# THE REPORTER

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President's Message

PRAISE AND APPRAISE

Who doesn't want their home to be more valuable today than it was yesterday? More value equates to money in the pocket when it comes to resale, refinance, or a home equity loan.

Section President

Frederick B. Farmer
Lowe Farmer Bacon and Roe, Olathe

Praise the appraiser.

A high appraisal can seem to be the best friend of the homeowner at first. But what happens when an aggressive lender and broker, home builder, and/or real estate agent, wanting to make a deal (and a commission), suggests to the appraiser that he needs to hit a number to make the deal work? What happens when the appraiser is told, "Here's the deal — straighten this appraisal out or you will never work for me again"? What is wrong with a fudged appraisal?

Google "appraisal inflation" and "appraiser fraud" (not "appraisal fudge") and you'll get hundreds of hits. There you'll find varying survey results, but all concur the majority of appraisers have felt pressured to inflate home values.

But what's the big deal?

Appraisers look in part to recent sales of comparable homes. A 10 percent fudge today affects the accuracy of upcoming valuations. And a 10 percent fudge tomorrow can equate to a 20 percent value increase in two days. That translates into a nice little profit for an investor/property flipper. However, the incentive for money now will risk the homeowner not being able to sell for a high enough price to pay off his mortgage(s), even if there is no downturn in the real estate market.

On a broader scale, the Federal National Mortgage Association, along with all lending institutions, can easily have vastly overvalued portfolios should the appraisers have fudged the market value of a house by 5, 10, 20 percent or more. A portfolio of houses worth less than their appraised values could affect the ability to sell securities backed by the mortgages on these overvalued houses. If Fannie Mae is unable to sell its securitized mortgages, well then, the funds juicing the housing market will dry up. Cheap mortgage money will be replaced with very expensive mortgage money.

What's being done?

The Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency are promoting changes in banks' lending and appraising operations. For example, the person responsible for obtaining information as to the property's value should not be the same person who makes the loan. The Appraisal Institute is advocating federal laws that would bar lenders from requesting appraisers to hit a predetermined number. The number of real estate fraudulent investigations by the FBI has doubled in two years, as has the average prison term handed down by federal judges in these schemes.

From a personal perspective, I don't mind my house being appraised for the highest fair market value for all purposes (except for the county's appraised value). ■

In This Issue ...

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

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

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

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

Estate Tax Notes

Tax Cases and Rulings Affecting the Estate and Business Succession Planner

Gift Tax

1. **Tax results of surviving spouse's renunciation of qualifying income interest in severed qualified terminable interest property (QTIP) trust**

The decedent was survived by his wife. The decedent's trust provided that his residuary trust estate was to pass to the Marital Trust, under which his wife was to receive all income during her lifetime at least quarterly. The trustee could distribute principal from the Marital Trust to the wife for her maintenance, health, and welfare. Upon the wife's death, the balance of the Marital Trust was to be distributed as follows: a certain dollar amount to the wife's son, provided he survived her, and the balance in equal shares to the decedent's two daughters. On the decedent's estate tax return, an election was made to treat the Marital Trust as qualified terminable interest property under Internal Revenue Code Section 2056(b)(7)(B)(v).

The wife petitioned for a court order to sever the Marital Trust into two separate and distinct marital trusts, to be called Marital Trust A and Marital Trust B. The two new trusts would have terms identical to the Marital Trust, except that Marital Trust B would not contain the specific bequest to the wife's son, but Marital Trust A would, such that the son's interest after the severance would remain the same as his interest in the Marital Trust before the severance. The court order further provided that once the Marital Trust was severed, the wife would renounce her entire interest in Marital Trust B and would waive her right of recovery under Code Section 2207A(b) for any gift taxes paid as a result of the renunciation. Under state law, upon the wife's renunciation, Marital Trust B would terminate, and the assets would be accelerated to the daughters.

The Internal Revenue Service (IRS) held that the proposed severance, as permitted under state law, the proposed funding of the new trusts, and the wife's renunciation of her entire interest in Marital Trust B would have no effect on the status of the new trusts as qualified terminable interest property trusts. When the wife renounced her qualified income interest in Marital Trust B, she would be deemed to have made a transfer of all of Marital Trust B's property, other than her qualifying income interest therein; thus the wife would be treated as making a gift under Code Section 2519 of the fair market value of Marital Trust B, determined on the date of disposition, reduced by the value of her qualified income interest, and further reduced by the amount the wife would be entitled to recover under Code Section 2207A(b). The transfer of her income interest upon renunciation would be a transfer by the wife under Code Section 2511, and the amount of the gift would be equal to the value of her qualified income interest on the date of disposition. Upon waiver of her right to recovery as provided in Code Section 2207A(b), the wife would be treated as transferring the unrecovered gift tax amount to the daughters. The amount of the gift would be the amount of reimbursement to which the wife was entitled. Pursuant to Code Section 2044(b)(2), no part of the property of Marital Trust B deemed transferred under Code Section 2519 would be included in the wife's gross estate. Upon renunciation of her entire interest in Marital Trust B, the wife's interest in Marital Trust A would not be treated as retained for purposes of Code Section 2702(a)(1), such that the interest would not be valued at zero. P.L.R. 200530014.

2. **Gift to social club constitutes gift to one entity for purposes of annual gift tax exclusion**

The taxpayer, a member of a Code Section 501(c)(7) social club, proposes to make cash contributions to the club. The club is organized as a nonstock corporation and does not issue stock to its members. The club's facilities include dining rooms, a bar, banquet facilities, private meeting rooms, a library, a game room, and overnight guest rooms. Its activities include dinners, dances, lecture series, special guest speakers, and athletic events. The cash contributions made by the taxpayer will be used by the club to upgrade its facilities. Any gift to the club by a member is subject to the immediate control of the board of directors.

Under Regulation Section 25.2511-1(h)(1), a transfer of property by a donor to a corporation generally represents a gift by the donor to the other individual shareholders of the corporation to the extent of those shareholders' proportionate interests in the corporation. The regulation section provides for exceptions to the general rule for transfers made to charitable,

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public, political, or similar organizations, which may constitute gifts to the organization as a single entity. The IRS held that the club was a nonprofit organization under Code Section 501(c)(7) and that none of its earnings inure to the benefit of any individual. It is operated solely for nonprofitable purposes and not for the economic benefit of its members; thus the IRS held that the club falls within the exception to the general rule, and the taxpayer's transfer to the club will be a gift to the club as a single entity. Further, the IRS held that because the club will receive immediate and unrestricted use to the gift, the gift will constitute a gift not limited to commence in use, possession, or enjoyment at a future date or time and will, thus, be a gift of a present interest eligible for the annual gift tax exclusion under Code Section 2503(b). P.L.R. 200533001.

3. Assignment of potential proceeds from wrongful death action to irrevocable trust is taxable gift

Following her husband's death, the taxpayer filed a claim for wrongful death in federal court. The taxpayer subsequently created an irrevocable trust for the benefit of her children and more remote descendants. The taxpayer is prohibited from serving as trustee of the irrevocable trust and proposes to assign part or all of the potential proceeds of the wrongful death action, or the proceeds from the settlement of the action, to the irrevocable trust. Following such an assignment, however, the taxpayer would remain the named party in the claim and would continue to have direct responsibility for directing legal representation and making settlement decisions. Under applicable state law, the potential proceeds of a judgment or settlement from a cause of action are recognized as a property interest that can be equitably assigned by one party to another. The IRS held that when the taxpayer assigns a portion of the potential proceeds of the cause of action to the irrevocable trust, she will have parted with dominion and control over the proceeds; thus the assignment would constitute a completed, taxable gift at the time of the assignment. P.L.R. 200534015. **Query:** How did the donor determine the market value of such a gift?

Retirement Benefits

4. Surviving spouse can roll over IRA proceeds payable to decedent's estate

The decedent died in 2000, survived by her husband and three children. At the time of her death, the decedent maintained two individual retirement arrangements (IRAs) with a bank. The decedent's husband represented that the decedent had prepared a beneficiary designation form naming him as primary beneficiary of the IRAs, but the bank has been unable to locate any beneficiary designation on file for the decedent. As a result, the bank's position is that the beneficiary of the decedent's IRAs is the decedent's estate. The decedent's will provides for the distribution of all property to the decedent's husband. Her husband was also named executor and trustee in the will. As executor, the decedent's husband will cause the IRA proceeds to be distributed to the decedent's estate. In accordance with his right as sole beneficiary under the will, the decedent's husband will request distribution of the IRA proceeds and will roll over the proceeds to an IRA in his own name within 60 days of the date the proceeds are distributed from the decedent's IRAs.

The IRS held that the proceeds of the decedent's IRAs that will be distributed to the decedent's estate and subsequently paid to the decedent's husband as sole beneficiary of the estate will not constitute inherited IRAs within the meaning of Code Section 408(d)(3)(C) with respect to the decedent's husband; thus, the decedent's husband may roll over the IRA distributions into an IRA setup and maintain it in his name. Further, the decedent's husband will not be required to include the IRA proceeds as income for federal income tax purposes, provided the proceeds are timely rolled over. P.L.R. 200526023.

5. Life insurance contracts distributed from qualified retirement plans to be valued at fair market value

The IRS issued final regulations under Code Section 402(a) regarding the amount includible in a distributee's income when life insurance contracts are distributed by a qualified retirement plan. Final regulations were also issued under Code Sections 79 and 83 regarding the amount includible in income when an employee is provided permanent benefits in combination with group term life insurance or when a life insurance contract is transferred in connection with the performance of services. Regulation Section 1.402(a)-1(a)(1)(iii) clarifies that when a qualified plan distributes a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection, the fair market value of such contract is included in the distributee's income, and not merely the cash value of the contract. If a qualified plan transfers property to a plan participant or beneficiary for consideration less than fair market value, the transfer is treated as a plan distribution to the participant or beneficiary to the extent the fair market value of the distributed property exceeds the value of the consideration. It applies to any such distribution occurring on or after Feb.13, 2004. Regulation Section 1.79-1(d)(3) replaces the term "cash value" in the formula for determining the cost of permanent benefits with the term "fair market value." It applies to permanent benefits provided on or after Feb. 13, 2004. Regulation Section 1.83-3(e) applies the definition of property for new split-dollar life insurance arrangements to all situations involving the transfer of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection. It applies to any transfer occurring on or after Feb. 13, 2004. It does not, however, apply to the transfer of a life insurance contract that is part of a split-dollar life insurance arrangement entered into on or before Sept. 17, 2003, and not materially modified after that date. T.D. 9223, 70 Fed. Reg. 50967 (Aug. 29, 2005).

6. Proposed regulations on nonqualified, deferred compensation issued

The IRS recently issued proposed regulations under Code Section 409A regarding nonqualified, deferred compensation arrangements. The proposed rules extend the deadline for plan document and good faith compliance with Code Section 409A for one year, from Dec. 31, 2005, to Dec. 31, 2006, and they generally follow the guidance issued in Notice 2005-1. The regulations provide that a plan provides for the deferral of compensation only if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that has

not been actually or constructively received and included in gross income, and that, pursuant to the terms of the plan, is payable to (or on behalf of) the service provider in a later year.

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Newsletter

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

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The regulations address, among other issues, application of Code Section 409A to various foreign arrangements and separation pay arrangements, definitions of a plan and of a substantial risk of forfeiture, initial deferral election rules, application of the rules to nonqualified deferred compensation plans that are linked to qualified plans, statutory effective dates, and transition relief. The proposed regulations do not address arrangements between partnerships and partners. Taxpayers may continue to rely on Notice 2005-1 for guidance on such issues until further guidance is published. They also do not address the calculation of amounts of deferrals or amounts of income and related withholding obligations, the funding of deferrals of compensation in offshore trusts (or other arrangements), or pursuant to a change in the financial health of the employer. REG 158080-04, I.R.B. 2005-43.

Charitable Planning

7. Disclaimer and reformation of testamentary trust creates charitable remainder unitrust (CRUT) and provides estate tax charitable deduction

The decedent's will created a trust and transferred the residue of his estate to it. A corporate fiduciary was named as trustee of the trust and as executor of the decedent's estate. The trust provided that the trustee was to pay to the decedent's adult son 50 percent of the trust income. The trustee had the discretion to pay any portion of the remaining income for the son's comfort, maintenance, or support. Any remaining income was to be added to corpus. The trustee also had the discretion to pay and apply trust principal for the son's medical expenses. At the end of 10 years, if the son was still living, the trustee was to distribute outright to him 50 percent of the trust principal. The other 50 percent was to remain in trust until the son's death (unless earlier distributed), at which time the remaining trust principal and income were to be distributed equally among four charities and a sibling. Because the charitable remainder interests do not qualify for the estate tax charitable deduction under Code Section 2055(a), the following actions were taken.

First, the son disclaimed the discretionary invasions of principal for his medical expenses. He had never received any distributions from the trust under such interest and had never accepted or received any benefits from such interest. The disclaimer was delivered to the trustee and filed with the local court prior to nine months following the decedent's death. Second, the trustee instituted a judicial proceeding in the local court to reform the decedent's will in two steps. In the first step, the trust was to be severed into two trusts (Trust A and Trust B), effective as of the date of the decedent's death. One-half of the estate residue would be allocated to each trust. The son would receive 50 percent of the income of both Trust A and Trust B, along with such additional income as needed for the son's comfort, maintenance or support, as determined in the discretion of the trustee. If the son survives the 10-year period following the decedent's death, he will receive outright the principal of Trust A. If he dies during such period, the assets will be distributed equally to the four charities and the sibling. With respect to Trust B, the principal is to be held until the son's death, at which time it is distributable to the four charities and the sibling. In the second step of the reformation, Trust B will be replaced by a unitrust, intending to qualify as a charitable remainder unitrust (CRUT) within the meaning of Code Section 2055(e)(2)(A). The trustee will distribute outright to the sibling a certain amount as the value of his partial contingent remainder interest in Trust B. Under the reformed unitrust provisions, effective as of the date of the decedent's death, the Trustee will pay each year, in quarterly installments, an amount equal to 5 percent of the net fair market value of the unitrust assets. A fractional portion of the unitrust amount will be paid in equal shares to the four charities, determined by a formula under which the actuarial value of their remainder interests and their portion of the unitrust amount, when added together, equal the actuarial value of the charitable remainder interests in Trust B prior to reformation as a unitrust. The remaining portion of the unitrust amount will be paid to the son. Upon the son's death, the property in Trust B will be distributed in equal shares to the four charities. The local court has approved both steps of the reformation, approval of the second step being contingent upon a favorable ruling from the IRS.

The IRS first ruled that the reformation of Trust B was qualified because it met the requirements of Code Section 2055(e)(3), namely the following: (1) the interest is one for which a deduction would be allowable under

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Code Section 2055(e) at the time of the decedent's death, but for Code Section 2055(e)(2); (2) the nonremainder interest both before and after the qualified reformation must terminate at the same time (upon the son's death); (3) the reformation is effective as of the date of the decedent's death; (4) the difference between the actuarial value of the qualified interest, determined as of the date of the decedent's death and the actuarial value of the reformable interest does not exceed 5 percent of the actuarial value of the reformable interest; and (5) because the noncharitable interest in the trust prior to reformation is not expressed in a specified dollar amount or a fixed percentage of the fair market value of the property, the judicial proceeding must be commenced no later than 90 days after the federal estate tax return is due, or if none, then the last date for filing the income tax return for the first taxable year for the trust; thus the IRS held that if Trust B met the requirements of Code Section 664(d)(2) for a CRUT, an estate tax charitable deduction would be allowed under Code Section 2055(a) for the present value of the charitable interest. The IRS also held that the reformation would not constitute a sale, exchange, or other disposition of property that would cause the estate, a trust, or beneficiary to realize gain or loss for purposes of Code Section 1001 or income for purposes of Code Section 61. In so holding, it cited *Cottage Savings Ass'n. v. Comm.*, 499 U.S. 554 (1991), in finding that the interests of the beneficiaries would not differ materially because the reformation is retroactive to the date of the decedent's death. P.L.R. 200535006.

Estate Inclusion

8. **Full value of residence includible in gross estate where decedent retained life estate**

In year one, daughter conveyed a residence to her parents, the decedent, and his spouse. Eleven years later, the decedent and his spouse conveyed the residence to their daughter, as grantee. However, the deed stated that the grantors reserved unto themselves a life estate in the property for their own lives without liability for waste, and also reserved unto themselves the full power and authority during their lifetimes to sell, convey, and dispose of the property (but not to devise the property) and to retain absolutely as their own all of the proceeds thereof, thereby divesting the remainder granted by the deed. They also reserved the right to mortgage the entire fee simple estate in the property. The decedent's spouse subsequently died, and the decedent continued to reside in the residence. The decedent died approximately three months later. The daughter was appointed as the personal representative of the decedent's estate. She, as personal representative, retained an attorney prior to filing the decedent's federal estate tax return. She represented that she instructed the attorney to prepare a disclaimer for purposes of disclaiming, on behalf of the decedent, one-half of the value of the residence that purportedly passed from the spouse to the decedent at the spouse's death. If such disclaimer had been properly and timely executed, no estate tax would have been imposed on the decedent's estate. However, because the disclaimer was never executed, an estate tax liability showed on the federal estate tax return as the entire value of the residence was included in the decedent's gross estate. The daughter subsequently commenced an action against the attorney alleging malpractice in his representation of the daughter, as personal representative. The estate ultimately recovered an amount approximately equal to the additional federal and state estate tax, interest, and penalties that were paid by the estate attributable to the attorney's alleged malpractice. The decedent's estate subsequently
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filed a claim for refund of estate taxes, contending that only one-half

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of the value of the residence was properly included in the decedent's gross estate. In addition, it claimed a deduction under Code Section 2053(a)(2) for amounts representing attorney's fees and litigation costs arising from the malpractice suit filed against the attorney.

The IRS recognized that pursuant to the daughter's original deed, she conveyed the residence to her parents, or the survivor of them, in fee simple; thus, immediately prior to the second deed, the decedent and his spouse each held an undivided one-half interest in the residence that each transferred in accordance with the second deed. Regarding the decedent's transfer, he transferred his one-half interest in the residence while retaining a life estate in his one-half interest. In accordance with Rev. Rul. 69-577, the date of death value of that undivided one-half interest is includible in the decedent's gross estate under Code Sections 2036(a)(1) and (2). Regarding the spouse's one-half interest, the IRS held that after the spouse's death, the decedent succeeded to a life estate in the entire property. Citing Rev. Rul. 69-342, the IRS recognized, as of the time of the decedent's death, he possessed the unrestricted power to appropriate the entire value of the residence for his own benefit. He also possessed a general power of appointment over the one-half interest that the spouse conveyed pursuant to the second deed; thus, such one-half interest was includible in the decedent's gross estate under Code Section 2041(a)(2). In summary, the IRS held that the full value of the residence was includible in the decedent's gross estate: one-half under Code Sections 2036(a)(1) and (2) and one-half under Code Section 2041(a)(2). Finally, the IRS held that the fees incurred with respect to the malpractice suit were incurred to recover estate assets and avoided dissipation of estate assets; thus the fees were allowable as an administration expense under Code Section 2053. T.A.M. 200532049.

9. No portion of trusts included in grantor's estate, even though grantor is shareholder in family trust company

The taxpayer formed a family-owned trust company as a corporation. The trust company has two classes of stock, Class A voting stock and Class B nonvoting stock. Each class of stock is identical with respect to distribution and liquidation rights. The holders of Class A stock are permitted to vote on shareholder and corporate matters, while the holders of Class B stock are not. The taxpayer owns all of the Class B stock and an irrevocable trust (Trust 1), created by the taxpayer, owns all of the Class A stock. The trust company will not solicit trust customers from the public-at-large. The trust company's articles of incorporation provide for no fewer than three and no more than five directors, no more than one-half of whom may be related or subordinate to the taxpayer, as defined in Code Section 672(c). The taxpayer may not serve as a director. Discretionary distribution powers must be exercised by a distribution committee composed of no less than one and no more than three members, all of whom are directors of the trust company. Further, each member of the distribution committee must be a person who (i) is not a grantor of or donor to any trust of which the trust company is trustee, nor the spouse of any such grantor or donor; (ii) is not a current or contingent beneficiary of any trust in which the trust company is trustee, nor the spouse of any such beneficiary; and (iii) is not related or subordinate to any grantor of or donor to any trust of which the trust company is trustee, nor to any current beneficiary of any trust of which the trust company is trustee.

During the taxpayer's lifetime, the property held by Trust 1 is held as a single trust for the benefit of the taxpayer's lineal descendants. The trustee of Trust 1 may distribute income or principal to the taxpayer's lineal descendants for health, education, maintenance, support and welfare to the extent such distributions will not jeopardize Trust 1's stated purpose of holding the Class A stock of the trust company. Upon the taxpayer's death, the trustee of Trust 1 will pay such amounts of its principal to or for the benefit of such of *the taxpayer's lineal descendants as the taxpayer appoints by will*. Such testamentary power of appointment is not exercisable with respect to any "accumulations" in Trust 1, which is that part of Trust 1 consisting of the gross income of Trust 1, including proceeds from capital gains, undistributed income that the trustee has added to principal, and other corpus income that was earned or generated during the taxpayer's lifetime. The unappointed portion of Trust 1 will continue to be held in trust for the benefit of the taxpayer's lineal descendants. The trust is required to have at least three trustees at all times. No lineal descendant of the taxpayer, nor any person who is related or subordinate to any such lineal descendant, may serve as trustee. No more than one-half of the trustees may be persons who are related or subordinate to the taxpayer. With respect to Trust 1, the IRS held that the taxpayer's reserved, testamentary and limited power of appointment will not cause the taxpayer to be treated as the owner of any portion of Trust 1 under Code Sections 671 and 674. The IRS specifically made no ruling on whether Trust 1 would be included in the taxpayer's estate.

The taxpayer also created Trust 2 for the benefit of one child and Trust 3 for the benefit of another child (collectively the Series I Trusts). Three trustees not related or subordinate to the taxpayer serve as the voting trustees, and each child serves as a nonvoting trustee of his respective trust. Each Series I Trust provides that the trustees have the discretionary power to distribute income or principal for the named child of the trust and his issue, or any one or more of the taxpayer's descendants or organizations described in Code Section 170(c), which may be added to the class of beneficiaries by the trustees. Any person or organization added by the trustees to the class of beneficiaries in a given year may be removed by the trustees in a subsequent year. The named child may terminate the trustees' power to add permissible beneficiaries at any time by written instrument delivered to the trustees. The Series I Trusts provide that a successor trustee may be appointed by the currently serving trustees. If there is a trustee vacancy, the trustees may appoint an individual as successor trustee, other than the taxpayer or two other individuals. Further, the trustees have the right to appoint an additional trustee to serve, for a total of five trustees, including the named child. The trustees of the Series I Trusts propose to obtain a court order modifying the successor trustee provisions in order to appoint the trust company to serve indefinitely as successor trustee.

The taxpayer also created Trusts 4 and 5 (collectively the Series II Trusts) for the benefit of his respective children. The Series II Trusts provide that no beneficiary/trustee shall have any powers or participate in the exercise of any powers that would constitute a general power of appointment under Code Section 2041. The Series II Trusts further provide that no donor of a trust may serve as a trustee, including the taxpayer and his wife. During the taxpayer's lifetime, no more than

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Real Estate Cases

Kansas Supreme Court

SOUTH ET AL. V. MCCARTER ET AL.
SHAWNEE DISTRICT COURT
AFFIRMED
NO. 93,066 – SEPTEMBER 9, 2005
Premises Liability

ATTORNEYS: Frank D. Taff, Topeka, for appellant; and Leonard R. Frischer and Michael L. Hughes, Frischer & Associates Chtd., Overland Park, for appellee S&J Investments of Topeka Inc. (S&J).

FACTS: John and Linda South and their minor son, Isaac, lived in the Green Acres Mobile Home Park. On his way home from work one day, Isaac exchanged words in the mobile home park with Joshua Mills and James McCarter. After Isaac dropped off his car, he returned to confront Mills and McCarter. Words and punches were exchanged and the stories conflicted as to who started and continued the incident. Isaac returned home badly beaten and with a broken jaw. His medical expenses were nearly $30,000 for the jaw surgery and two bone grafts. Nearly two years before this incident occurred, McCarter had been in a similar incident. At that time, management sent McCarter a letter ordering him off the premises permanently and any return would be criminal trespass. McCarter's father signed for the letter, discussed the letter with management, and alleges he informed management that McCarter was not involved in the previous incident and management said he could remain on the property with his aunt. South sued McCarter and his parents, Mills and his parents, American Family Mutual Insurance, and later amended the petition to include S&J, the owner/manager of the mobile home park.

The trial court granted summary judgment to Mills' mother, because South failed to show that Mills acted willfully or maliciously or that he intended to cause injury to South, and stayed summary judgement against Mills' father because he had filed for bankruptcy. The trial court granted summary judgment to Mills finding he did not cause South's injuries. Concerning McCarter's parents, the trial court found there was a genuine issue whether McCarter acted willfully and intended to cause injuries to South, but because he failed to present evidence that the injuries were the result of parental neglect, the trial court granted the McCarters partial summary judgment by limiting their liability to $5,000. The trial court granted summary judgment to S&J finding there was not a duty to evict Joshua's family and that neither Joshua, his parents, nor S&J were the legal cause of Isaac's injuries. South was allowed an interlocutory appeal.

ISSUES: Was S&J negligent in providing services necessary for the protection of the South family as stated in the rental agreement? Was S&J liable under provisions of premises liability?

HELD: Court affirmed. Court found summary judgment was proper regarding premises liability because S&J did not owe a duty to South as the harm was not foreseeable. Court stated that the excessive noise clause of the mobile home agreement created no contractual duty on the part of S&J to provide security and protect tenants from the harm that resulted in this case.

The Court also stated that the at-will provisions of the agreement did not impose a contractual duty on S&J to monitor the security risk of guests of tenants of the park. The prevailing rule in Kansas is that in the absence of a "special relationship" there is no duty on a person to control the conduct of a third person to prevent harm to others. A special relationship may exist between parent and child, master and servant, or the possessor of land and licensees. The court stated there was not a special relationship existent that would create liability, and that S&J did not have a duty to exercise reasonable care to protect its tenants from the attack in this case because it was not reasonably foreseeable and within the landlord's control. Court stated it was not foreseeable as a matter of law. The Court cited the lack of specific information as to McCarter's past conduct and the actual risk involved, that two years had passed since the prior incident, and there was no evidence of current problems between South and McCarter or that a fight would be taking place.

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Author

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

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Finally, the Court found no liability under several sections of the Restatement (Second) of Torts, including negligent performance of undertaking to render services, §§ 323 and 324A. The action taken by S&J in contacting an attorney and directing him to send a letter to McCarter banning him from the premises was not an undertaking to address the situation presented (i.e., to protect the residents of Green Acres from physical harm by McCarter) but, rather, was an undertaking to respond to the complaint of a resident about noise in the mobile home park. S&J's actions did not constitute an undertaking necessary for protection of its residents as to give rise to a duty.

STATUTES: K.S.A. 20-3017; K.S.A. 60-2102

Kansas Court of Appeals

BENDER V. KANSAS SECURED TITLE AND CHICAGO TITLE INSURANCE CO.
DOUGLAS DISTRICT COURT
REVERSED AND REMANDED
NO. 93,121 – SEPTEMBER 16, 2005
Title Insurance, Damages, and Diminution in Value

ATTORNEYS: Edward G. Collister Jr., Collister & Kampschroeder, Lawrence, for appellant; Arthur E. Palmer, Goodell, Stratton, Edmonds & Palmer LLP, Topeka, for appellee Kansas Secured Title (KST); and J. Patrick Shepard and Joel B. Laner, Hazelton & Laner LLP, Kansas City, Mo., for appellee Chicago Title Insurance Co. (Chicago Title).

FACTS: In 1999 Bender, as the trustee of two trusts for his children, purchased 160 acres of property in Shawnee County, intending to develop a rural subdivision. Kansas Secured Title provided title work on the property that revealed an easement to Martin Marietta Corp. covering one acre in the corner of the property for an active quarry, but KST (underwriter for Chicago Title) gave clean title otherwise. One year after the sale, Bender began developing the property and discovered an active natural gas pipeline owned by Williams Pipeline Co., and Williams confirmed that it had a blanket easement across the entire property. KST had missed the easement during its title search. Bender filed a claim with Chicago Title. Bender refused Williams' partial release narrowing the pipeline easement to 33 feet on each side of the pipeline. Bender sued KST and Chicago Title based on contract and negligence for the purchase price, plus interest and costs. The trial court found the title insurance policy restricted Bender's recoverable damages to diminution in value and concluded Bender had no such diminution in value as long as Williams released the easement on the property, except for the 66-foot easement. Williams granted the reduced easement in December 2003 but required indemnification. The trial court found that the partial release satisfied the defendants' obligation under the title policy. The trial court denied Bender's claim for negligence finding he had not suffered any damage.

ISSUES: Did the trial court err in concluding that Bender had sustained no damages caused by the breach of contract? Did the trial court err in denying relief against KST on Bender's negligence theory?

HELD: Court reversed and remanded. Court held the trial court did not err in enforcing the policy language that the liability of the insurer shall not exceed the lesser of the amount of insurance or the diminution in value suffered by reason of the title defect. However, the court held the trial court erred by not reconsidering the damage issue since no unconditional narrowed easement was secured as initially ordered. Court stated the trial court erred in concluding that there was no diminution in value triggering liability under the policy without evidence addressing the impact of all provisions of the proposed release on market value. The trial court should allow appraisal testimony on the impact, if any, of the indemnification. Court also held the trial court erred in holding that Bender's negligence claim against the defendant Kansas Secured Title failed for lack of damages. Court stated the trial court's finding was premised on the erroneous assumption that the measure of damages for the tort claim was identical to the measure of damages for the contract claim, and that all terms and conditions of the policy regarding the insurer's opportunity to establish title, the obligation of Bender to aid in such opportunity, and the express limitation on amount of recoverable damages are simply not applicable to the tort claim against the abstractor. On remand, the trial court is directed to determine two matters. First, the contractual liability of Chicago Title is based upon evidence of diminution of value, if any, as a result of the language contained in any partial release that has been tendered at time of trial on remand. Second, the tort liability of Kansas Secured Title is based strictly upon tort principles and without regard to contractual terms and conditions; meaning that the current state of title, without regard to mere tender of partial release, shall be the benchmark for assessment of Bender's damages, unless it can be shown that Bender has failed to mitigate losses under traditional tort mitigation analysis.

STATUTES: K.S.A. 58-2802(b)(2)

SUTTON V. SUTTON
DOUGLAS DISTRICT COURT – AFFIRMED
NO. 93,473 – SEPTEMBER 2, 2005
Divorce, Real Estate, and Fraud

ATTORNEYS: Joan Hawkins, Hawkins & Singleton, Lawrence, for appellant; and Bradley R. Finkeldei, Stevens & Brand LLP, Lawrence, for appellees.

FACTS: In 1979 William and Shirley Sutton lived on 160 acres in Douglas County. The property was owned by William Sutton's mother, Loretta Sutton. In 1979 Loretta Sutton contracted to sell the property to William and Shirley Sutton for $90,000 less a $25,500 down payment with yearly payments thereafter. Loretta Sutton deeded the real estate to the Suttons. No payments were made on the contract, but the Suttons continued to live on the property. In 1994 Loretta Sutton's attorney drafted a deed to transfer the real estate back to her in exchange for cancellation of the debt. The deed was not executed and Shirley Sutton was admitted to the hospital in 1995 with a serious medical condition. The Suttons did not have health insurance to cover the looming medical expenses and were concerned that creditors would take the real property if they defaulted on the medical debt. William Sutton asked Shirley Sutton to sign the deed

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[illegible] Sutton's attorney had signed so the property could be transferred back to Loretta. Shirley Sutton alleged William Sutton told her the transfer would only be temporary. Shirley Sutton signed the deed in May 1995. Loretta Sutton deeded the property to the Loretta Sutton Trust in July 1995, and in October 2000 William Sutton became the sole beneficiary of the trust. Loretta Sutton died in 2003. Later that same year, William Sutton filed for divorce from Shirley Sutton. In January 2004 Shirley Sutton filed an action against William Sutton and the trustee (William Sutton's sister) to bring the real property into the marital estate alleging she lacked mental capacity to execute the deed and that her signature was procured by undue influence and misrepresentations. The trial court granted the divorce, but retained jurisdiction over the real estate dispute. The trial court granted summary judgment in favor of William Sutton finding the action was barred by the expiration of the two-year statute of limitations for fraud.

ISSUE: Was Shirley Sutton's action barred by the two-year statute of limitations for fraud?

HELD: Court affirmed. The court found the trial court correctly applied the two-year statute of limitations for fraud, instead of the 15-year limitation period for actions for recovery of real property. The mere fact that an action pertains to real estate does not necessarily constitute it an action for the recovery of real estate. To maintain an action for recovery of real property based on a conveyance of title perpetrated through fraud, a plaintiff must first nullify the fraudulent conveyance before attempting to recover the real property. The suit to nullify the fraudulent conveyance, however, must be brought within the appropriate time frame for such actions (i.e., two years from the time the fraud was or should have been discovered) in accordance with K.S.A. 2004 Supp. 60-513(a)(3). While the suit to nullify the fraudulent conveyance and for recovery of an interest in the property may be combined in one action, the second count to recover the property has no standing until the matter of title is disposed. The court held that although Shirley did not specifically plead for relief on the basis of fraud, the court can look beyond what was pleaded to the real issue involved. Both misrepresentation and undue influences are claims based in fraud, thus her action was based on a conveyance of title perpetrated by alleged fraud. The court held that Shirley failed to bring her action within two years of the time she knew or should have known of the alleged fraud. The court stated it was uncontroverted that Shirley knew and understood that she had signed the deed in May 1995. Shirley knew Loretta was the owner of the property thereafter, and she had at least constructive notice of the alleged fraud. Thus, the two-year statute of limitations ran long before Shirley filed this action in January 2004.

STATUTES: K.S.A. 2004 Supp. 60-513(a)(3); and K.S.A. 60-507

SALL ET AL. V. T'S INC.
JOHNSON DISTRICT COURT – AFFIRMED
NO. 93,013 – AUGUST 19, 2005
Premises Liability and Golf Courses

ATTORNEYS: Bryson R. Cloon, Cloon Law Firm, Leawood, for appellants; and Steve R. Fabert, Fisher, Patterson, Sayler & Smith LLP, Topeka, for appellee.

FACTS: After playing just two holes of golf with his friend, Sall was hit and severely injured by lightning at Smiley's Golf Complex (SGC) in Johnson County on his return to the clubhouse after a warning horn was sounded. Sall was severely injured and now requires total care. Sall's guardians filed lawsuit alleging SGC staff had duty to warn Sall of danger it knew or should have known about, and claiming negligence in failing to properly monitor weather, sound timely warning, utilize lightning detection equipment, have appropriate medical equipment, and render timely and appropriate medical care. Plaintiffs contend that their son, Patrick, would have been able to protect himself had he been given sufficient warning of the imminent storm. The facts of the case indicate that Patrick and his friend, Gannon, saw a lightning strike, and ignored it, prior to warning horn being sounded. The second lightning strike occurred as the horn was blown when Patrick and Gannon were on the second green. Instead of immediately returning to the clubhouse, Patrick and Gannon lingered on the golf course and continued to finish the hole. They made a conscious decision to finish the hole they were playing, rather than heeding the warning immediately. Apparently, no one thought the danger was imminent. Essentially, the *Sall* case was based on a premises liability theory that golf courses have a duty to warn their patrons about dangerous weather conditions and to protect those patrons from lightning injury. Defendants filed motion for summary judgment, claiming no breach of duty, and claiming any duty owed to Sall was satisfied with timely warning to leave the golf course. Based on lack of foreseeability of lightning strike, and finding facts insufficient to invoke Restatement (Second) of Torts §§ 323 (an assumption of duty theory), district court granted defendant's motion. Sall appealed.

ISSUES: (1) Duty to warn of lightning strikes and (2) Restatement (Second) of Torts §§ 323

HELD: Court affirmed defendant's motion for summary judgment. Kansas' courts have not defined forseeability of lightning strikes within context of premises liability. Lightning bolt at golf course in direct proximity to Patrick was not foreseeable, and SGC did not breach any applicable standard of care. The court seems to distinguish between the foreseeability of a thunderstorm heading for the golf course with lightning that might strike the golf course somewhere, versus the foreseeability of a bolt of lightning that would strike the ground in direct proximity to Patrick. There is no golf course industry-wide standard of care that requires use of a lightning detection system. Regardless of what other golf courses in the area were doing, a golf course does not breach any applicable standard of care by failing to use a lightning detection system. Under circumstances, SGC had no duty to foresee lightning, and even if duty existed, there was no breach where SGC provided a 10-minute notice of lightning seen in the area. With respect to the assumption of duty theory, the court was

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of the opinion that no other court has ever relied on Restatement (Second) of Torts § 323 to impose liability for golf course lightning injury claim, and that this theory of an assumption of duty did not apply to the facts of this case. The location of a lightning strike is not foreseeable, therefore, there can be no duty to prevent injuries as a result of such a strike. Without a duty there can be no breach.

DISSENT: (McAnany, J.) Majority does not always focus on facts most favorable to a nonmoving party, and further, conflicts in experts' testimony should be resolved by a jury. First, the majority opinion would require not merely foreseeability of harm on SGC's premises, but foreseeability that the lightning would strike on a particular fairway. Second, it ignores the fact that even SGC foresaw the danger, because that is, after all, why they sounded the warning. Issue is not whether storm's danger to golf course was foreseeable, but when it was foreseeable and whether SGC was negligent in sounding warning. The restatement rule clearly applies to facts of case. The genuine issue of material fact remains as to whether SGC was negligent in timeliness of its warning, having undertaken the task of warning golfers of threat of approaching storms. Finally, the majority opinion concludes that the restatement rule does not apply because SGC was not negligent. However, if one must show negligence before the restatement rule applies, it becomes utterly meaningless since to establish negligence there must be the breach of a duty. To the contrary, the restatement rule is simply a vehicle for recognizing a duty, which, but for the conduct of the defendant, the law would otherwise not impose and thus applies to the facts of this case.

STATUTES: No statutes cited.

NATIONAL CITY MORTGAGE V. ROSS ET AL.
JOHNSON DISTRICT COURT – AFFIRMED
NO. 93,285 – AUGUST 12, 2005
Real Estate, Mortgage, and Subrogation Rights

ATTORNEYS: Charles S. Scott, Jr., Kansas City, Mo., for appellants; and Linda S. Mock, Overland Park, for appellee.

FACTS: On June 15, 2000, the Boldridges entered into a contract for deed with the Tumbergers to purchase real estate in Shawnee for $165,000. From July 2000 to June 2001 the Boldridges made payments totaling $21,595.61. In June 2001 the Tumbergers resold and conveyed the property by warranty deed to the Rosses. The Rosses secured a mortgage loan from National City Mortgage (NCM) in the amount of $208,000. NCM had appraised the property in May 2001. Both the warranty deed and the mortgage from the sale to the Rosses were recorded with the register of deeds on June 25, 2001. The title report done by NCM indicated the Tumbergers were the owners of record. The Boldridges refinanced the property to include current and back taxes and were told the mortgage had been refinanced with NCM in the name of Kevin Ross. The Boldridges continued making payments until they discovered the mortgage had been refinanced for $208,000. In April 2002 NCM brought an action to foreclose its mortgage on the property against the Rosses and the Boldridges, asserting the Rosses had defaulted on their mortgage in December 2001. On August 2003 the Boldridges filed a third-party petition against the Tumbergers, the Rosses, and NCM. The Boldridges sought a judgment for damages from the Tumbergers. The Boldridges claimed they had been deprived of the use of their equity in the property as a result of the resale of the property to the Rosses and the Rosses' execution of a mortgage to NCM, and they requested fee simple title. Ross told NCM's attorney that all the information he gave for the mortgage was false, and the Tumbergers and his attorney approached him about purchasing the property in his name, and then in a couple months it would be moved out of his name in order to help someone who wanted to purchase the house but couldn't obtain financing. Before trial, in settlement and payment of the Boldridges' claim against the Tumbergers, the Tumbergers agreed to relinquish their title and interest in the property and executed a quitclaim deed to the Boldridges. The trial court held the Boldridges had been enriched to the extent of the discharge of the two prior mortgages, and the Boldridges rights were subject to the two pre-existing, valid mortgages on the property. The Boldridges did not show they had to change or that they had been induced to change their position because of the satisfaction of the two prior mortgages. As a result, any negligence on the part of NCM in failing to make an adequate inquiry as to the Boldridges' possession of the premises did not bar NCM from the right of subrogation.

ISSUES: Is the doctrine of subrogation inapplicable to the case because of the negligence of NCM in failing to investigate the Boldridges' possession of the premises? Did the Boldridges' possession of the property constitute constructive notice of their rights under their contract for deed?

HELD: Court affirmed. Court held the trial court correctly applied the doctrine of subrogation. Court found that subrogation was just and equitable under the circumstances based on the fact that the Boldridges failed to protect their interests by recording their contract for deed and that the Tumbergers perpetrated a fraud on both NCM and the Boldridges. Court found NCM had both constructive and actual notice of the Boldridges' prior equitable title and ownership under the contract for deed, and that NCM's lack of care was the primary contributing factor and exceeded the lack of care of the Boldridges. However, any negligence on the part of NCM in failing to make an adequate inquiry as to the possession of the premises by the Boldridges did not bar NCM from the right of subrogation. Court stated that the doctrine of subrogation is designed to promote natural justice and to permit NCM to assert the rights of the two pre-existing valid mortgages against the Boldridges would not prejudice the Boldridges' interests. Court held no abuse of discretion in granting subrogation in the case.

STATUTES: No statutes cited.

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FITZMORRIS V. DEMAS ET AL.
WILSON DISTRICT COURT
REVERSED AND REMANDED WITH DIRECTIONS
NO. 92,817 – AUGUST 5, 2005
Real Estate, Termite Inspection, and Disclosure of Prior Report

ATTORNEYS: Robert E. Barker, Chanute, for appellant; and David W. Rogers, Rogers Law Office, Fredonia, for appellee.

FACTS: The Harkraders entered into a real estate contract with Pickell (Seller) to purchase Seller's residence for $35,000. The Harkraders hired Morrow Construction to inspect the home. Morrow's report estimated termite damage in the house to be substantial and the cost of repair between $18,000 and $25,000. The Harkraders voided the contract based on the termite damage. Morrow Construction gave a copy of its report to Larry Marshall, Seller's real estate agent, who in turn gave a copy to Seller. Seller hired Sunrise Construction to inspect the termite damage and estimated repairs. The report statedthat there was damage to floor joints due to termites and the cost to repair was at $5,000 or less. Fitzmorris looked at the property. Marshall advised Fitzmorris of the termite damage and of the estimate of $5,000 to make repairs, but Marshall did not advise that of the Morrow report. Fitzmorris was given the choice of either paying $35,000 for the house and having the Seller repair the termite damage, or receiving a $5,000 price reduction with no repairs. Fitzmorris ultimately purchased the house for $29,500 reflecting a price reduction for the estimated repair of the termite damage. Prior to closing, Fitzmorris had D&M Pest Control conduct a termite inspection, which also reported previous damage to floor joists, but no other visible evidence of termite infestation. After Fitzmorris purchased the house, she began redecorating and in the process, found substantial termite damage to the walls and in the ceiling and rafters. Fitzmorris sued D&M Pest Control, Marshall and Seller. The district court granted summary judgment in favor of all the defendants. Fitzmorris appealed the district court's denial of her motion for summary judgment against Marshall arguing he fraudulently concealed the Morrow report, that the report was material, and that had Marshall disclosed the report she would have known of the prior voiding of a contract on the property and that the structural damage was nearly as much as the home itself.

ISSUE: Whether the district court, in granting summary judgment to Marshall, erred by concluding that Marshall, as Pickell's agent, had no duty under K.S.A. 2004 Supp. 58-30,106(d)(4) to disclose the Morrow report to Fitzmorris.

HELD: The Brokerage Relationships in Real Estate Transactions Act (BRETA), K.S.A. 2004 Supp. 58-30,101 *et seq*., defines the responsibility of real estate licensees with respect to disclosures of defects. K.S.A. 2004 Supp. 58-30,106 sets out the minimum obligations for seller and landlord agents. K.S.A. 2004 Supp. 58-30,106(d)(3) discusses the obligations of sellers' agents to provide written reports, "[except as provided in subsection (d)(4)]." K.S.A. 2004 Supp. 58-30,106(d)(4) provides: "A seller's or landlord's agent shall disclose to the client or customer *any* facts actually known by the licensee that were omitted from or contradict *any* information included in a written report described in subsection (d)(3)." (Emphasis added.) The court determined that subsections (d)(3) and (d)(4) should import a materiality requirement. Without such a requirement, a seller's obligation would be unlimited, contrary to the intent and language of the statute. A matter is material if it is "one to which a reasonable person would attach importance in the determination of his or her choice of action in the transaction in question." Next, the court concluded that a reasonable person, in determining whether to purchase the home, may well have attached importance to the more extensive description of the termite damage and the much higher repair estimate contained in the Morrow report. This is particularly true in light of the proportionality of the repair estimate to the listed price of the home and the fact that the house failed the prior structural inspection, causing the previous buyers to void their purchase contract. The court concluded that because Marshall was aware of this material information and was aware that this information contradicted information contained in the written report provided to the buyer, the seller's agent was required to disclose the information pursuant to K.S.A. 2004 Supp. 58-30,106(d)(4). The court held the district court erred in granting Marshall summary judgment and denying summary judgment to Fitzmorris on her claim of fraudulent concealment. The court reversed and remanded with directions to enter summary judgment in favor of Fitzmorris on her claim of fraudulent concealment against Marshall.

STATUTES: K.S.A. 2004 Supp. 58-30,106(d)(1), (3), (4)

IN RE TAX EXEMPTION APPLICATION OF KANSAS STATE UNIVERSITY FOUNDATION
BOARD OF TAX APPEALS – AFFIRMED
NO. 92,407 – JUNE 24, 2005
Ad Valorem Property Tax Exemption

ATTORNEYS: S. Lucky DeFries and Jeffrey A. Wietharn, Coffman, DeFries & Nothern P.A., Topeka, for appellant; and Michael A. Montoya, Michael A. Montoya P.A., Salina, for appellee.

FACTS: The Kansas State University Foundation (Foundation) purchased a commercial building in Riley County, located at 5980 Corporate Drive, Manhattan. The Foundation planned to lease the building to Kansas State University (KSU) to house the university's printing operations. The Foundation is organized as a nonprofit, charitable organization, which is tax-exempt under IRC Section 501(c)(3). The Foundation's charitable purpose involves eliciting private financial contributions, which are applied to the support and extension of the educational, research, and public service goals of KSU. Like the Foundation, KSU is also a nonprofit, charitable organization, which is tax-exempt under IRC Section 501(c)(3). The Foundation obtained a mortgage loan on the building in the amount of $825,000 with monthly payments of $6,311.20. In February 2003 the Foundation signed a five-year lease with KSU, whereby KSU would pay monthly rent of $6,417.12, plus a special annual assessment of public utilities in the amount of $7,893.28. The Foundation calculated the monthly lease payment by adding the Foundation's administrative costs ($105.02 per month) to the mortgage payments. KSU took possession and used the building to house its printing departments, which do not include commercial printing services. In April 2003 the Foundation requested an exemption for ad valorem property taxation. The Foundation and BOTA agreed that the use of the building is educational, within the meaning of K.S.A. 2004 Supp.

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79-201 *Second*. BOTA denied the Foundation's request for exemption of ad valorem property taxation under K.S.A. 2004 Supp. 79-201 *Second*. The Foundation appealed BOTA's order.

ISSUE: Exemption from Ad Valorem Taxation under K.S.A. 2004 Supp. 79-201 *Second*

HELD: No Kansas case involving K.S.A. 79-201 *Second* on analogous facts. *In re Tax Appeal of Univ. of Kan. School of Medicine*, 266 Kan. 737 (1999), is distinguished. Whether the organizations using the property possess a tax-exempt character is relatively immaterial because it is the use of the property, not the character of the owner, which determines the applicability of an ad valorem tax exemption. Where public property is not involved, a tax exemption must be based upon the use of the property and not on the basis of ownership alone. Complete reimbursement from KSU for foundation's acquisition of a material asset falls within specific prohibition against use of property for investment purposes. Investment use of property cannot be deemed merely incidental and inconsequential to actual use of property by KSU for educational purposes. The lease payments provide the Foundation with the means to pay for the ownership interest in the property. As the mortgage is paid and the building presumably appreciates in value, the ownership interest becomes a financial asset. If KSU breaches the lease or if the parties do not renew the lease at the end of the lease term, the Foundation can sell the building, pay off the remaining mortgage, and keep the equity obtained through KSU's lease payments. Under the lease arrangement, the court concluded that the Foundation's only use of the property is a financial one. Legislative attention to this close question of simultaneous use is invited. BOTA's decision is affirmed.

STATUTES: 26 U.S.C. 501(c)(3) (2000); K.S.A. 2004 Supp. 79-201 Second sections (b) and (c); K.S.A. 77-621, 79-210 *Second* and *Ninth*

United States Bankruptcy Court
District of Kansas

IN RE JORGE COLON JR. AND ANTOINETTE VALENTINA ORTINZ-COLON
HAMILTON V. WASHINGTON MUTUAL BANK FA.
CASE NO. 04-42174, ADVERSARY NO. 05-7032
SEPTEMBER 9, 2005
Homestead Exemption, Mortgage Perfection and Avoidance

FACTS: Debtors filed for bankruptcy under Chapter 13 and filed a Chapter 13 plan. Because the mortgage on their homestead appeared to be improperly perfected (the mortgage misidentified the Debtors' lot), Debtors' plan included two alternatives for payment of debts, depending on whether the lien is held to be valid. Washington Mutual, the mortgagee, did not object and the court confirmed the plan. The Trustee initiated this adversary proceeding to avoid Washington Mutual's mortgage. Washington Mutual moved to dismiss on the basis that the Trustee has no standing to bring this action, and that he has no power to avoid the transfer. This memorandum and order denies the motion to dismiss.

ISSUES: (1) Trustee's standing to bring action avoiding lien on exempt property and (2) Trustee's power to avoid a transfer under a Chapter 13 plan contemplating a challenge to the lien

HELD: The court denied the motion to dismiss. Noting that all property owned by a debtor on the date of filing is part of the bankruptcy estate, and that strong arm powers under 11 U.S.C. § 544(a) are fixed "as of the commencement of the case," the court held that the Trustee's avoidance powers extended to all of Debtors' property, even property that may be removed from the estate as exempt. The court also found that the plan properly delayed revesting of the exempt property until the end of the case. Because the Chapter 13 plan contemplated a challenge to the mortgage and provided alternative distributions depending on the outcome of that challenge, the Trustee has post-confirmation power to pursue avoidance of the mortgage. The court distinguished *Gilliam v. Bank of America Mortgage (In re Gilliam)*, Adv. No. 03-6053 (Oct. 28, 2004) (Somers, J.). *Gilliam* held that a debtor cannot bring an avoidance action under § 544(a) on his own behalf. In the present case, the Trustee brought the avoidance action. The court held that the Trustee has the authority to bring an action to avoid the mortgage.

STATUTES: 11 U.S.C. § 544(a)

Office of the Attorney General
State of Kansas

OPINION NO. 2005-19
Taxation – Property Exempt From Taxation; Federal Property.
Federal Jurisdiction – Federal Property;
Jurisdiction – Taxing Certain Property Upon Military Reservations.
Cities and Municipalities – General Provisions – Tax Subdivisions Authorized to Enter into Agreements with Owners of Tax Exempt Property for Payments in Lieu of Taxes.
August 18, 2005

SYNOPSIS: Pursuant to K.S.A. 2004 Supp. 79-201a *First*, property owned by the federal government is not subject to Kansas property tax. Thus, if the fee ownership in property located within a federal enclave remains vested in the U.S. government, it is exempt from state property tax. Additionally, other property within the Fort Leavenworth military reservation is generally not taxable by the state due to provisions of the act ceding that property, and jurisdiction over it, to the federal government. The exception to this rule is for property of corporations within the reservation. Real or personal property owned by a private corporation within the Fort Leavenworth enclave should be valued and taxed at the rates applicable to such property generally. A payment in lieu of taxes agreement may be entered into K.S.A. 12-147 if the property is exempt from taxation. If property is not exempt from taxation, K.S.A. 79-1703 generally prohibits a county commission from releasing, discharging, remitting, or commuting any portion of the taxes assessed or levied against any person or property within their respective jurisdictions for any reason.

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Author

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

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

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Probate and Trust Cases

IN RE KESTER
Bankruptcy Case No. 02-24689
REDMOND V. KESTER
Adversary No. 03-6089
(Judge Robert D. Berger)
September 16, 2005

Attorneys: Jacob W. Stauffer and Robert D. Maher, of Husch & Eppenberger, LLC, Kansas City, Mo., represented Christopher J. Redmond, trustee; and debtors were *pro se*.

The Chapter 7 Trustee sought summary judgment to deny the debtors' homestead exemption for their principal residence because it was owned by their "self-settled living revocable trust." The Trustee claimed that the debtors are not entitled to exempt property that they placed in their revocable trust. The bankruptcy court looked to the equitable interest owned by the debtors as beneficiaries and cited several early Kansas opinions that an equitable owner of real property is entitled to claim a homestead. The homestead rights of the debtors were thus held to exist notwithstanding the transfer of their real property to their revocable trust. This holding is consistent with the 2004 amendment to the Kansas Uniform Trust Code at K.S.A. 58a-1107(c)(1). ■

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Real Estate Cases

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STATUTES: K.S.A. 12-147; K.S.A. 2004 Supp. 17-7662; K.S.A. 27-102; 27-102b; 27-102c; 27-104; K.S.A. 2004 Supp. 79-201a, as amended by L. 2005, Ch. 199, § 5; 79-412; K.S.A. 2004 Supp. 79-1439; 79-1703; 10 U.S.C. §§ 2667, 2878; L. 1875, ch. 66 § 1

OPINION NO. 2005-20
Waters and Watercourses – Clean Drinking Water Fee – Imposition of Clean Drinking Water Fee; Opt Out by Public Water Supply System.
August 16, 2005

SYNOPSIS: The clean drinking water fee may not be included as a separate line item on consumers' water supply system bills, whether designated as a clean drinking water fee or as some other assessment that includes the amount of the clean drinking water fee. In our opinion, the "price to the consumer of water" is that amount a consumer must pay in order to have water delivered. K.S.A. 82a-2101 prohibits this amount, i.e., the "price of water," from including the amount of the clean drinking water fee. If a water supply system elects to pay the clean drinking water fee (instead of paying otherwise applicable sales taxes), it may not then *increase* the price to the consumer of water in the amount of this fee. K.S.A. 82a-2101 authorizes, in exchange for not paying otherwise applicable sales taxes, a water supply system to pay the clean drinking water fee from its general operating fund. Even though for the most part a water supply system's operating fund is comprised of moneys received from customers for water, this conclusion is in keeping with the sentiment of K.S.A. 82a-2101 to disallow a water supply system from (1) electing to pay the clean drinking water fee, (2) reaping financial benefits of not paying otherwise applicable sales taxes, and then (3) reaping an additional financial benefit by charging its customers with the amount of the clean drinking water fee.

STATUTES: K.S.A.82a-2101 ■

Estate Tax Notes

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one-half of the trustees then serving may be related or subordinate to the taxpayer. No more than two of the trustees serving at any time as trustee may have a beneficial interest in that trust or any other Series II Trust. The trustees of the Series II Trusts propose to obtain a court order modifying the trusts to have the trust company serve as sole successor trustee.

With respect to the Series I Trusts and Series II Trusts, the IRS ruled that the trust company is not a related or subordinate party to the taxpayer within the meaning of Code Section 672(c)(2), and may, therefore, exercise the powers described in Code Section 674(c) with regard to the trusts without causing the taxpayer to be treated as the owner of any portion of those trusts under Code Section 674(a). Further, the IRS held that following appointment of the trust company as trustee of the Series I Trusts and Series II Trusts, none of the beneficiaries of such trusts would have the power to vest the corpus or income of the trusts in themselves. Therefore, the appointment of the trust company and its exercise as trustee of any discretionary distribution powers would not cause any beneficiary of such trusts to be treated as an owner of any portion of the trusts under Code Section 678(a) during the taxpayer's lifetime. Finally, the IRS held that the appointment of the trust company as successor trustee of the Series I Trusts and Series II Trusts would not result in the inclusion of any portion of the trusts in the taxpayer's estate under Code Sections 2036 or 2038, and would not result in the inclusion of any portion of the trusts in the estate of a beneficiary under Code Section 2041. P.L.R. 200523003.

10. Residence included in decedent's gross estate due to rent-free use

In March 1990 the decedent purchased a condominium in Maryland for $240,000. In November 1997 the decedent entered into an agreement with his eight children regarding the residence. The agreement provided the decedent with the sole and exclusive right to use and occupy the residence indefinitely. While occupying the residence, the decedent did not have to pay any rent, but was responsible for the payment of any mortgage against the property, the monthly condominium assessment, the annual real estate taxes, the annual insurance premiums, and all costs or expenses in connection with the maintenance and repair of the residence. At such time as the decedent ceased to occupy the residence, the proceeds from its sale were to be divided between the owners in accordance with their percentage interests.

On the same day the agreement was executed, the decedent also executed a deed conveying an undivided 4.5 percent interest to each of his eight children, as tenants in common. The following year, he executed another deed conveying another undivided 4.5 percent interest to each of his children, and in 1999 he executed a third deed conveying an undivided 3.5 percent interest to each of his children, such that the decedent no longer owned any interest in the residence. At all times until his death, the decedent continued to occupy the residence, and paid between $1,000 and $1,100 per month for expenses related to the residence. Following the decedent's death, his children sold the residence. On the date of the decedent's death, the fair rental value of the residence was between $1,600 and $2,200 per month, and the fair market value of the residence was $275,000. The decedent's estate tax return reported a zero value for real estate owned. The IRS issued a notice of deficiency to include in the decedent's gross estate the residence at a value of $310,000.

At issue for the U.S. Tax Court was whether the decedent retained for his life the possession or enjoyment of the residence within the meaning of Code Section 2036(a)(1). The estate argued that under the three deeds, the decedent did not retain for his life the right to possession or enjoyment of the residence because the three deeds were absolute transfers of fee interests in the residence without reservation. The decedent acquired the right to exclusive possession of the residence by contract, under which the children gave up their right to use and occupancy in return for the decedent's agreement to pay all of the expenses and not look to them for contribution. The IRS argued that inclusion under Code Section 2036(a)(1) is required where the decedent retained possession or enjoyment or right to income from property transferred *for less than full consideration*. Here, the decedent transferred legal title, and no consideration was paid by his children. Further, the decedent retained complete possession or enjoyment before, during and after the series of transfers. The Tax Court agreed with the IRS and held that the decedent retained a life estate in the residence until the date of his death, and that the value of the residence was includible in the decedent's gross estate under Code Section 2036(a)(1). *Estate of Tehan v. Comm.*, T.C. Memo 2005-128.

Valuation

11. Decedent's nontransferable right to future lottery payments is annuity properly valued by tables

The decedent won the Massachusetts lottery on Jan. 4, 1999, on which date Massachusetts issued him the first of 20 annual $100,000 checks. Under Massachusetts law, he was not permitted to assign the winnings. The decedent died on Jan. 23, 1999. His estate tax return showed no estate tax due and listed the remaining lottery payments as an asset valued by an appraiser at $367,482. The IRS calculated the asset as being worth $1,091,553 by reference to statutory annuity tables. The increase resulted in an additional tax liability of $173,611 plus interest, which the decedent's estate paid. The estate subsequently filed a claim for refund of such amount, and the present suit resulted. The government filed a motion for summary judgment.

Regulation Section 20.2031-1(b) provides that the value of every item of property includible in a decedent's gross estate is the fair market value at the time of the decedent's death, which is the price at which the property would change hands between a willing buyer and a willing seller. However, Regulation Section 20.7520-1(b) provides an alternative when calculating the value of private annuities by use of the Code Section 7520 tables, the factors from which are composed of an interest rate component and a mortality component. When the annuity is for a term of years, the mortality component is equal to such term of years.

The court first looked to the question of whether the lottery winnings constituted an annuity. Citing Regulation Section 20.7520-

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3(b)(1)(i)(A), it found that the lottery prize was an annuity. The court rejected the estate's contention that the lottery winnings were not an ordinary annuity, but rather were a restricted beneficial interest excepted from Code Section 7520 tables by Regulation Section 20.7520-3(b)(1)(ii). The court found that a "restriction" within the meaning of the Regulation was one that jeopardized receipt of the payment stream, and that a restriction of marketability was not one that justified characterizing the proceeds as a restricted beneficial interest. The court, having determined that the lottery winnings constituted an annuity, turned to the question of whether the annuity was to be valued pursuant to Code Section 7520 tables.

The court noted that Code Section 7520 tables must be used unless it is shown that the result is so unrealistic and unreasonable that some modification in the method should be made, or complete departure from the method should be taken. The party challenging applicability of the tables has the substantial burden of demonstrating that the tables produce an unreasonable result. The court held that the plaintiff failed to meet that burden. Noting that a split in authority has developed, the court examined the Second and Ninth Circuit views that non-marketability should be factored into the valuation of such interests, and the Fifth Circuit and Tax Court views that to do so would be inappropriate. The court found that the nonmarketability of lottery winnings did not warrant valuation outside the annuity tables. The government's motion for summary judgment was granted. *Estate of Donovan Jr. v. U.S.*, 95 AFTR 2d 2005-2131 (D. Mass.).

12. Built-in capital gain tax liability reduces value of closely held stock

The decedent died in 1999. His gross estate included a 6.44 percent interest in a closely held corporation whose assets consisted primarily of marketable securities. The corporation had a relatively high rate of return in the form of annual dividends coupled with capital appreciation of approximately 23 percent annually for the five-year period prior to the decedent's death. At the time of the decedent's death, the securities had a market value of approximately $178 million and a built-in capital gain tax liability of approximately $51 million if all the securities were to be sold on the valuation date. The net asset value of the corporation without consideration of the effect of the built-in capital gain tax liability was approximately $188 million. The decedent's estate contended that the $188 million value should be reduced by the entire $51 million before considering discounts for lack of control and marketability. The IRS contended that the built-in capital gain tax liability should be discounted to account for time because it would be incurred in the future rather than immediately. Under the IRS' approach, the reduction for built-in capital gain tax liability would be approximately $21 million. The parties also disagreed about the discounts for lack of control and marketability. The estate reported approximately $4.5 million as the value of the decedent's interest in the corporation, and the IRS reported it as approximately $9.1 million.

In considering the issue of the built-in capital gain tax liability, the U.S. Tax Court held that because the decedent's 6.44 percent interest would be insufficient to cause liquidation, and because the corporation performed well and kept pace with the S&P 500, defying the notion that it was an underperforming company, an assumption of complete liquidation on the valuation date did not apply in this case. The Tax Court found use of a 13.2 percent discount rate to be reasonable when considering the built-in capital gain tax liability. In addition, the 6 percent turnover rate of the securities per year used in arriving at the discount rate was conservative and reasonable under the circumstances. Such turnover rate reasonably predicted a 16-year period of recognition for the tax liability attributable to the built-in capital gain. The Tax Court held that a discounted total liability of approximately $21 million was appropriate, resulting in a total undiscounted value of the corporation on the decedent's date of death of $167.5 million.

The Tax Court next compared the corporation's performance to other investment companies and held that a 10 percent lack of control discount was appropriate. Finally, the Tax Court held that the corporation's financial performance warranted a lower-than-average discount for lack of marketability, even though the corporation's dividends were lower than those of similar companies because it had a successful history of long-term appreciation. In addition, it was a holding company with a diversity of blue chip securities, and its performance was relatively reliable and easily verified. On the other hand, the holding period for the corporation's stock would favor a higher-than-average discount because gain from the investment relies more heavily on long-term appreciation, effectively extending the necessary holding period to realize the investor's goals in such an investment. Overall, however, the Tax Court held the facts examined favored a lower-than-average discount of 15 percent for lack of marketability; thus a total discount of 23.5 percent was applied to arrive at a discounted value of the decedent's interest in the corporation of approximately $8.2 million. *Estate of Jelke v. Comm.*, T.C. Memo 2005-131.

Partnerships

13. Family Limited Partnership (FLP) assets included in decedent's estate under Code Section 2036(a)(1)

Austin and Edna Korby were married in 1948. They had three sons. In 1993 Edna entered into a nursing home. She died in July 1998. Austin died in December 1998 following several illnesses and nursing home stays during 1996 and again prior to his death. In 1993, Austin and his son, Dennis, met with an estate-planning attorney. Austin and Edna created a living trust, naming Austin and Dennis as trustees. Between 1993 and 1995 the following assets were transferred to the living trust: money market account, house in Minnesota, vacant lot in Minnesota, checking account, savings account, household furnishings, 1 percent general partnership interest in Crane Properties, a limited partnership, 2 percent general partnership interest in Korby Properties, a limited partnership (the Partnership), and the Korbys' monthly social security checks.

The partnership was formed in March 1994. Austin, Edna, and their four sons each signed the partnership agreement as limited partners. The living trust was the general partner. The partnership agreement provided for management fees to be paid to the general partner and to be measured by the time required to manage and administer the partnership, by the value of property under administration, and by the responsibilities the general partners assumed in discharging of

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the duties of the general partner. The general partner was to decide the amount of the management fees. The partnership agreement also required the partnership to reimburse the general partner for all reasonable and necessary business expenses incurred in managing and administering the partnership. The partnership was not funded and did not commence business until spring 1995, at which time the living trust transferred its money market account with a balance of $37,841. In exchange, the living trust received the 2 percent general-partnership interest. Austin and Edna transferred the following assets to the partnership in exchange for a 98 percent limited-partnership interest: stocks valued at more than $1.3 million, state and municipal bonds valued at almost $450,000, and U.S. savings bonds worth approximately $71,000. Austin and Edna then gave 24.5 percent limited-partnership interests to irrevocable trusts created for each of their four sons. Approximately 90 percent of the transferred assets had been held by Austin and Edna in joint tenancy. The remaining 10 percent had been held by Austin individually or in joint tenancy with his sons. As a result, Austin contributed 58.46 percent of the partnership's assets, Edna contributed 38.26 percent, the sons contributed 1.28 percent, and the living trust contributed 2 percent. Following the transfers to the living trust and to the partnership, Austin and Edna did not have any bank accounts open in their individual names. Austin and Edna reported the gifts to the irrevocable trusts on their 1995 gift tax returns and elected to split gifts. The returns applied a 43.61 percent discount to the value of the transferred partnership interests because the interests were minority interests and lacked management control.

From 1995 through 1998 the partnership and living trust paid many of the Korbys' household expenses, and the living trust made payments to Edna's nursing home, various drug stores, other miscellaneous stores, and the IRS. The living trust also made occasional payments to Austin. To pay all such expenses, the living trust received cash payments from the partnership and from the Korbys' social security payments. The partnership paid the utility and heating bills, property taxes, and insurance for the Korbys' residence, and paid for subscriptions to newspapers and periodicals. In 1998 the partnership redeemed its U.S. savings bonds, and one-half of the proceeds were used to purchase an annuity, under which Dennis (the son) was named the annuitant, and the four sons were named as the four equal owners and beneficiaries. The other one-half of the proceeds were deposited into the living trust's checking account.

Edna's estate tax return listed as jointly owned property one-half of all property held by the living trust and showed a zero tax due. The IRS issued a notice of deficiency, determining that the full values of the assets held by the partnership were includible in the gross estate under Code Sections 2036(a)(1) and (2) and/or 2038(a)(1). The estate tax deficiency totaled more than $1.1 million. The Tax Court held that the facts showed that Austin and Edna had an implied agreement with their sons that they were entitled to the income from the assets they transferred to the partnership. It further found that the partnership was formed as a testamentary vehicle designed to transfer assets to their sons during their lives at a significant discount, while retaining the economic enjoyment of the assets. The Tax Court next held that the bona fide sale exception did not apply because Austin essentially stood on all sides of the partnership's formation and approved the provisions of the partnership agreement without negotiation or input from the limited partners. Further, Austin and Edna attempted to shield their income-producing assets from the estate tax by transferring them to the partnership, rather than retaining assets sufficient to provide the income they would need as their medical expenses grew; thus the Tax Court held that Code Section 2036(a)(1) applied to the partnership assets contributed by Austin and Edna. As a result, 38.26 percent of the partnership value was includible in Edna's gross estate. *Estate of Korby v. Comm.*, T.C. Memo 2005-102.

14. Assets transferred to Family Limited Partnerships (FLPs) included in decedent's estate

Ida Abraham suffered from Alzheimer's disease and was placed under guardianship in 1993. As part of Ida's estate plan, in 1995, three pieces of commercial property were transferred to three FLPs pursuant to a state probate court decree entered to ensure that Ida's financial needs would be met and to prevent her estate from being drained by contentious litigation among her children. Ida and three of her children were partners in the FLPs. Between 1995, when the FLPs were created, and 1997, when Ida died, she, through her guardian, transferred percentage interests of her share in the FLPs to her children and their families. Upon her death, her estate tax return included only the percentage interests in the FLPs still held by her at her death, which were valued by applying minority and lack of marketability discounts. The IRS assessed an estate tax deficiency based on Code Section 2036. The Tax Court rejected the estate's challenge, finding that it was the understanding of the children and the legal representatives that Ida was entitled to any and all funds generated from the FLPs for her support. Only after Ida's needs were satisfied could any excess be distributed in proportion to the partners' supposed ownership interests. The Tax Court found it clear that at the time of the transfers, Ida explicitly retained the right to the income that the FLPs generated to the extent necessary to meet her needs.

On appeal, the estate argued that Ida did not retain a legally enforceable right within the meaning of Code Section 2036, and that there was no agreement that Ida would retain a first-access interest in all the income from the FLPs to the extent necessary for her support. The First Circuit held that in order for Code Section 2036 to apply, it is not necessary that the transfer or retain a legally enforceable interest in the property. It further found that the Tax Court did not make such a finding and dismissed the estate's first argument. The First Circuit next recognized evidence at the trial showed the motivation for formation of the FLPs was to protect Ida's financial needs so as to maintain her in status quo and to prevent her estate from being drained by litigation. The probate court decree, outlining the understanding of the parties at the time of the creation of the FLPs, concluded that the parties explicitly made monies available, in the discretion of the limited guardian (appointed with respect to Ida's FLP interests only), for Ida's support. Only after Ida's support needs were satisfied, FLP income would be distributed to the partners. Further, the court found the limited guardian had exclusive control over the FLP accounts and failed to segregate Ida's personal funds from the bank accounts for the FLPs; thus, the Tax Court's finding was not clearly erroneous, and the full value of assets transferred to

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the FLPs were includible in Ida's gross estate. *Estate of Abraham v. Comm.*, 95 AFTR 2d 2005-2591 (1st Cir.).

Generation-Skipping Transfer (GST)

15. Final GST Regulations Issued

The IRS issued final regulations on assigning individuals to particular generations for purposes of the GST tax in cases where a parent predeceases his or her offspring. The final regulations generally follow the proposed regulations that were issued in September 2004, but several changes were made. With respect to collateral heirs, the final regulations require that, for the predeceased parent rule to apply to transfers to collateral heirs, the transferor must have no living lineal descendants at the time of the transfer.

For purposes of Code Section 2651(e), the final regulations state an individual's interest in property or a trust is established or derived when the transferor is subject to estate or gift tax. If a transferor is subject to transfer tax on the property more than once, then the individual's interest is considered established or derived on the earliest of such occasions. The interest of a remainder beneficiary of a trust for which a QTIP election has been made is deemed to have been established or derived, to the extent of the QTIP election, on the date the value of the trust corpus is first subject to tax under Code Section 2519 or Code Section 2044. However, under the final regulations, this rule does not apply to a trust to the extent that a reverse QTIP election has been made for the trust because, to the extent of a reverse QTIP election, the spouse who established the trust will remain the transferor of the trust for GST purposes.

Under the proposed regulations, if an adoptive parent legally adopts an individual who is: (1) a descendant of a parent of the adoptive parent (or the adoptive parent's spouse or former spouse); and (2) under the age of 18 at the time of the adoption, then the adopted individual would be treated as a member of the generation that is one generation below the adoptive parent for purposes of determining whether a transfer from the adoptive parent (or the spouse or former spouse of the adoptive parent, or a lineal descendant of a grandparent of the adoptive parent) to the adopted individual is subject to GST tax. The final regulations retain this rule, but add an additional requirement that the individual not be adopted primarily for GST tax-avoidance purposes. Whether the adoption was made for GST tax-avoidance purposes is to be based on all the facts and circumstances, with the most significant factor being whether there is a bona fide parent/child relationship between the adoptive parent and adoptive individual.

If an individual's generation assignment is adjusted with regard to a transfer under Code Section 2651(e) or as a result of an adoption, a corresponding adjustment with respect to that transfer is made to the generation assignment of that individual's spouse or former spouse, that individual's descendants, and the spouse or former spouse of each of that individual's descendants. The final regulations apply for terminations, distributions, and transfers occurring after July 17, 2005. T.D. 9214.

The IRS also issued final regulations clarifying procedures for opting out of automatic GST exemption allocations. Transferors may elect out with respect to (i) a current transfer only; (ii) a current-year transfer and all future transfers to the same trust; (iii) certain designated future transfers to a trust; or (iv) all future transfers made by the transferor to any trust, regardless of whether the trust exists at the time of the election out. The proposed regulations had allowed the election out only with respect to items (i) and (ii). An election out of the automatic rules for future years is limited to automatic allocations under Code Section 2632(c) and has no effect on the automatic allocations rules that apply after the transferor's death under Code Section 2632(e). An automatic allocation to an indirect skip under Code Section 2632(c) is effective as of the date of the transfer and becomes irrevocable on the due date for filing Form 709 for the calendar year in which the transfer is made, whether a gift tax return is filed reporting the transfer. An affirmative partial allocation of GST exemption is treated as an election out of the automatic allocation rules with regard to the balance of that transfer. T.D. 9208. ■

KBA CLE Docket

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