KANSAS BAR ASSOCIATION
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KBA Real Estate, Probate & Trust Section Newsletter

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Section President's Message

By *Frederick B. Farmer*
Lowe, Farmer, Bacon & Roe, Olathe

On behalf of the entire section, I extend thanks and gratitude to Mike Dwyer for his leadership over the past two years. I also want to extend a special thanks to Cal Karlin for his tireless efforts as Editor of the Section Newsletter which was revived during Mike's tenure as president.

Cal and his contributing authors have put together another excellent newsletter. As you see, it was an interesting legislative session for the real estate, probate and trust practice areas.

One of the major goals of our Section is to keep our members informed regarding significant developments in our practice areas and to monitor and provide input to various pieces of legislation. All can benefit from the contributions of time and talent our members choose to make. Anyone interested in submitting an article or sharing Section news for publication should contact either Cal or me. Bob Hughes, our legislative liaison, and Dan Peare, CLE liaison, seek member assistance and support as well.

Without sending a formal questionnaire, your ideas and suggestions for upgrading and enhancing the value of Section membership are always welcome. Please contact me or any member of the executive committee with suggestions. Your involvement will be appreciated and a benefit to all.

Probate and Trust Cases

By Calvin J. Karlin
Barber Emerson, L.C., Lawrence

Moore V. Luther
291 F. Supp. 2d 1194
(Judge Richard Rogers, September 8, 2003)

In this case, Judge Rogers held that fraud and outrage claims against insurer of decedent driver and insurer's attorney were time barred. This is a factually and legally complex case that should be read in its entirety if you have a similar situation.

On March 31, 1997, Mrs. Moore was involved in an auto accident with Mr. Luther. Mrs. Moore submitted a claim to State Farm (Mr. Luther's insurer). The claim was denied and the denial was communicated to Mrs. Moore on April 11, 1997. Mr. Luther died September 5, 1997. Mr. and Mrs. Moore filed a lawsuit against Mr. Luther on March 26, 1999 (five days before the statute of limitations ran). State Farm's attorney filed an answer and propounded discovery on behalf of the deceased defendant (without revealing the death). On July 23, 1999, State Farm's attorney filed a suggestion of death on the record; and three days later moved to dismiss the case. On appeal the Kansas Court of Appeals remanded the case with instructions to dismiss without prejudice for lack of jurisdiction (because plaintiffs had named a defendant who was dead at the time of filing). In dicta, the Kansas Court of Appeals implied that the two year limitations may have been tolled by State Farm's attorney's failure to notify plaintiffs of Mr. Luther's death.

Upon remand the trial court dismissed the case on January 9, 2002. Mr. Luther's estate was reopened in Iowa (his state of residence) and Mrs. Luther was appointed as his executor on June 28, 2002. The Moores filed this federal case on July 3, 2002, for fraud and outrage, naming Mrs. Luther (as executor), State Farm, and State Farm's attorney as defendants.

The defendants sought dismissal based upon the statutes of limitation. The federal court held that the two year statute of limitations for fraud commenced to run three days after the July 26, 1999, suggestion of death was mailed to plaintiff's attorney by State Farm's attorney. The statute of limitations for the tort of outrage is only one year so it had also run by the time plaintiffs filed their federal lawsuit.

Judge Rogers rejected plaintiff's claim that the deceased Mr. Luther concealed himself so as to toll the statute of limitation. Judge Rogers reviewed several seemingly inconsistent prior decisions by the Kansas Court of Appeals on similar facts (*Yoh v. Hoffman*, 29 Kan. App. 2d 312, 27 P. 3d 927 (2001); *Moore v. Luther*, 29 Kan. App. 2d 1004, 35 P. 3d 277 (2001); and *Hinds v. Estate of Huston*, 31 Kan. App. 2d 478, 66 P. 3d 925 (2003)). Judge Rogers also reviewed alternative dates that could be argued for beginning and ending the statute of limitations. Judge Rogers concluded that while State Farm and its attorney were not forthcoming as to Mr. Luther's death, the plaintiffs had numerous opportunities to learn of Mr. Luther's death and to act expeditiously thereafter. Judge Rogers refused to apply the doctrine of equitable estoppel to save plaintiffs from their own failures.

This case did not seem to involve in any way the filing of a claim against the Iowa estate of Mr. Luther or an allegation that notice of a claim filing deadline was not provided pursuant to *Tulsa Professional Collection Services, Inc. v. Pope*, 485 U.S. 478 (1988). Presumably the plaintiffs were interested in the insurance money and not in the decedent's possible estate.

In re Somers
89 P. 3d 898
(Kansas Supreme Court, May 14, 2004)

Kansas was the first state to adopt the Uniform Trust Code. This is the second decision under the Kansas Uniform Trust Code (the first being *In re Harris Testamentary Trust*, 275 Kan. 946, 69 P. 3d 1109 (2003)). The Kansas Supreme Court recognizes that the KUTC allows greater flexibility regarding modification of long term trusts, so long as the settlor's objectives are still met.

Eula Somers died in 1956 and left a testamentary trust worth approximately $120,000 to provide $100 per month to her two grandchildren during their lives. By January 2001 the trust had grown to approximately $3,500,000. The two grandchildren and the remainder bene-

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ficiary (the Shriners Hospitals for Children) agreed to terminate the trust and give each grandchild $150,000 with the balance to the Shriners and the Shriners agreeing to continue the $100 monthly payments to the grandchildren. The bank trustee opposed termination of the trust.

The district court refused to terminate the trust or allow the $150,000 individual distributions to the grandchildren. The district court utilized its equity jurisdiction to order an immediate distribution to the Shriners of all but $500,000. This amount would remain in trust to fund the monthly payments to the grandchildren. The bank trustee appealed. The grandchildren and the Shriners cross-appealed.

The grandchildren claimed that despite a spendthrift provision in the testamentary trust, the court had the power to terminate the trust because the spendthrift provision was not a material purpose of the trust. The Kansas Supreme Court indicated that the grandchildren cited no authority for the proposition that a spendthrift provision must apply to a substantial portion of a trust to be material, and found the argument to be without merit.

The grandchildren also argued that an annuity purchased for them by the Shriners outside of the trust could continue the purpose of lifetime payments. Under Kansas law (K.S.A. 60-2304) an annuity is not protected from attachment by an annuitant's creditors. The Kansas Supreme Court held that such an annuity would not preserve the decedent's purpose of protecting the trust assets from her grandchildren's creditors.

The Kansas Supreme Court upheld the substantial distribution to the Shriners Hospitals for Children as an appropriate trust modification under the KUTC. The trust's growth and present value was found to be a circumstance that was not anticipated by the settlor.

The attorneys for the grandchildren sought attorneys fees and expenses at the district court level of $117,454.98. The district court judge allowed $111,149.93. The Kansas Supreme Court deferred to the district court's judgment as to the amount of fees but noted that it did "not consider this litigation complex or contentious." The Kansas Supreme Court held that the lower court fees should be divided equally between the Shriners and the grandchildren.

The Kansas Supreme Court then reviewed the $45,566.92 appellate fee and expense request of the grandchildren and concluded that the fee request was unreasonable. The Kansas Supreme Court found $15,000.00 to be reasonable for fees and $849.42 for expenses. The grandchildren were held to be responsible for these amounts.

Godley v. Valley View State Bank
89 P. 3d 595
(Kansas Supreme Court, May 14, 2004)

The issue in this case was whether the trustee's failure to sign a trust amendment rendered the amendment ineffective as to the dispositive provisions. The Kansas Supreme Court held that it would not allow trustees such a veto provision over dispositive provisions. The Court thus upheld the disposition provided in the amendments.

Mariza Tolivar's original trust was properly executed in 1993 by her, as settlor, and Mariza and her husband Jack, as trustees. In January 1998, Merrill Lynch Trust Company prepared and Jack and Mariza executed a trust amendment naming Merrill Lynch as successor trustee. Less than one month later Jack died leaving Mariza as sole trustee and Merrill Lynch as successor trustee. Approximately six weeks after Jack's death, Mariza executed as settlor a 39-page trust amendment. This long trust amendment relieved Mariza of her duties as trustee and named Merrill Lynch as the trustee. It was delivered to Merrill Lynch and when it was still unsigned 20 days later, Mariza's attorney wrote Merrill Lynch reminding them of their agreement to sign and expressing concern about the imminence of Mariza's death. Mariza died that day. Two days later Merrill Lynch surprised Mariza's attorney by declining the position of trustee.

The original trust agreement provided the settlor could amend it "by duly executed instrument delivered to the trustee." It further provided that, "No amendment shall be made, however, which shall in any way increase the obligations of the Trustee hereunder or change its rights or duties without its written consent." Finding that no Kansas courts had addressed such language, the Kansas Supreme Court turned to *Woodward v. Ameritrust Co.*, 751 F. 2d 157 (6th Cir. 1984). Following *Woodward's* lead, the Court held that the dispositive provisions provided in the 39-page amendment would be upheld. The Court summarized its ruling as follows: "A trustee's noncooperation should not be allowed to destroy a settlor's modification to her estate plan, particularly when, like here, the settlor has died, and where neither undue influence nor the settlor's mental capacity is an issue." The Court indicated that this principle applies whether the trustee refuses to sign due to financial overreaching, concerns about the proposed amendment, or for no reason whatsoever.

Although the Court recognized that the acceptance and handling of property by the trustee is necessary to the establishment of an express trust, it indicated that this is not a requirement for an amendment to the dispositive provisions of an already established trust.

The Court refused to apply the provisions of the Kansas Uniform Trust Code (KUTC) that became effective January 1, 2003, approximately 3 1/2 months after entry of the district court's order. Although the KUTC applies by its terms to judicial proceedings concerning trusts commenced before its effective date, there is an exception if application of a particular provision of the KUTC would prejudice the rights of the parties. The Kansas Supreme Court found that applying the KUTC would cause the defendants to be replaced as residuary beneficiaries and would therefore prejudice their rights.

Homestead Power of Attorney

Among the changes to the Kansas Durable Power of Attorney Act, as enacted in House Bill 2554, as amended by the Kansas Senate, is a provision that a husband and wife can sign separate powers of attorney that will be deemed to meet the joint consent requirement for conveying the homestead if certain conditions are met. It remains to be seen whether this statutory change will be incorporated into the Kansas Title Standards given the "joint consent" requirement of Article 15, Section 9, of the Kansas Constitution, several old cases (*Wallace v. Ins. Co.*, 54 Kan. 442 (1894); *Ott v. Sprague*, 27 Kan. 620 (1882)) interpreting and applying the Constitutional provision, and the current Title Standards. Until this is resolved, the safer approach will be to follow the current Title Standard 6.12 methodology of both spouses jointly executing the same instrument granting a power of attorney as to the home-

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By Mark A. Andersen,
Barber Emerson, LC, Lawrence

KANSAS SUPREME COURT

ALIRES V. MCGEHEE
SEWARD DISTRICT COURT - REVERSED
COURT OF APPEALS - AFFIRMED
NO. 88,514 - 20 PAGES - MARCH 19, 2004
Fraud

FACTS: Alireses purchased house from McGehees, and sued when basement leaked. District court entered judgment for Alireses, finding McGehees had fraudulently misrepresented condition of house. In unpublished opinion, Court of Appeals reversed, finding evidence did not establish McGehees made untrue statements with intent to deceive or fraudulently induce sale, or that Alireses were justified in relying on alleged misrepresentations. Alireses' petition for review granted.

ISSUE: Fraud in real estate sale.

HELD: Court of Appeals erroneously relied on McGehees' attempt to back out of sale in determining there was no intent to deceive, and under facts, erroneously relied on Alireses' failure to note important representations on seller's disclosure statement. Conclusion of Court of Appeals is still affirmed. Under facts, substantial competent evidence supports trial court's finding that untrue statements of fact were knowingly made. However, buyer of real estate could not reasonably rely upon representations of seller when truth or falsity of representation would have been revealed by inspection and misrepresentations were made prior to or as part of contract in which buyer contracted for right to inspect, when buyer agreed that seller's statement were not warranties and did not replace right of inspection, and when buyer declined inspection and thereby waived any claims arising from defects which would have been revealed by an inspection.

STATUTES: None.

CITY OF TOPEKA V.
BOARD OF SHAWNEE COUNTY COMM'RS
SHAWNEE DISTRICT COURT -
REVERSED AND REMANDED
NO. 90,620 - MAY 14, 2004
Cities and Counties

FACTS: Shawnee County enacted charter approving subdivision plat for Hickory Creek Subdivision, and directed Shawnee County Register of Deeds to record the plat. City of Topeka sued to challenge County's authority to approve plat in a three-mile area outside the City's limits, an area governed by a joint city and county planning commission. District court granted judgment to defendants, finding *Moore v. City of Lawrence*, 232 Kan. 353 (1982), was no longer good law. City's appeal transferred to Supreme Court.

ISSUE: County home rule and subdivisions

HELD: Once a county elects to conduct joint community planing according to K.S.A. 12-741 et seq., it must follow the procedures so mandated. Planning procedures may not be avoided by reference to a county's home rule power. Moore remains vital. Reversed and remanded.

STATUTES: K.S.A. 2003 Supp. 19-101a(1); K.S.A. 12-401, -715(d), -741 et seq., -749(d), - 750, -752, -757, 19-101b(d), -2633, -2901 et seq. -2905, -2956 et seq., -2961, 20-3018.

STONE V. U.S.D. NO. 222
WASHINGTON DISTRICT COURT -
JUDGMENT OF
THE COURT OF APPEALS AFFIRMING
THE DISTRICT COURT IS REVERSED.
JUDGMENT OF THE DISTRICT COURT IS
REVERSED AND REMANDED WITH DIRECTIONS
NO. 90,317 - JUNE 25, 2004
Property; Railroad Right-of-Way

FACTS: Burlington Northern Railroad Company conveyed certain property to the school district by quitclaim deed. The property was held by the Railroad as a right of way, but the railroad line was abandoned quite some time ago. The school district began securing fill dirt from the subject property to backfill a hole left when a school was razed. The Stones were the adjacent landowners to the subject property and they filed a petition for damages based on trespass against the school district and the excavators. The school district argued the railroad was granted fee simple title in the original warranty deed and the railroad conveyed the same to the school district. The Stones argued that the railroad only had an easement in the subject property which was used as a railroad right-of-way and the property reverted to them as adjacent landowners upon abandonment of use. The district court granted summary judgment to the Stones as the adjoining landowners on abandonment of the right-of-way. The Court of Appeals affirmed the district court's ruling.

ISSUE: Whether the railroad's interest in the subject property was limited to a right-of-way or if it was a fee simple absolute interest?

HELD: The Court reversed the district court and the Court of Appeals. Court stated that a railroad may acquire an interest in real property by eminent domain, by purchase, or by voluntary grant. If a railroad owns the land under its tracks in fee simple, the abandonment of rail service does not affect its property rights at all. However, Court stated that in Kansas, railroads take only as easement in strips taken for railroad right-of-ways regardless of whether taken by condemnation or deed. Upon abandonment, the strip reverts back to the original landowners. Court held that under the facts of this case, the original unambiguous deed did not contain any use restrictions or reversion clause and thus, granted the railroad title to the land in fee simple absolute. The fact that the railroad sold all of the original conveyance except for that portion used for a right-of-way which was subsequently abandoned did not alter the railroad''s interest nor prevent it from conveying the property in fee simple absolute.

Kansas Court of Appeals

SOUTHWEST & ASSOCS. INC. V. STEVEN ENTERPRISES, L.L.C.
SEDGWICK DISTRICT COURT - AFFIRMED
NO. 90,398 - 11 PAGES - MAY 7, 2004
Contract

FACTS: Southwest & Associates (Southwest) provided aluminum siding in remodeling project. Southwest billed general contractor (LEI) as Steven Enterprises (Steven) had directed, but LEI declared bankruptcy before Southwest was paid. In lawsuit filed by Southwest against Steven, district court found Steven directly negotiated the contract with Southwest, and was therefore liable. Steven appealed.

ISSUE: Enforceable contract.

HELD: Substantial competent evidence supports district court's finding that only enforceable contract was between Southwest and Steven. Standard of review does not allow re-weighing fact of Southwest's claim in LEI's bankruptcy, even if appellate court might have weighed this evidence differently. *Stewart v. Cunningham*, 219 Kan. 374 (1976), is not to be read as requiring a written contract between subcontractor and owner to establish an independent contractual obligation outside a general contract. Where no writing manifests a contract between a supplier to a construction project and either the owner or a general contractor, there is no presumption that all contracts related to the construction project obligate only the general contractor. Classic principles of contract law are to be applied for determination of an enforceable contract.

STATUTES: K.S.A. 60-1101.

T.R. INCORPORATED V. BRANDON, ET AL.
CLARK DISTRICT COURT - AFFIRMED
NO. 90,469 - 15 PAGES - APRIL 2, 2004
Farm and Ranch Lease

FACTS: T.R. entered into a lease agreement with Brandon and others involving 3,697 acres of ranch and farmland. The lease granted T.R. the right to produce and harvest wheat in 1999, 2000, and 2001, and to receive government wheat payments for those years. Brandon terminated the lease in 2001 and T.R. did not receive any of the 2001 alfalfa crop or the wheat crop in 2002. The trial court ordered T.R. to reimburse Brandon for the 2001 crop payment. The parties also disagreed on the pasture land rented and which party was entitled to the second half payment on a 6-month pasture lease for T.R.'s 120 head of cattle. T.R. removed the cattle, didn't pay the lease payment, and Brandon filed a lien to recover the money owed. The trial court interpreted the lease as giving the 2002 crop proceeds and the government feed grain payment to Brandon. The court also ruled the writ-

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ten lease was controlling and T.R. was not entitled to recover the value of the perennial alfalfa crop under the doctrine of unjust enrichment. The trial court concluded that a 1/3 reduction in acreage under the pasture agreement resulted in a 1/3 reduction in the rent owed by T.R.

ISSUE: Did the trial court correctly interpret the lease agreement?

HELD: Court affirmed the trial court's ruling. Court stated it is not a function of the courts to rewrite a contract of the parties. Court stated the language of the lease was ambiguous and confusing when examined in the light of the entire contract and the customary farming practices in the region. Court concluded the trial court was correct in granting summary judgment to Brandon and finding it was the intent of the lease for T.R. to receive the wheat payments through 2001 when the lease ended and the year "2002" was a typographical error. The Court concluded it would be unconscionable to give T.R. the crop proceeds and the government feed grain payments after the lease was terminated since it appears to be against the intent of the parties and the lease. Court agreed with the trial court that T.R.'s claim of unjust enrichment due to the perennial alfalfa crop was without merit based on the controlling three-year lease. Court stated that if T.R. had a claim for the 1998 crop payment it was against the prior tenant who received the payment and not Brandon. Court held there was insufficient evidence concerning the issue of reimbursement for T.R.'s spraying of the 2001 alfalfa crop. The Court affirmed the trial court's decision on Brandon's cross-appeal for abatement of rent. Court stated that given the admitted shortage of acreage and the number of T.R.'s barren cows, it was not an abuse of discretion for the trial court to exercise its equitable powers and order 1/3 refund of the pasture rent.

STATUTES: No statutes cited.

HUBER CO. V. DESOUZA, ET AL.
LEAVENWORTH DISTRICT COURT - AFFIRMED IN PART AND REVERSED IN PART
NO. 57,390 - 7 PAGES - FEBRUARY 27, 1986
(ORDERED PUBLISHED ON NOVEMBER 12, 2003)
Mechanic's Liens

FACTS: Previously filed as an unpublished opinion, the Supreme Court granted a motion to publish pursuant to Rule 7.04 (2002 Kan. Ct. R. Annot. 46). The Huber Co. filed an action on a contract and to foreclose two mechanics' liens. The contract and lien statements were attached to each lien. However, there was no indication of what labor was done or how Huber arrived at the amount due on the property. The trial court upheld the liens by determining that the dealings between the parties and the itemized billings Huber sent DeSouza remedied any deficiencies in the filings.

ISSUE: Were the lien statements filed by Huber "fair and sufficient" to inform the Desouzas of Huber's claims?

HELD: Court affirmed the trial court's judgment for monetary damages, but reversed the court's judgment granting foreclosure of the two liens. Court stated that since the mechanics lien is purely a statutory creation, only strict compliance with the provisions in the statute will give rise to an enforceable lien and that K.S.A. 60-1102(a)(4) requires that a statement be given which is neither excessive nor sufficient in detail but which is fair and sufficient to inform the landowner of the claim and to enable him or her to ascertain whether the material was furnished and the charges fair. Court held that (1) liens were invalid on basis that itemization of liens claims were insufficient, and (2) contract attached to each mechanics' lien claim did not remedy contractor's failure to provide sufficient itemized statement.

STATUTES: K.S.A. 60-1101, -1102(a)(4).

G.L. MACRAY V. CLUBS, INC., ET AL.
WYANDOTTE DISTRICT COURT - REVERSED IN PART, VACATED IN PART, AND REMANDED WITH DIRECTIONS
NO. 90,260 - 8 PAGES - APRIL 16, 2004
Leases; Limited Actions; Restraining Orders

FACTS: Macray and Clubs/Chad Waldrop entered a two-year lease expiring on November 25, 2002. By October 2002, Clubs was approximately $24,000 in arrears on rent payments. Macray filed a peaceable entry and forcible detainer action, sent Clubs a "Notice to Quit," and informed Clubs the lease would not be renewed and demanded Clubs vacate the property immediately. Waldrop threatened to burn down the building and Macray obtained an order in October 2002 restraining Waldrop from entering the property. Macray agreed to delay court proceedings based on an immediate payment of $12,000 and possession of an automobile until the remaining $12,000 was paid before November 25, 2002. Clubs did not appear at a November 13, 2002, hearing, court granted Macray a default, and on November 26, 2002, court gave Macray possession of the property, $21,000 in damages and ownership of automobile. District court set aside default based on prior agreement and ordered that Clubs could remain in possession of property until trial. Parties tried to negotiate lease renewal without success and Clubs gave Macray a check for $1,800. Clubs said it was for December rent, Macray said it was applied to taxes owed by Clubs. District court ordered Macray to return automobile and Macray was given possession of property. District court said the $1,800 for December rent would be taken off the $12,000 unless another contract year was granted. However, later the district court stated it intended to rule that it did not know what the $1,800 payment was for, but if it was for taxes, it was too much. Clubs paid Macray $10,200 as ordered by court and Macray returned the automobile.

ISSUES: Whether Clubs' payment extended the lease, giving it the right to continue its occupancy of the leased property? Did the district court have authority to issue the restraining order?

HELD: Court agreed with Macray that Clubs acquiesced in the trial court's judgment regarding payment of past due rent and the only issue concerned extension of lease by the December payment. Court held there is clearly confusion in the trial court's decision as for the purpose, whether rent or taxes, of the $1800 December payment. Court remanded to determine the purpose of the $1,800 payment. Court found there were no Chapter 60 procedures adopted by the Chapter 61 limited actions code to provide for issuance of restraining orders. Consequently, the trial court had no authority to issue the restraining order under Chapter 61 and order was vacated.

STATUTES: K.S.A. 58-2502; K.S.A. 60-903; K.S.A. 2003 Supp. 61-2801 et seq., - 2912.

SALINE COUNTY BOARD OF COUNTY COMM'RS V. JENSEN, ET AL.
SALINE DISTRICT COURT - AFFIRMED IN PART, REVERSED IN PART, AND REMANDED WITH DIRECTIONS
NO. 90,942 - 22 PAGES - APRIL 23, 2004
Property Tax Appeal

FACTS: The Jensens' paid property tax under protest for tax year 1999 contending the County's valuations were excessive for three multifamily developments located in Saline County commonly known as Southwind, Chalet and Birch Manor. Southwind consisted of 30 multifamily duplex units built in 1958 and remodeled into fourplexes in 1987. BOTA valued the property in 1999 at $2,540,510 relying primarily on the County's aggregated sales comparison approach. The district court concluded the County used the wrong approach and valued the property at $1,940,000 using the Jensens' income approach. Chalet is a single apartment building containing 18 two-bedroom apartments. BOTA valued Chalet at $475,010 relying exclusively on the County's income approach. The district court adjusted certain components within the income approach resulting in a final value of $377,000. Birch Manor is a three building 27-unit condominium complex of which the Jensens own 23 units and each unit is considered a separate parcel. BOTA concluded the units should be valued as apartments, relied exclusively on the Jensens' income approach to value the entire unit at $580,000 and then allocating the value to each unit. The district court affirmed BOTA's value.

ISSUES: (1) Did BOTA err in its Valuation of Southwind?; (2) Did BOTA err in its Valuation of Chalet?; and (3) Did BOTA err in its Valuation of Birch Manor?

HELD: (1) Court concluded, as did the district court, that the aggregate sales comparison approach proposed by the County and adopted by BOTA was violative of the Uniform Standards of Professional Appraisal Practice (USPAP). However, the Court did not accept the district court's value conclusion because the Court was unable to determine an appropriate reserve. Court remanded to the district court to remand

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to BOTA to determine the fair market value of Southwind as a single parcel, with due consideration of its unique characteristics, without reference or reliance on the flawed aggregate sales comparison approach, with due consideration if not principal reliance on the income approach pursuant to K.S.A. 79-503a, and with careful adherence to generally accepted appraisal practice including the USPAP standards in redetermining repair and replacement reserves to be utilized within the income approach to value. (2) Court concluded the district court did not err in determining that BOTA's valuation was not supported by substantial evidence. Court stated the County's initial appraisal standing alone cannot be sustained absent supporting evidence of its validity and correctness, and such evidence should be provided by someone with appraisal experience who is familiar with the property, the appraisal, and the local market for such properties. Court held BOTA departed from a prescribed procedure in adopting the County's valuation absent a demonstration of the validity and correctness of the valuation. (3) Court rejected the County's argument that BOTA and the district court erred as a matter of law in disregarding the zoning prohibition for Birch Manor to be used as apartments and that the highest and best use cannot possibly be an illegal use. Court found the County failed to demonstrate the illegal use of the property. As a result the County's argument that Jensens' valuations violate the uniform and equal mandate also failed.

STATUTES: K.S.A. 77-621; K.S.A. 79-503a, -505, -506, -2005(I).

L.P.P. MORTGAGE, LTD V. NATHAN HAYSE, ET AL.
KIOWA DISTRICT COURT - AFFIRMED IN PART, DISMISSED IN PART, AND REMANDED WITH INSTRUCTIONS
NO. 90,937 - 19 PAGES - MARCH 12, 2004
Foreclosure; Appellate Jurisdiction

FACTS: The defendants borrowed money from the Small Business Administration in 1978 and the mortgage encumbered the three parcels of land that are the subject of later foreclosure proceedings. After bankruptcy proceedings were filed by the defendants, the SBA assigned the note to LPP when they purchased the loan in August 2000. LPP filed a foreclosure action in May 2002 when the defendants failed to make proper payments under the bankruptcy agreements. LPP was granted a default judgment, but LPP set aside the judgment after they discovered they failed to sue a necessary party. LPP amended its petition to include the necessary party. The court ruled that the bankruptcy proceedings created a new contract between the parties in 1997 and as such incorporated all the terms originally contained in the note and mortgage, including the provision for the collection of attorney fees. The court awarded judgment to LPP for $159,415.16 and on March 10, 2003, the mortgage on the three tracts of land was ordered foreclosed with a three-month redemption period. On March 20, 2003, the defendants filed a motion to alter or amend the court ruling. The district court denied the motion and directed a sheriff's sale to proceed on May 2, 2003. Central Bank purchase all three tracts at the sheriff's sale on May 2, 2003. The district court confirmed the sale on May 21, 2003, but entered a nunc pro tunc order on June 3, 2003 that the sale had been conducted in conformity with the law, equity and the court's prior orders. The district court ordered LPP to pay any casualty insurance proceeds into court and directed LPP's attorney to provide the defendants attorney an itemized account of all fees and expenses they had included in the judgment. The defendants filed a notice of appeal on June 30, 2003 from "all adverse rulings" of the district court.

ISSUE: What rulings does the Court have jurisdiction to consider on appeal?

HELD: The Court held there was no appeal from the order of foreclosure filed on March 10, 2003. The defendants properly filed a motion to alter or amend the judgment and it tolled the time for appeal. The district court denied the motion on March 25, 2003. No one appealed from the order denying the motion to alter or amend the foreclosure judgment. The defendants appealed after the district court entered its order of confirmation of the sheriff's sale. Court held that an order confirming a sheriff's sale is not a repetition of the judgment of foreclosure. The two orders are contiguous but not identical. A judgment of foreclosure and sale is a final decree. The proceedings subsequent thereto relating to the sale are analogous to the execution of a judgment and simply enforce the parties' right which have been adjudicated. A party who wishes to contest the judgment of foreclosure must appeal from that judgment. The judgment of foreclosure cannot be challenged on appeal from an order confirming a sale. The Court held the defendants failed to timely appeal the rulings made by the district court in its judgment of foreclosure. Those rulings cannot be attacked in an appeal from the order confirming the sheriff's sale. The Court held there were no transcripts provided concerning the fees and expenses and the court remanded for an evidentiary proceeding to determine the appropriate amount of attorney fees and expenses that should be awarded. The Court also held the record did not contain any substantiation of the defendants' claims for reimbursement for completed storm repairs and their entitlement to casualty insurance proceeds. The Court dismissed the portion of the appeal dealing with casualty insurance since no final order had been issued by the district court.

STATUTES: K.S.A. 60-259(f); K.S.A. 2003 Supp. 60-2103(a).

LEGLEITER V. GOTTSCHALK D/B/A
BRASS RAIL TAVERN
ELLIS DISTRICT COURT - AFFIRMED
NO. 91,191 - JUNE 25, 2004
Respondeat Superior; Premises Liability

FACTS: Gribben was managing the Brass Rail Tavern owned by Gottschalk. Gribben made the last call on a slow Monday night and he had to throw Hamby from the tavern because Hamby started a new pool game and the two argued. Outside Hamby continued to fight and struggle and Gribben took him to the ground. As Gribben and Hamby struggled, Lynn retrieved a bat from his car and in a struggle between Lynn and Karst, Legleiter allegedly struck Karst. Karst attacked Legleiter on the public sidewalk and the street in front of the tavern. Legleiter was knocked out and became unresponsive. Legleiter was severely injured and was hospitalized for an extended period of time. Karst was apparently prosecuted for his actions. Legleiter sued Gottschalk for personal injuries and substantial damage under a theory of respondeat superior and the duty of the owner or his employees to use reasonable and ordinary care regarding patrons of the tavern. The district court found Legleiter was injured on public property, not possessed or controlled by Gottschalk or Gribben and therefore, as a matter of law, no liability existed on Gottschalk's part to control the actions of third parties, namely Karst.

ISSUE: Did Gottschalk owe Legleiter a duty to protect him from the criminal acts of a third party?

HELD: Court stated the general rule that business owners are not responsible to protect their customers from the acts of third parties outside the premises of the business. Court cited the lack of prior unruliness or criminal activity at the business or that evening and that Gribben was not creating a known, obvious, and imminently dangerous situation. Court held the district court did not err in granting summary judgment to Gottschalk. The facts failed to show the breach of any duty owed by Gottschalk and Gribben to Legleiter and summary judgment was proper.

STATUTES: No statutes cited.

<u>United States District Court for the District of Kansas</u>

AKHLAGHI V BERRY
NO. 03-2485-JWL - DECEMBER 11, 2003
294 F.Supp.2d 1238 (D. Kan)
Landlord/Tenant - Fair Housing Act

Background: Landlord sued tenants in state court seeking unpaid rent and possession of rental property. Tenants asserted counterclaims of conversion, abuse of process, malicious prosecution, unlawful interference with their right to lease real property in violation of § 1982, and racial discrimination in violation of the Fair Housing Act. After tenants removed the action on the basis of their federal law claims, landlord moved to dismiss, to remand, or to sever and remand.

Holding: The District Court, Lungstrum, J., held that tenants' counterclaims did not allege that they would be denied or could not enforce a specific federal right in state court, as required to support petition for removal of civil rights action. Motion to remand granted.

STATUTES: 28 U.S.C.A. 1443(1); 42 U.S.C.A. 1982; 42 U.S.C.A. 3601.

MEASE, ET AL. V. CITY OF SHAWNEE
NO. 02-2041-CM - OCTOBER 2, 2003

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2003 WL 23498473 (D. Kan)

Wood Shingles

Background: On January 13, 2003, the City of Shawnee passed Ordinance No. 2655 which made it "unlawful to establish or enforce a restrictive covenant which permits the use of wood shingles or wood shake shingles or any other unrated roofing material on a residential dwelling . . . unless the restrictive covenant also permits as an alternative the use of . . . composition roofing material." Plaintiffs sued the city seeking an injunction.

Holding: The District Court, Murguia, J., granted a permanent injunction stating that the ordinance impaired plaintiffs' constitutional right to contract and went beyond the City's stated goals.

Resulting Action: On December 22, 2003, the City of Shawnee passed Ordinance No. 2697, which made it "unlawful to establish or attempt to enforce a restrictive covenant which requires the exclusive use of wood shingles or wood shake roof covering material on a residential dwelling . . . unless the restrictive covenant also allows the use of one or more class of fire resistance rated composition or asphalt shingle . . . ." This ordinance is in accord with Judge Murguia's statement in the Memorandum and Order granting the plaintiffs' preliminary injunction. See *Mease v. City of Shawnee*, No. 03-2041-CM, 26 F.Supp.2d 1270, 1278 (D. Kan. 2003) (suggesting that a permissible alternative would be an ordinance that "would void deed restrictions that require the use of wood shingles.").

Office of the Attorney General
State of Kansas
OPINION 2004-10

Personal and Real Property —
Real Estate Brokers and Salespersons —
Minimum Requirements
of Seller's or Landlord's Agents
Personal and Real Property; Real Estate
Brokers and Salespersons; Prohibited Acts

SYNOPSIS: A real estate broker has a duty to disclose to a customer all adverse material facts actually known by the broker. Adverse material facts are those facts that relate to the property that is the subject of a transaction, the title to the property and the client's ability to perform the terms of the contract, but not to information about who may reside in close proximity to the subject property. Consequently, the Brokerage Relationships in Real Estate Transactions Act does not impose a duty on a broker to disclose the fact that a registered sex offender resides in the neighborhood. Nevertheless, if a prospective purchaser asks a broker whether a registered sex offender resides nearby, the broker must respond truthfully concerning any known information. To respond in any other manner would subject the broker to disciplinary action by the Real Estate Commission, and possibly civil liability, for engaging in fraud or making a substantial misrepresentation.

To date, no Kansas appellate decision has addressed whether a duty should be imposed on real estate brokers, builders or developers to disclose that a registered sex offender resides in close proximity to property that a prospective purchaser is interested in buying. Consequently, we are unable to say with any degree of certainty whether a Kansas appellate court would find such a disclosure duty should a child be molested by a registered sex offender that a broker, builder or developer knew resided nearby but did not disclose that fact to a purchaser.

STATUTES: K.S.A. 2003 Supp. 58-3063; 58-30,106.

OPINION 2004-12

Taxation — Mortgage Registration and Intangibles
Mortgage Registration; Fee; Property in More
Than One County; Timing of Filing

SYNOPSIS: Once the proper mortgage registration fee has been paid in full to one county, and sufficient evidence of that fact provided to a subsequent county's register of deeds, the mortgage should be timely filed by the second county. We find no authority allowing the

By Timothy P. O'Sullivan
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Medicaid Planning (House Substitute for Senate Bill 272)

House Substitute for Senate Bill 272 was passed by the Kansas legislature in 2004 during the veto session at the end of April. It will markedly change Medicaid estate planning techniques in the state of Kansas. Fraught with policy and constitutional issues, it was never heard before the Judiciary Committee of either the House or Senate which could have reviewed these issues. Instead, it went through appropriations committees in each chamber in the waning days of the 2003 Session. After passing the Senate, it failed to secure approval in the House and became a holdover Bill in conference committee during the 2004 Session. As noted below, the Bill in its final form was only slightly modified from its original form, despite the Kansas Judicial Council and practitioners, including Molly Wood and Tim O'Sullivan recommending that numerous changes be made to the Bill.

From a policy and taxpayer perspective, there can be little legitimate objection to the consideration of most "available" resources, save limited exempt resources, of a person otherwise qualifying for Medicaid benefits prior to the granting of such benefits. Similarly, there should be no objection in most circumstances to SRS being able to require a "payback" of Medicaid benefits received by the Medicaid recipient from assets owned by the Medicaid recipient and which "pass to" another person or entity as a result of the Medicaid recipient's death. Indeed, the Real Property, Probate and Trust Section of the Kansas Bar Association has supported much legislation in the public interest, notwithstanding it may have a negative economic impact on estate planning professionals. Such legislation includes the 1998 repeal of the Kansas inheritance tax, the Kansas Spousal Elective Share Act, and provisions facilitating beneficiary designations and revocable trusts as probate avoidance devices.

However, as noted below, certain provisions of this legislation are not in the public interest due to being too overreaching, arbitrary in their application, laden with constitutional issues and poorly thought out from a public policy perspective.

Placement of Lien on Residence of Medicaid Recipient

This Bill permits SRS to place a lien on the real property (including the personal residence) of a Medicaid recipient. In its original form, its provisions could have created significant title problems on the conveyance of any real property, as it did not provide that filed prior liens took precedence over the Medicaid lien and did not provide such liens were subject to standard mortgage practices. These objections were removed through amendments by the 2004 Kansas legislature. The lien cannot be placed on real property without a hearing. Nonetheless, with regard to married Medicaid recipients, it will encumber the residence, even if owned in part by the "well spouse," such that the well spouse may not be able to utilize the equity in the residence for personal support or maintenance needs (e.g., through a reverse mortgage) or sell the residence and purchase a new residence.

Full Value of Joint Tenancy Property a Resource for Medicaid Benefits

Section (e)(2) of the Bill provides that "if an applicant or recipient owns property in joint tenancy with some other party and the applicant or recipient of medical assistance has restricted or conditioned their interest in such property to a specific property interest less than 100 percent, then such designation will cause the full value of the property to be considered an available resource to the applicant or recipient."

This provision appears to be either poorly drafted or disingenuous. All joint tenancies create an interest in more than one person. By definition, no joint tenant owns a 100 percent interest in the subject property. Otherwise, the property would be solely owned. If the idea was not to include all joint tenancies, the legislation, as summarized in the Supplemental Note, fails to do that. If the idea was to include all interest in joint tenancies, the legislation should have simply provided as such rather than use language that implies that the person has somehow created an interest that is outside the norm and therefore for some unexplained reason should not be honored for Medicaid qualification purposes.

This provision is also devoid of a rationale. If the purpose is to fully consider the available resources of a Medicaid applicant, this provision is much too overbroad. It considers the ownership interest in property of other parties. There is no legitimate rationale for considering the ownership interest of other parties in property (other than a spouse for "division of asset" purposes) prior to qualifying a Medicaid applicant for benefits. Such property is not an available resource to the Medicaid recipient and not subject to disposition by the Medicaid recipient. If the idea is to avoid a person transferring property to qualify for Medicaid benefits, this policy objective is achieved by other provisions which create a disqualification period in that event (one month for every $3,000 transfer). This provision appears to create a disqualifying transfer on the creation of a joint tenancy by a Medicaid applicant, yet still consider the gifted interest as a resource.

By irrationally singling out "joint tenancy" property for this treatment without a supportable underlying rationale, this provision appears to be highly vulnerable to equal protection constitutional problems. It treats joint tenancy differently from tenancy in common property, both of which are virtually identical from a property ownership perspective. It also fails to consider whether the other joint tenant(s) created the joint tenancy or contributed to the creation of the joint tenancy interest. For example, it would apply to a brother and sister who each purchased an interest in joint tenancy property. Even assuming there was a rationale underpinning for considering the ownership interest of others in property, what conceivable reason could there be for considering a sibling's purchased interest in such property if either sibling later needed long term care?

Claim Against "Medical Assistance Estate"

The Bill broadens the property that may be subject to the Medicaid claim of the SRS against the estate of the Medicaid recipient or the estate of the surviving spouse of the Medicaid recipient. Under current law, such claim extends to the probate estate, "POD" property having a beneficiary (i.e., banks, savings and loans, and credit union accounts), and possibly (as the statute is somewhat ambiguous) "TOD" property having a beneficiary (i.e., real property). The Bill under Section 1(g)(3)(B) defines the "Medical Assistance Estate" subject to the claim to include all property in which the deceased individual had an interest, whether probate property, joint tenancy property, property having any beneficiary designation, property passing under a trust or life estate property. This would effectively preclude the use of pro-

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bate avoidance devices previously not subject to the Medicaid claim (e.g., a 99 percent/1 percent joint tenancy interest, the Medicaid recipient having the 99 percent interest and a child the 1 percent interest) to avoid the claim. Including life estate property in this definition is questionable, as the life tenant's interest is limited to income from the property, all other interest in the property is owned by the remaindermen, and the life tenant's interest terminates at death. Hopefully, this problem was rectified by an amendment added in the Conference Committee at the recommendation of the Judicial Council which limits the claim to the value of the decedent's interest in the property (which should be zero at time of death with regard to a life estate).

Full Value of Joint Tenancy Property Subject to Medicaid Claim

In its original form, although not entirely clear in this regard, Section 1(g)(3)(B) of the Bill appeared to purport to subject the entire interest in joint tenancy property to a Medicaid claim on the Medicaid recipient's death. It defined a "Medical Assistance Estate" to include all property in which the Medicaid recipient had any legal title or interest. This should have been limited to the interest of the Medicaid recipient in the property which passes to another party as a result of the Medicaid recipient's death. Otherwise, this provision would be highly vulnerable to a due process challenge in the unlawful taking of another person's interest in the property without compensation. This issue would not only arise in a joint tenancy context, but also in tenancy in common situations. In addition to its clear constitutional problems, it is devoid of a rational policy.

Fortunately, the Conference Committee during the 2004 Veto Session acceded to the Kansas Judicial Council's recommendations and provided that such claim only attached to the interest of the Medicaid recipient in Medical Assistance Estate property.

Limitations on Caregiver Payments to Non-Licensed Individuals

Section 1(e)(4) of the Bill provides that personal service contracts of non-licensed individuals (e.g., a Medicaid recipient's child) regarding home health or other care, must be in writing and executed prior to any services being provided. Moreover, monies paid under the contract must bear a direct relationship to the fair market value of services provided by similarly situated non-licensed professionals, or if none can be found, based on federal hourly minimum wage standards, and reported as waged to the appropriate state and federal governmental revenue agencies. Moreover, the contract must be revocable by the Medicaid recipient and amounts under the contract cannot be made payable prior to the rendering of the service. These provisions substantially "tighten up" the ability of a caregiver relative to provide services to a Medicaid recipient without such payments being treated as a disqualifying transfer for Medicaid qualification purposes.

Provisions Relating to "Supplemental Needs" Trusts

Section 1(e)(3), providing that discretionary trusts created by third parties must specifically provide that trust assets are to be supplemental to Medicaid benefits (or Medical Assistance or to Title XIX of the Social Security Act providing for Medicaid benefits) in order to avoid the trust estate from being deemed an available resource, has no supportable rationale. First of all, if a trust is a pure discretionary trust, i.e., distributions are not tied to support and maintenance needs of a beneficiary, the Medicaid recipient could not compel a distribution from the Trustee under any circumstances. Consequently, the trust assets should not be deemed to be an available resource. Moreover, if a pure discretionary trust has multiple beneficiaries, e.g., all children of the grantor or a child and the child's descendants, there is no legitimate rationale for a position that all trust assets are available to each beneficiary. In short, there should be no requirement that any additional language be included in such trusts for them to be not considered a resource to a Medicaid applicant/beneficiary.

With regard to trusts which are not pure discretionary trusts (i.e., even though having discretionary distributions, such distributions are tied to a support or maintenance need of a beneficiary), the issue under current law is whether the grantor or testator intended that such distributions be supplemental to Medicaid benefits. There is no legitimate policy for requiring that such specific language be included to indicate such intent. The intent of the grantor of the trust with regard to Medicaid benefits being considered a resource prior to making trust distributions is substantively identical whether the trust provides that distributions are to be "supplemental to all other resources," "supplemental to governmental resources," or "supplemental to Medicaid benefits." Most attorneys draft these trust provisions using broad language to ensure all other resources are fully considered, whatever the name of the source. Requiring specific language in this regard disingenuously gives the erroneous impression that broader language does not indicate that the grantor desired that Medicaid benefits were to be considered prior to making a distribution. It creates both an arbitrary qualification issue and a "trap for the unwary." It would appear to have significant equal protection problems.

Moreover, by requiring such language be "specific contemporaneous language," the provision discloses its true arbitrary intent. That is, even if an instrument containing broader language was judicially modified or conformed to include such specific language in complying with the grantor's intent, this reformation would be ignored by SRS.

The additional provision in such Section which requires that even if the "supplemental to Medicaid" language is included in the instrument, the grantor (or testator) must not have an obligation to support the Medicaid applicant at the time of the creation of the trust if the trust is not to be considered a resource is both poorly thought out and devoid of a rational policy. For example, most of these types of trusts are created post-death under the provisions of a Will or Revocable Trust. No decedent has a legal obligation to support any living person.

Even if this provision applies to such testamentary trusts, it applies in an arbitrary fashion. For example, if a decedent created a trust for his seventeen year old daughter, the trust assets would be considered a resource for the rest of her life prior to qualifying for Medicaid benefits, not just the one remaining year the decedent would otherwise have had a support obligation. Conversely, if the same decedent had lived another year, the assets in such trust would not have been considered to the decedent's daughter at any time during the remainder of her lifetime.

These provisions also create severe practical problems and issues. If discretionary trusts not including such specific language are considered a resource, what are the consequences of trust provisions permitting the Trustee or a Special Trustee to amend the trust to delete the Medicaid applicant as a trust beneficiary? Does such an amendment result in a disqualifying transfer? If so, not only would the trust assets have been considered a resource without the trust beneficiary being able to compel a distribution, but the trust beneficiary would continue not to qualify for Medicaid benefits for an extended period following such amendment even though the Medicaid applicant was no

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longer a beneficiary and had no control over such amendment. Is there any cogent rationale for a different consequence in such event than would have been the case had the beneficiary simply not been included as a beneficiary by the grantor or testator at the time of creation of the trust? As an additional problem, if there are multiple beneficiaries of a discretionary trust which under the foregoing provisions would be considered a resource, when the Trustee makes distributions to beneficiaries other than the Medicaid applicant as authorized under the trust instrument, does this also inequitably result in a disqualifying transfer?

In sum, current law prior to the passage of this Bill adequately and appropriately addresses qualification issues with regard to trust assets being considered a resource for Medicaid benefits. The foregoing provisions are not only arbitrary and devoid of a valid policy under-girding, they also ostensibly apply to discretionary testamentary trusts created by a predeceased spouse for a surviving spouse, which are specifically countenanced under federal law.

Effective Date

The provisions of the Bill addressing joint tenancy property as a resource are effective for medical assistance eligibility determinations on or after July 1, 2004. The provisions applicable to trusts as a resource and caregiver contracts appear to be retroactive. The provision providing for the effective date of the definition of the Medical Assistance Estate is ambiguous. It provides that it is applicable with respect to an individual receiving medical assistance on or after July 1, 2004. It does not specifically limit the application of the broader definition to medical assistance provided after such date.

Status

Despite numerous objections to this Bill, it was signed into law by Governor Sebelius on May 17, 2004.

Amendments to Kansas Durable Power of Attorney Act (H.B. 2554)

This Bill makes three minor amendments to the Kansas Durable Power of Attorney Act, which became effective July 1, 2003. First, it allows an attorney in fact vested with general powers to execute any power of attorney required by any governmental agency on behalf of the principal. Secondly, it allows the spouse of a principal to waive homestead rights by consenting to the alienation of the homestead in the principal's power of attorney instrument. No longer do the husband and wife have to consent to the alienation of the homestead in a separate power of attorney document specifically drafted for that purpose. The requirement that the document contain the legal description and any street address of the homestead is retained, along with the statement that the spouse agrees that the consent of the attorney in fact will constitute the consent of the principal as required under Article 15, Section 9 of the Kansas Constitution. Finally, a provision has been added to the Act permitting the authorization of the payment of reasonable funeral and burial expenses of the principal, or other disposition of the body, following the principal's death. This ties in with the Kansas health care power of attorney provisions, which permit a health care agent to authorize funeral and burial arrangements of the principal, as well as autopsies, post-death. In all other circumstances, the authority of the attorney in fact or agent terminates at death.

The Bill was signed into law by Governor Sebelius on April 12, 2004.

Clarification of Probate Provisions (H.B. 2555)

This Bill makes two minor changes to the probate code. First, it clarifies, consistent with similar provisions of the Uniform Trust Code applicable to revocable trusts, that an adopted child of a testator, as can children by blood of a testator under current law, may validly prepare the will of the testator and still inherit there under up to the amount he or she would receive by intestate succession (i.e., had the decedent had died without a will). In addition, it clarifies that if a creditor receives a notice from the executor as to the four month period to file a claim in the probate estate, such creditor will always have 30 days to file a claim from the date of actual notice thereof, even if such claim is received just prior to the expiration of the four month period.

The Bill was signed into law by the governor on April 14, 2004.

UTC Provisions Clarified and Improved (H.B. 2556)

The Uniform Trust Code (UTC), which Kansas was the first state to adopt, was passed in 2002 and became effective January 1, 2003. Due to significant changes Kansas made to the uniform act prior to its passage, there were some drafting glitches, oversights and a few minor typos. This legislation, which was approved by the Judicial Council, addresses several of these issues, including issues which were proposed in legislation last year by the Kansas Bar Association, but which were carried over into the 2004 legislative session. Some of its more important provisions are discussed below.

First, the Bill clarifies the term "qualified beneficiary," which applies in many circumstances under the UTC, including who is entitled to notices and accountings and parties required to concur in many trust procedures. The term includes beneficiaries currently entitled to income and principal, and remainder beneficiaries who would be entitled to trust assets upon the termination of the trust. The current language is somewhat ambiguous in its phraseology, leading some practitioners and trustees to construe it to be applicable disjunctively, i.e., to one class of beneficiaries or the other. The language clarifies that the term must be applied conjunctively, i.e., to both classes of beneficiaries.

In addition, Kansas UTC provisions which were intended to remove any notice or accounting requirements to remainder beneficiaries of "by pass" trusts who are descendants of a surviving spouse would be corrected to effectuate that result. Kansas modified the UTC requirement that notices and accountings had to be sent by the trustee to all remainder beneficiaries, even those who were children of a surviving spouse. Proponents of the change felt that most decedents would not want the trustee to be required to account to descendants of the couple with respect to the management of the trust. However, only the notice requirement was waived by the 2002 Kansas legislature in making the change, thereby retaining accounting requirements. The Bill would remove both notice and accounting requirements to remainder beneficiaries in that situation.

Further, provisions which would cause the lapse of a withdrawal right in excess of an amount equal to the greater of the annual gift tax exclusion or the "5 and 5" amount to be deemed a "self-settled" trust exposed to the claims of the power holder's creditors would be modified to exclude their application to the lapse of a general power of appointment held by a surviving spouse. In the absence of this modification, current UTC provisions could cause adverse estate tax consequences and exposure to the claims of the surviving spouse's creditors with respect to assets left in trust for a surviving spouse by the predeceased spouse in circumstances where reciprocal spousal general powers of appointment are employed as an estate planning technique.

Another provision would provide that a transfer of property to the trust rather than to the trustee nonetheless results in a valid conveyance to the trustee. As trusts are not technically legal entities, without this provision, there would be the

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issue of whether a conveyance made to a trust rather than to the trustee of the trust would be valid. There is at least some case law in other states which would suggest that conveyances to trusts, in the absence of a statutory savings provision such as this one, are invalid.

An additional provision would further "beef up" the effectiveness of spendthrift clauses beyond the substantial protection already accorded under the current Kansas version of the UTC, which has no exceptions to their validity. The current language provides that if the trust contains a valid spendthrift clause, a creditor cannot compel a trust distribution that is subject to the trustee's discretion in order to satisfy the debt of a trust beneficiary. The additional language in the Bill makes it clear that such result would ensue even if the discretion is expressed in the form of a standard (e.g., health, education, support and maintenance) and the trustee has abused such discretion. This will further buttress the Kansas spendthrift provision, which is already one of the strongest in the country.

The Judicial Council's recommendations also include an optional provision for trustees of revocable trust to establish a statute of limitations for creditors to present their claims in order to shorten such period from what would otherwise be applicable with regard to the settlor of the trust. This provision essentially parallels similar provisions applicable to probate estates. A trustee may publish notice for three consecutive weeks in a newspaper and claims will be barred within the later of four months from the date of the first published notice or thirty days after receipt of the actual notice to reasonably ascertainable creditors (which the trustee would be required to notify to secure the barring of the claim) which are received prior to the expiration of the four month period.

The Judicial Council also recommended including two provisions in the UTC which were opposed by the Kansas Bar Association two years ago. Due to the Bar's opposition, such provisions were deleted in 2002 prior to final passage of the UTC. Those provisions would permit nonjudicial settlement agreements with respect to "the interpretation or construction of the terms of the trust" and with respect to "the direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power." The Bar continues to oppose such provisions as being far too broad and placing too much control in the hands of trust beneficiaries without judicial oversight. Although the provisions state that a non-judicial settlement will not be valid if it violates a "material purpose" of the trust and must be entered into by "interested persons," there is no definition of "material purpose" or specific definition of "interested persons" in the UTC. Moreover, the Comments by the UTC Commissioners indicate that the trustee may not even be a necessary party unless directly affected (e.g., an accounting issue). The Bar's opposition at the hearing on this Bill in the House Judiciary Committee in February of this year resulted in the Committee deleting these provisions prior to passage.

Property Transfer to Trusts (SB 424; amended into House Bill 2556)

This Bill, proposed by the KBA Real Property, Probate and Trust Section, provides that the transfer of real property to a revocable trust shall have no adverse effect on the coverage of any title insurance (if by Warranty Deed), affect any otherwise applicable homestead exemption (with respect to creditors) or redemption right under a mortgage, or cause a due on sale or similar clause to be activated under a mortgage or security interest. This legislation was needed to avoid potentially adverse effects in the foregoing areas when real property was transferred to the trustee of a revocable trust.

By Dan C. Peare
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1. **TRANSFERS TO PARTNERSHIP WERE BONA FIDE**

Prior to her death, the decedent had created a revocable living trust (the "Trust"), as well as a limited liability company (the "LLC"), of which she owned a 50 percent interest, and her son and his wife each owned 25 percent interests. In the same month that the LLC was formed, the decedent formed a limited partnership (the "Partnership"). Her Trust contributed $2.5 million in cash, oil and gas working interests and royalty interests, securities, notes and other assets for a 99 percent pro rata limited partner interest. The LLC contributed $25,000 in cash for a one percent pro rata general partner interest. The decedent retained more than $450,000 in assets outside of the LLC and the Partnership for her personal expenses. Upon the decedent's death, her estate claimed a 49 percent discount on the value of her interest in the Partnership and her interest in the LLC. The Internal Revenue Service (the "IRS") determined that the full value of the assets transferred to the Partnership and the LLC were includible in her gross estate under Code Section 2036. The estate paid the additional tax due and filed a claim for refund. Upon the government's motion for summary judgment, the district court determined that, as a matter of law, the decedent's transfer of assets to the Partnership and the LLC were subject to Code Section 2036, and that the IRS correctly included the full value of the assets in the decedent's estate.

Under Code Section 2036, the value of the gross estate includes the value of all property that a decedent transfers during his or her lifetime and retains the possession, enjoyment of, or right to income from the property, or retains the power to designate the beneficiaries of the property. However, if the property was transferred in a bona fide sale for an adequate and full consideration in money or money's worth, Code Section 2036 does not apply.

The Fifth Circuit recognized that the district court found that the bona fide sale exception did not apply in the present case because one requirement for a bona fide sale is an arm's length transaction. Relying on Black's Law Dictionary, the district court defined "arm's length transaction" as involving parties who are not related or not on close terms. Because the decedent and/or her family members were present on both sides of the transactions in question, the district court determined that the transactions were not bona fide. The district court also found that even if the transfer was a bona fide sale, the pro rata interest the decedent received was not adequate consideration for the assets she transferred to the Partnership because the transaction was a paper transaction resulting in a mere recycling of value.

The Fifth Circuit determined that the district court erred in failing to analyze the bona fide sale requirement separate from the adequate and full consideration requirement. In order to show the transaction was bona fide, the Fifth Circuit held that the estate must show the transaction was entered into in good faith and that it was not feigned; that the decedent actually parted with her interest in the assets transferred, and the partnership actually parted with the partnership interest; and that there was some legitimate purpose to the transaction. In this regard, the Fifth Circuit recognized that the decedent retained sufficient assets outside the Partnership for her own support, and there was no commingling of Partnership assets and personal assets. In addition, partnership formalities were satisfied, and the assets contributed to the Partnership were actually assigned to the Partnership. Finally, the decedent had several legitimate purposes in forming the Partnership, including providing legal protection from creditors, keeping the pool of capital together in one entity rather than subdividing it by distributions to subsequent generations, reducing administrative costs, and avoiding the costs of recording transfers in the properties from generation to generation, among others. Thus, the transaction met the requirements for a bona fide sale.

To show the transaction was for adequate and full consideration, the Fifth Circuit held that there must be pro rata distributions, the contributions must be reflected in the capital accounts, and liquidations rights must follow the capital accounts. The Fifth Circuit found these requirements were met in this case. Thus, the decedent's transfers were for adequate and full consideration.

Based on its analysis, the Fifth Circuit determined that the district court erred in granting the government's motion for summary judgment because the transfer to the Partnership qualified as a bona fide sale for adequate and full consideration so as to remove the assets from the decedent's estate. *Kimbell v. U.S.*, (5th Cir. May 20, 2004).

2. **GUIDANCE ISSUED ON GRANTOR'S PAYMENT OF INCOME TAXES FOR DEFECTIVE GRANTOR TRUST**

A taxpayer establishes and funds an irrevocable inter vivos trust for the benefit of his descendants. The governing instrument of the trust requires that the trustee be a person not related or subordinate to the taxpayer within the meaning of Code Section 672(c). Under the terms of the trust, the taxpayer retains no interest in or power over the trust that would cause the gift to be incomplete or that would cause the assets to be included in the taxpayer's gross estate. The taxpayer does, however, retain sufficient powers so that he is treated as the owner of the trust for income tax purposes. During the year, the trust receives taxable income of $10x, which the taxpayer includes in his income under Code Section 671. As a result, the taxpayer's income tax liability increases by $2.5x. The taxpayer dies three years later, when the trust assets are worth $150x.

Situation 1: Neither state law nor the trust's governing instrument contains any provision requiring or permitting the trustee to distribute amounts to the taxpayer sufficient to satisfy his income tax liability attributable to the trust's income. Accordingly, the taxpayer pays the additional $2.5x from his own funds. The IRS held that the taxpayer's payment of the $2.5x income tax liability does not constitute a gift by the taxpayer to the trust beneficiaries because the taxpayer is liable for the taxes. In addition, no portion of the trust is includible in the taxpayer's gross estate under Code Section 2036 because the taxpayer has not retained

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the right to have trust property expended in discharge of his legal obligation.

Situation 2: The trust's governing instrument provides that if the taxpayer is treated as the owner of any portion of the trust for income tax purposes, the trustee shall distribute to the taxpayer amounts sufficient to satisfy the taxpayer's personal income tax liability attributable to the inclusion of all or part of the trust's income in the taxpayer's taxable income. Accordingly, the trustee distributes \$2.5x to the taxpayer to reimburse him for his increase in income tax liability. The IRS held that the taxpayer's \$2.5x payment of the income tax liability does not constitute a gift to the trust beneficiaries because the taxpayer is liable for the tax. The trustee's distribution of \$2.5x to the taxpayer is not a gift by the trust beneficiaries to the taxpayer because the distribution is required by the trust's governing instrument. However, the taxpayer has retained the right to have trust property expended in discharge of his legal obligation, which causes the full value of the trust's assets (\$150x) to be included in the taxpayer's gross estate under Code Section 2036(a)(1).

Situation 3: The trust's governing instrument provides that if the taxpayer is treated as the owner of any portion of the trust for income tax purposes, the trustee may, in his or her discretion, distribute assets to the taxpayer in satisfaction of his personal income tax liability attributable to the inclusion of all or part of the trust's income in the taxpayer's taxable income. Pursuant to the exercise of the trustee's discretionary power, the trustee distributes \$2.5x to the taxpayer to reimburse him for his increase in income tax liability. As in the other situations, the payment by the taxpayer of the \$2.5x tax liability does not constitute a gift to the trust beneficiaries because the taxpayer is liable for the tax. The trustee's distribution of \$2.5x to the taxpayer is not a gift by the trust beneficiaries to the taxpayer because it was made pursuant to the trustee's discretionary powers. Assuming there is no understanding, express or implied, between the taxpayer and trustee regarding the trustee's exercise of discretion, the trustee's discretion to satisfy the taxpayer's obligation would not, by itself, cause inclusion of the trust's assets in the taxpayer's gross estate. This is the result regardless of whether the trustee actually reimburses the taxpayer for the tax. Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

3. Subsequent Financial Statements Properly Excluded in Valuing Stock for Gift Tax Purposes

Polack owned a closely held corporation (the "Corporation") that printed bulk mail pieces and prepared them for mailing. Prior to 1991, the Corporation received a postage discount, which it shared with its customers. In 1991, the Corporation qualified for a new value-added refund program. The Corporation retained all of the value-added refund it received in 1991, but began sharing it with customers in 1992. In December 1992, Polack gave more than one million shares of the Corporation's nonvoting common stock to his children. Based in part on Polack's predictions to the appraiser that the Corporation would likely retain only 25 percent to 35 percent of the future value-added refunds, the appraiser valued the stock at \$.50 per share. The IRS increased the value of the stock and assessed a gift tax deficiency. The IRS' appraiser estimated that the Corporation would retain 50 percent of its future value-added refunds. The Tax Court agreed with the IRS' valuation of the stock.

Polack appealed the Tax Court's decision, asserting that the Corporation's 1993 and 1994 financial statements showed that the Corporation's actual income for those years was less than that estimated by both his own appraiser and the IRS' appraiser. In affirming the Tax Court's decision, the Court stated that the 1993 and 1994 financial statements were not relevant. It stated that whether evidence relating to subsequent events is admissible in determining the fair market value of property on an earlier date is an issue of relevance, and most subsequent events are not relevant because the measure of the tax must be determined according to the situation as it existed on the date in question, and not according to subsequent events. It held that subsequent events may be relevant when they shed light on what a willing buyer would have paid on the date in question, such as evidence of actual sales prices received for property after the date, so long as the sale occurred within a reasonable time and no intervening events drastically changed the value of the property. The 1993 and 1994 financial statements were not relevant because post-transaction earnings would not have been known to a prospective purchaser on the critical date. Thus, the Eighth Circuit held that the Tax Court did not abuse its discretion in excluding the financial statements, and its determination of fair market value was not clearly erroneous. *Polack v. Comm.*, 93 AFTR 2d 2004-2094 (8th Cir.).

4. Partition of Property by Tenants in Common Does Not Cause Gain or Loss Recognition

The taxpayer and two other persons owned a single parcel of real estate as tenants in common. Their one-third (1/3) interests were identical in every respect. They proposed to partition the property, whereby each would acquire legal ownership of a separate parcel approximately equal in value. The IRS held that the result in Revenue Ruling 56-437 would apply, and based on the facts presented, the partition would not be treated as a sale or exchange. Accordingly, no gain or loss would be realized under Code Section 1001 as a result of the partition. P.L.R.s 200411022; 200411023.

5. Failure to Properly Comply with Substantiation Requirements Results in Total Denial of Charitable Contribution Deduction

In 1997, Mr. Addis offered a charity the option of purchasing an interest in an insurance policy that a trust he and his wife created was going to buy on Mrs. Addis' life. The insurance policy had an annual premium of \$40,000. Mr. Addis and the charity entered into a charitable split-dollar arrangement giving the charity the option of paying 90 percent of the annual premium, or \$36,000 per year, for 12 years in exchange for a fixed amount of \$557,280 (56 percent of the initial death benefit) upon Mrs. Addis' death. The trust would pay ten percent of the annual policy premiums and receive 44 percent of the initial death benefit, in addition to any projected increases. In October 1997, the Addises paid \$285 to the charity to establish a charitable foundation under the charity's umbrella. In November 1997, they sent \$36,000 to the charity with a cover letter requesting that the charity use the money to pay the policy premiums. The charity did use the payment and a similar payment in

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1998 to pay the premiums in those years. The Addises paid their $4,000 share of the premiums in both years. The charity's receipts substantiating the Addises' payments stated that the Addises received no consideration from the charity. The Addises claimed charitable contribution deductions of $36,285 in 1997 and $36,000 in 1998. The charity ceased in engaging in split-dollar arrangements after the enactment in 1999 of Code Section 170(f)(10), which disallowed charitable deductions and imposed excise taxes on charitable split-dollar arrangements. The IRS disallowed the Addises' deductions for 1997 and 1998, and the Tax Court agreed, holding that Code Section 170(f)(8) disallowed the deductions because the contemporaneous substantiation of the payments stated that the Addises received no consideration and did not reveal that they expected the charity to use the payments to pay premiums on insurance owned by the Trust.

The Ninth Circuit affirmed the Tax Court decision, clarifying that the Addises' payments were inducements for the charity to take the split-dollar deal in the option agreement. The split-dollar insurance arrangement, which conferred benefits on the Addises disproportionate to their ten percent premium payments, was the consideration that the receipts failed to disclose. The Ninth Circuit concluded that the Addises expected consideration for their payments to the charity, and their receipts did not meet the requirements of Code Section 170(f)(8). The consequence of failing to meet such requirements is total denial of any deduction. Thus, the Addises were not entitled to any charitable contribution deduction for their payments to the charity in 1997 and 1998. *Addis v. Comm.*, 94 AFTR 2d 2004-5134 (9th Cir.).

6. Marital Deduction Allowed for Property Passing Under Settlement Agreement

Prior to their marriage, husband and wife entered into a prenuptial agreement whereby they agreed that in the event that husband predeceased wife, husband would designate wife as beneficiary of certain life insurance policies and provide her with the use and occupancy of certain properties for her lifetime, or until she remarried or began cohabiting with another male. The agreement also provided that neither spouse would elect to take against the other's will. Subsequently, the husband executed an irrevocable trust that provided certain benefits to the wife. The trust provided for the creation of a Marital QTIP Trust to be established for the wife upon the husband's death. The wife was to receive all income annually, and the trustee had the discretion to invade principal for the health needs of the wife. Upon the wife's death, any assets remaining were to be distributed to charity. In addition, certain real property was to be held in trust for the wife's continued use and occupancy. The residuary of the trust was to be distributed to charity.

At some future date, the husband and wife entered into a postnuptial agreement whereby the wife agreed to waive all rights she may acquire as surviving spouse in the husband's estate upon his death. The husband died approximately one year later. Following his death, the wife filed a complaint in court alleging a discrepancy in the trust and alleging that the residuary provisions of the trust, when read in their entirety, required the trustee to hold all property not passing to the Marital QTIP Trust in trust for the wife's use during her lifetime. In addition, the wife contended that the waivers in the postnuptial agreement were invalid because they were the result of duress on the part of the husband. After lengthy negotiations between the wife and charity, the parties entered into a settlement agreement under which the Marital QTIP Trust would be funded with a certain amount of dollars plus the real property. The wife would receive the greater of income or a five percent unitrust payout annually, and would be entitled to possess and enjoy the real property for her lifetime. The IRS held that the settlement agreement resulted from a bona fide adversarial proceeding and was the product of arm's length negotiations. It further held that the settlement agreement provided an allocation of the trust's assets that was within a range of reasonable settlements, meaning that the interests received by each party reflected the enforceable rights of the parties. Consequently, the property passing to the wife under the settlement agreement would be treated as having passed from the husband for marital deduction purposes under Code Section 2056. P.L.R. 200417030.

7. Property Conveyed to Trust not Subject to IRS Lien

The IRS filed a notice of federal tax lien against Mr. Ball in 1994. Subsequently, two additional liens were filed against Mr. and Mrs. Ball. In March 1995, the Balls' children conveyed to Copeland, as trustee, certain property in trust for the benefit of the Balls. In March 1999, Copeland resigned as trustee, and a bank assumed responsibility. The bank subsequently sold a parcel of real property held in the trust. The bankruptcy trustee filed an adversarial proceeding seeking to have the bank turn over trust property. Pursuant to a settlement agreement, the bank agreed to pay $150,000 to the bankruptcy estate in full satisfaction of the estate's claims. The IRS was not named as a party to the proceeding and did not file any objection to the settlement or appear at the hearing despite being given proper notice. The IRS filed a proof of claim, a portion of which it claimed was secured. The bankruptcy trustee objected to the secured portion.

The IRS asserted its claim under Code Section 6321, which states that if any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States upon all property and rights to property belonging to such person. The Bankruptcy Court held that the IRS has some obligation to establish that its lien did attach to the property that the spendthrift trust used as consideration for the settlement and release of the bankruptcy trustee's claim. The Court stated that there was no evidence that would establish that the IRS ever had a lien upon the specific parcel of real property that the Balls' children conveyed to the trust and the proceeds of which were used to provide the money for the settlement with the bankruptcy trustee. Thus, the IRS' claim of lien against the proceeds of the settlement with the trust were invalidated. *Callahan v. IRS*, Bankr. W.D. Va., Adv. Proc. No. 03-00194, 03/10/04.

8. Transfers of Stock to FLPS are Indirect Gifts of Stock to Taxpayers' Children

In April 1998, the Sendas signed a family

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limited partnership agreement ("FLP1"). Each of the Sendas' three minor children initially held a .01 percent limited partnership interest, which interests were purportedly held for them in trust, although there was no written trust agreement at the time of the transfers. In December 1998, the Sendas contributed shares of stock to FLP1 in exchange for their partnership interests. The children purportedly contributed oral accounts receivable in exchange for their partnership interests; however, the accounts receivable were never reduced to writing and had no terms for repayment. On the same date, Mr. Senda gave to each child a 29.94657 percent limited partnership interest in FLP1, and Mrs. Senda gave a .0434 percent limited partnership interest to each child. The certificates of ownership reflecting the transfers were not prepared and signed until several years later. FLP1 has never had annual financial statements prepared or held partnership meetings. The only books and records maintained by Mr. Senda, as general partner, were brokerage account statements and partnership tax returns. Similar transactions occurred with a second family limited partnership ("FLP2") that the Sendas created. On their 1998, 1999 and 2000 gift tax returns, the Sendas applied lack of marketability and minority interest discounts to the gifts of the partnership interests. In the notice of deficiency, the IRS determined that the fair market value of the property was the value of the stock without application of marketability and minority discounts.

The Sendas argue that they made gifts of limited partnership interests, and that the partnerships have economic substance and are valid under Missouri law. Thus, the partnerships should not be disregarded for federal tax purposes. The IRS argues that the transfers of stock to the partnerships, coupled with the transfer of limited partnership interests to the children, were indirect gifts of the stock to the children. Accordingly, the stock, and not the partnership interests, should be valued for gift tax purposes. The Tax Court held that it was apparent from the record that the Sendas were concerned only with transferring beneficial ownership of the stock to the children, rather than with the formalities of the FLPs. It noted that Mr. Senda, as general partner did not maintain books or records for the partnership. In addition, the partnership tax returns were prepared months after the transfers of the partnership interests. Thus, they were unreliable in deciding whether the Sendas transferred the partnership interests to the children before or after they contributed the stock to the partnerships. Similarly, the certificates of ownership were not prepared until several weeks or years after the transfers. The Court held that at best, the transactions were integrated and, in effect, simultaneous. Therefore, the Court concluded that the value of the children's partnership interests were enhanced upon contributions of stock to the partnerships. Accordingly, it held that the transfers were indirect gifts of the stock to the children for purposes of Code Sections 2501 and 2511. Thus, the gift tax should be determined on the value of the stock rather than on the value of the partnership interests transferred. *Senda v. Comm.*, T.C. Memo 2004-160. Query: Was there in fact a completed gift, or did the Sendas retain a right under Code Section 2038?

9. QTIP Election for Full Value of Trust Property Cannot be Changed to Partial QTIP Election

Article Third of the decedent's will provided for the creation of a marital trust funded with an interest in real property owned by the decedent at her death. The trustee was to pay to or apply for the benefit of the decedent's husband the net income of the trust at least monthly. The trustee also had the discretion to distribute principal for the benefit of the husband. Upon the husband's death, any property remaining in the marital trust would pass to the decedent's children, in equal shares, per stirpes. The decedent's will gave the personal representative the discretion to determine whether to elect under Code Section 2056(b)(7) to qualify all or any portion of the marital trust for the marital deduction. The will further provided that the decedent anticipated that the personal representative would elect to minimize the estate tax payable by the husband's estate upon his death. On the decedent's estate tax return, a QTIP election was made for the entire marital trust, resulting in only a portion of the decedent's unified credit being utilized.

The decedent's estate requested relief under Regulation Section 301.9100-3 to make a partial QTIP election with respect to the marital trust and requested that the full QTIP election be nullified. The IRS held that Regulation Section 301.9100-3 did not apply in the present case because the decedent's estate was not requesting an extension of time to make the QTIP election. Rather, it was seeking to partially revoke a QTIP election previously made, that, pursuant to Code Section 2056(b)(7) is irrevocable. The IRS further held that Rev. Proc. 2001-38, pursuant to which the IRS will treat QTIP elections as null and void under certain circumstances, did not apply to situations where only a partial QTIP election was required to reduce the estate tax liability to zero, but the executor made the election with respect to more trust property than was necessary. Therefore, the QTIP election with respect to the entire marital trust was valid and effective, and 100 percent of the value of the marital trust would be includible in the husband's gross estate under Code Section 2044. P.L.R. 200422050.

10. Business Transfers Were Gifts and Loans, not Compensation for Services

Prior to his divorce in 1981, Demetree owned and operated a property management firm. In order to devote his time to contentious divorce proceedings, he closed the firm. The following year, he remarried and subsequently was awarded sole custody of his four children. Demetree stayed at home to care for his four children and his wife's child and to perform domestic duties. He relied heavily on gifts and loans from his parents to supplement his wife's salary. His parents gave him two homes, $900,000 in trust for his children, annual exclusion gifts to him, his wife, and his children, automobiles to each of his children, and weekly gifts of cash and food. They also made substantial loans to him, documented with promissory notes. Upon default of some of the loans, his parents obtained judgments against him. Yet, they continued to transfer significant amounts of money to him. From 1983 through 1991, Demetree occasionally assisted his father by performing services for his father's commercial property management

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sole proprietorship. He also signed, pursuant to a power of attorney, his father's name on business checks and deposit slips, including checks payable to himself. His father did not deduct the amounts transferred to Demetree, issue him a Form W-2, or issue a Form 1099-MISC. Following his father's death in 1991, Demetree began managing the properties formerly managed by his father.

The IRS argued that all of the income earned by the property management firm prior to the father's death should have been attributed to Demetree because he, not his father, controlled the business. The Tax Court disagreed. Demetree performed domestic duties and was a full-time care provider to his five children. He merely assisted his father, who made the major business decisions. His father successfully ran the property management firm for ten years prior to Demetree assisting him. The Tax Court also held that the amounts Demetree received from his father's firm were not compensation for services rendered because he was under no obligation to perform services. Rather, the transfers were consistent with his parents' established pattern of making frequent and substantial gifts and loans to him and his family. Thus, the income from his father's business was not attributable to Demetree. *Demetree v. Comm.*, T.C. Memo 2003-323.

11. IRS Intends to Crack Down on Improper Deductions for Easements Transferred to Charities

The IRS issued a new notice advising taxpayers that it will disallow improper charitable contribution deductions for transfers of easements (1) on real property to charities, and (2) in connection with purchases of real property from charities. Code Section 170(f)(3)(B)(iii) provides an exception to the general rule that charitable contribution deductions are not allowed for transfers of less than the taxpayer's entire interest in property, when the transfer involves a qualified conservation contribution. A qualified conservation contribution is a contribution of a qualified real property interest, which includes a restriction granted in perpetuity on the use that may be made of the real property, to a qualified organization exclusively for certain conservation purposes. Some permitted purposes are the protection of a natural habitat of fish, wildlife, plants, or similar ecosystem, and the preservation of open space, including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. A charitable contribution is allowed as a deduction only if substantiated in accordance with the Treasury Regulations. If allowed, the amount of the deduction may not exceed the fair market value of the contributed property (the contributed easement). No deduction is allowable where the donor reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation, or if the donation has no material effect on the value of the real property or enhances the value of the real property.

The IRS also noted that some taxpayers are claiming inappropriate charitable contribution deductions for cash payments to charitable organizations in connection with their purchases of real property. In some of these cases, the charitable organization purchases the property and places a conservation easement on it. The charitable organization then sells the property subject to the easement to a buyer for a price that is substantially less that what it initially paid for the property. As part of the sale, the buyer makes a second payment, designated as a charitable contribution, to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property. The IRS stated that in appropriate cases, it will treat these transactions in accordance with their substance, rather than their form, and treat the total of the buyer's payments as the purchase price paid by the buyer for the property.

The IRS intends to disallow improper deductions and may impose penalties under Code Section 6662 and excise taxes under Code Section 4958. The IRS will also review promotions of these transactions and may impose penalties on the promoters, appraisers or other persons under Code Sections 6700, 6701, and 6694. Notice 2004-41.

12. Discount Rate Used to Value Decedent's Stock Increased to Reflect Redemption-Related Risks

The decedent died in 1992, and his daughters were named co-executors of his estate. At his death, he owned preferred stock in a company (the "Company"), which was subject to a redemption agreement requiring the Company to redeem the stock by 1995 for $1,000 per share plus accrued dividends. Subsequent to his death, the Company redeemed the decedent's stock for approximately $1.9 million, including interest. The decedent's estate tax return showed a gross estate of more than $26 million and a taxable estate of approximately $12 million. The IRS claimed that the co-executors had knowingly underreported the taxable estate by approximately $22.8 million by excluding various assets and by undervaluing the stock and other assets. The IRS argued that the stock should have been valued at the post-death redemption price. The estate claimed that price was irrelevant because the Company was in financial difficulty at the time of the decedent's death. The IRS also imposed a fraud penalty under Code Section 6663.

In prior opinions, the Tax Court held that (i) the estate had omitted assets worth $4.5 million; (ii) the post-death redemption price was the benchmark for determining the value of the decedent's stock, but that a four percent discount rate should be applied; and (iii) a fraud penalty was proper. On appeal, the Ninth Circuit vacated and remanded the Tax Court's decision for its failure to detail its reasoning on the inclusion and value of the omitted assets and on choosing the discount rate used to value the decedent's stock. The Ninth Circuit also directed the Tax Court to consider revisiting its conclusions on the fraud penalty.

On remand, the Tax Court set forth in detail its findings as to the omitted assets and again concluded that assets worth $4.5 million were omitted from the decedent's estate tax return. Next, the Tax Court detailed the specific formulae it used to determine the fair market value of the stock. In discussing its previous discount rate, the Tax Court noted that the rate reflected only the time value of money and did not account for the risk that the Company would not meet its contractual obligation to redeem its preferred stock. On remand, the Tax Court concluded that the four percent discount rate undercompen-

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sated the hypothetical buyer for this risk. Thus, it used a 12.5 percent discount rate on remand to arrive at the stock's fair market value of approximately $2.2 million. With respect to the fraud penalty, the Tax Court held on remand that it was not appropriate to revisit its conclusions. It held that the co-executors' willing and conscious failure to disclose the assets of the estate, coupled with their deliberate undervaluation of certain assets, constituted clear and convincing evidence of fraud deserving of the penalty. Estate of *Trompeter v. Comm.*, T.C. Memo 2004-27.

13. Power of Appointment Transfers not Subject to GSTT

The decedent's revocable trust provides for the creation of a family trust upon the decedent's death. The terms of the family trust provide that the net income is to be distributed annually to the decedent's children, in equal shares. In addition, the decedent's children shall have the right annually to appoint from the principal of the family trust to each of his or her living children an amount equal to the maximum annual exclusion then available to each child ("special power of appointment"). Upon the death of each of the decedent's children, each such child shall have the right to appoint a fractional portion of the remaining trust principal. The fraction is based on the number of such child's children who are living, or who are deceased with living descendants, in relation to the total number of decedent's grandchildren who are living, or who are deceased with living descendants. Such appointment may be outright or in trust in such amounts or proportions "to one or more of the deceased child's descendants or to his or her estate" (emphasis added). In absence of appointment, the assets will be distributed to the decedent's deceased child's then-living descendants on a per stirpes basis.

The trustees represent that the phrase "to one or more of the deceased child's descendants or to his or her estate" has two possible meanings: (1) that a child can appoint the trust property to his or her descendants or to the estate of a descendant who has died; or (2) that a child can appoint the trust property to his or her descendants or to such child's own estate. The trustees assert that the decedent intended the latter, and that the decedent's children may exercise their powers in favor of their own estates. To resolve the ambiguity, the trustees filed a petition in court for a proper construction of the phrase. The court issued an order concluding that the power to appoint is construed as authorizing the decedent's children to exercise their respective powers of appointment in favor of their own estates. The IRS held that the powers of appointment, as construed by the court, constitute general powers of appointment. Accordingly, the exercise by decedent's children of their special powers of appointment will result in a transfer by the respective child of his or her right to receive the income from the distributed property for gift tax purposes under Code Section 2511. In addition, such an exercise will result in the release of the child's general power taking effect at death to appoint the distributed property, and the release will constitute a transfer by the child that is subject to gift tax under Code Section 2514. Pursuant to Code Section 2652(a)(1) and Regulation Section 26.2652-1(a), the decedent's children will be the transferors of the distributions for generation-skipping transfer tax purposes. Because the special powers of appointment may be exercised only in favor of a child's children, the distributions will not be made to skip persons as defined in Code Section 2613. Thus, the transfers will not be subject to the generation-skipping transfer tax. P.L.R. 200427018.

14. Tax Court Determines Apportionment Issues and Calculates Valuation Discounts for Decedent's Stock

The decedent died in 1997. Her will stated that all estate, inheritance and other death taxes were to be paid out of her estate and were not to be charged against any property upon or by reason of which such taxes were assessed and paid. The will also directed that all generation-skipping transfer ("GST") taxes on direct skips should not be deducted from or reduce the direct skip transfers. The decedent left one-half of the residue of her estate to charity and the other one-half in trust for her grandchildren. At her death, the decedent owned 5.09 percent, or 3,276 shares, of the outstanding common stock of a banking corporation (the "Corporation"). The decedent's estate tax return reported a gross estate of more than $3.3 million and valued the stock at $50 per share. The estate claimed a charitable contribution deduction of $1,565,678 for the residuary transfer to charity. The estate reported the residuary transfer to the grandchildren's trust as a direct skip of $1,565,678 and charged all federal and state estate and GST taxes to the property passing to the grandchildren's trust. The IRS issued a notice of deficiency, claiming that the value of the decedent's stock was $320 per share and that the charitable contribution deduction should be reduced to $801,723 because one-half of the estate taxes and all of the GST taxes should be allocated against the property passing to charity. The estate argued that the doctrine of equitable apportionment applied, serving to place the burden of the taxes on the property generating the taxes, because the decedent's will did not express a clear intent regarding allocation of taxes. Thus, the estate argued that all of the taxes should be apportioned to the grandchildren's residuary share. At trial, the IRS argued that all of the estate and GST taxes should be paid out of the charitable share.

The Tax Court held that state law governs the apportionment of the estate's taxes, noting that Missouri has no apportionment statute. Thus, the intent of the decedent, as construed from the decedent's will, will determine the issue of apportionment if the decedent's intent is clear. The Tax Court noted that the language in the decedent's will regarding payment of estate taxes and stated that the language was not clear as to who ultimately should bear the estate tax burden. The IRS argued that the charitable gift was the only gift that did not constitute property upon or by reason of which the estate taxes were assessed and paid. Thus, all estate taxes should be apportioned to the charitable bequest. The Tax Court agreed with the estate that the decedent's will lacked a clear expression of intent as to who was ultimately to bear the burden of the estate taxes. Thus, the Tax Court concluded that the doctrine of equitable apportionment applied and that no portion of the estate taxes was allocable to the bequest to charity. With respect to GST taxes, the Tax Court held that they were to be charged against the bequest to charity because of the decedent's clear expression of

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intent in her will regarding such taxes.

The Tax Court next turned to the value of the decedent's stock. At trial, the IRS argued that the value of the stock was $262.52 per share, relying on its expert who allowed a 15 percent minority interest discount and a 25 percent lack of marketability discount. The estate argued that it was $200 per share, relying on its expert who allowed a 17 percent minority interest discount and a 40 percent lack of marketability discount. Although the Tax Court was unsatisfied that either expert had adequately support his recommended minority interest discount, it held that a 17 percent discount was appropriate. With respect to the discount for lack of marketability, the Tax Court held that the estate's expert's consideration of a potential loan impairment and pending bankruptcy caused his recommendation to be overstated. In addition, the Tax Court held that the IRS' expert did not adequately support his recommendation. Thus, the Tax Court held that a 35 percent discount for lack of marketability was appropriate and concluded that the value of the stock was $220.18 per share. *Estate of Green v. Comm.*, T.C. Memo 2003-348.

15. Qualified Disclaimer Results in Overfunding of Trust and Estate Tax Deficiency

Prior to his death, the decedent executed a will, which provided for the creation of a trust (the "trust") that would be funded by an amount equal to the federal estate tax exemption equivalent. The will provided that this amount would not be reduced by any disclaimer that the decedent's wife might make and that any portion of the property passing to his wife that she disclaimed would be added to the trust. Following the decedent's death, his wife filed a qualified disclaimer in which she disclaimed her interest in the trust and in certain shares of stock. As a result, the IRS determined that the estate was liable for estate taxes resulting from the trust being overfunded. It argued that the trust was to be funded with an amount equal to the federal estate tax exemption equivalent and with the interests in securities specified in the wife's disclaimer. The estate argued that the decedent's will and the wife's disclaimer have the effect of funding the trust with an amount equal to the federal estate tax exemption equivalent only and that the disclaimer served only to specify which assets would pass to the trust. The Tax Court agreed with the IRS and held that the estate was liable for estate taxes resulting from the overfunded trust. *Estate of Katz v. Comm.*, T.C. Memo 2004-166.

16. Termination of Taxpayer's Power of Appointment Qualifies Trust Assets for Gift Tax Marital Deduction

The taxpayer proposes to create a trust into which he will transfer his separately owned property. The taxpayer will retain the power to appoint all of the income or principal of the trust. The power of appointment will cease to apply to any property that is distributed to a beneficiary pursuant to other provisions of the trust. The power of appointment will terminate upon the first of the following to occur: (1) the taxpayer's death; (2) the wife's death; (3) the taxpayer's written release of the power, signed and delivered to the trustee; or (4) the expiration of 20 years and two months from the date of the trust. During the taxpayer's lifetime, the trustee will pay all of the net income of the trust to the wife annually. Following the taxpayer's death, the trustee must pay all of the net income to the wife at least quarterly. The trustee must also make discretionary distributions of principal for the spouse's health, support, maintenance and education.

The trust will terminate at such time as the taxpayer and his wife agree, in which case the trust principal will be distributed to the wife. The taxpayer and his wife intend to enter into an agreement regarding the disposition of their property in the event of divorce. They agree that the property transferred to the trust will retain the characterization (marital property or separate property) it had prior to the transfer. In addition, the property will be divided as provided in the agreement in the event of divorce. This agreement will be null and void upon the first of the following to occur: (1) the taxpayer signing a document expressly nullifying the agreement; or (2) the expiration of 20 years from the date of the agreement.

The IRS ruled that the transfer of property to the trust by the taxpayer would not constitute a completed gift by the taxpayer due to his retained power of appointment. Further, each payment of income and principal to the wife will constitute a completed gift under Code Section 2501, and each gift will qualify for the gift tax marital deduction under Code Section 2523. The IRS also held that upon termination of the taxpayer's power of appointment and nullification of the agreement, if the taxpayer makes a valid QTIP election pursuant to Code Section 2523(f), then the trust assets will qualify for the gift tax marital deduction under Code Section 2523. Subsequently, if the wife survives the taxpayer, no part of the trust will be includible in the taxpayer's gross estate. Finally, upon the wife's subsequent death, the trust assets will be includible in her gross estate. The IRS held that the taxpayer, as trustee, had not retained any rights that would cause inclusion of the trust assets in his estate under Code Sections 2036 or 2038 because the trustee's powers are restricted by an ascertainable standard. P.L.R. 200413011.

17. Underpayment Interest does not Reduce Estate Tax Overpayment

In 1994, the IRS issued a notice of deficiency determining an estate tax deficiency and an accuracy-related penalty totaling nearly $900,000. The estate filed a petition with the Tax Court seeking redetermination of the deficiency. In 1998, after the Tax Court's initial decision that there was a deficiency in the amount of approximately $564,000, the estate remitted a payment of approximately $646,000. The initial decision was appealed and never became final. After many years of litigation, the Tax Court entered a decision in 2002 that there was an overpayment of estate tax of approximately $239,000 paid after the mailing of the notice of deficiency and that there was no penalty due from the estate under Code Section 6662(a). The IRS issued refunds to the estate that were less than the overpayment amount and interest, alleging that after the Tax Court's decision became final, it applied a portion of the overpayment to assessed but unpaid interest that had accrued on the estate tax deficiency prior to the date of payment. The estate filed a motion to enforce the Tax Court's overpayment determination.

In reaching its holding, the Tax Court first looked to the definition of an overpay-

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ment. It stated that an overpayment means any payment of tax in excess of the tax that is properly due. With respect to the meaning of the term tax, the Tax Court looked to Code Section 6601(e)(1), which provides that any reference in this title to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax. Thus, overpayment means the amount by which payments exceed the tax and the interest for the underpayment period. After considering issues of jurisdiction and finality of the overpayment decision, the Tax Court held that the amount of the refund should not have been reduced for underpayment interest because the interest was part of the tax amount considered in determining the amount of the overpayment. Thus, the IRS was required to refund the estate the overpayment of nearly $239,000 plus the interest thereon. *Estate of Smith v. Comm.*, 123 T.C. No. 2 (2004).

18. Deduction Allowed for Bequest of Art Collection to Museum Subject to Restrictions

The taxpayers, husband and wife, own a significant collection of art, which is currently displayed in the Donors' Gallery, a part of the taxpayers' home. The taxpayers entered into an agreement with a foundation and a museum concerning their donation of the collection either during life or upon the death of the survivor of them. The agreement contains numerous restrictions regarding the collection, including how and where the various pieces of the collection may be displayed, and restrictions on the museum's ability to dispose of pieces of the collection. If the museum defaults on its obligations, the foundation will have the option to terminate the agreement. Upon such a termination, all pieces in the collection will immediately revert to the foundation. The taxpayers executed identical wills, which bequeath their respective interests in the residence, art gallery, and tangible personal property, including the collection, to the surviving spouse. Upon the death of the surviving spouse, the residence and art gallery will pass to the foundation, and the collection will pass to the museum, subject to the agreement. If the museum refuses to accept the collection, it will pass to the foundation. Both the museum and foundation qualify as tax-exempt organizations under Code Section 501(c)(3). The IRS held that the value of the proposed bequest upon the death of the surviving taxpayer will be deductible from the taxpayer's gross estate under Code Section 2055. Further, the amount of the deduction will be equal to the full fair market value of the taxpayer's interest in the collection includible in the taxpayer's gross estate under Code Sections 2031 and 2033. P.L.R. 200418002.

19. Discounts for Lack of Marketability and Voting Rights Used to Value Gifted Stock

Marvin Schwan founded Schwan's Sales Enterprises Inc. (the "Corporation") in 1948. The Corporation's capital structure consisted of voting and nonvoting stock. The voting stock comprised .02 percent of equity capital, while the remaining 99.98 percent consisted of nonvoting shares. Schwan died in May 1993. Beginning in December 1992, Schwan's four children and three of their spouses (collectively the "taxpayers") began gifting shares of the Corporation's minority nonvoting stock that they owned to separate trusts established for the benefit of their respective children. The taxpayers obtained a valuation of the Corporation's stock in June 1993. Based on the valuation of $24.03 per share, each of the taxpayers filed a gift tax return reporting a gift of $600,750, a unified credit of $192,800, a generation-skipping transfer tax ("GSTT") exemption of $600,750, and a gift tax of $277. In connection with federal district court litigation involving another matter in 1996, the taxpayers retained another valuation company to appraise the Corporation's value. This company appraised the value at $17.40 as of December 1992. As a result of the lower valuation, the taxpayers filed a claim for refund with the IRS seeking restoration of their respective unified credits in the amount of $59,100, restoration of their respective GSTT exemptions in the amount of $165,760, and gift tax refunds of $277. In 1994, the taxpayers again made gifts of stock, which led to disputed calculations of their 1994 gift taxes and income taxes based upon the disputed value of the Corporation's shares as of December 1994. The Court of Federal Claims accepted the taxpayers' valuation of $19.77 per share as of December 1994, leaving for consideration the value of the shares as of December 1992. The Court of Federal Claims accepted the IRS' value based on the income and capital market valuation methods but rejected the discount rates. It found that the appropriate combined discount rate was 45 percent, 40 percent for lack of marketability and five percent for lack of voting rights, resulting in a value of $24.36 per share. The Federal Circuit Court upheld the lower court's holding, finding that the lower court applied the correct legal standards to valuation and made no factual errors. *Okerlund v. U.S.*, 93 AFTR 2d 2004-1715 (Fed. Cir.).

20. LLC Formed to Manage CRUTS does not Trigger Self Dealing Taxes

Four family members created ten charitable remainder unitrusts ("CRUTs") benefiting family members of one of the grantors. A private foundation is the charitable beneficiary and trustee of each CRUT. The private foundation proposes to form a limited liability company ("LLC") to coordinate the investments of all ten CRUTs, which would allow the CRUTs to diversify their portfolios, pool their assets to obtain economies of scale and more negotiating power, and obtain access to investments with higher minimums than each CRUT could satisfy using its assets alone. The LLC will invest only in money markets, bonds and other marketable securities and will have more than 95 percent of the gross income derived from passive sources.

The IRS ruled that the formation, cash capital contributions and withdrawals from the LLC will not constitute a sale or exchange between the CRUTs and the LLC within the meaning of the self-dealing rules of Code Section 4941(d)(1)(A), and will not constitute a transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation within the meaning of the self-dealing rules of Code Section 4941(d)(1)(E). In addition, the CRUTs' sharing of the LLC investment expenses, payment of management fees to managers, and payment of trustees' fees will not constitute self dealing within the meaning of the self-dealing rules of Code Sections

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4941(d)(1)(C), (D), or (E). The LLC is not a disqualified person as described by Code Section 4946(a)(1) with regard to any of the CRUTs or the private foundation. P.L.R. 200423029.

21. Beneficiaries Bound by Discounted Value of Assets Used by Decedent's Estate

Prior to his death, the decedent owned and operated an art gallery. The decedent's sons were the sole equal beneficiaries of his estate. The sons had the gallery appraised by Sotheby's following the decedent's death. Sotheby's determined the undiscounted value of the collection was more than $25.5 million but warned in its appraisal report that it had not provided for discounts that might result from placing the entire holdings for sale in the ordinary course in the market at one time, nor had it provided for dealers' discounts. In addition, the appraisal report stated that the overall value was derived from valuing the individual works and that Sotheby's had not undertaken to determine the value of the gallery as a whole. On the estate tax return, the sons reported the value of the gallery at approximately $19.5 million, applying a discount for the large number of works in the collection by certain artists (which discount was recommended by Sotheby's), and a discount to account for the portion of the collection that would likely be sold in the dealer market. An additional discount was applied to account for (i) the inability to sell the gallery in the retail market for individual works of art; (ii) the gallery buyer not paying the full resale price of the underlying assets acquired in the bulk sale; and (iii) the gallery buyer taking into account the cost of maintaining the business for a reasonable period. An IRS Art Advisory Panel (the "Panel") examined the collection and determined the undiscounted value to be more than $36.6 million and the discounted value to be nearly $30 million. The sons agreed to the adjustments made by the IRS and paid the additional tax owed.

The sons operated the gallery until 1995, when the assets of the trust were distributed to them in equal shares. They subsequently contributed their interests in the gallery to a partnership, which continued to operate the gallery throughout the years in issue. On the partnership's Schedule C for 1990, the gallery used the discounted value of the collection as originally reported on the estate tax return in order to determine cost of goods sold. The 1991 and 1992 income tax returns were similarly prepared. In 1994, the partnership prepared amended fiduciary income tax returns for 1990 through 1992, using the Panel's undiscounted value as the gallery's beginning inventory value. The tax returns for subsequent years similarly reflected the gallery's use of the undiscounted value as the value for its inventory. The IRS determined that for purposes of calculating the gallery's cost of goods sold for the years 1990 through 1997, the gallery's basis in the collection should have been reported in accordance with the discounted value that had been determined by the Panel and agreed to by the sons for estate tax purposes, rather than the undiscounted value. The Tax Court determined that under Code Section 1014, the sons' bases in each work of art in the collection was equal to the work's proportionately discounted value as determined for estate tax purposes. In addition, the Tax Court held that the sons were bound to use the collection's discounted value as their bases for purposes of calculating the gallery's cost of goods sold based on the duty of consistency. *Janis v. Comm.*, T.C. Memo 2004-117.

22. Reciprocal Trust Doctrine not Applicable to Trusts Created by Husband and Wife

Husband and wife proposed to each create irrevocable trust agreements for which the spouse will be the trustee. The terns of the trusts are identical in many respects. Specified beneficiaries have the right to withdraw specified portions of each transfer to the trust for a limited time. During the joint lifetimes of the spouses, the trustee must distribute to or for the benefit of the spouse and/or a son any amounts of income or principal necessary for their health, support, maintenance and education. The son's needs must be satisfied prior to any distributions for the spouse. If the spouse predeceases the grantor, the distributions for the son will continue for his lifetime. Upon his death, the assets will be divided among and held for the grantor's then-living issue. If the son predeceases the grantor, but the spouse survives, any property of the trust included in the grantor's gross estate will be held as a separate Marital Trust. During the surviving spouse's lifetime, the spouse will receive all of the net income at least quarterly and any principal the trustee deems necessary for the spouse's health, support, maintenance and education.

The two trusts also differ in many respects. The husband's trust provides that after the son's death, the wife shall have the noncumulative personal right in any calendar year to withdrawal certain amounts of principal. The wife also has the power to dictate how the trust principal should be distributed following the son's death, which power is exercisable in favor of the husband's issue or their spouses. With respect to the Marital Trust, the husband's trust provides that the trustee must pay to the wife such sums from the principal as she may request in writing, not to exceed specified amounts. Upon the wife's death, the assets of the Marital Trust are to be paid as she appoints to the husband's issue or to charities. The wife's trust provides that the husband is a beneficiary of the trust only when his net worth is less than a specified amount, his income from personal services for a calendar year is less than a specified amount, and the year is more than three years after the wife's death. In addition, at any time when the husband may be a beneficiary, distributions to him are limited in amount.

The IRS held that the two trusts created by the husband and wife are not interrelated because each trust differs from the other in many respects. Thus, neither the husband's trust nor the wife's trust will be includible in the husband's gross estate for federal estate tax purposes by application of the reciprocal trust doctrine. Similarly, neither trust will be includible in the wife's gross estate by application of the reciprocal trust doctrine. P.L.R. 200426008.

23. Marital Trust not Includible in Surviving Spouse's Estate Under Duty of Consistency

The decedent's husband died in 1975. His will devised one-half of his estate to a marital trust for the decedent. His will also contained a provision stating that his trustee could not hold or exercise any power or discretion over, or make payments or distributions from, the marital trust that would in any way adversely affect qualification of the marital trust, prevent his estate from receiv-

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ing maximum benefit from the marital deduction, affect the decedent's right to all income from the marital trust, or affect her right to dispose of the income and principal of the marital trust in the amount and to the extent necessary to qualify the trust for the marital deduction. His will included none of the substantive dispositions, such as for income beneficiaries, remaindermen, and powers of appointment, normally found in a document establishing a testamentary trust. The husband's estate tax return claimed a marital deduction with respect to the marital trust property. The IRS audited the estate tax return and allowed the claimed marital deduction.

The decedent subsequently died in 1996. Her will disinherited her two daughters and directed that the marital trust property, valued at approximately $5 million, be distributed to her revocable trust, where it would pass to her son, his family, and three charities. The daughters unsuccessfully challenged the validity of the will. The daughters argued that the decedent possessed no power of appointment over the marital trust property and that the property should revert to the husband's estate to be distributed equally to the three children pursuant to the residuary clause in his will. The Circuit Court for Baltimore, Maryland, determined that the marital trust property was not part of the decedent's estate, but rather reverted to the husband's estate. The Maryland Court of Special Appeals affirmed the lower court, and Maryland's highest court declined to hear the case.

In 1998, while litigation was still pending, the son filed the decedent's estate tax return, including the marital trust in the decedent's estate. In 2000, after the litigation was completed, the son filed a claim for refund, arguing the inclusion of the marital trust property in the decedent's estate was in error. The IRS issued a notice of deficiency disallowing the estate's refund claim. The Tax Court, deferring to the Maryland courts, held that the decedent did not possess a general power of appointment over the marital trust property for purposes of Code Section 2041(a)(2). In so holding, the Tax Court rejected the IRS' argument that the failure of the husband's will to provide substantive dispositions of income and principal was a scrivener's error and that his intent was to grant the decedent a general power of appointment over the trust. The IRS also argued that by the husband's estate claiming a marital deduction for the marital trust property, it represented that the decedent possessed a general power of appointment over the marital trust property. Consequently, the duty of consistency would preclude the decedent's estate from now taking the contrary position, upon which its claim for refund was predicated, that the decedent possessed no general power of appointment. The Tax Court disagreed, holding that the duty of consistency does not apply to a mutual mistake on the part of a taxpayer and the IRS concerning a pure question of law. Accordingly, the marital trust property was not includible in the decedent's gross estate. *Estate of Posner v. Comm.*, T.C. Memo 2004-112.

24. Estate Tax Inclusion Period Applied; Extension of Time to Allocate GST Exemption Granted

Husband and wife had three children and six grandchildren for whom they created seven different irrevocable trusts—one for each grandchild, including an unborn grandchild, with the grandchild's parent who is a child of husband and wife as the primary initial beneficiary of each trust. The seven trusts are identical except for the identities of the beneficiaries and the trustees. Each trust provides that the trustee must distribute the entire net income of the trust to the child of husband and wife who is the primary beneficiary at least quarterly. In addition, the trustee may distribute principal as it deems advisable and not subject to any ascertainable standard. After the death of a child who is the primary beneficiary, the trust assets will be held for the benefit of the grandchild who is the primary beneficiary. Distributions are the same for a grandchild as they were for the child. Each trust provides for the creation of an advisory committee composed of husband, wife, and an unrelated party, to consult on various matters, such as investment policy, discretionary payments of principal, and decisions involving real estate and closely held corporations. The trustee may not take action on these issues without unanimous consent of the advisory committee unless the advisory committee fails to direct the trustee within 30 days of a request. Vacancies in the advisory committee are filled by agreement of the remaining members, and the advisory committee may remove or replace a trustee by unanimous consent.

In Year 1, the wife transferred a portion of her interest in real property to two of the trusts. Deeds for the transfers were not executed or recorded until the following year, but they referred to the transfer in Year 1. Also in Year 1, the wife transferred some of her corporation stock to the two trusts. She contended the stock had no value at the time of the transfer. She applied for an automatic extension of time to file her federal income tax return for Year 1, indicating that she expected to file a gift tax return. She later filed a gift tax return stating that no gifts had been made during the year. In Year 2, both husband and wife transferred stock to the other five trusts, and the wife transferred an additional portion of the real property to the initial two trusts. In Year 3, the wife again transferred a portion of the real property to the two trusts. The husband intended to transfer stock to the same two trusts, but the documents evidencing the transfer were not executed and filed until Year 3. Husband and wife both relied on an accountant and attorney to create the trusts, make all required elections, allocate their generation-skipping transfer ("GST") exemptions to the trusts, and file the necessary returns. The attorney relied on the accountant to make the necessary elections and file the necessary returns, but the accountant failed to file the gift tax returns for Year 1 and Year 3 and failed to allocate the wife's GST exemption to the transfers for all three years. The mistakes were discovered during a third party review of a child's marital assets and estate plan. Husband and wife subsequently resigned from the trusts' advisory committees, and the husband died sometime later. After the husband's death, the wife, children and grandchildren obtained a court order retroactively reforming each trust to include certain language subjecting the trustees' discretionary powers to distribute principal to an ascertainable standard.

The IRS first held that the reformation would not be retroactively applied for transfer tax purposes because it found no clear and

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convincing evidence that a mistake of fact had been made, as required under Indiana law for reformation. Thus, until the date of the court order, the trustees' powers were not limited by an ascertainable standard. The IRS further held that although the husband and wife were not trustees, they were members of the advisory committees, and their consents were required before the trustee could make any distribution. Thus, the husband and wife retained powers over the trusts that would cause trust property to be included in their gross estates under Code Section 2038. In addition, the transfers to the trusts would be subject to an estate tax inclusion period ("ETIP") under Code Section 2642(f)(3) for purposes of the GST tax. The ETIP did not terminate until the date on which the husband and wife resigned from the advisory committee for each trust. The IRS also granted the wife an extension of time to allocate her GST exemption to the trusts, finding that the wife had acted reasonably and in good faith in relying on a qualified tax professional who failed to make the election, as required by Regulation Section 301.9100-3. Accordingly, the allocations subject to the extensions would be effective as of the date when husband and wife resigned from the advisory committees, the date on which the ETIP ended, and the inclusion ratio for each trust would be determined based on the value of the corpus of each trust as of such date. P.L.R. 200419011.

25. Decedent's General Powers of Appointment Includible in Gross Estate

The decedent was a beneficiary under a testamentary trust created by her grandmother. Under the testamentary trust, the decedent received a one-sixth share of the income. Upon the decedent's death, her share of the testamentary trust was to be paid over to such persons and in such manner as the decedent by her will designated. In the absence of appointment, it would be paid to the decedent's heirs. The decedent was also a beneficiary under an inter vivos trust created by her aunt. Under the inter vivos trust, the decedent received a one-sixth share of the income. She also had an annual withdrawal right of up to $5,000. The decedent died in 1998. Her will gave her remaining entire estate in equal shares to her children, per stirpes. After her death, the trustee distributed one-sixth of the principal of the testamentary trust to her children and one-sixth of the principal of the inter vivos trust to her children. The decedent's estate tax return did not include in the decedent's gross estate any amounts with respect to the testamentary trust or the inter vivos trust. The IRS issued a notice of deficiency to the estate, determining that the decedent had a general power of appointment with respect to one-sixth of the principal of the testamentary trust and that the decedent exercised that power in her will. The IRS further determined that at the time of her death, the decedent had the power to withdraw $5,000 from the principal of the inter vivos trust and that the power was a general power of appointment. The Tax Court agreed with the IRS, holding that one-sixth of the testamentary trust was includible in the decedent's gross estate under Code Section 2041(a)(1), and that $5,000 was includible under Code Section 2041(a)(2). *Estate of Greve v. Comm.*, T.C. Memo 2004-91.

26. IRS Provides Guidance on Electing out of GST Automatic Allocation Rules

The IRS issued proposed regulations providing guidance for electing out of the generation-skipping transfer ("GST") tax allocation rules under Code Section 2632. Under Code Section 2632(b), an individual's unused GST exemption is automatically allocated to lifetime transfers that are direct skips to the extent necessary to make the inclusion ratio zero for the property transferred. Under Code Section 2632(c), the transferor's available GST exemption is automatically allocated to lifetime transfers made after December 31, 2000, that are indirect skips to the extent necessary to make the inclusion ratio zero for the property transferred. Under Code Section 2632(c)(5)(A)(i)(I), an individual may elect out of the deemed allocation rules so that GST exemption will not be allocated automatically to a particular transfer that is an indirect skip. The election out is deemed timely if made on a timely filed gift tax return for the calendar year in which the transfer was made. Under the proposed regulations, a transferor who wants to elect out of the automatic allocation rules for indirect skips has the option of electing out for the specific transfer, or making a single election with regard to the trust that applies to the current transfer and all subsequent transfers made by that transferor to the trust. Under the second option, once the election is made with regard to a trust, the election remains effective for all subsequent transfers to that trust by the electing transferor until that transferor's election is terminated. These rules are intended to alleviate the need to repeatedly file a gift tax return to elect out of the automatic allocation rules for transfers that would not otherwise require a federal gift tax return to be filed. The proposed regulations also revise the examples illustrating the rules for allocation of GST exemption to reflect recent statutory changes. The proposed regulations apply to elections made on or after July 13, 2004. REG-153841-02 (07/13/2004).

27. Buy-Sell Agreement Disregarded in Valuing Decedent's Stock

The decedent and his brother-in-law each owned 50 percent of the outstanding shares of a construction company (the "Corporation"). In 1981, the decedent, his brother-in-law, and the Corporation entered into a buy-sell agreement restricting transfers of the Corporation's stock both during the shareholders' lifetimes and at death. Lifetime transfers required the consent of the other shareholders. At death, a shareholder's estate was required to sell, and the Corporation was required to buy, the shareholder's shares at a price set in the agreement. The agreement provided that it could be modified only upon written consent of the parties to the agreement. The decedent and his brother-in-law subsequently transferred stock to an employee stock ownership plan ("ESOP") that the Corporation established. The brother-in-law died in 1996, and the Corporation purchased his shares pursuant to the agreement, leaving the decedent and the ESOP as the only remaining shareholders, with the decedent owning 83.2 percent of the shares. After learning he had terminal cancer in 1996, the decedent modified the agreement, changing the price and terms under which the Corporation would redeem the decedent's shares upon his death. The modified price was $4 million, substantially lower than

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the price that would have been payable pursuant to the original agreement. The modification was made without the consent of the ESOP. The decedent died in September 1997, and the Corporation redeemed his shares for $4 million. The decedent's estate reported the value of the shares at the price set forth in the modified agreement. The IRS determined a federal estate tax deficiency after concluding that the value of the decedent's shares was more than $4 million.

The Tax Court determined that the decedent had the unilateral ability to modify the agreement because of his controlling interest. As a result, pursuant to Regulation Section 20.2031-2(h), the agreement was not binding during his lifetime and, thus, did not fix the estate tax value of the shares. The Tax Court also held that because the 1996 modification was substantial, Code Section 2703, which provides that an agreement to acquire property at a price less than its fair market value is disregarded for federal estate tax purposes, applied to the modified agreement. The Tax Court further held that the exceptions in Code Section 2703(b) did not apply because the terms of the modified agreement were not comparable to similar agreements entered into at arm's length. Based on the testimony from two expert witnesses, the Tax Court determined that the fair market value of the Corporation was nearly $9.9 million. The Tax Court applied no discounts or premiums on the decedent's stock, but rather multiplied the total value by the decedent's 83.2 percent to yield a value for the decedent's shares of just more than $8.2 million. *Estate of Blount v. Comm.*, T.C. Memo 2004-116.

28. IRS' Claim for Estate Taxes was General Unsecured Claim

Roth and his father (the "decedent") were joint owners of a car dealership (the "Corporation"). The decedent owned 78 percent of the stock, and Roth owned the remaining 22 percent. Following the decedent's death in 1991, his shares were devised to Roth, who became the sole shareholder of the Corporation. The executors of the decedent's estate elected under Code Section 6166 to pay the estate tax over a period not to exceed ten years. The executors also entered into an agreement with the IRS under Code Section 6324A, subjecting the decedent's shares to a lien in favor of the IRS in the amount of the deferred taxes plus interest. Roth subsequently entered into an asset purchase agreement pursuant to which nearly all of the Corporation's assets were conveyed to a third party. As a condition of the sale, Roth and the third party entered into a consulting agreement. Roth subsequently filed for bankruptcy.

The IRS filed a proof of claim comprised of a secured claim, an unsecured priority claim, and a general unsecured claim. The IRS originally claimed three alternative theories for asserting an interest in the assets recovered by the bankruptcy trustee. First, it argued that Code Section 6324(a)(1) creates a lien on the gross estate of the decedent for unpaid estate tax liability plus interest. The IRS argued that its lien attaches to any property recovered by the trustee that Roth acquired from his father's estate or with proceeds thereof. Second, the IRS asserted a lien under Code Section 6324(a)(2) whereby the beneficiaries who receive property included within the gross estate can become personally liable for the tax to the extent of the value of the property they received. Finally, the IRS asserted that it possessed an equitable lien under Code Section 6324A. Under this theory, the IRS argued that because Roth converted the value of the decedent's stock to his own benefit by selling the underlying assets and using some of the proceeds for his personal benefit, equity requires that the lien attach to the assets of the Corporation and the proceeds from their sale.

The Bankruptcy Court held that the IRS' statutory liens under Code Sections 6324(a)(1) and (2) ceased to exist by virtue of its agreement to designate the decedent's stock as the subject of the Code Section 6324A lien and its subsequent perfection of the lien. Thus, the Bankruptcy Court held that the IRS' lien rights were defined solely by the terms of its agreement with the decedent's estate and extended only to the property specifically designated in the agreement. Further, the Bankruptcy Court held that because the tax lien was statutory, it could not be extended through equitable principles. Therefore, the IRS' lien applied only to the stock and could not be extended to reach assets of the Corporation or proceeds thereof. Because the shares of stock lacked value, the IRS' claim for taxes arising from the decedent's estate amounted to a general unsecured claim.

The district court affirmed. On appeal, the IRS argued that its liens under Code Section 6324(a) did not cease to exist by virtue of its Code Section 6324A lien. The language of Code Section 6324A(d)(4) states that if there is a lien under this section on any property with respect to any estate, there shall not be a lien under Code Section 6324 on such property with respect to the same estate. Thus, the IRS insisted that it continued to possess a general estate tax lien over all other property within the decedent's gross estate. However, the district court held that the assets in Roth's bankruptcy estate were not assets of the decedent's estate to which a Code Section 6324(a) lien could attach. The IRS also contended that Roth was personally liable for the payment of the decedent's unpaid estate taxes. The district court held that Code Section 6324(a)(2) applied only to property included in the decedent's gross estate under Code Sections 2034 through 2042, none of which applied to the shares of stock in the present case. Therefore, Roth was not personally liable. As a result, the IRS' claim in Roth's bankruptcy proceeding had the status of a general unsecured claim. *In re Roth*, 93 AFTR 2d 2004-1663 (W.D. Pa.).

29. Repayment of IRA Distributions on Behalf of Decedent not a Tax-Free Rollover

Prior to her death in 2002, the decedent received distributions from an IRA maintained by her. When the decedent's son/executor became aware of the distributions, he immediately returned a portion of the distributions to the IRA. The son requested a ruling that his payments to the IRA qualified as a rollover under Code Section 408(d)(3). The IRS ruled that the son's payment to the IRA did not qualify as a rollover because the decedent died prior to the payment. In addition, the son was neither the recipient of the IRA distributions, nor was he the individual on whose behalf the IRA was maintained. Accordingly, the IRA distributions were required to be included in the decedent's gross income. P.L.R. 200415011.