THE REPORTER

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HOW ABOUT CONSUMER ORIENTED LOAN SERVICING?

Foreclosures are reaching record levels across the country. However, the problem does not entirely rest on the shoulders of the consumer, as there is plenty of blame to go around. There are so many players involved in the lending industry, the average home-owner is at the mercy of a machine. In the last issue of *THE REPORTER*, I touched on the role of the appraiser.

Section President

Frederick B. Farmer
Lowe Farmer Bacon and Roe, Olathe

There are also "predatory lenders," who mislead borrowers into undertaking a loan that they can't reasonably afford. Such lending practices set people up to enter into loans, having rates and fees so high that the borrowers will almost certainly miss payments, leading to foreclosure. Borrowers, unable to meet traditional underwriting requirements, become a profitable source of business at higher prices than those paid by prime borrowers.

Not receiving nearly the publicity are the covert acts of the loan servicing industry. While the consumer can shop for mortgage rates, terms, etc., he has no choice as to a loan servicer; the servicer is chosen by the investor who owns loans, and the servicer may be changed several times during the life of the loan. The consumer can't take his business elsewhere when he is mistreated, except to refinance and that can be an expensive proposition, and then he's gambling the new servicer will be better. What are the odds on that bet?

Loan servicing may be worse than predatory lending as it does not discriminate in its application and affects prime, subprime, and no prime loans; every loan is fair game. We all have had the experience that what shows on the computer screen is the ultimate authority. It is seemingly impossible to fix even the most minor servicing issue without going all the way to the top, and then it may not be the "done deal" as represented. The computer screen rules. The servicer takes unfair advantage of the borrower who has little opportunity or resources to fight back.

While numerous legislative and regulatory actions have been taken at the federal and state levels to curb predatory lending, loan servicing has been relatively immune.

Recently, Fairbanks Capital Corp. reached a $40 million settlement with the Federal Trade Commission (FTC). Fairbanks charged homeowners for overpriced insurance, even though the homeowner already had insurance, assessed hefty prepayment penalties contrary to loan documents, provided confusing account settlements, did not pay taxes on time or in the correct amount, gave inaccurate information to credit bureaus, charged late penalties on payments that were received on time, etc. Families paid under the threat of foreclosure; those that couldn't lost their homes in foreclosure. It earned the title "predatory mortgage servicer."

Such actions by the FTC are useful, but won't stop predatory servicing because there is much money to be made. Predatory servicing won't go away until the servicers start losing customers.

Wouldn't it be a good idea to empower borrowers with the option to select the servicer of their loans? To win the favor of the opt-outs, servicers would be obligated to compete. To compete they would have to offer service with efficient and courteous support people, short waits, easy-to-read statements, etc. The market would then work for the borrower rather than the lender. ■

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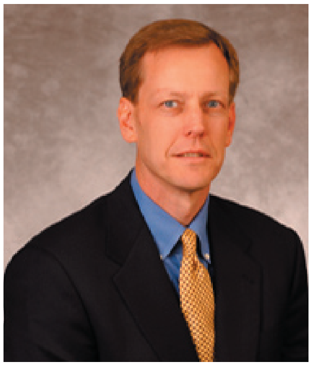
Author



Dan C. Peare, Wichita, is an attorney with Hinkle Elkouri Law Firm LLC.

He received his J.D. from the University of Kansas School of Law and his MBA and BBA in finance from Wichita State University (WSU).

He is a member of the KBA Executive Committee of the REPT Section and serves as the committee's liaison to the KBA Continuing Legal Education Committee. He is a member and past director of the Wichita Estate Planning Council and the Wichita Estate Planning Forum. He is on the WSU Foundation Board of Directors, where he serves as chairman of the Foundation's Giving Committee, and is a member of the National Advisory Council for WSU. Peare is also a member and past chairman of WSU Foundaion's Planned Giving Professional Advisory Committee.

He provides a regular report on selected estate planning topics for the segment "Eye on Your Money," for KWCH-TV Channel 12, Wichita. Peare can be reached via e-mail at dpeare@hinklaw.com.

Estate Tax Notes

TAX CASES AND RULINGS AFFECTING THE ESTATE AND BUSINESS SUCCESSION PLANNER

Estate Inclusion

1. **Grantor's Retention of Power to Substitute Assets will not Cause Inclusion of Trust Assets in Gross Estate**

The grantor created an irrevocable trust, which was funded with cash and marketable securities. The trustee is not a descendant of the grantor and is not otherwise related or subordinate to the grantor. During the grantor's lifetime, the trustee may distribute income and principal of the trust to the grantor's spouse and issue. Upon the grantor's death, the trust assets are to be distributed to the grantor's issue, per stirpes. Under the terms of the trust, the grantor may acquire any or all trust property by substitution of other property of equivalent value to the property acquired, measured at the time of substitution. The grantor's power to reacquire trust property may only be exercised in a fiduciary capacity, meaning that it must be undertaken in good faith, in the best interests of the trust and its beneficiaries, and subject to fiduciary standards imposed under state law. The grantor proposes to exercise his power of substitution by transferring shares of a publicly traded company to the trust in exchange for shares of a different publicly traded company. To the extent necessary, the grantor will either transfer to the trust or withdraw from the trust cash or cash equivalents in an amount necessary to equalize the transfer.

The IRS held that retention by the grantor of the power of substitution would not cause the trust property to be included in his gross estate under Code Sections 2033, 2036(a), 2038, or 2039. Additionally, the proposed transfer would not constitute a gift to the trust by the grantor for federal gift tax purposes. Finally, the IRS held that the trust would be treated as a grantor trust in its entirety with respect to the grantor under Code Section 677. Accordingly, all items of income, deductions, and credits against tax of the trust will be included in computing the grantor's taxable income and credits. Further, the proposed transfer of assets will be disregarded for federal income tax purposes, so neither the grantor nor the trust will recognize any income or loss under Code Sections 61 or 1001 by reason of the proposed transaction. P.L.R. 200603040.

2. **Substance Over Form Argument Rejected; Property Included in Decedent's Gross Estate**

The decedent, Maniglia, died in 1999, survived by one of her two sons. In May 1977, an apartment building (the property) was conveyed to Maniglia and one son (Frank), as joint tenants. The property was paid for with a $100,000 bank loan, a $75,000 loan from the seller, and $25,000 cash. In June 1977, Frank conveyed his undivided one-half interest in the property to Maniglia for nominal consideration. In August 1977, the decedent created a trust, under which she was the grantor and sole beneficiary, and conveyed the property to it. The trust named Maniglia's son, Joseph, as trustee.

In December 1985, Maniglia refinanced the property with a $350,000 bank loan. Immediately prior to recording the mortgage, Joseph, as trustee, conveyed the property to Maniglia. Immediately after recording the mortgage, Maniglia reconveyed the property to Joseph, as trustee. Mortgage interest on the refinanced loan was reported to Maniglia. The real estate tax bills for the property were issued to the trust, and the property was insured in the name of the trust. From 1978 through 1999, federal partnership returns were filed in the name of the trust, and from 1996 through 1999, state partnership returns were filed in the name of the trust. For taxable years 1996 through 1999, the partnership filed Schedules K-1, indicating that Maniglia and Joseph each owned a 50 percent interest in the partnership, and Maniglia and Joseph each reported the amounts on their individual federal income tax returns. No written partnership agreement existed, and no formal records of the partners' capital accounts or formal financial statements existed. Maniglia's federal estate tax return reported that she owned a 50 percent interest in the trust and reported only 50 percent of the property's date of death value. The IRS contended that Maniglia was the sole beneficiary of the trust, so the entire value of the property was includible in her gross estate.

The court held that the estate did not produce sufficient credible evidence to show that the ownership of the property was different from the form set forth in all the relevant documents and, therefore, did not prove that the substance of the transaction was different from its form. The court stated that the filing of partnership returns in the name of the trust for taxable

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years 1978 through 1999 was not sufficient proof that a partnership owned an interest in the property. There was no written partnership agreement, no balance sheets showing the partnership assets, and no formal financial statements indicating the property was owned by a partnership. To the contrary, the trust document, deeds, and other documents indicated that the trust owned the property, that Maniglia was the sole beneficiary of the trust, and that Joseph was the trustee of the trust. Therefore, the court held that the property was not owned by a partnership, but was held by the trust. Accordingly, the IRS properly included the entire value of the property in Maniglia's gross estate. *Estate of Maniglia v. Comm.*, T.C. Memo 2005-247.

3. Assets Held in Decedent's Personal Account But Attributable to Qualified Terminable Interest Property (QTIP) Trust Includible in Decedent's Gross Estate

The decedent survived his wife. Under the wife's revocable trust, her assets were to be divided into two shares at her death, the marital trust and the residual trust. The marital trust was to be funded with a fractional share of the wife's trust that would provide the maximum marital deduction for federal estate tax purposes to the wife's estate. The balance of the assets were to pass to the residual trust. Under the terms of the marital trust, the decedent was to receive all net income at least quarterly. The trustee was authorized to distribute the principal to the decedent in order to provide for his care and support in the style and manner of living to which he had been accustomed or for his medical or other emergency needs. The trustee was also authorized to distribute the principal to the decedent in amounts not in excess of annual exclusion gifts he may have made to the wife's issue. Upon the decedent's death, assets remaining in the marital trust were to become a part of the residual trust.

On the wife's federal estate tax return, QTIP treatment was elected under Code Section 2056(b)(7) for property passing to the marital trust, and an estate tax marital deduction was claimed for the date of death value of the marital trust. Subsequent to the wife's death, the decedent, as trustee of the marital trust, signed letters authorizing the transfer of all assets held in the marital trust to a separate account titled in his name individually. The decedent additionally issued personal notes payable to the marital trust, which were marked "canceled" two days later. The marital trust assets continued to be held in the decedent's individual account until his death.

Upon audit of the decedent's estate tax return, the value of the separate account the decedent created following his wife's death and included in the decedent's gross estate was increased, and the value of a promissory note that had been discounted was increased. The decedent's estate filed a claim for refund and a request for abatement, arguing that the property withdrawn from the marital trust by the decedent and put into the individually titled account and the promissory note were not includible in the decedent's gross estate under Code Section 2044. The estate contended that the decedent was properly treated as having disposed of his qualifying income interest for life in the property when he withdrew the assets and transferred them to his personal account and endorsed the promissory note to himself. The estate argued that the decedent's transfer of assets to his personal account was not authorized under the wife's trust and constituted a breach of the decedent's fiduciary duty. Therefore, the estate argued a constructive trust was imposed on the assets. Under constructive trust principles, because the decedent commingled his assets with the assets of the marital trust, it became impossible to determine which assets were attributable to the marital trust. Thus, the decedent's interest in the marital trust assets terminated and a disposition under Code Section 2519 occurred.

The IRS rejected the estate's argument and held that the value of the promissory note and assets held in the decedent's personal account that were attributable to assets withdrawn from the marital trust were includible in the decedent's gross estate under Code Section 2044. After the withdrawal from the marital trust, the decedent was in possession of, and retained an income interest in, the entire property that would otherwise be the subject matter of a gift. Although the property was in a different form, the decedent still possessed the qualifying income interest for life in the property that was initially subject to the QTIP election. Therefore, the transaction did not constitute a disposition that would trigger a gift, and the assets were includible in the decedent's gross estate under Code Section 2044. T.A.M. 200602033.

4. Enactment of State Statute Eliminates Wife's General Power of Appointment; Assets not Includible in Wife's Gross Estate

The decedent was survived by his wife and three children. Under the decedent's will, a trust was created, whereby the trustee was authorized to distribute trust income to the wife and children, and issue of the children, as determined in the sole discretion of the trustee. There was no power to distribute trust principal during the lifetime of the wife. Upon the wife's death, the trust provided for distributions to the decedent's issue. The decedent's father, brother, and wife were designated as initial co-trustees of the trust. At the time of the ruling request, the wife and her sister were the co-trustees. State law provided that unless the terms of a trust referred specifically to the statute and provided to the contrary, a trustee was prohibited from making discretionary distributions of principal or income for the benefit of the trustee, except to provide for the health, education, maintenance, or support of the trustee. The statute also prohibited a trustee from making discretionary distributions of principal or income to satisfy any legal or support obligations of the trustee. The statute applied to all irrevocable trusts existing on July 7, 1995. The decedent's trust was irrevocable on Sept. 25, 1985.

The IRS recognized that prior to the effective date of the statute, the wife's unlimited power to distribute income to herself as a trustee-beneficiary constituted a general power of appointment over the trust income under Code Sections 2041(b)(1)(A) and 2514(c)(1). However, consistent with Rev. Proc. 94-44, enactment of the statute would not be treated as causing a lapse of the wife's general power of appointment over trust income for transfer tax purposes. In the present case, the statute would be treated as effective with respect to the decedent's trust on the effective date of the statute. Therefore, as of the effective date, the wife would not have the power to appoint trust income for her own benefit, except as needed for her health, education, maintenance, and support. Because her power to distribute trust income to herself was limited to an ascertainable standard, she would

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Section Officers

President
Frederick B. Farmer
ffarmer@lfbrlaw.com
(913) 782-0422

President-elect & Legislative Liaison
Robert M. Hughes
rmhughes@beverdye.com
(316) 263-8294

Secretary/Treasurer
Vernon L. Jarboe
vjarboe@sloanlawfirm.com
(785) 357-6311

CLE Liaison
Dan C. Peare
dpeare@hinklaw.com
(316) 267-2000

Section Editor
Calvin J. Karlin
ckarlin@barberemerson.com
(785) 843-6600

Past President
D. Michael Dwyer
mdwyer@kansaslaw.net
(913) 383-3131

KBA Staff
Tonya Foster-Bell, committees and sections coordinator
tbell@ksbar.org
(785) 234-5696

James W. Clark, legislative counsel
jclark@ksbar.org
(785) 234-5696

Newsletter

To be successful and informative, a section newsletter needs articles or ideas that reflect the needs of its membership. If you would like to contribute to the newsletter, contact Calvin J. Karlin at ckarlin@barberemerson.com.

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not possess a general power of appointment over the trust income for transfer tax purposes. Accordingly, no portion of the trust income would be includible in the wife's gross estate under Code Section 2041(b)(2) upon her death, and distributions of trust income to the trust beneficiaries would not be subject to gift tax under Code Section 2514(c)(1). Further, enactment of the statute would not constitute a modification that would cause the trust to lose its status as a trust exempt from application of the Generation Skipping Transfer tax. P.L.R. 200530020.

Valuation

5. Actuarial Factor for Valuing Gifts Made by Terminally Ill Taxpayer Supplied

The taxpayer owned life estate interests in 20 parcels of real property. He released his life estate interests in all parcels to the owners of the remainder interests. At the time of release, the taxpayer had been medically diagnosed as suffering from metastatic cancer, and his overall health was failing. His medical prognosis was that he was terminally ill, and there was at least a 50 percent probability that he would die within one year of the date he released his life estate interests. The taxpayer died 57 days after the release. The taxpayer's estate sought a ruling to determine the applicable factor to be used in valuing the release of the life estate interests. The IRS recognized that at the time the gifts were made, the taxpayer had been diagnosed as being terminally ill with at least a 50 percent probability of dying within one year. Because the taxpayer was terminally ill within the meaning of Regulation Section 25.7520-3(b)(3) at the time of the gifts, the mortality component prescribed under Code Section 7520 for ordinary life estate interests was inapplicable. Thus, the IRS provided an actuarial factor of 0.03325 to be used in valuing the gifts. P.L.R. 200551013.

6. Restrictive Provision in FLP Agreement Disregarded in Valuing Gifts

The decedent, Smith, made gifts of fractional interests in a family limited partnership (FLP) that he and his children formed in 1997. The sole asset of the FLP was 100 percent of the common stock of an operating company, which had been previously owned by Smith. Upon formation, the FLP had two general partners: Smith, who owned a 2 percent general partner interest, and his son, who owned a 1 percent general partner interest. In addition, Smith owned a 95.15 percent limited partner interest, Smith's son owned a 0.9 percent limited partner interest, and Smith's daughter owned a 0.95 percent limited partner interest. In January 1998, Smith gave each of his children a 6.865 percent limited partner interest, and in December 1998, he gifted an additional 13.37 percent interest to each child. He reported the 1998 gifts at a value of $1,025,392. In 2001, the IRS issued an assessment in which it valued the gifts at more than $1.8 million and assessed additional gift tax of more than $360,000.

The sole issue before the court was the correct valuation of the limited partner interests that Smith gifted in 1998. Smith took the position that the value of the interests were subject to a significant marketability discount due to a provision in the FLP agreement that limited the price and terms upon which the FLP would be required to pay a partner for his or her limited interests in the FLP, if the FLP exercised its right of first refusal. The IRS disregarded the provision in arriving at the fair market value of the gifted interests by application of Code Section 2703(a), which provides that for purposes of calculating gift taxes, the fair market value is determined without regard to (i) any option, agreement, or other right to acquire or use the property at a price less than its fair market value; or (ii) any restriction on the right to sell or use such property. Smith disputed the applicability of Code Section 2703(a), arguing that the provision did not apply to restrictive provisions contained in "entity-creating partnership agreements," but pertained solely to independent buy-sell agreements. Alternatively, Smith argued that the FLP agreement fell within the safe harbor exception found in Code Section 2703(b), which provides that Code Section 2703(a) will not apply to any option, agreement, right, or restriction that meets each of the following requirements: (i) it is a bona fide business arrangement, (ii) it is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (iii) its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

The court first held that regardless of whether Code Section 2703 applied in this situation, the FLP agreement must meet the requirements of the pre-section 2703 law to

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control value for federal estate tax purposes. The court noted that in this case the FLP agreement provides that the general partners are to make all decisions and otherwise act by a majority vote of the total general partnership interests. During all times at issue in this case, Smith owned two-thirds of all general partnership interests and was able to unilaterally make all general partner decisions under the FLP agreement. The FLP agreement further provides that the general partners may not amend or modify the FLP agreement without the prior written consent or approval of the limited partners owning at least one-half of all limited partnership interests. During all times at issue in this case, Smith owned more than one-half of all limited partnership interests, enabling him to unilaterally give the consent required to amend or modify the FLP agreement, including the terms of the restrictive provision at issue in the case. Consequently, the court held that the agreement and the terms of the restrictive provision were not binding on Smith during his lifetime and should be disregarded when determining value for federal gift tax purposes. *Smith v. U.S.*, 96 AFTR 2d 2005-6549, (W.D. Pa.).

7. Use of Annuity Tables to Value Lottery Payments Questioned

At issue in this case was the proper method of valuing the decedent's state lottery winnings for estate tax purposes. At the time of the decedent's death, 10 annual payments of approximately $209,000 each remained payable to the decedent's estate. The IRS argued that the right to receive ongoing lottery payments was properly valued by reference to the annuity tables set forth in the code, yielding a taxable value of approximately $1.6 million. The estate argued that its right to receive future lottery payments was nonassignable, necessarily resulting in a lower value if it was freely transferable. Reference to the annuity tables, it argued, would produce a distorted and overstated value for tax purposes and asserted the value should be approximately $800,000.

In making its analysis, the court noted that the 5th Circuit had concluded that lottery annuity payments were properly valued by reference to the annuity tables in the code, and that the 2nd and 9th circuits had concluded that the annuity tables did not accurately reflect the fair market value of future lottery payments to the extent they failed to account for the lack of marketability. The parties in this case stipulated that the 10 remaining lottery payments constituted an annuity, and that the decedent's interest in the payments was an ordinary annuity interest within the meaning of Regulation Section 20.7520-3(b)(1)(i)(A). Accordingly, the general rule for estate tax purposes was that the annuity must be valued by reference to the annuity tables in the code. However, the court noted, citing a 5th Circuit case, there was an exception to the general rule if the value ascribed by the tables to the decedent's annuity was unrealistic and unreasonable and there was a more reasonable and realistic means by which to determine its fair market value. The court noted that the annuity tables in the code take into consideration only two factors (time and a discount interest rate), which yields a present value number. However, for estate tax purposes, the focus is on an asset's fair market value, rather than its present value. Accordingly, the present value of a nonmarketable annuity was not necessarily representative of its fair market value because the tables failed to take into consideration the fact that the annuity was nonmarketable. A hypothetical buyer would naturally be willing to pay less for a nonmarketable annuity than for a marketable one. Therefore, the court held that the right to receive 10 future payments was less valuable than if the right were freely alienable. Offered as tangible proof of the possible negative effect of the lack of marketability of the lottery payments was the fact that the estate could not simply sell the annuity to a third party for its fair market value and then distribute the lump sum to the estate's beneficiaries. Rather, the estate might be forced to remain open to administer the annual receipts and would likely incur additional administrative and legal expenses that it could otherwise avoid. However, any discrepancy between the annuity tables and the true fair market value of the annuity does not necessarily compel the conclusion that it was improper to employ the annuity tables. Using a valuation method other than the annuity tables was warranted only if the difference between the value yielded by the tables and the value determined by an alternate valuation method was sufficiently substantial to warrant the conclusion that the annuity tables produced an unreasonable and unrealistic value. Because the estate and the IRS did not agree on a value of the annuity under an alternate valuation method, the court could not hold, as a matter of law, that application of the annuity tables to the annuity in question was inappropriate. *Davis v. U.S.*, 97 AFTR 2d 2006-332 (D. N.H.).

8. Undiscounted Value of Assets Used to Value Indirect Gifts of Stock

In 1998, the Sendas created a family limited partnership (partnership) and transferred 28,500 shares of MCI WorldCom stock (worth approximately $2 million) to it in exchange for their interests. In 1999, the Sendas formed a second partnership and transferred 18,477 shares of MCI WorldCom stock (worth approximately $1.5 million) to it in exchange for their interests. In each instance, the Sendas gave limited interests to their three minor children. They claim they made gifts of limited partnership interests to the children and valued the gifted interests by applying discounts for marketability and minority factors. The IRS claimed the Sendas made indirect gifts of stock to the children and valued the gifts at the full undiscounted value of the stock.

The Tax Court held for the IRS, stating that the Sendas presented no reliable evidence that they contributed the stock to the partnerships prior to transferring the partnership interests to the children. The Tax Court noted that the sequence was critical because a contribution of stock after the transfer of partnership interests would result in an indirect gift to the partners to the extent of their proportionate interest in the partnership. The Sendas appealed, citing evidence such as the gift tax returns, the income tax returns of the partnerships, and the certificates of ownership for the partnerships. The 8th Circuit affirmed the Tax Court, finding that the Sendas presented no reliable evidence that they contributed the stock prior to transferring the partnership interests to the children. The court held that the Tax Court did not clearly err in ruling the evidence produced by the Sendas unreliable and agreed that the key findings showed the transactions were integrated and simultaneous. Accordingly, the gifts were properly valued at the full undiscounted value of the stock. *Senda v. Comm.*, 97 AFTR 2d 2006-419 (8th Cir.).

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9. Value of IRAs Cannot be Reduced by Potential Tax Liability at Distribution

At the time of her death, the decedent owned two individual retirement accounts (IRAs). Both IRA trust agreements provided that the interests in the IRAs themselves were not transferable; however, both IRAs allowed the underlying marketable securities to be sold. On the decedent's estate tax return, the estate reduced the net asset value of the two IRAs to reflect the income tax liability from the distribution of their assets to the beneficiaries. The IRS issued a notice of deficiency disallowing the reduction in value of the IRAs.

The estate contended that application of the willing buyer-willing seller test mandated a reduction in the fair market value of the IRAs to reflect the tax liability associated with their distribution, reasoning that the IRAs themselves were not transferable and, therefore, were unmarketable. The estate further argued that the only way the IRA owner could create an asset that a willing seller could sell and a willing buyer could buy was to distribute the underlying assets in the IRAs and to pay the income tax liability resulting from the distribution. Upon distribution, the beneficiary would pay income tax. Therefore, the income tax liability the beneficiary would pay on distribution of the assets in the IRAs was a cost necessary to render the assets marketable, and such cost must be considered in valuing the IRAs.

The court disagreed with the estate and held that application of the willing buyer-willing seller test did not allow the estate to reduce the value of its retirement accounts by the income tax liability. The court reasoned that the tax or marketability burden on the IRAs must be borne by the seller because the IRAs could not legally be sold, and, therefore, their inherent tax liability and marketability restrictions could not be passed on to a hypothetical buyer. Therefore, there was no reason a hypothetical buyer would seek to adjust the price of the marketable securities that were ultimately being purchased. Similarly, a hypothetical seller would not accept a downward adjustment in the value of the securities for a tax liability that does not survive the transfer of ownership in the assets. A hypothetical buyer would not purchase the IRAs because they are not transferable. The buyer would purchase the marketable securities held in the IRAs and would obtain a tax basis in the assets equal to the buyer's cost. The buyer would only have taxable gain on the disposition of the marketable securities to the extent they appreciated in value subsequent to the time of acquisition. Therefore, the buyer would be willing to pay the full fair market value for the securities without any discount. Correctly applying the willing buyer-willing seller test demonstrated that a hypothetical buyer would not consider the income tax liability to a beneficiary on the income in respect of a decedent since he was not the beneficiary and would not be paying the income tax. Therefore, the court held that the IRAs were to be valued based on their respective account balances on the date of the decedent's death. *Estate of Kahn v. Comm.*, 125 T.C. No. 11.

10. Tax Court Values Investment Family Limited Partnership

In 1999, the decedent and the Loudens (who were the personal representatives of the decedent's estate) organized a limited liability company (LLC) and a limited partnership (partnership). The decedent contributed more than $1.1 million cash and certificates of deposit to the partnership, and the Loudens contributed $50,000 cash to it. At the time of his death, the decedent owned a 94.83 percent interest in the partnership and a 33.33 percent interest in the LLC. The Loudens owned the remaining two-thirds interest in the LLC and a 4.17 percent interest in the partnership. The LLC owned the remaining 1 percent interest of the partnership, which was the only asset of the LLC. At the time of the decedent's death, the partnership held assets totaling more than $1.2 million, which consisted of more than $800,000 cash and more than $400,000 in certificates of deposit. It had no liabilities. The estate's appraiser valued the decedent's interests in the entities by applying a 53.5 percent discount. The IRS contended that the estate was entitled to a 25.2 percent discount.

With respect to a minority discount interest, the court concluded that 12 percent was appropriate on the grounds that the IRS effectively conceded that a discount factor of up to 12 percent would be appropriate, and the estate failed to prove that a discount greater than 12 percent would be appropriate. With respect to a marketability discount, the court concluded that an initial discount of 20 percent was appropriate, with an upward adjustment of 3 percent to incorporate characteristics specific to the partnership. *Estate of Kelley v. Comm.*, T.C. Memo 2005-235.

11. Transfer Tax Value of Family Business Interests not Determined by Buy-Sell Agreement

Blount and Jennings were the only shareholders of Blount Construction Co. (company). In 1981, they entered into a stock-purchase agreement (agreement) with the company that required shareholder consent to transfer stock and established that the company would purchase the stock on the death of the holder at a price agreed upon by the parties, or in the event of no such agreement, for a purchase price based on the book value of the company. In the early 1990s, the company purchased insurance policies solely for the purpose of ensuring that it could continue operations while fulfilling its commitments to purchase stock under the agreement. The policies would provide roughly $3 million, respectively, for the repurchasing of Jennings' and Blount's stock. In 1992, the company began an employee stock ownership program (ESOP) to which it made annual contributions, either by purchasing stock from Blount and Jennings, or by new issuances. Annual valuations were completed by a third party to facilitate the ESOP purchases. In January 1996, Jennings died owning 46 percent of the company's outstanding shares. The company received approximately $3 million from the insurance proceeds and paid a little less than $3 million to Jennings' estate. The company used the previous year's book value to determine the amount to be paid to Jennings' estate. In October 1996, Blount was diagnosed with cancer and given only a few months to live. Concerned that the buyout requirement of the agreement would deprive the company of the liquidity it needed to function, he commissioned several studies regarding the amount of money his estate could receive for his shares and still leave the company in a healthy financial condition. In November 1996, Blount executed an amendment to the agreement that bound himself and the company to exchange $4 million for the shares he owned at his death. When Blount died in September 1997, he owned roughly 83 percent of the company. His estate received $4 million from the company for his shares, in accordance with the amended

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Real Estate Cases

Kansas Supreme Court

CONDEMNATION OF LAND FOR STATE HIGHWAY PURPOSES V. STRANGER VALLEY LAND COMPANY LLC
RUSSELL DISTRICT COURT
– REVERSED AND REMANDED WITH DIRECTIONS
NO. 93,113 – DECEMBER 9, 2005
Eminent domain

ATTORNEYS: Oswald S. Dwyer and Sally A. Howard, Topeka, for appellant; Jerry E. Driscoll, Driscoll Law Office, Russell, for appellee; and Terrence J. Campbell, Jane M. Eldredge, and Terence E. Leibold, Barber Emerson L.C., Lawrence, *amicus curiae* brief.

FACTS: The Kansas Department of Transportation (KDOT) filed an eminent domain proceeding to acquire property owned by Stranger Valley Land Co., LLC (Stranger Valley) for state highway purposes. After the appraisers filed their report fixing that amount of compensation, KDOT deposited the stated compensation amount with the district court. Stranger Valley filed a notice of appeal with the district court, but failed to pay a docket fee. The district court granted KDOT's motion to dismiss the appeal for failure to properly docket the appeal and that the district court lacked jurisdiction to extend the time. Upon a motion to reconsider filed by Stranger Valley, the district court reconsidered its decision and found the payment of the docket fee was not jurisdictional. The district court certified an interlocutory appeal.

ISSUE: Whether the district court acquired subject matter jurisdiction over Stranger Valley's appeal from the appraiser's award when it timely filed the notice of appeal, but did not comply with the provisions of K.S.A. 2004 Supp. 26-508 requiring the payment of a docket fee and the docketing of the appeal as a new civil action.

HELD: Court reversed and remanded with directions. Court held a district court acquires subject matter jurisdiction over an appeal from the appraiser's award in a condemnation action only if the appeal is perfected within 30 days "by filing a written notice of appeal with the clerk of the district court and paying the docket fee of a new court action" under K.S.A. 2004 Supp. 26-508. While the timely filing of the notice of appeal and the payment of the docket fee are jurisdictional requirements, the failure to docket the appeal as a new civil action does not defeat subject matter jurisdiction. Court reversed and remanded to the district court with directions to dismiss Stranger Valley's appeal from the appraiser's award in the condemnation action.

NOTE: SB 398 has been introduced in the 2006 Kansas Legislature to amend K.S.A. 26-508 so that an appeal from an appraiser's award in a condemnation case will be deemed perfected upon the filing of the notice of appeal, regardless of when the docket fee is paid. The amendment, if passed, would be retroactive to apply to all eminent domain proceedings pending on or commenced after July 1, 2003, and would reverse the holding of the Kansas Supreme Court in the *Stranger Valley* opinion.

STATUTES: K.S.A. 20-3018(c); K.S.A. 1980 Supp. 22-3609; K.S.A. 26-501 *et seq.*, -501(a), - 516; K.S.A. 2004 Supp. 26-508; K.S.A. 44-1011; K.S.A. 1980 Supp. 59-2401; K.S.A. 60-2102(b); K.S.A. 2004 Supp. 60-206(b), -2102(c); K.S.A. 1974 Supp. 60-2001(a); and K.S.A. 1974 Supp. 61-2102, -2103

THE BOARD OF COUNTY COMMISSIONERS OF JOHNSON COUNTY V. SMITH ET AL.
JOHNSON DISTRICT COURT – REVERSED AND REMANDED WITH DIRECTIONS
NO. 93,286 – DECEMBER 9, 2005
Eminent domain

ATTORNEYS: Robert A. Ford, Olathe, for appellant; and Marvin E. Rainey and M. Ellis Rainey II, Rainey and Rainey, Overland Park, for appellees.

FACTS: In 2001, Johnson County took the Smiths' 80-acre property by eminent domain. The property is within the city limits of Overland Park, and is located within one mile of the Johnson County Executive Airport. The county filed a motion in limine in the eminent domain appeal asking the district court to find that

(Continued on Page 8)

Author

***Mark A. Andersen**, Lawrence, is a member of Barber Emerson L.C. He received his B.A. from Bethany College and his J.D. from the University of Kansas School of Law, where he was a member of the* Kansas Law Review.

Andersen is admitted to the bar in Kansas and Missouri and is a member of the Kansas Society of Farm Managers and Rural Appraisers. His practice includes real estate, like-kind exchanges, and construction. Andersen can be reached via e-mail at mandersen@barberemerson.com.

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the highest and best use of the property on the date of the taking was low-density residential and to prevent the Smiths from presenting evidence that the highest and best use of the property was high-density residential. The district court recognized that in 1989, the city had taken action to rezone the property from A-J (agriculture, allowing low-density residential) to R-1 (single family, allowing high-density residential). The district court ruled that because the county had not approved the rezoning of property within one mile of the airport, the property had retained its county A-J zoning classification since annexed by the city in 1985. The district court later vacated its ruling, concluding that the zoning had changed to R-1 in 1989. The county received permission to take an interlocutory appeal.

ISSUE: Should an appellate court determine a property's zoning classification on the date of taking if the classification will largely determine the amount of just compensation?

HELD: Court reversed and remanded with directions. Court held under the facts of this case the questions of (i) whether to determine the zoning classification of property taken under a county's eminent domain powers and, if so, (ii) the actual determination of the zoning classification itself are for the jury, not an appellate court. Court held the district court erred in determining that the zoning classification of the taken property was R-1. Court held the district court also erred in designating a controlling question of law pursuant to K.S.A. 2004 Supp. 60-2102(c) for an interlocutory appeal because it will not make the determination of the actual zoning on the date of the taking, which may or may not be important to the jury in its final valuation.

STATUTES: K.S.A. 3-301 *et seq.*, -307e, -705, -709; K.S.A. 12-712 (Ensley 1982) (repealed 1991); K.S.A. 12-741 *et seq.*, -759(d), (f), -760; K.S.A. 19-223; K.S.A. 20-3017; K.S.A. 26-513(d), (e); and K.S.A. 2004 Supp. 60-2102(c)

Kansas Court of Appeals

DUNCAN ET AL. V. CITY OF ARKANSAS CITY
COWLEY DISTRICT COURT – AFFIRMED
NO. 90,878 – FEBRUARY 17, 2006
Flood damage and municipal corporations

ATTORNEYS: Randall K. Rathbun, Dennis L. Gillen, and Tony L. Atterbury, Depew, Gillen, Rathbun & McInteer L.C., Wichita, for appellants/cross-appellees; Otis W. Morrow, city special council, Alvin D. Herrington, Edward L. Keeley, McDonald, Tinker, Skaer, Quinn and Herrington P.A., Wichita, Sally A. Howard, chief counsel, and Gelene Savage, of KDOT, Topeka, for appellees/cross-appellants.

FACTS: Landowners filed negligence/nuisance action against city and KDOT for damage to their property by 1998 flood. Plaintiffs claimed the approved highway and levee plan failed to incorporate a contingency plan to protect landowners' property during delay in constructing second of two levees. District court granted summary judgment to defendants, finding no proximate cause for liability.

ISSUE: Governmental liability

HELD: District court affirmed. Expert's affidavit that a contingency plan was customary and a practice of industry, which was contrary to his deposition testimony, did not create genuine issue of material fact. Absent evidence that any acts or omissions of defendants caused flood damage in excess of that which would have been sustained in any event, there was no proximate cause established under facts of case.

STATUTES: K.S.A. 2005 Supp. 75-6104, -6104(m) and K.S.A. 75-6101 *et seq.*

THOMPSON V. HILLTOP LODGE INC. ET AL.
MITCHELL DISTRICT COURT – AFFIRMED
NO, 94,006 – JANUARY 20, 2006
Adverse possession

ATTORNEYS: James M. Johnson, Frasier & Johnson, Beloit, for the appellees; and Kevin L. Phillips, Weltmer Phillips Law Office, Mankato, for appellants.

FACTS: This case involves a dispute over ownership of a tract of land located on the north edge of property owned by Hilltop Lodge, Inc., and on the south edge of property owned by Ray and Theresa Thompson. The Thompsons commenced an action to quiet title to the disputed property and appealed the trial court's determination that they did not acquire title to the disputed piece of property by adverse possession.

ISSUE: Did the trial court err in finding the Thompsons did not acquire title to the subject property by adverse possession?

HELD: Court affirmed. Court found there was substantial competent evidence that both parties cared for the property in various ways, with no indication that the Thompsons were exclusively providing the maintenance. Court also found there was substantial competent evidence to support the trial court's determination that the Thompsons' use of the property did not give unequivocal notice to Hilltop of the Thompsons' claim of title to the tract and that the Thompsons did not have exclusive possession of the disputed tract of land for 15 years. Court also stated the discussions between the parties about improvements showed the lack of good faith belief of ownership by the Thompsons. Finally, the court stated there were no facts to support the contention that the Thompsons occupied the property under "color of title" and the Thompsons were not entitled to damages for improvements.

STATUTES: K.S.A. 60-503, -1004

DAVIS ET AL. V. KEY GAS CORP. ET AL.
BARBER DISTRICT COURT – REVERSED AND REMANDED WITH DIRECTIONS
NO. 94,308 – DECEMBER 16, 2005
Oil and gas

ATTORNEYS: Alan C. Goering, Goering and Slinkard, Medicine Lodge, for appellants; and Gordon B. Stull, Stull & Rein LLC, Pratt, for appellee.

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FACTS: Davis granted two oil and gas leases to Thomas Energy and the leases were later assigned to Key Gas. The oil and gas leases contained a condition precedent requiring Key Gas to charge transportation costs and other expenses to the leases before Key Gas became liable for these expenses. Because the costs in question were not charged to the leases that exist between Key Gas and Davis, but rather were deducted by ONEOK under the gas purchase agreement from the amount given to Key Gas by ONEOK for gas purchased, the condition precedent which would trigger Key Gas' liability for these costs was never fulfilled. Davis sued Key Gas.

ISSUE: Whether Key Gas was required to pay Davis' portion of the transportation costs and other expenses deducted under the gas purchase agreement that Key Gas had entered with ONEOK.

HELD: Court reversed and remanded. Court found that Key Gas had control of this condition precedent under the oil and gas lease and had an implied obligation to protect Davis against transportation costs and other expenses that would reduce Davis' royalty. Key Gas made the completion of the condition impossible when it entered into the gas purchase agreement with ONEOK and allowed ONEOK to deduct transportation costs and other expenses. Court stated there was no evidence in this case that Key Gas used reasonable diligence to retain control of the costs and charge them to the oil and gas leases, thereby protecting Davis from these costs. Court held that Key Gas will not be allowed to use its own action which prevented the condition precedent from being fulfilled to escape liability for these costs. Court reversed and remanded with directions that Davis recover from Key Gas the amount charged by ONEOK for gas treatment, dehydration, compression, transportation or water hauling, plus interest.

DISSENT: The dissent stated that Davis seeks, and the majority awarded, a royalty based upon the value of gas from the well at an inflated price that ignored the realities of the market that affect price after the gas left Davis' leased property and amounts to a "free lunch." The dissent would "affirm the sound and common-sense decision of the district court."

STATUTES: No statutes cited.

ST. CATHERINE HOSPITAL V. ALAN ROOP, FINNEY COUNTY APPRAISER; AND FARM GOLD LLC V. ALAN ROOP, FINNEY COUNTY APPRAISER
FINNEY DISTRICT COURT – REVERSED AND REMANDED
NO. 93,437 – NOVEMBER 10, 2005
Property appraisal and construction type

ATTORNEYS: Troy W. Purinton and John R. Gerdes, Fleeson, Gooing, Coulson & Kitch LLC, Wichita, for appellants; and Linda Terrill, of Neill, Terrill & Embree L.C., Overland Park, for appellee.

FACTS: Two property taxpayers, St. Catherine Hospital and Farm Gold LLC, had the construction type of building material on their property mis-classified. Property owned by St. Catherine Hospital was classified by the county as "fireproof," rather than "fire resistant." Property owned by Farm Gold was classified by the county composed of fire resistant materials, rather than pre-engineered steel. The county agreed in both cases that the original classifications were a mistake and that an employee of the appraiser's office viewed the buildings after they were built and guessed at their type of construction by viewing the exterior instead of viewing the properties during construction. However, in each instance, the county refused to treat the mis-classification as a clerical error within the meaning of K.S.A. 79-1701, which allows for the repayment of any tax overpaid in the previous years as a result of the mis-classification. St. Catherine and Farm Gold filed separate tax grievance applications. BOTA ruled that it lacked jurisdiction over the applications because the errors were not, in BOTA's opinion, clerical errors subject to retroactive remedy under K.S.A. 79-1701. BOTA denied the motion for reconsideration. The district court affirmed the BOTA decision.

ISSUES: What is the definition of "clerical error" in property valuation? Were the appraiser's mistakes clerical errors, which caused errors in the appraised value of the properties?

HELD: Court reversed and remanded. Court held that under the facts of this case, the types of clerical errors listed in K.S.A. 79-1701 all have as a major component an error that did not involve an act of discretion on the part of appraisal officials. The mis-classification of the components of construction materials described in this case constituted a clerical error listed and described in K.S.A. 79-1701. Court remanded the case to BOTA for proceedings to allow the taxpayers the opportunity to present evidence of the fair market values to show how they were harmed by the errors.

STATUTES: K.S.A. 77-601 *et seq.*, -621(c); K.S.A. 79-1701, -1702 and K.S.A. 2004 Supp. 79-1701

U. S. Bankruptcy Court District of Kansas

IN RE RAFTER SEVEN RANCHES L.P.
CASE NO. 05-40483
DECEMBER 6, 2005
Equitable mortgage

ATTORNEYS: Timothy H. Girard, Woner, Glenn, Reeder, Girard & Riordan P.A., for creditor WNL Investments LLC; and William E. Metcalf, for debtor.

FACTS: Rafter Seven Ranches L.P. (debtor) and WNL Investments LLC (WNL) engaged in identical transactions in October 2002, concerning three tracts of land that were subject to a tax foreclosure action. On the face of the transactions, debtor is the seller of land to WNL, who then leases the land back to debtor. Each transfer agreement recites, "The Seller/Lessee acknowledges that this conveyance transaction is an absolute sale and conveyance of fee simple title of the property," and provides that WNL is liable for property taxes. Debtor executed warranty deeds to WNL. WNL in turn leased the land back to debtor through the end of 2005. The transfer agreements provided that WNL would not sell the tracts during the lease term, and debtor would have the option to repurchase the land during the lease term. The repurchase price was higher than the initial price paid by WNL. The transfer agreements contained merger clauses, stating that the documents represent the "entire contract" between

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the parties. WNL filed a motion in limine to prevent debtor from introducing extrinsic evidence showing that the transactions were not absolute conveyances, but actually equitable mortgages.

ISSUE: Whether debtor may introduce extrinsic evidence showing that the transactions were actually equitable mortgages, rather than absolute conveyances, when the transaction documents explicitly provide that the conveyances are absolute and that the documents represent the entire agreement between the parties.

HELD: The court denied WNL's motion *in limine*, and allowed debtor to present extrinsic evidence. Kansas law has long recognized that a deed absolute on its face, but intended by the parties to be security for a loan, the courts will be construed as an equitable mortgage. The court noted that to determine whether a transaction is a secured loan or a true sale, all of the circumstances must be examined to determine the parties' intent. The indicia of an equitable mortgage transaction include the property having value greatly exceeding the consideration transferred, continued possession by the seller, and periodic payments of money regarded as interest. Kansas courts have long held that parol evidence is admissible in support of a contention that a deed, absolute on its face, is actually a mortgage. This is true even if a claim for relief is not based on special equitable grounds or when there is no foundation for the equitable mortgage argument in the express language of the parties' contract. Although WNL argued that extrinsic evidence should not be allowed because the contract is unambiguous and the parties are sophisticated commercial entities, the court held that the equitable mortgage doctrine applies to all transactions, not just those between family members or social acquaintances.

STATUTE: 11 U.S.C. § 365

IN RE COLON; HAMILTON V. WASHINGTON MUTUAL BANK FA
CASE NO. 04-42174
ADVERSARY NO. 05-7032
DECEMBER 5, 2005
Legal description and improperly recorded mortgage

FACTS: Debtors purchased a home in May 2001 and executed a mortgage at that time. The mortgage properly identified the property and was properly recorded. Debtors refinanced that mortgage in 2003 with a predecessor of Washington Mutual. The refinanced mortgage described the property as "Lot 29" in the correct subdivision, with the correct tax parcel identification number and correct street address. However, the correct lot number for debtors' property was actually "Lot 79" in the same subdivision. The only error in the description is in the lot number. The refinanced mortgage was recorded by the Shawnee County Register of Deeds in the title records under Lot 29, not Lot 79. The mortgage was properly cross-indexed in the grantor index under debtors' names. Debtors filed a Chapter 13 petition in August 2004, and the trustee initiated this adversary proceeding seeking to avoid Washington Mutual's lien. Washington Mutual filed for summary judgment.

ISSUE: Whether the mortgage sufficiently described the property, notwithstanding inclusion of the incorrect lot number, to impart constructive notice to the trustee.

HELD: The court found that the mortgage would not impart constructive notice to a hypothetical purchaser, because it actually described another lot. A purchaser of real property is under no duty to know or learn what other property the seller might own, and can reasonably assume that a recorded mortgage purporting to encumber one specific lot in the city does not actually encumber a different lot. An examination of the index for Lot 79 (debtors' lot) would not reveal the mortgage recorded under Lot 29 of the same subdivision. Even if the hypothetical purchaser became aware of the mortgage on the other lot (by looking at the grantor index) and examined the actual instrument, nothing in that instrument would have put the purchaser on notice that the mortgage contained an error. There is nothing within the four corners of the instrument that would put a purchaser researching the title to this property on notice that he needed to check further. As such, the trustee may avoid the mortgage as either a hypothetical lien creditor or as a bona fide purchaser of real property.

STATUTE: 11 U.S.C. § 544

IN RE ELDER; MORRIS V. SOLOMON STATE BANK
CASE NO. 04-12898
ADVERSARY NO. 04-5229
NOVEMBER 7, 2005
Manufactured home and avoiding lien

ATTORNEYS: J. Michael Morris, Klenda, Mitchell, Austerman & Zuercher LLC, Wichita, for the trustee; and Michael P. Alley, Clark, Mize & Linville Chtd., Salina, for Solomon State Bank.

FACTS: In October 2003, Thomas L. Elder and Mary E. Perry Elder (debtors) mortgaged their homestead to Solomon State Bank (bank). Debtors' homestead included a manufactured home affixed to a basement foundation, to which a garage, deck, and porch have been added. The mortgage described the affected property as extending to "any personal property which is now or hereafter attached to said real estate and is or becomes a fixture." The bank intended that the Note be secured by the debtor's homestead. Both parties intended the mortgage to apply to both the real property and the manufactured home. The bank did not show its security interest on the manufactured home's certificate of title. Debtors never surrendered the certificate of title for their manufactured home.

ISSUES: Whether the bank had a lien on the manufactured home and, if so, whether that lien was perfected.

HELD: The court found that the bank had an unperfected lien on the manufactured home, and held that as such, the trustee could avoid the lien as a hypothetical lien creditor. The bank opposed lien avoidance on the theory that, although it intended it acquire a perfected lien on the manufactured home, the loan documentation was insufficient to create even a security interest. The bank contends that none of the loan documents sufficiently described the manufactured home because

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they did not include a serial number, and that the manufactured home could not become a fixture under Kansas law. The court found that the manufactured home had become a fixture for purposes of the mortgage description, because the loan documents clearly evidenced the parties intention to encumber the manufactured home. Referring to the mortgage's property description, the court noted "[t]here is no reason why a person intending to include the manufactured home within the property subject to the mortgage would have thought the description inadequate." The court also rejected the bank's argument that the Kansas Manufactured Housing Act requires a surrender of the title certificate for a manufactured home to become a fixture. Rather, the act's surrender requirements are only for the purposes of the act itself. Kansas law still allows a manufactured home to become a fixture for mortgage description purposes without a surrender of a title certificate. Notwithstanding the Kansas Manufactured Housing Act, the property description contained in the mortgage sufficiently describes debtors' manufactured home. The court held that the trustee could avoid the bank's unperfected lien on the manufactured home.

STATUTES: 11 U.S.C. § 544(a)(2); K.S.A. 58-4201 to -4214; K.S.A. 84-9-102(52), -109, -311(a)(2), & -317(a)

U.S. Court of Appeals for the District of Columbia Circuit

AMERICAN BAR ASSN. V. FTC
U.S. DISTRICT COURT FOR DISTRICT OF COLUMBIA – AFFIRMED
NO. 04-5257 – DECEMBER 6, 2005
CONSOLIDATED WITH NO. 04-5258
Gramm-Leach-Bliley Act

FACTS: The Federal Trade Commission (FTC) appeals from an order of the district court granting summary judgement in consolidated cases brought by the appellees American Bar Association (ABA) and the New York State Bar Association (collectively, the bar associations). The bar associations sought a declaratory judgement that the FTC's decision that attorneys engaged in the practice of law are covered by the Gramm-Leach-Bliley Act (GLBA) exceeded the statutory authority of the FTC and was therefore invalid as a matter of law. Effective Nov. 12, 1999, Congress enacted the GLBA. The GLBA declared it to be "the policy of Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information." Congress enacted broad privacy protective provisions, and empowered the FTC, along with other federal regulatory agencies, to "prescribe ... such regulations as may be necessary to carry out the purposes of this subchapter with respect to the financial institutions subject to their jurisdiction under section 6805 of this title." In May 2000, the FTC issued regulations. Although the FTC relied in the first instance on Congress's definition of financial institution as "an institution the business of which is engaging in financial activities", the FTC restated the definition, stating that "an institution that is significantly engaged in financial activities is a financial institution." Like the statute, the regulations at no point describe the statutory or regulatory scheme as governing the practice of law as such. Indeed, the phrase "practice of law" never appears, and the word "attorneys," while present in two places, appears in the context of describing persons to whom financial institutions can make release of customer information, if authorized, not in the context of defining "financial institutions" as including attorneys. The New York State and the American bar associations separately filed actions for declaratory judgment. The district court found no genuine issues as to any material fact and, incorporating its earlier decision on a motion to dismiss, held that Congress did not intend the GLBA's privacy provisions to apply to attorneys engaged in the practice of law. The current appeal followed.

ISSUE: Does the FTC's decision that attorneys engaged in the practice of law are covered by the GLBA exceed the statutory authority of the FTC and, therefore, is invalid as a matter of law?

HELD: The D.C. Circuit held that the privacy provisions of the Gramm-Leach-Bliley Act do not apply to lawyers. The FTC argued essentially that because "real estate settlement services" is a financial activity and because lawyers engage in real estate settlement services, then the GLBA privacy regulations governing "financial institutions" applied to lawyers. The D.C. Circuit stated that the question is not whether the statute permits exemption from regulation for attorneys, but whether it supports such regulation at all. Even if we accept the inclusion of "entities" such as law firms within the meaning of "institutions," the "business" of a law firm is the practice of the profession of law. It is undisputed that the regulation of the practice of law is traditionally the province of the states. Federal law "may not be interpreted to reach into areas of state sovereignty unless the language of the federal law compels the intrusion." Therefore, the judgment appealed from is affirmed.

STATUTES: 15 U.S.C. § 6801(a); 15 U.S.C. § 6805(a)(7); 15 U.S.C. § 6809(3)(A). ■

CLE Docket 2006

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Rodriquez-Tocker v. Estate of Tocker
Kansas Court of Appeals
February10, 2006

Attorneys: Vern Miller, Wichita; Robert M. Hughes, Bever Dye L.C., Wichita; and Coy M. Martin and John Terry Moore, Moore Martin L.C., for plaintiff/appellee; and Warren R. Southard, Madden & Orsi, Wichita; and Robert Martin and Ross W. Townsend, Martin, Pringle, Oliver, Wallace & Bauer LLP, Wichita, for defendants/appellants.

Two medical doctors executed an antenuptial agreement. Fifteen years after their marriage, they executed a postnuptial agreement amending one paragraph and ratifying the remainder of the antenuptial agreement. In 2000, apparently unknown to wife, husband created a living trust in which wife was neither named a trustee nor a beneficiary. Husband died in 2001. The couple had no children. Husband's nephew sought probate of husband's will and indicated the probate asset value as $277,410. The trust was worth approximately $8 million.

Through various defenses and claims in the probate case, wife sought to bring the trust assets into the probate estate for distribution pursuant to a spousal share election. Following wife's motion for summary judgment, the district court held that the antenuptial and postnuptial agreements did not contain language clearly waiving wife's rights. The district court granted a request for an interlocutory appeal, but the Court of Appeals motions panel denied the application (so the three judge panel deciding this appeal indicated that they were without jurisdiction to review the district court's partial summary judgment).

Wife also moved to enjoin defendants from depleting the trust assets and to remove and disqualify the named trustees and executors (who were husband's brother and nephew). The district court found "inherent conflicts of interest" and ordered removal (with replacements to be named after conferring by the parties). Unlike the partial summary judgment as to the marital agreements, removal of a fiduciary and granting an injunction give rise to appeals of right. This was held to be so even though the trustee and executor had not yet actually been removed (pending the appeal), but had just been ordered removed.

The court upheld the injunction against further distributions citing the district court's justifiable concerns regarding the amount left to satisfy wife's elective share after prior distributions to other beneficiaries in excess of $1.8 million, legal fees of approximately $633,000 and a pending tax penalty of approximately $700,000. The defendants argued that wife lacked standing to remove the trustee because she was not a "qualified beneficiary" of the trust under the Kansas Uniform Trust Code. The district court and Court of Appeals both held that her right to receive an elective share of husband's augmented estate would necessarily make her a beneficiary of the trust by operation of law. Both courts also cited an independent authority to remove the trustee and executor for selfdealing, conflicts of interest and failure to perform duties. The court held that it could not overturn the district court's findings in support of removal absent "abuse of discretion."

The peremptory disqualification of the successor trustee (husband's brother) during the pendency of wife's claim was also upheld due to his relationship (father) to the first trustee and the possible need to assert positions adverse to his own son while litigation with the widow is pending.

In the Matter of the Estate of Esther R. Broderick, Deceased
Kansas Court of Appeals
December 16, 2005
34 Kan. App. 2d 695

Attorneys: Susan L. Mauch, Cosgrove, Webb & Oman, Topeka, for appellant Margaret Puls; and Dan K. Wiley and John C. Tillotson, Murray, Tillotson & Wiley Chtd., Leavenworth, for appellee Gene Ludwig, special administrator/executor.

Appellant Margaret Puls proceeded pro se in the Leavenworth District Court to oppose probate of the decedent's self-proved will and to seek the decedent's medical records to help her oppose the decedent's capacity. In a carefully written opinion by Judge Buser (with Judge Elliott and Judge Johnson also on the panel) the court made the following determinations:

1. "There is no statute prescribing the requirements for a written defense in probate proceedings. Supreme Court Rule 143 addresses procedural matters when a written defense to a petition is filed in a probate case, but it does not indicate the form or substantive content for a valid written defense."

2. "If a will containing a self-proving affidavit is contested, the will is treated as if it contained no such affidavit. Thus, once a self-proved will is contested, the question of the validity of the self-proving affidavit is moot because the affidavit is no longer conclusive as to the admission of the will to probate."

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Author

***Calvin J. Karlin**, Lawrence, is a member of Barber Emerson L.C. His practice includes estate and trust planning and litigation.*

He received his B.A. and J.D. from the University of Kansas, where he was Phi Beta Kappa, Order of the Coif, and Kansas Law Review *note and comment editor.*

He is a member of the KBA Executive Committee of the REPT Section and serves as section editor. Karlin can be reached via e-mail at ckarlin@barberemerson.com.

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3. Because the executor's attorney candidly conceded that Puls' motion for a continuance constituted a written defense, the district judge agreed the executor "had the burden of proof to make a prima facie case showing capacity and due execution of that will." He did not do so by merely presenting the decedent's self-proved will without supporting witnesses at the continued hearing at which Ms. Puls appeared by telephone. The Court of Appeals, thus, held that "there was insufficient evidence for the district court's factual findings and conclusions of law that the will be admitted to probate."

4. Discovery issues were also addressed and the court ordered a reasonable additional period of time for discovery before the remanded will contest hearing.

5. The court opinion provides an excellent review of the Health Insurance Portability and Accountability Act of 1996, 42 U.S.C. § 1320d *et seq*. procedures and options involving a decedent's medical records. It also addresses the Kansas discovery options, especially the notification requirements and objection opportunity as to a subpoena duces tecum under K.S.A. 60-245a against a nonparty.

6. While confirming the availability of the discovery procedures set forth in K.S.A. 60-226 to K.S.A. 60-237 in a contested probate matter, the court indicated that the *pro se* litigant Puls had not sought the decedent's medical records in a procedurally proper manner. Consistent with prior Kansas case law, the court stated that, "A *pro se* litigant in a civil case cannot be given either an advantage or a disadvantage solely because of proceeding *pro se*."

In the Matter of Larry L. Myers
Kansas Supreme Court
February 3, 2006

Attorneys: Alexander M. Walczak and Stanton A. Hazlett, Topeka, for Disciplinary Administrator; and G. Craig Robinson, Wichita, and Larry L. Myers, Garden City, *pro se*, for respondent.

Public censure was ordered for Myers for two reasons — lack of competent representation and unreasonable fees. It was found that Myers failed to competently represent a husband and wife when he created trust documents that failed to protect their assets from being available for nursing home care. After Social and Rehabilitation Services (SRS) denied the Medicaid application, Myers recommended an appeal despite well established law to the contrary. The SRS decision was affirmed and Myers billed the widow $3,600 for his work on the appeal.

The Supreme Court quoted the disciplinary hearing panel finding that Myers "blatantly misstated the law by stating that filing a Kansas estate tax return was mandatory" when, in fact, the estate fell below the threshold for filing. Charging for an unnecessary service was found to be unreasonable and unethical. Another problem was that Myers billed in one-hour increments and acknowledged that he had not always spent one hour when doing so. Myers conceded that this billing practice was improper, even though he was still using it at the time of the hearing. The Supreme Court wrote that it agreed "with the deputy disciplinary administrator that billing for quarter hours is not a violation if that time is spent on a client's business. The violation is in not spending the time billed to the client on the client's business." ■

<u>*Estate Tax Notes*</u>

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agreement. The estate tax return reported the value of Blount's shares as $4 million, and the IRS filed a notice of deficiency claiming the stock was worth almost $8 million.

The Tax Court held that the agreement was to be disregarded for purposes of determining the value of the shares because it was unilaterally changeable during Blount's lifetime. It also held that the amount of tax should have been calculated by adding the insurance proceeds to the other assets of the company to arrive at the fair market value of the company. After correcting errors in the valuation analyses of both parties' experts, the Tax Court concluded that both parties arrived at the same base value for the corporation of $6.75 million. The Tax Court then added the insurance proceeds of $3.1 million to compute the value of the stock at $9.85 million, resulting in a value of $8.2 million for the shares owned by Blount. However, the Tax Court limited the amount assessed to the value determined by the IRS in its original notice of deficiency, which was just under $8 million.

On appeal, the 11th Circuit noted that the original agreement was substantially modified in 1996, thereby making it subject to the 1990 tax code changes. As evidence that the changes were substantial, the court noted that the company lost the ability to pay the buyout in installments, and both parties to the agreement lost the ability to have the price adjusted according to the book value or to an annually agreed-upon valuation. The court next discussed the Tax Court's analysis that the agreement failed to meet the exception to the general rule for property subject to a valid buy-sell agreement. For the exception to apply (i) the offering price must be fixed and determinable under the agreement, (ii) the agreement must be binding on the parties both during life and after death, and (iii) the restrictive agreement must have been entered into for a bona fide business reason and must not be a substitute for a testamentary disposition. With regard to the second requirement, the court noted that the agreement could only be modified by the parties thereto. By the time the 1996 amendment was made, the only remaining parties were the company and Blount. Blount owned an 83 percent interest in the company, was the only person on its board of directors, and was the president. The parties to the agreement who were needed to change it were Blount and the company, which Blount completely controlled. The estate argued that the ESOP's approval was required; however, the court noted that the ESOP was not a party to the agreement, and its consent was not necessary to modify it. Thus, Blount had the unilateral ability to modify the agreement during his life and did so. Therefore, the agreement did not meet the exception to the general rule, and the value of the shares in his estate was to be determined using a fair market valuation.

The court next noted that because the agreement did not establish the value of the stock for tax purposes, the Tax Court properly concluded that it must establish the fair market value of the company in order to determine the value of Blount's shares. The court held, however, that the Tax Court erred in adding the insurance proceeds that the company received on Blount's death to the value of the company. Regulation Section 20.2031-2(f)(2) provides that in valuing corporate stock, consideration shall be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent that such nonoperating assets have not been taken into account in the determination of net worth. The court held that the limiting phrase "to the extent that such nonoperating assets have not been taken into account" precluded the inclusion of the insurance proceeds in this case because the company acquired the insurance policy for the sole purpose of funding its obligation to purchase Blount's shares in accordance with the agreement. Even though the agreement was inoperative for purposes of establishing the value of the company for tax purposes, the agreement remained an enforceable liability against the valued company. Thus, the insurance proceeds were not the kind of ordinary nonoperating assets that should be included in the value of the company under the regulations because of the enforceable contractual obligation that offset the proceeds. Accordingly, the court rejected the Tax Court's inclusion of the insurance proceeds in computing the fair market value of the company. *Estate of Blount v. Comm.*, 96 AFTR 2d 2005-6795 (11th Cir.).

Generation Skipping Transfer (GST) Tax

12. Information on Gift Tax Return Sufficient to Constitute Timely Allocation of GST Exemption

The decedent created an irrevocable trust with GST tax potential. The decedent retained an accounting firm to prepare and file his gift tax return reporting the transfer to the irrevocable trust. The accounting firm properly identified the property that was the subject of the gift, and properly reported on Schedule C, part 2, line 5 and on the Notice of Allocation that the decedent was allocating a portion of his GST exemption. However, on Schedule A, part 1 and on the Notice of Allocation, the accounting firm inadvertently misidentified the donee of the gift. The decedent's estate sought a ruling that the gift tax return substantially complied with the requirements for making a timely allocation of GST exemption to the irrevocable trust, such that the irrevocable trust would have an inclusion ratio of zero. After examining the facts disclosed on the gift tax return, the IRS concluded that the information contained on the return was sufficient to constitute a timely allocation of the decedent's GST exemption to the irrevocable trust. P.L.R. 200550006.

13. Modification of Trust will not Change Its GST Exempt Status

The grantor created an irrevocable trust for the benefit of the children and grandchildren of 41 named members of a family. The grantor is not related to the 41 family members or their children or grandchildren. The children and grandchildren of the family belong to a generation that is two or more generations below the grantor. The trust assets are to be divided into separate shares for each child of the 41 family members. Upon the birth of a child to any of the 41 family members, the child will have an equal share with each of the other beneficiaries. Each trust then in existence will transfer a fraction of its corpus to a new trust for the benefit of each after-born child. Each trust share will have the same three co-trustees, which are selected by a majority vote of the electors. The electors consist of (i) certain individuals named in the trust who are either members of the family or associated with the family, (ii) each of the 41 named members of the family who have attained the age of 18 years, (iii) the spouses of each of the 41 named family members, and (iv) the beneficiaries of any trust who have attained the age of 18 years. The

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term of each trust will be 50 years from the date of creation of the irrevocable trust. Thereafter, any trust may be terminated by a vote of at least two-thirds of the electors. Upon termination, the corpus of each trust is to be distributed to the beneficiary of that trust or his or her legal representative. Each share will constitute a separate trust, and the account of each beneficiary is to be kept separately at all times. However, the trustees may operate the trusts collectively as a single trust. No principal may be distributed during the trust term, but income may be distributed at the discretion of the trustees. No additions have been made to the trust since Sept. 24, 1985.

As a result of litigation among the parties associated with the trust, a court has determined that the trust terms should be modified. Under the proposed modification, a trust would be created to hold the interests in any limited liability companies (LLC) trust that have been allocated to the separate trusts. During the term of the LLC trust, all net income of the LLC trust must be distributed to the separate trusts annually. The trustees may set aside a reserve to cover future contingencies, but the reserve may not exceed 10 percent of the net income in that year. The term of the LLC trust is specified, but it may continue thereafter until terminated by a vote of at least two-thirds of the electors. The proposed modification would also create a trust for contingent beneficiaries (CBT), which would be funded with a percentage of the corpus of each separate trust. The purpose of the CBT would be to facilitate the funding of trusts for children born to any of the 41 named family members after the modification. Upon the birth of a child, one-third of the then existing trust corpus of the CBT will be transferred to a new separate trust for the benefit of that child. Upon the birth of a second after-born child, one-half of the then existing trust corpus will be transferred to a new separate trust for the benefit of that child. Upon the birth of a third after-born child, the balance of the CBT will be transferred to a new separate trust for the benefit of that child, and the CBT will terminate. Upon the birth of any additional after-born children after the date the modification becomes final, such child or children will have an equal share with each other child born after the modification becomes final. The trusts in existence with the existing children born to any of the family members after the modification becomes final will transfer a fraction of their corpus to create a new trust for the after-born child, meaning that such after-born children will share only the percentage of the assets initially transferred to the CBT. A new provision will be added to provide that upon the death of a beneficiary prior to distribution of his or her trust share, the remaining assets in such beneficiary's trust share will be divided into separate trust shares for such beneficiary's then-living issue, per stirpes. The modification would also change the manner in which trustees are selected for the separate trusts. The electors with respect to any given trust share will consist of the parent of the primary beneficiary, the parent's spouse, such parent's living parent who is individually named as an elector in the trust, and all issue of such parent who are beneficiaries of an individual trust and who have attained the age of 18 years. Finally, the modification would maintain that no corpus may be distributed to the beneficiaries during the trust term, but all income must be distributed at least annually.

The IRS held that creation of the LLC trust and CBT would not cause the interests of the beneficiaries of the separate trusts to differ materially because the existing separate trusts would be divided on a pro rata basis. The beneficiaries would hold essentially the same interests before and after the pro rata division. Therefore, the proposed creation of the two new trusts would not result in the realization of any gain or loss from a sale or other disposition of property under Code Sections 61 and 1001. The IRS next held that all separate trusts are exempt from the GST tax under Code Section 2601 because they were irrevocable on Sept. 25, 1985, neither Code Section 2038 nor Code Section 2042 applies, and no additions have been made to the separate trusts after Sept. 25, 1985. The IRS also ruled that the other modifications, including (i) creation of the LLC trust and CBT, (ii) modification to provide that the siblings of a beneficiary not survived by issue would receive the corpus of that beneficiary's trust, (iii) expanding the definition of issue to include adopted persons, and (iv) the new method for electing trustees, would not shift a beneficial interest in any trust to a beneficiary occupying a lower generation than the persons who held beneficial interests prior to creation of the trusts. In addition, the modifications would extend the time for vesting of any beneficial interest in the original separate trusts. Therefore, the modifications would not affect the status of any other separate trust as exempt from the GST tax under Code Section 2601. P.L.R. 200601010.

Gift Tax

14. Renunciation not Timely Made, Constitutes Completed Gift

Prior to Jan. 1, 1977, the grantor funded a trust, the terms of which provided for distributions of income to the grantor's son for his life. Upon the son's death, the trust was to be divided into separate equal shares for each grandchild, and the income from a respective grandchild's share is to be distributed to the grandchild for life. Upon the death of a grandchild, the trust terminated as to that grandchild and was distributed outright pursuant to a testamentary limited power of appointment to a class consisting of the grandchild's spouse, issue, and spouses of such issue. In the absence of appointment, the assets were to be distributed outright to the grandchild's issue.

The taxpayer, the grantor's grandson, learned of his interest in the trust and reached the age of majority prior to Jan. 1, 1977. The taxpayer's father subsequently died, and the taxpayer's interest in the trust commenced. The taxpayer wished to renounce one-fifth of his remainder interest, which would then pass to his issue. The IRS ruled that the renunciation would constitute a taxable gift because it would not have been made within a reasonable time after the taxpayer learned of the existence of the transfer that created the remainder. Further, by accepting the entire trust income prior to the renunciation, the taxpayer accepted the entire trust corpus. Therefore, the renunciation would constitute a taxable gift. Following the proposed renunciation, the taxpayer would retain his income interest in the trust. Because an income interest is not a qualified interest, it would be valued at zero. Accordingly, the taxpayer would be treated as making a gift of one-fifth of the entire value of the trust corpus, and no actuarial factor would be necessary. Finally, the IRS held that the taxpayer would be treated as the transferor of one-fifth of the entire value of the trust corpus, and the taxable gift would cause one-fifth of the entire value of the trust to become subject to the generation-skipping transfer tax. P.L.R. 200530002.

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15. Transfer of Stock to Son not a Taxable Gift

A son provided his father with the funds for the initial purchase of shares in a company. The father agreed to take title to the shares for the benefit of the son. The stock was issued in the father's name so that the company could benefit from the father's creditworthiness. The father was willing to execute personal guarantees to enable the company to obtain financing. At the time of the company's organization, the son was experiencing credit difficulties. The father, although the majority shareholder of the company, was not involved in the business. As a shareholder, the father received an interest in a partnership. The company loaned funds to the shareholders for the investment, and the shareholders contributed the loaned amounts to the partnership. The father's credit rating is no longer needed by the company, and the father would like to transfer the shares in the company to the son. The father proposes to cause the stock register of the company to be changed to reflect that the beneficial ownership of all interests is in the son, rather than in the father. The father represents that he never held any beneficial ownership of the shares issued in his name, and all of the founding shareholders were aware that the father was holding the shares in trust for the son.

The IRS recognized that the son provided the funds to purchase the shares in the company that were conveyed to the father. The father never acquired a beneficial interest in the shares. Rather, the father held the shares in a resulting trust for the benefit of the son. Accordingly, the IRS held that the conveyance of stock in the company did not constitute a gift. Consequently, the transfer of stock in the company to the son would not be a gift under Code Section 2511. P.L.R. 200534014.

16. Disclaimers of Interests in Trust not Subject to Gift Tax

Under the terms of Trust 1, the taxpayer may receive discretionary distributions of income and principal during the trust term. In addition, the taxpayer will be entitled to receive a share of the per stirpital portion of the Trust 1 remainder if her father dies prior to the termination of Trust 1 and the taxpayer survives. The taxpayer has already received discretionary distributions from Trust 1. Under the terms of Trust 2 and Trust 3, after the death of the taxpayer's father, the taxpayer will be entitled to receive trust income and principal during the trust term, and a distribution of a per stirpital portion of the remainder when the trusts terminates. The taxpayer has not received any income or principal distributions from Trust 2 or Trust 3. Under the terms of Trust 4, while the taxpayer's grandfather is still living, the taxpayer is entitled to distributions of income from a one-third share of the trust. After the deaths of the taxpayer's father and grandfather, the taxpayer will be entitled to distributions of income and principal of a portion of Trust 4 and a distribution of all or a portion of the remainder when the trust terminates. Subsequent to the creation of the four trusts, the taxpayer attained the age of majority and proposes to disclaim her contingent right to receive the trust corpus on termination of the trust, including any interest she would receive as a potential appointee of her grandfather's power of appointment. The disclaimers will be executed by the taxpayer within nine months of her attaining the age of majority. The four trusts were created prior to 1977.

The IRS held that the proposed disclaimers would be considered to be made within the time prescribed by Regulation Section 25.2511-1(c)(2). The IRS also held that the disclaimers would be unequivocal because the disclaimed interests would pass without any direction on the part of the taxpayer. Further, the taxpayer would not accept the benefits of the disclaimed interests after the disclaimers. The IRS recognized that the disclaimers would be valid under state law. Consequently, the IRS ruled that the disclaimers would not constitute transfers subject to the federal gift tax. P.L.R. 200535012.

Charitable Giving

17. Charitable Lead Trust Requirements Discussed

The grantor created a charitable lead trust, naming two of the grantor's three children and another unrelated individual as the trustees. Upon the grantor's death, the third child will become a co-trustee, along with the other three individuals. The grantor did not retain any power or control over any portion of the trust. The trustees, however, are given the discretion to choose the charities to receive the lead payment each year. If no charities are selected on or before 15 days prior to the close of any year, the lead payment will be distributed to the charities named in the trust agreement.

The IRS held that the annuity satisfies the requirements of Regulation Section 25.2522(c)-3(c)(2)(vi)(a), and will, therefore, constitute a qualified annuity for purposes of Code Section 2522(c)(2)(B). Accordingly, the grantor will be entitled to a gift tax charitable deduction under Code Section 2522 equal to the present value of the guaranteed annuity interest, valued as of the date property is transferred to the trust. The IRS further held that the trust will be allowed deductions in accordance with Code Section 642(c)(1) for amounts of gross income paid to the charities during that taxable year, if the trustee makes an election under Regulation Section 1.642(c)-1(b). Finally, the IRS held that the grantor trust rules would not apply to the trust to cause the grantor or any other person to be treated as the owner of any portion of the trust. P.L.R. 200536013.

18. Transfer to Church on Termination of Split-Interest Trust was Deductible

In 1994, the decedent, Jackson, created a revocable inter vivos trust under which she received income and principal from the trust during her life. Upon her death, the trust became irrevocable and provided that her nephew and three nieces would each receive outright distribution of $150,000 and one-fourth of the income from the balance of the assets held in the trust. First United Methodist Church of Elkins (church) was named as the remainder beneficiary and was entitled to receive one-fourth of the trust corpus upon the death of each income beneficiary. Jackson died in November 1999. Estridge was named the executor of Jackson's estate. He also served as a co-trustee of the trust with Davis Trust Co. and with Schoonover, who drafted the trust agreement. Trust investment decisions were made by the trust committee on behalf of Davis Trust. The trust committee included two members of the church, and Schoonover was also a member of the church. Shortly after Jackson's death, Schoonover became concerned about potential conflicts of interest arising from the family beneficiaries' dissatisfaction with the diminished income from the trust

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and Estridge's marriage to one of Jackson's nieces who was a beneficiary. To avoid disputes arising from the conflicts, the family beneficiaries and the church signed an agreement terminating the trust. The income proceeds of the trust were distributed to the family beneficiaries for fair market value based on life expectancy calculations derived from IRS actuarial tables, and the church received the balance of the assets. The estate claimed a charitable deduction for the contribution to the church on its income tax return. The IRS denied the deduction.

The parties agreed that the trust created a split-interest remainder that did not conform with the requirements of Code Section 2055(e)(2) and that the trust was never reformed in accordance with Code Section 2055(e)(3). Therefore, the question before the court was whether the split-interest exception in Code Section 2055(e)(2) applied to the assets distributed to the church pursuant to the termination agreement. The IRS maintained that Code Section 2055(e) was only inapplicable where the nondeductible split interest was terminated in a settlement of a will or to avoid an imminent breach of fiduciary duty. However, the court held that such a narrow rule was inconsistent with the purpose of the statute of ensuring that an estate's charitable deduction corresponded to the value received by the charity. Accordingly, courts generally focused on the following factors in analyzing this issue: (i) whether property was directly transferred to the charitable beneficiary, (ii) whether a noncharitable beneficiary maintained an interest in that property, (iii) whether the deduction sought was for the actual benefit received by the charitable entity, and (iv) whether the estate was concerned solely with gaining a charitable deduction by skirting the split-interest rules of Code Section 2055(e). In the present case, the court noted that the church received an outright distribution of money pursuant to the termination agreement, and that the family beneficiaries had no interest in that property at the time of distribution. Moreover, the deduction sought by the estate equaled the amount received by the church. With respect to the fourth factor, the court recognized that the trustees and/or beneficiaries were aware of the requirements of Code Section 2055(e) before the execution of the termination agreement, but that uncontradicted testimony established that they did not terminate the trust to circumvent Code Section 2055(e). Rather, the court recognized that the trustees believed in good faith that conflicts of interest threatened to compromise their ability to impartially administer the trust. Therefore, the court concluded that the direct, indivisible and fixed distribution to the church rendered Code Section 2055(e) inapplicable, and the charitable deduction was allowed. *Estate of Jackson v. U.S.*, 96 AFTR 2d 2005-5623 (N.D. W. Va.).

Retirement Benefits

19. Transfer of IRA Qualified for Spousal Rollover Treatment

The decedent, whose date of birth was in 1931, died in 2003 and was survived by his wife. The wife's date of birth was in 1936. At the time of his death, the decedent owned an individual retirement account (IRA) and had attained his required beginning date. The named primary beneficiary of the IRA was a trust that had been created by the decedent's wife in 1992. Under the terms of the trust, the wife had the right to revoke the trust during her lifetime and reclaim all trust property. In addition, she had the right to withdraw any trust property during her lifetime. In 2004, the decedent's wife transferred, by means of a trustee to trustee transfer, the amounts remaining in the IRA into an IRA set up and maintained in her name.

The IRS held that the wife's trust was a grantor trust treated as wholly owned by the wife under Code Sections 671 and 678. Therefore, she would be treated as the owner of all trust assets for federal income tax purposes. The IRS further held that it would treat amounts distributed from the decedent's IRA, and eventually placed in an IRA set up and maintained in the wife's name, as being received by her IRA directly from the decedent's IRA, and not from the trust. Thus, the deemed transfer of the IRA to the trust, followed by the transfer into an IRA set up and maintained in the wife's name, would be treated as a spousal rollover eligible for favorable treatment under Code Section 408. Pursuant to Code Section 408(d)(3), none of the proceeds of the decedent's IRA would be includible in the wife's gross income for federal income tax purposes for either the calendar year in which the assets were distributed from the decedent's IRA or the calendar year in which they were transferred into the wife's IRA. P.L.R. 200549021.

20. Separate Trusts Qualify as See-Through Trusts

The decedent created an IRA Inheritance Trust (trust) and named nine separate trusts created under the trust as the primary beneficiaries of her individual retirement account (IRA). Each of the nine separate trusts was allocated a specific percentage of the IRA, which corresponded to the percentages allocated to each such trust under the terms of the trust. Included on the beneficiary designation was the reference "all above trusts established as separate trusts under the trust." The decedent died prior to his required beginning date. Under the terms of the trust, the trustee was to create nine separate shares, in accordance with the beneficiary designation. The trust stated the decedent's intent that the trust beneficiaries enjoy the benefit of distributions of any retirement assets being stretched out over their separate life expectancies. Each of the nine trusts was to be administered such that all amounts distributed to each trust from the IRA or other retirement assets while the named beneficiary was living were to be paid to or for the benefit of such an individual as soon as possible following receipt of such amounts by the trustee, it being the decedent's intent that each such trust share constitute a conduit trust for purposes of the required minimum distribution rule. Upon the death of a beneficiary, up to one-half of his or her remaining trust share was to be distributed to any individual or charitable organization (specifically excluding the beneficiary's estate, creditors, and the creditors of the beneficiary's estate) as appointed by the beneficiary, either outright or in trust. The remaining assets not so appointed were to be divided and added to the other remaining shares in proportion to their relative percentage and distributed as if an original part of such respective share. Within nine months of the decedent's death, the trust protector exercised its powers granted under the trust to convert Trust J (one of the nine separate trusts) to an accumulation trust and to limit potential remaindermen of Trust J to persons not older than the primary beneficiary of Trust J.

The IRS first recognized that the interest of each primary beneficiary in his or her trust share would terminate on the beneficiary's death. Accordingly, the primary beneficiary would not possess an interest

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in the trust corpus that would cause the trust to be includible in the primary beneficiary's gross estate under Code Section 2033. In addition, possession of the power of appointment at death would not cause the trust share corpus to be included in the primary beneficiary's gross estate under Code Section 2041 because the testamentary power of appointment was a limited power of appointment. Thus, upon the death of a primary beneficiary of a trust share, the trust share would not be includible in the primary beneficiary's gross estate. The IRS next held that the separate trusts (except Trust J) would not be treated as if there was an accumulation of distributions from retirement accounts. Accordingly, each of the trusts (except Trust J) would qualify as a "see-through" trust, as defined in Regulation Section 1.401(a)(9)-5, Question and Answer 5. With respect to calculating required minimum distributions, the appropriate measuring life for each of the separate trusts (including Trust J) would be the primary beneficiary of the respective trust. P.L.R. 200537044.

Marital Deduction

21. Marital Deduction Allowed Despite Survivorship Condition in Self-Drafted Will

The decedent, Sowder, died in 1995. In his self-prepared last will and testament, Sowder bequeathed $200,000 to each of his three children, and left the balance of his estate to his wife, provided she survived him. In the event the wife did not survive him or died before his estate was distributed to her, the balance of the estate was to pass to Sowder's surviving issue, in equal shares, per stirpes. The estate tax return filed for Sowder's estate claimed that no tax was due because of the marital deduction. On audit, the IRS determined the estate owed more than $800,000 in estate taxes, plus additional interest, because the gift to Sowder's wife did not qualify for the marital deduction due to the survivorship language. The estate paid the taxes and filed a claim for refund, which the IRS denied.

The court granted the estate's motion for summary judgment, finding that Sowder intended a marital deduction gift and that any language to the contrary was inconsistent with his broad gift of the residue to his wife. The 9th Circuit reversed the court's order, holding that the government should have had an opportunity to rebut the affidavits submitted by the estate and directing the lower court to permit the government to conduct discovery and then make a factual finding on Sowder's intent. On reconsideration, the court found that the documentary and testimonial evidence demonstrated that Sowder understood the concept of deferring taxes until the second death as between him and his wife, and that as a general proposition, he did not want to pay any more tax than necessary. Upon consideration of the totality of the circumstances, the court found that Sowder intended his gift to his wife to qualify for the marital deduction when he drafted his will. Accordingly, it concluded that his estate plainly qualified for the marital deduction under Code Section 2056(a). *Sowder v. U.S.*, 96 AFTR 2d 2005-7177 (E.D. Wash.).

Partnerships

22. District Court Refuses Summary Judgment in Family Partnership Case

In 1998, the decedent and her husband created a family trust (family trust), which provided that upon the death of either spouse, the family trust would be divided into two parts: Trust A, consisting of the survivor's interest in the community property and his or her separate property; and Trust M, consisting of all remaining property. Upon the death of the decedent's husband in 1999, the decedent disclaimed so much of the property passing to Trust M as would cause the taxable estate plus gifts to equal $3 million. The decedent's husband's estate tax return reported a gross estate of more than $167.4 million. In 2000, a management company was created, under which the decedent was named as president and treasurer, Harithas was named as vice president, and Anderson was named as vice president and secretary. All three were named as directors. The management company was authorized to issue 100,000 shares, par value $0.01, to the decedent upon receipt of $1,000. Also in 2000, the decedent, in her capacity as president of the management company, as trustee of Trust A, and as trustee of Trust M, executed an agreement of limited partnership (partnership). The stated purpose of the partnership was to provide a means for the family to manage family assets. The management company was the initial general partner, with a 0.1 percent interest, while Trusts A and M were the initial limited partners, with a 49.95 percent interest each. The initial capital contributions to the partnership were not specified in the partnership agreement. The decedent died less than one week following creation of the management company and the partnership. The decedent's estate paid more than $147.8 million in estate taxes with respect to the decedent's more than $383.6 million gross estate. More than $368.7 million was attributable to Trusts A and M, of which more than $260.7 million was attributable to the Trusts' interest in the partnership. The estate subsequently filed a claim for refund of more than $40.4 million in taxes paid. The claim for refund was based primarily upon a discounting of the value of partnership interests allegedly owned by Trusts A and M that were included in the decedent's estate for estate tax purposes.

The government filed a motion for summary judgment. It first asserted that Trust A and Trust M, which entered into the partnership agreement, did not exist for lack of a corpus. In response, the estate asserted that the beneficial interests of Trust A and Trust M in the assets of the family trust vested upon the death of the decedent's husband, and that neither legal title to trust assets nor segregation of trust assets was required for the recognition of a trust's existence. The court agreed that legal title and segregation were unnecessary and concluded that summary judgment was not appropriate as to such issue.

The government next argued that the management company was not authorized to conduct business because it had not received $1,000 in value for issuance of its shares. As a result, the partnership never came into existence because it neither had limited partners nor a general partner, and, as such, the trusts' assets were properly included in the decedent's estate. The estate responded first by noting that under Texas law, the management company existed as a valid corporation because a certificate of incorporation had been issued. The estate also

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suggested that the effect of the failure to contribute $1,000 made the directors personally liable for the debts of the entity up to the unpaid amount, but it did not affect its authority to operate. The court agreed that the failure to contribute the $1,000 was not fatal to the estate's claim, citing state law provided for joint and several liability of the directors if the required consideration was not received before commencing business. The court noted that the provision of a statutory remedy for noncompliance supported the notion that the intent of the statute was protective in nature. Accordingly, the court held that summary judgment was not warranted as to such issue.

Finally, the government argued that even if the partnership was formed, there were no assets in it at the time of the decedent's death. Further, the government argued that there was no legally binding agreement to transfer assets to the partnership. In support of its position, the government noted that the schedule to the partnership agreement did not show the initial capital contributions of the partners, and there was no other writing signed or initialed by the decedent evidencing her intent as to what the initial contributions to the partnership were to be. It also noted that the only evidence regarding the amount of capital contributions were alleged oral statements by the decedent to her accountants, which the government argued were barred by the Texas rules of evidence. In response, the estate argued that the Texas rules of evidence would not bar such testimony, and suggested that the federal rules of evidence should govern the testimony of the relevant witnesses. The court concluded that the discussion between the parties underscored the inappropriateness of summary judgment on the issue.

In the alternative, the government argued that the partnership assets were properly included in the decedent's estate under Code Sections 2036(a) and 2038(a) because the decedent retained a life interest in the property transferred to the partnership and/or the power to revoke any transfer of property to the partnership. The estate argued that neither provision applied because the transaction at issue constituted a bona fide sale for an adequate and full consideration in money or money's worth. Regardless, the estate argued that the decedent did not retain possession or enjoyment of the transferred property or any power to revoke the transfer of property. After discussing the *Strangi* and *Kimbell* cases, the court concluded that summary judgment would be inappropriate on the issue because establishing applicability of the exception argued by the estate would turn on a detailed and thorough analysis of the facts of the case. *Keller v. U.S.*, 96 AFTR 2d 2005-6736 (D. Tx.).

Other

23. Division of Charitable Remainder Unitrust will not Cause Gain or Loss, will not Cause Trusts to Fail to Qualify as Charitable Remainder Trusts

A husband and wife were the grantors, trustees, and unitrust beneficiaries of a charitable remainder unitrust (CRUT), which was funded with community property. The unitrust payments to the husband and wife were to continue until the earlier of the expiration of 20 years, or the later death of the husband or wife. At such time, the remaining assets were to be distributed to one or more charitable organizations as selected by the husband and wife.

Subsequent to creation of the CRUT, a court entered a judgment dissolving the marriage of the husband and wife. As part of the marital dissolution, the husband and wife proposed to divide the CRUT into two separate trusts, with division of the assets being equally in kind between the two trusts. The husband and wife would each be the sole trustee and income beneficiary of his or her respective trust. However, if either predeceased the 20-year period, the other would become the sole beneficiary of such predeceased spouse's trust for the remainder of the trust term. Each spouse would have the right to designate the charitable beneficiaries of his or her respective trust but would not have the right to change the charitable beneficiaries of the other trust in the event one spouse predeceased the 20-year period. The court approved the petition to divide the CRUT into two separate trusts.

The IRS concluded that division of the CRUT into two separate trusts would not cause any of the three trusts to fail to qualify as charitable remainder trusts under Code Section 664. The IRS further held that Code Section 1041 shielded both spouses from the recognition of gain or loss on the transfer because the CRUT's division was a property transfer between spouses or former spouses incident to divorce. The new trusts would determine their basis in the assets by reference to the basis of the assets in the hands of the CRUT under Code Section 1015(a) or (b), and the holding periods of the assets held by the new trusts would include the period for which the assets were held by the CRUT. Finally, the IRS held that any transfers of property between the spouses would not be subject to the gift tax. P.L.R. 200539008.

24. IRS Issues Initial Guidance on Family Shareholder S Corporation Election

The IRS issued a notice to inform taxpayers that it intends to issue future guidance regarding the election under Code Section 1361(c)(1)(D), which allows members of a family to be treated as a single S corporation shareholder. The election was created by Section 231 of the American Jobs Creation Act of 2004, enacted on Oct. 22, 2004. The election may be made for taxable years of the S corporation beginning after Dec. 31, 2004. Once made, an election will remain in effect until terminated, as provided in the regulations. Until the guidance is issued, taxpayers may rely on the notice in making such elections.

The election may be made by notifying the corporation to which the election applies. The notification should identify by name the member of the family making the election, the "common ancestor" of the family to which the election applies, and the first taxable year of the corporation for which the election is to be effective. The notice also contains guidance on additional persons treated as members of the family. If a corporation has two or more elections in effect, and the members of one family for which the election has been made (the inclusive family) include all the members of another family for which the election was also made (the subsumed family), then the members of the inclusive family will be counted as one shareholder, and the members of the subsumed family will not be counted as a separate and additional shareholder. Notice 2005-91, 2005-51 I.R.B. 1164 (11/22/05).

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25. Decedent's Promissory Note not Deductible as a Claim Against the Estate

The decedent's husband founded Advance Leasing during his lifetime. The husband died in 1996. The decedent was the sole owner of the stock of Advance Leasing from 1996 until she died in 1999. Following the decedent's husband's death, McBride became the sole officer and director of Advance Leasing. The decedent issued a durable power of attorney to McBride in 1996. The following year, in order to ensure that a son of the decedent would always have a place to work, McBride executed a stock subscription agreement and promissory note on behalf of the decedent and Advance Leasing that stated that the decedent promised to pay $400,000 to Advance Leasing on demand in exchange for 4,000 shares of common stock in Advance Leasing. Advance Leasing issued a stock certificate to the decedent for the 4,000 shares. Following the decedent's death in 1999, McBride paid the $400,000 to Advance Leasing. The terms of the stock subscription agreement were not negotiated, and the business was not appraised. Neither the $400,000 promissory note nor the 4,000 shares were identified on Advance Leasing's 1997 or 1998 financial statements or corporate income tax returns. Advance Leasing's bookkeeper and its certified public accountant knew nothing about the stock subscription agreement or promissory note.

The decedent's estate reported on the estate tax return that her gross estate included $150,000 of principal Advance Leasing owed on notes to entities created by the decedent and her husband but did not include interest owed on the notes as of the decedent's date of death. The estate tax return also included a deduction of $400,000 as a claim against the estate based on the $400,000 promissory note. The stock of Advance Leasing was reported to have no value on the decedent's date of death because liabilities exceeded the fair market value of the assets. At issue in the case was whether the $400,000 was deductible as a claim against the decedent's gross estate and whether the interest owed to the decedent by Advance Leasing on certain promissory notes was includible in the decedent's gross estate.

With respect to the $400,000, the estate contended that such amount was deductible on the basis of the estate's obligation to pay the promissory note. It contended that the note was the result of a bona fide contract for full and adequate consideration in money or money's worth and that the decedent received full and adequate consideration because she received 4,000 shares of stock in a corporation that appeared ready to become profitable. The court held that the 4,000 shares issued to the decedent had little or no value when McBride signed the stock subscription agreement, and, therefore, the decedent did not receive full and adequate consideration as required by Code Section 2053(c)(1)(A) for the $400,000 she agreed to pay Advance Leasing in exchange for the additional shares. The court also disagreed that the stock subscription agreement was contracted bona fide for the following reasons: (i) the terms of the agreement were not negotiated at arm's length; (ii) Advance Leasing's business was not appraised, and the business had annual net losses and a negative net worth both before and after the transaction; (iii) the transaction was not reflected on Advance Leasing's 1997 or 1998 financial statements or income tax returns; (iv) the bookkeeper and certified public accountant knew nothing about the agreement; and (v) Advance Leasing and McBride did not demand payment of the note until 1999. Accordingly, the court held that the $400,000 was not deductible from the decedent's gross estate as a claim against her estate under Code Section 2053(a)(3). In addition, the court held that interest accrued on notes owing from Advance Leasing to the decedent at her date of death was not includible in her gross estate because Advance Leasing was insolvent at the time, and a willing buyer with knowledge of the financial situation would not pay any amount for the accrued interest. *Estate of Hughes v. Comm.*, T.C. Memo 2005-296.

26. Statutory Tax Rates, Exemptions, and Deductions for 2006

The following changes affect estate planners for transfers made, and estates of decedents dying, in 2006:

(a) The gift tax annual exclusion under Section 2503 of the Internal Revenue Code of 1986, as amended (code) increases to $12,000 per donee.

(b) The annual exclusion for gifts to a noncitizen spouse under Code Section 2523(i)(2) will be $120,000.

(c) The generation-skipping transfer tax exemption under Code Section 2631 will be $2 million.

(d) The aggregate amount that special use valuation of farm or business real estate may reduce an estate under Code Section 2032(A) will be $900,000.

(e) If an estate elects to defer payment of estate taxes under Code Section 6166, the amount of the business interest of an estate, the taxes of which are subject to a 2 percent interest rate under Code Section 6601(j), will be $1.2 million.

(f) The income tax rates for taxable income of an estate or trust will be 15 percent for taxable income not more than $2,050; 25 percent for taxable income more than $2,050 but not over $4,850; 28 percent for taxable income more than $4,850 but not more than $7,400; 33 percent for taxable income more than $7,400 but not more than $10,050; and 35 percent for taxable income more than $10,050.

(g) The highest estate tax rate under the Code is 46 percent, resulting in a flat tax rate. ■

2006 Robert L. Gernon Award for Outstanding Service to Continuing Legal Education in Kansas

In 2005, the Kansas Continuing Legal Education Commission established the Robert L. Gernon Award for Outstanding Service to Continuing Legal Education in Kansas. The award is named for Kansas Supreme Court Justice Robert L. Gernon (1943-2005), whose career included tireless devotion to the training, education, and professionalism of attorneys in Kansas and across the nation. Any organization or attorney that has been instrumental in providing quality continuing legal education to the attorneys in Kansas is eligible to receive the award. Consideration will be given to nominees who have a record of demonstrated excellence in and commitment to continuing legal education up to and including the 2005-2006 compliance period. The award recipient must have demonstrated a unique commitment to continuing legal education in Kansas. Outstanding service to continuing legal education as a presenter, writer, or speaker are among the factors that will be considered in the selection process. The Kansas Continuing Legal Education Commission will select an award recipient and will notify the person, or organization, in writing. The presentation of the award will be determined by the Commission and the award recipient.

For more information on the nomination process, please visit the Kansas CLE Commission Web site at www.kscle.org. The nomination package must be postmarked by June 30, 2006. E-mails and faxes will not be accepted. ■

2006-2007 REPT Section Proposed Officer Slate

Robert M. Hughes – President

Vernon L. Jarboe – President-elect

Kevin M. Conley – Secretary/Treasurer

Dan C. Peare – CLE Liaison

Scott D. Jensen – Legislative Liaison

Calvin J. Karlin - Section Editor

The Kansas Bar Association Real Estate, Probate, and Trust Law Section nomination committee has selected a proposed slate of officers. If you are interested in becoming involved in the section leadership, contact:
Robert M. Hughes
Bever Dye LC
301 N Main St Ste 600
Epic Center
Wichita, KS 67202-4806
Phone: (316) 263-8294
Fax: (316) 263-3142
rmhughes@beverdye.com