately owned property, JRTs may result in the unintended transmutation of separate property into marital property for equitable distribution purposes in the event of divorce (however unforeseeable).

With the increased Federal estate, gift, and generation-skipping transfer (GST) tax exemption or "Applicable Exclusion Amount" (currently $5.43 million, as indexed for 2015)[5] — as well as the permanent availability of the portability election for the transfer of any unused Federal estate and gift tax exemption from the deceased spouse to the surviving spouse[6] — potential transfer tax risks associated with JRTs may not be a concern for some married clients based on their total net-worth. As a result, more attorneys are increasingly willing to recommend or consider using a JRT for such clients. Nevertheless, various pitfalls can be encountered if the JRT is not designed and implemented properly. Preservation of a stepped-up basis in the couple's assets, and being able to identify which portion of the JRT is includible in the estate of the first spouse to die, is critical for income tax purposes. Certain marital law and other non-tax issues should also be considered and properly addressed before implementing a JRT for couples who do not reside in a community property state or own assets that are community property.

JRTs vs. Joint Spousal Property

Traditionally, for most married couples, particularly those in first-time "long-term" marriages, the idea of owning their assets jointly offers many benefits and advantages. Owning assets jointly conveys a sense of comfort and security to many spouses because the assets are perceived as "ours" rather than "mine" or "yours." During the spouses' joint lifetime, each spouse generally has access to the principal and income from the joint spousal property. If owned by the spouses as joint tenants with rights of survivorship (JTWRS) or as tenants by the entirety (TBE), the asset will generally avoid probate upon the first spouse's death and pass automatically by operation of law to the surviving spousal owner; thereby postponing probate of the property until the surviving spouse's death. In addition, the TBE character available only for spousal joint ownership confers additional asset protection benefits in that the property generally cannot be used to satisfy any judgment obtained by the creditors of an individual spouse.[7] With the advent and permanence of the portability election for Federal estate and gift tax purposes,[8] it is also possible to transfer any unused estate and gift tax exemption from the deceased spouse to the surviving spouse, thereby ensuring full utilization of the deceased spouse's estate and gift tax exemption without the necessity of funding or disclaiming assets into a so-called "bypass trust" or "credit shelter trust" (CST) at the first spouse's death.[9] Joint spousal ownership also allows for a full basis adjustment for income tax purposes in the assets at the surviving

spouse's death.[10] Conversely, assets used to fund a CST are not eligible for a basis adjustment at the surviving spouse's death because the assets are generally not includible in the surviving spouse's estate for estate tax purposes.[11]

JRTs offer most of the perceived benefits of joint spousal property discussed above, including some additional advantages. Firstly, JRTs generally avoid probate of the couple's assets upon their simultaneous death (or upon the subsequent death of the surviving spouse), whereas if the assets are jointly owned, probate of assets of the estate of the spouse presumed to have survived (or the estate of the surviving spouse upon his or her subsequent death) would generally be required. Secondly, JRTs can provide more specific terms and direction as to the desired management and distribution of the couple's assets in the event of their incapacity. Thirdly, the TBE character of joint spousal property contributed to a JRT can be preserved in many states, including Virginia and Maryland, at least during the couple's joint lifetime.[12] Finally, as with joint spousal property, the Federal portability election would generally be available to transfer any unused estate and gift tax exemption amount from the deceased spouse to the surviving spouse. In the alternative, a qualified disclaimer of the portion of the JRT assets otherwise passing to the surviving spouse could be made to fund a CST at the first spouse's death; however, because of the potential for commingling the surviving spouse's share of the JRT with the deceased spouse's share, the surviving spouse may be more likely to inadvertently accept benefits from the property to be disclaimed which could prevent a qualified disclaimer.[13]

Basic Design of JRTs for Non-Community Property

The basic design alternatives of a JRT for non-community property are as follows:

1. JRT with Separate Shares. Separate shares for the couple's joint spousal property and separately-owned property contributed by each respective spouse are created upon contribution of assets to the JRT, and maintained during the couple's joint lifetime. Both spouses are co-trustees.
   a. During the spouses' joint lifetime, they are each entitled to distributions of income and principal from their share of the trust assets (i.e., 50% of joint spousal property and 100% of separately-owned property contributed by each respective spouse) and either spouse has the unilateral right to revoke the JRT and receive outright distribution of such spouse's share of the trust assets.
   b. At the death of the first spouse to die, the deceased spouse's share of the JRT becomes irrevocable. The deceased spouse's share of separate property and the deceased spouse's one-half share of joint spousal property contributed to the trust is directed to the surviving spouse's share of the JRT ("Survivor's Share") or to a Marital Trust (typically designed as a Qualified Terminable Interest Property or "QTIP" Marital Trust). In the alternative, assets of the deceased spouse's share of the JRT are directed (or disclaimed by the surviving spouse) to a CST for the benefit of the surviving spouse and children, up to the deceased spouse's unused exemption amount, with any remaining assets directed to the Survivor's Share or to a QTIP Marital Trust.
   c. *Example 1*: Husband (H) and Wife (W) contribute $4 million of joint spousal property to the JRT, which is directed to Share A of the JRT (Joint Spousal Share). In addition, H contributes $4 million of separately-owned property, which is directed to Share B (H's Separate Property Share). W contributes $2 million of separately-owned property to the JRT, which is directed to Share C (W's Separate Property Share). At H's death, his one-half share of Share A and all of Share B become irrevocable and are directed to Share C (Survivor's Share). In the alternative, H's portion of Share A and Share B can be directed (or disclaimed by W) to a CST up to H's unused estate tax exemption amount, with any assets in excess of this amount directed to the Survivor's Share or to a QTIP Marital Trust.
2. "Estate Equalization" JRT. Regardless of the respective ownership and value of assets contributed by either spouse to the JRT, each spouse is

presumed to own a fractional percentage (typically 50%) of the trust assets as tenants in common. Separate shares are not created or maintained. Both spouses are co-trustees.

a. During the spouses' joint lifetime, they are each entitled to equal distributions of income and principal from the trust assets and either spouse has the unilateral right to revoke the trust and receive outright distribution of such spouse's one-half (or other fractional percentage) share of the trust assets.

b. At the death of the first spouse to die, the deceased spouse's one-half (or other fractional percentage) share of the JRT becomes irrevocable, and is directed to the Survivor's Share or to a QTIP Marital Trust. In the alternative, the deceased spouse's one-half (or other fractional percentage) share of the JRT is directed (or disclaimed by the surviving spouse) to a CST for the benefit of the surviving spouse and children, up to the deceased spouse's unused exemption amount, with any remaining assets directed to the Survivor's Share or to a QTIP Marital Trust.

c. _Example 2_: Husband (H) and Wife (W) contribute $4 million of joint spousal property to the JRT. In addition, H contributes $4 million of separately-owned property and W contributes $2 million of separately-owned property to the JRT. The terms of the JRT provide that, upon contribution of assets to the trust and at all times thereafter, each spouse is deemed to own an undivided 50% of the trust assets ($10 million x 50% = $5 million) as tenants in common. Separate shares are not created or maintained. At H's death, his one-half share of the JRT becomes irrevocable and is directed to the Survivor's Share. In the alternative, H's 50% share can be directed (or disclaimed by W) to a CST up to H's unused estate tax exemption amount, with any assets in excess of this amount directed to the Survivor's Share or to a QTIP Marital Trust.

3. _General Power of Appointment "Add-on" for Separate Share or Estate Equalization JRT._ As an "add-on" feature to either the Separate Share JRT or Estate Equalization JRT discussed above, the first spouse to die is given a testamentary (or lifetime) general power of appointment (i.e., exercisable in favor of the decedent, the decedent's estate, the decedent's creditors, or creditors of the decedent's estate) over 100% of the trust assets, which shall be exercisable alone and in all events. In default of exercise of this power, the assets subject to the power of appointment are directed to the Survivor's Share or directed to a CST up to the deceased spouse's unused exemption amount with any excess to the Survivor's Share or to a QTIP Marital Trust.

a. As a result of the general power of appointment granted to the first spouse to die, 100% of the JRT assets (including any portion of the trust assets contributed by the surviving spouse) are includible in the deceased spouse's estate under Code Section 2041, and available to fund the CST up to the deceased spouse's unused estate tax exemption. The goal of this technique is to achieve maximum funding of the CST and utilization of the deceased spouse's exemption amount.[14] Although Private Letter Rulings (individually, a "PLR") are not binding and cannot be cited as precedent, the Internal Revenue Service (IRS) has ruled favorably that: (i) the assets subject to the general power of appointment granted to the first spouse to die would be includible in the deceased spouse's estate; (ii) the surviving spouse would make a completed gift to the deceased spouse at the deceased spouse's death of the surviving spouse's share of the trust assets subject to the general power of appointment and this gift would generally qualify for the unlimited marital deduction; and (iii) any portion of the surviving spouse's assets used to fund the CST would not be includible in the surviving spouse's estate because the surviving spouse would not be considered the "transferor."[15]

b. In addition, some practitioners believe that the general power of appointment technique discussed above would allow for a 100% basis adjustment in the trust assets at the first

spouse's death,[16] although the IRS has ruled otherwise based on the exception in Code Section 1014(e).[17]

c. Several potential issues with the general power of appointment add-on technique were not raised or discussed by the IRS rulings, including whether the first spouse to die would be considered to have a valid general power of appointment over the surviving spouse's share of the trust assets if it is effectively contingent on the surviving spouse not exercising the surviving spouse's power to withdraw those assets from the trust. In such case, the power would only be exercisable in conjunction with the creator of the power and would be deemed not to be a general power of appointment under Code Section 2041(b)(1)(C)(i). As a result, the surviving spouse would remain the "transferor" with regard to the surviving spouse's share of the JRT assets used to fund the CST, and this portion of the CST would be includible in the surviving spouse's estate under Code Sections 2036 and 2038.[18] In addition, the IRS could argue that the assets of the CST are includible in the surviving spouse's estate under the step-transaction doctrine,[19] and potentially change its position that the gift of the surviving spouse's share of trust assets to the deceased spouse upon the deceased spouse's death qualifies for the unlimited marital deduction. Thus, the technique is not without risks and may not be suitable for every client situation.[20]

d. An alternative technique that potentially achieves a 100% basis adjustment in the JRT assets at the first spouse's death is a Joint Community Property Trust.[21] Both Alaska and Tennessee have enacted laws which allow nonresidents to create joint community trusts to potentially convert separate property into community property so that the surviving spouse's one-half share of the JRT would be eligible for a basis adjustment at the deceased spouse's death under Code Section 1014(b)(6).[22] In order to qualify under the statute, at least one trustee must be a resident of the applicable state. It is unclear whether the IRS would recognize such a conversion for income or transfer tax purposes.[23]

Basic Questions for JRTs

When analyzing the tax and legal effects and implications of a JRT, there are four basic questions that should be addressed:

1. What portion of the JRT does each spouse own during the spouses' joint lifetime?
2. What portion of the JRT is includible in the estate of the first spouse to die for estate tax purposes, as well as for income tax purposes in determining what portion of the trust is eligible for a basis adjustment?
3. What portion of the JRT remains revocable after the first spouse's death?
4. What portion of the JRT is includible in the estate of the surviving spouse?

Avoiding Taxable Gift upon Funding a JRT

Another threshold and somewhat esoteric question that is often raised about JRTs, but can be easily avoided with proper drafting, is whether any taxable gift is made between the spouses upon funding the JRT, particularly if the spouses contribute unequal amounts of separately-owned property to: (i) an Estate Equalization JRT; or (ii) a Separate Share JRT where separate shares are not properly maintained and the spouses retain only a joint power of revocation.

> _Example 3:_ Same facts as *Example 2* above (Estate Equalization JRT). During the spouses' joint lifetime, they are each entitled to equal distributions of income and principal from the trust assets and either spouse has the unilateral right to revoke the trust and receive outright distribution of such spouse's one-half (or other fractional percentage) share of the trust assets. H's share of joint spousal property [$4 million/2 = $2 million] *plus* separately-owned property contributed by H [$4 million] *less* H's retained 50% interest in the trust [$10 million/2 = $5 million] results in a completed gift of $1 million to W because H has given up dominion and control over

this portion of the trust assets.[24] Because W has the unilateral power to revoke over this amount, the gift would qualify for the unlimited marital gift tax deduction.[25]

If only a joint revocation power were retained by H and W in this Example, the gift would still be considered complete because the power to revoke is only exercisable in conjunction with a person having a substantial adverse interest in the disposition of the transferred property (i.e., W as co-beneficiary of the JRT).[26] The gift, however, would not qualify for the unlimited marital deduction because there is a possibility that H (the donor spouse) may possess or enjoy this portion of the JRT after W's (the donee spouse) death; therefore, the gift would generally be considered a nondeductible terminable interest.[27]

In the case of a Separate Share JRT, in order to avoid any completed gift upon the contribution of unequal amounts of separately owned property, each spouse should retain the unilateral right to revoke such spouse's share of joint spousal property and any separately owned property contributed by the respective spouse.[28] Nevertheless, if separate shares are not properly maintained, it may be difficult to identify which portion of the trust property is subject to the unilateral right of revocation in order to validly exercise the power.

Marital Law Considerations with JRTs

When separate property owned by an individual spouse is retitled into the couple's joint names—or contributed to a Separate Share JRT and separate shares are not properly maintained, or contributed to an Estate Equalization JRT where each spouse is deemed to own 50% of the trust assets regardless of the proportionate value of assets contributed—there is generally a presumption in most states that the property has been gifted to the marital estate.[29] In order to rebut this presumption and demonstrate the couple's intent to avoid any marital gift or transmutation upon funding a JRT, a separate written agreement should be executed by the parties to affirm that assets currently held or after-acquired as non-marital property shall remain non-marital property (and any marital property owned or acquired during the marriage shall remain marital property), and that any retitling of such property is being done for estate planning purposes only.[30]

Additional Pitfalls with Separate Share JRTs

A JRT may not be appropriate for every client, particularly couples who own significant amounts of separately owned property. With a Separate Share JRT, it may be difficult to determine the portion of trust assets owned by each spouse and which portion of the trust assets is includible in the estate of the first spouse to die if separate shares are not properly maintained and are commingled. This can often require the "tracing" of each spouse's contributions to the JRT, which can result in additional complications in administering the JRT, particularly in the event of the couple's subsequent divorce or at the first spouse's death if the couple remains married. Even if estate tax is not a concern for the couple, being able to sufficiently determine the deceased spouse's share of the JRT is critical in order to establish which portion of the trust assets is eligible for a basis adjustment at the first spouse's death under Code Section 1014(a).

Sometimes it can also be unclear which portion of the JRT remains revocable after the first spouse's death, which could inadvertently result in a completed gift by the surviving spouse of the surviving spouse's share of trust assets to the remainder beneficiaries if the surviving spouse is deemed to have relinquished such right to revoke the surviving spouse's share of the JRT. Moreover, if a CST is intended to be funded at the first spouse's death and the deceased spouse's share of the JRT cannot be properly ascertained due to the commingling of the separate shares, there is a risk that a portion of the surviving spouse's share of the trust assets would be used to fund the CST. If the surviving spouse is a beneficiary of the CST, this could result in inclusion of the CST assets in the surviving spouse's estate under Code Section 2036(a)(1). Thus, for couples who desire to maintain the separate property character of their assets, a separate revocable trust for each spouse is highly recommended rather than a JRT. Regardless, after the first spouse's death, it is often easier and prudent for the surviving spouse to transfer the surviving spouse's share of the JRT assets (if ascertainable) to a newly-created revocable trust for the benefit of the surviving spouse, so that

the terms of the surviving spouse's estate plan can be more efficiently updated and amended as needed in a separate document.

Estate Equalization JRTs – Other Traps to Avoid

Estate Equalization JRTs alleviate the question of ascertaining the portion of trust assets owned by each spouse and which portion of the trust assets is includible in the estate of the first spouse to die because each spouse is an equal owner of an undivided portion (or some other defined fractional amount) of the trust assets.[31] In order to preserve this pro-rata ownership, the trust terms should require that during the joint lives of the grantors, distributions should be made equally to each spouse (or proportionate to each spouse's fractional interest in the JRT).[32] Furthermore, if the JRT is revoked, the trust terms should direct that the trust assets be similarly distributed to each spouse. As discussed above, the trust terms should expressly provide that the surviving spouse retains the right to revoke the Survivor's Share of the JRT upon the deceased spouse's death and that the deceased spouse's share becomes irrevocable. Because typically only the deceased spouse's share of JRT assets would be includible in the deceased spouse's estate (unless the general power of appointment add-on technique is utilized, as discussed above), this may not result in maximum funding of the CST up to the deceased spouse's unused exemption amount; however, the portability election could be made to transfer any unused exemption to the surviving spouse. As with a Separate Share JRT, the surviving spouse may wish to consider transferring the Survivor's Share of the trust assets to a newly-created revocable trust in order to more efficiently implement and update the surviving spouse's estate plan after the deceased spouse's death.

Conclusion

With the increase in the Federal estate, gift, and GST exemptions, and the advent of portability of the Federal estate and gift tax exemptions between spouses, a JRT may be an appropriate estate planning tool for some married clients, particularly couples who prefer to own all or most of their assets as joint spousal property. Careful consideration should be utilized in drafting, funding, and administering a JRT in order to avoid unintended income and transfer tax consequences and complexities, as well as potential marital law issues in the case of the couple's subsequent divorce. ⚜

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(Endnotes)

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2. Melinda S. Merk, *Joint Revocable Trusts for Married Couples Domiciled in Common-Law Property States*, 32 REAL PROP. PROB. & TR. J. 345 (1997); Lauren A. Jenkins & Melinda Merk, You Give Trusts a Bad Name: Avoiding Pitfalls in Joint Trust Administration, presented at the Virginia CLE 33rd Annual Trusts and Estates Conference (Fall 2014), from which this article is partly adapted; Melinda Merk & Brian Tsu, Income and Wealth Transfer Tax Aspects of Joint Trusts in Community Property and Common Law Jurisdictions, presented at the ABA Tax Section Fiduciary Income Tax Committee Midyear Meeting (2014); Melinda Merk, Jeannette Roegge & Logan Winn, Joint Revocable Trusts Update, presented at the D.C. Bar Tax Section (2012).

3. The scope of this article is limited to the use of JRTs in non-community property law states for couples who do not own community property (states that apply community property law include Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin). For purposes of this article, it is also assumed that both spouses are U.S. citizens eligible for the unlimited marital gift and estate tax deduction.

4. For an excellent discussion of the various pitfalls of JRTs and how to avoid them, see John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP.

PROB. & TR. J. 275 (2004); Louis S. Harrison and Emily J. Kuo, The Good, the Bad, and the Innovative: The Evolution of Joint Spousal Trusts in Today's Estate Planning, presented before the American College of Trust and Estate Counsel (Oct. 25, 2013) [hereinafter Harrison & Kuo ACTEC]; J. Lee E. Osborne, Joint Trusts, presented at The Douglas W. Conner 35th Annual Advanced Estate Planning and Administration Seminar (May 2014).

5. I.R.C. §§ 2010(c)(3)(A) & (B), and Rev. Proc. 2014-61.

6. I.R.C. §§ 2010(c)(2)(B), 2010(c)(4).

7. *See* Sumy v. Schlossberg, 777 F.2d 921 (4th Cir. 1985) (concluding TBE property is protected from judgment creditor under Maryland law, unless both tenants are liable on the debt); Ragsdale v. Genesco, Inc., 674 F.2d 277 (4th Cir. 1982) (holding same under Virginia law).

8. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 and the American Taxpayer Relief Act of 2012 created and made portability permanent. The portability election must be made on a timely-filed estate tax return for the deceased spouse, regardless of whether the estate of the deceased spouse is otherwise required to file an estate tax return. The portability election is not available for non-resident alien decedents, and is not available for GST tax purposes. Generally, portability is not available for state estate tax purposes, although in 2014, Maryland enacted legislation allowing portability of the Maryland estate tax exemption between married couples starting in 2019. *See* MD. CODE ANN., TAX—GEN. § 7-309. Once the election is made, it is generally irrevocable, and extends the statute of limitations for the deceased spouse's estate tax return for purposes of determining the deceased spouse's unused exemption amount available to the surviving spouse.

9. Because assets owned as JTWRS or TBE pass automatically by operation of law to the surviving spouse at the first spouse's death, these assets are generally not available to fund the CST, unless a qualified disclaimer is made in writing with regard to the deceased spouse's interest in the property otherwise passing to the surviving spouse within nine (9) months of the deceased spouse's death. I.R.C. § 2518.

10. In non-community property states, 50% of any joint spousal property is generally eligible for a basis adjustment at the first spouse's death under Code Section 2040(b). A 100% basis adjustment may be available at the first spouse's death for joint spousal property acquired prior to 1977, under the contribution test of the so-called *Gallenstein* rule. Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).

11. Various tax and non-tax benefits can still be obtained by allowing for the flexibility and funding of a CST at the first spouse's death, including ensuring full utilization of the GST and any applicable state estate tax exemption (for which the portability election is generally not available), exclusion of future appreciation of assets in the surviving spouse's estate, and management and preservation of the assets in trust during the surviving spouse's lifetime and after the surviving spouse's death, particularly in the case of children from a prior marriage or if spendthrift concerns exist.

12. *See* MD. CODE ANN., EST. & TRUSTS § 14-113 and VA. CODE § 55-20.2; *see also* Robert K. Kirkland, *Tenancy by the Entirety States and Qualified Spousal Trusts*, Jan. 28, 2014, *available at* http://www.actec.org/public/Documents/Studies/Kirkland-Tenancy-by-the-Entirety-States-and-Qualified-Spousal-Trusts-1-28-2014.pdf.

13. *See* I.R.C. § 2518(b)(3).

14. Maximum utilization of the deceased spouse's estate and gift tax exemption could also be achieved via the portability election in lieu of funding a CST at the first spouse's death; however, as discussed in note 11 *supra*, there are various other advantages to funding a CST vs. portability.

15. *See* I.R.S. Priv. Ltr. Rul. 200210051 (Mar. 8, 2002) (involving joint revocable trusts where the first spouse to die is granted a general power of appointment over the JRT assets); I.R.S. Priv. Ltr. Rul. 200101021 (Jan. 8, 2001); *see also* I.R.S. Priv. Ltr. Rul. 200604028 (Jan. 27, 2006) (involving separate revocable trusts where the first spouse to die is granted a general power of appointment over assets of the other spouse's revocable trust); I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004).

16. *See* Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, EST. PLAN., Oct. 2013, at 3; Alan S. Gassman, Christopher J. Denicolo & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, EST. PLAN., Nov. 2013, at 14 [hereinafter collectively the JEST Articles].

17. In PLR 200101021 and PLR 200210051, the IRS concluded that Code Section 1014(e) would preclude a basis adjustment for the surviving spouse's share of trust assets subject to the deceased spouse's power of appointment and be includible in the deceased spouse's estate because such property: (i) was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death; and (ii) was acquired from the decedent by (or passes from the decedent to) the donor of such property (i.e., surviving spouse), either directly or indirectly, pursuant to the deceased spouse's exercise, or failure to exercise, the general power of appointment. The authors of the JEST Articles believe that the IRS is wrong, and that a basis adjustment should be available, particularly if the surviving spouse is only a discretionary beneficiary or is not a beneficiary of the CST.

18. *See* Michael D. Mulligan, *Is It Safer to Use a Power of Appointment in Predeceasing Spouse to Avoid Wasting Applicable Exclusion Amount?*, 32 EST. GIFTS & TR. J. 191 (2007).

19. *Id.; see also* Mitchell M. Gans, Jonathan G. Blattmachr & Austin Bramwell, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do in the Interim?*, 42 REAL PROP. PROB. & TR. J. 413 (2007).

20. The JEST Articles discuss the potential risks of the general power of appointment add-on technique in detail, and offer various planning tips and savings clauses to purportedly counteract

and safeguard against these arguments.

21. *See* Jonathan G. Blattmachr, Howard M. Zaritsky & Mark L. Ascher, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 REAL PROP. PROB. & TR. J. 615 (1999).

22. *See* ALASKA STAT. §§ 34.77.020–.995; TENN. CODE ANN. §§ 35-17-101 to -108.

23. *See* Comm'r v. Harmon, 323 U.S. 44 (1944) (ruling that statute allowing spouses to elect a community property system under Oklahoma law would not be recognized for federal income tax reporting purposes); Rev. Rul. 77-359, 1977-2 C.B. 24 (Washington couple agreed to convert their separate property to community property, IRS ruled that conversion was effective for federal tax purposes, but added "to the extent that the agreement affects the income from separate property and not the separate property itself, the Service will not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns").

24. Treas. Reg. § 25.2511-2(b). Such a completed gift could be avoided if H were to retain a testamentary power of appointment over this portion or all of the trust assets, as utilized in the "JEST" technique discussed in the JEST Articles.

25. Treas. Reg. § 25.2523(e)-1(f)(6).

26. *See* Treas. Reg. § 25.2511-2(e).

27. I.R.C. § 2523(b). The QTIP election under Code Section 2523(f) would generally not be available because the donee spouse does not have the exclusive right to income from the gifted portion of the JRT, and thus does not have a "qualified income interest for life." *See* I.R.C. §§ 2523(f)(2)(B), 2523(f)(3), 2056(b)(7)(B)(ii).

28. *See* I.R.S. Priv. Ltr. Rul. 200604028 (Jan. 27, 2006) (regarding separate revocable trusts created by each spouse); I.R.S. Priv. Ltr. Rul. 200403094 (Jan. 16, 2004).

29. *See* Harrison & Kuo ACTEC, at 3-5. A similar issue can arise when assets are retitled from one spouse to the other when funding a separate revocable trust for each spouse.

30. *See* Harrison & Kuo ACTEC, at Attachment G (Sample Memorandum of Intent, Marital/Non-Marital Property Agreement).

31. *See supra* note 4, I.R.S. Priv. Ltr. Rul. 201429009 (July 18, 2004). In this PLR, an Estate Equalization JRT was used and the surviving spouse (as trustee) failed to divide the trust assets at the first spouse's death between the Family Trust (with the deceased spouse's one-half share of the trust assets) and the Survivor's Trust (with the surviving spouse's one-half share of the trust assets), as directed by the trust documents; rather, all assets were administered as a combined trust. Upon subsequent advice by estate planning counsel, corrective action was taken to properly allocate assets between the Family Trust and the Survivor's Share. Through a forensic review of the historical financial records, the surviving spouse was able to ascertain and track the assets which should have been allocated to the Family Trust at the deceased spouse's death. Accordingly, the IRS ruled that the value of the assets of the Family Trust was not includible in the surviving spouse's estate.

32. For an excellent sample form and recommended drafting considerations for an Estate Equalization JRT, see Osborne, *supra* note 4. ⚜

Pooled Special Needs Trusts: A Valuable, Cost-Effective Tool When Planning for Individuals with Special Needs

By Joanne Marcus, MSW

Estate planning attorneys often utilize inter vivos or testamentary special needs trusts (SNTs) when helping clients establish a plan to provide an inheritance for their loved one with a disability. Along with making decisions on what assets, income, and other resources to bequeath, determining who will oversee the trust is also an important consideration. Some families select a family member, such as a sibling or other relative, to serve as trustee; however, in many instances, a professional trustee may be better suited given the complexities that often arise when administering a SNT, particularly for a beneficiary who receives Supplemental Security Income (SSI) and Medicaid benefits. Finding a professional trustee that is proficient in administering this type of trust, has the specialized skills in working with individuals who have a disability, and is able to provide these services cost-effectively can be challenging. Thankfully, nonprofit organizations that administer *pooled special needs trusts* exist to address these concerns.

Pooled special needs trusts are administered by a nonprofit organization, governed by a volunteer board of directors. Most pooled trust organizations administer both third-party (family-funded) and self-funded (self-settled) SNTs. Responsibilities taken on by pooled trust organizations include managing disbursements from the trust, investing trust funds, fulfilling reporting requests to government agencies, and staying abreast of changing regulations for SSI and Medicaid. (*Note:* As of 2015, an individual can have no more than $2,000 in countable assets in order to qualify for Medicaid and SSI;[1] however, funds placed in a SNT are not counted as income, so the individual can qualify for or maintain eligibility for these government means-tested benefits.)[2]

R. Shawn Majette, Esq., who directs the elder law section for ThompsonMcMullan, P.C., and is a member of the Virginia Bar Association and National Academy of Elder Law Attorneys, noted that, "I have often referred clients and worked with lawyers interested in creating [pooled trust] accounts, especially in modest cases involving personal injury recoveries and unexpected inheritances."[3]

Pooled trust organizations typically partner with a financial services firm or bank, or contract with individual financial professionals, for investment management services. Funds from each trust are pooled together to increase the principal for investment purposes and reduce administrative fees. All earnings based on a beneficiary's share of the principal are reinvested into each beneficiary's individual sub-account. Because the funds are invested together, most pooled trusts accept cash assets only. Each sub-account is maintained separately, and financial statements or internet access should be made available to approved individuals.

For pooled trusts, enrollment costs, administration fees, and funding requirements are typically lower than other professional trustee alternatives. For example, administration fees for a pooled trust can be one percent or slightly lower on an annual basis. Additionally, pooled trusts often have lower funding requirements. Financial institutions, such as a bank or investment firm, may require a minimum of $350,000 to $750,000 to fund a stand-alone SNT. A beneficiary can establish a pooled SNT with as little as $5,000. Pooled trust organizations have the expertise to provide trust services for both small and large accounts. Because fees and funding requirements will vary, it is important to ask pooled trust organizations about their enrollment costs, ongoing administrative fees, and funding requirements.

The remainder policy that applies when the beneficiary passes away varies among pooled trust organizations. The organization may retain all of the funds, retain a percentage of the funds, or disburse the remainder to whomever is named in the joinder agreement. It is important to note that for a beneficiary with a self-funded SNT who received Medicaid, state Medicaid payback rules also need to be taken into consideration

when determining how the remainder is handled. These payback rules vary from state to state and only apply to self-funded SNTs.

Regardless of the type of pooled trust, each grantor joins the Master Trust Agreement by completing a joinder agreement. The Master Trust Agreement allows the trustee to administer the trusts under the umbrella of the "master." Both the third-party SNT and self-funded SNT Master Trust Agreements should be drafted by attorneys with expertise in this area of the law and notarized by the board of directors of the nonprofit organization.

The grantor(s) name(s) advocates in the joinder agreement who will work closely with the pooled trust organization to submit disbursement requests for the benefit of the beneficiary and provide information about the beneficiary's needs. An advocate is generally a relative, guardian, conservator, case worker, agent under a power of attorney, or the beneficiary. Hence, siblings, for example, can still play an important role by collaborating with the pooled trust organization on behalf of their loved one who has a disability.

When naming a professional to serve as trustee is in the best interest of an individual with a disability, pooled SNTs can provide affordable, comprehensive trust services with expertise in working with individuals with a disability along with their advocates and other representatives. ✤

Joanne Marcus, MSW*, is the Executive Director of Commonwealth Community Trust (CCT), a national nonprofit organization that has provided effective, affordable administration of pooled special needs trusts since 1990. CCT trust services are available throughout the United States and CCT has served over 1,100 clients since inception. To learn more, call (804)740-6930 / toll-free (888)241-6039 or visit the CCT website (www.trustCCT.org) to access all documents including the Joinder Agreements, fee schedules, FAQs, attorney checklists and Master Trust Agreements.*

(Endnotes)

1. *See*, Social Security Administration, *Understanding Supplemental Security Income SSI Resources -- 2015 Edition*, online version (http://www.socialsecurity.gov/ssi/text-resources-ussi.htm) accessed on May 28, 2015, and Virginia Department of Social Servises, *Medicaid Fact Sheet #15 – Aged, Blind or Disabled Individuals with Income Less Than or Equal To 80% of the Federal Poverty Level (Form Number D032-03-0631-87-13-eng)*, online version (http://www.dss.virginia.gov/files/division/bp/medical_assistance/intro_page/covered_groups/adults_aged_65/D032-03-0631-13-eng.pdf) accesssed on May 28, 2015.

2. *See*, Social Security Administration, *Spotlight on Trusts -- 2015 Edition*, online version (http://www.socialsecurity.gov/ssi/spotlights/spot-trusts.htm) accessed on May 28, 2015, and Virginia Department of Social Services, *Medicaid Eligibility Manual, Volume XIII, Subchapter S1120.200 (Property That May or May Not Be a Resource, M1120.200 Trust Property)* at 12-22.

3. E-mail from R. Shawn Majette, Esq., Director, ThompsonMcMullan, P.C., to Joanne Marcus, Executive Director, Commonwealth Community Trust (May 1, 2015, 7:13PM EDT) (on file with author). ✤

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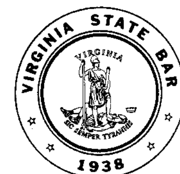

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