PHILADELPHIA BAR ASSOCIATION

Probate and Trust Law Section Newsletter

Published by the Section on Probate and Trust Law of the Philadelphia Bar Association

AUGUST 2022 | NO. 158

IN THIS ISSUE

03 Estate of Levin v. Commissioner: Split-Dollar Insurance Receivables are not Required to be Valued at their Cash-Surrender Value

06 Beware the Philadelphia Realty Transfer Tax Trap

11 Paying a Charitable Pledge From a Donor Advised Fund: Welcome Guidance from the IRS

12 Tax Update

13 Practice Points: Client Education Opportunity: Intestacy Isn't Always What You'd Expect

14 Income and Transfer Tax Consequences of Expatriation

18 Diversity Committee Update

19 Case Summary from the Orphans' Court Litigation Committee

24 Planning and Ethical Considerations in light of Mohen v. Mohen

28 Smaldino: A Lesson in What Not to do

31 The SECURE Act Proposed Regulations Provides Clarifications and Unexpected

NEWSLETTER ARTICLES

Would you like to see something in future issues of the Probate and Trust Law Section Newsletter? Then, why don't you write it? If you are interested, please contact the editor:

Michael Breslow
email: mbreslow@htts.com

REPORT OF THE CHAIR

BY KATHRYN H. CRARY, ESQUIRE | GADSDEN SCHNEIDER & WOODWARD LLP

The theme of my last column was connection, with a particular focus on the committees of the Probate and Trust Law Section and the opportunities that committee participation provides for knowledge-building, friendship, and personal growth. I am therefore pleased to report that the Probate Section and its committees have had a meaningful first half of the year, continuing to deepen the ties not only between ourselves as Section members but also with the bench of the Philadelphia Orphans' Court and within the broader community. Below are just a few highlights from our 2022 Section activities to date:

Our Section's social activities kicked into high gear in April with our "Wills Wellness Walk" which was co-sponsored by the Philadelphia Bar Association's Wellness Committee and the office of the Register of Wills. This event was held at Philadelphia's John Heinz Wildlife Refuge, which is part of the U.S. Fish and Wildlife Service's National Wildlife Refuge System, a network of lands set aside for the benefit of native wildlife and plants. Hosted by the Honorable Tracy Gordon, Register of Wills, and Wellness Committee Co-Chair (and Probate Section Liaison to the Philadelphia Bar Association Board of Governors) Maureen Farrell, this event provided a tremendous opportunity for fellowship and camaraderie in an inspiring natural setting. Register Gordon's familiarity with the history and biodiversity of the Refuge added a unique depth to the experience, with many participants expressing a desire to participate in similar events in the future.

The Section's Diversity Committee has been very busy, kicking off the year with a May program on intersectionality and gender identity facilitated by an LGBTQ+ Inclusion Consultant, Amelia Michael. The lively discussion offered tips for the attendees as to how to improve their documents, and provided a welcoming environment in which the participants felt safe to ask open and honest questions about how to make their practices more inclusive.

continued on page 2

REPORT OF THE CHAIR, CONTINUED

Hot on the heels of the May program, the Section's Education and Diversity Committees co-sponsored a terrific Probate Section quarterly meeting in June along with the Solo & Small Firm Management Committee. This program, titled "Cultural Competence in Life and Estate Planning" was moderated by the Associate Director of the Philadelphia Bar Association's Officer of Diversity, Tara Phoenix, and included speakers on a variety of topics related to estate planning for diverse audiences.

The Section's Rules and Practice Committee has also been hard at work this spring, partnering with the Orphans' Court Litigation and Dispute Resolution Committee to address the rules relating to so-called "default" judgements. Building on this collaboration, the Rules and Practice Committee has submitted comments to and received feedback from the Philadelphia County Orphans' Court on proposed revisions to Orphans' Court Rules 3.5A and 5.50A concerning default judgements and the settlement of small estates by petition, respectively. Both the Committee and the Orphans' Court hope to finalize these revisions before the end of the year. The Committee has also been approached to weigh in on the possible extension of the Pa.R.J.A 1990 In Forma Pauperis fee waiver process to the office of the Register of Wills.

Throughout the spring and summer, the theme of connectivity has continued with renewed efforts by the Philadelphia County Orphans' Court to partner with the Section in order to improve and streamline Bench/Bar relations, with the Court seeking input on areas ranging from improving the mediation process to collaboration with the Clerks' office to community outreach and engagement. I am particularly grateful for the leadership efforts of the Honorable Sheila Woods-Skipper in this area. Our meetings have highlighted the ongoing need for more pro bono volunteers to assist the court by representing incapacitated persons and their proposed guardians in order to improve and streamline the guardianship process. I hope that each of you consider serving in this important role.

I close by also asking that you consider attending a meeting of one of our committees this fall – and if you're already a regular attendee at one of our meetings, I thank you for your service! The success of the Section's committees depends on your consistent engagement and willingness to serve the greater good. With your participation, the Probate and Trust Law Section and the greater Philadelphia legal community will continue to thrive for many years to come.

ESTATE OF LEVIN v. COMMISSIONER: SPLIT-DOLLAR INSURANCE RECEIVABLES ARE NOT REQUIRED TO BE VALUED AT THEIR CASH-SURRENDER VALUE

BY AARON LECLAIR, ESQUIRE, LLM

In February of this year the U.S. Tax Court held in *Estate of Levine v. Comm'r of Internal Revenue*, No. 13370-13 (U.S.T.C. Feb. 28, 2022) that §§ 2036 and 2038 of the Internal Revenue Code do not require that the split-dollar life insurance receivable be valued at its cash-surrender value.

Split-dollar insurance is not, as the name might imply, a type of insurance. It is in fact a permanent life insurance policy. The name comes from the method of funding it. It is typically, though not exclusively, used as a form of employee compensation. The "split" in the name refers to the division of the policy's proceeds, with the typical policy paying the cash value and death benefit to the employer, and any remaining is paid to the employee or their beneficiary. But because of some provisions in the Internal Revenue Code the split-dollar insurance policy is basically treated like a tax advantaged savings account. By way of comparison, when you earn income from mutual funds or CDs you are taxed on the income; but the inside build-up of split-dollar insurance is not taxed. A taxpayer will eventually pay on the increase in value, but that could be years or decades in the future.

The Commissioner's contentions in *Levine* rest on his interpretations of §§ 2036, 2038, and 2703, as well as Treasury Regulation §1.61-22. §2036 is meant to prevent taxpayers from avoiding the estate tax by simply relinquishing their ownership of their assets. It includes any property that a decedent transfers while retaining possession, a right to income, or the right to designate who would enjoy the property or the income therefrom. §2038 causes the inclusion of property that the decedent transferred but kept a power to alter, amend, revoke, or terminate transferee's enjoyment of the transferred property. §2703 concerns valuing property for gift, estate and generation skipping transfer tax purposes. Under certain circumstances §2703 disallows some rights or restrictions to be taken into account if it would reduce the value of property below its fair market value. Finally, Treasury Regulation §1.61-22 concerns the taxation of split-dollar life insurance policies.

Prior to this case there had been two split-dollar life insurance cases decided before the Tax Court in recent years, *Estate of Cahill* and *Morrissette II*. Both cases concerned the tax treatment of split-dollar life insurance as it related to the receivable's inclusion in the decedent's estate. In both cases the Court ruled that the cash-surrender value was to be included in the estate. The rulings in these cases would seem to council against engaging in wealth planning using this complicated method. The IRS has signaled that it is especially wary of this method and will scrutinize it heavily. The rulings in *Cahill* and *Morrissette II* had a chilling effect on the use of the intergenerational split-dollar life insurance avenue of asset protection. *Levine* has given us a rough outline of how to make this wealth planning tool work.

In 2007 Marion Levine retained the Parsinen firm to review Ms. Levine's estate plan. While Levine was given standard estate planning advice, such as the creation of a GRAT[1] and a QPRT[2], she was also advised to make use of intergenerational split-dollar life

1 Grantor Retained Annuity Trust.

2 Qualified Personal Residence Trust.

continued on page 4

insurance. To facilitate that, she had an irrevocable life insurance trust ("ILIT") created to own the split-dollar insurance policies. Her daughter Nancy, her son-in-law Robert, and grandchildren were named as the beneficiaries of the policies. Nancy and her husband Robert, the subjects of the two "last-to-die" insurance policies, signed gift tax returns in 2008 and 2009, paying $2,644. Six months after the plans were put into effect, Ms. Levine passed. The estate assessed the value of the split-dollar receivable at $2 million based on the present value of the policies, taking a 65% discount. The Commissioner disagreed with that assessment, instead asserting that the policies' value cash-surrender value was $6.2 million at Ms. Levine's death.

The Court in *Levine* first discarded the Commissioner's contention that the split-dollar insurance's value in the estate was governed by Treas. Reg. §1.61-22(d)(2), as that regulation only determines the gift tax consequences of transactions involving split-dollar insurance.

The Commissioner next argued that the cash-surrender value was includable under §2036. He argued that Ms. Levine (hereafter referred to as "decedent") retained the right to determine who would benefit from the insurance policy. Alternatively, the Commissioner also argued that, under §2038, the cash-surrender value was includable in the estate because the decedent had the power to "alter, amend, revoke, or terminate" the enjoyment of the policies.

The reasoning behind both arguments is quite similar. As to the first part, the estate asked what exactly had been transferred? The split-dollar insurance policies have always been owned by the ILIT. The decedent made an inter vivos transfer to a revocable trust which agreed to pay the premium on the policies in exchange for the ILIT assigning the insurance policies to the revocable trust as collateral. The decedent therefore never owned the policies. As such, the only thing the estate held was a right to receive a split-dollar receivable, and that had never been transferred either.

The next argument the Commissioner makes is that, when the transaction is viewed as a whole, the decedent retained a right to the cash-surrender value because decedent could have terminated the policies. The regulations hold that, if at transfer, there is: "an understanding, express or implied, that the interest or right would later be conferred" then this is a retained right caught by §2036. But it is clear that the decedent did not retain an interest in the cash she transferred. The Court notes that the decedent had no immediate right to the cash-surrender value though, which distinguishes it from *Estate of Cahill* and *Morrissette II*. In those cases, the agreements could be terminated by mutually agreeing to do so. The Court draws a line between those cases, wherein the decedent could agree to terminate the agreement, and here, where the decedent had no power to terminate the agreement in any way whatsoever.

The Commissioner next argued that the estate had the right to amend the terms of the agreement between the ILIT and revocable trust, assuming the ILIT agreed, and therefore the policies are rightfully included in the estate. The Court found this unpersuasive, citing *Estate of Tully*: "A power to 'alter, amend, revoke or terminate' would trigger inclusion in an estate, but that kind of power 'does not extend to powers of persuasion.'" Basically saying that such a speculative possibility does not rise to the level of a power contained in the instrument itself.

The Commissioner then asked that the Court look beyond the formalities of the contracts to see the decedent as being on both sides of the arrangement. In reality, the only one who stood on both sides of the agreement was the

continued on page 5

SPLIT-DOLLAR INSURANCE RECEIVABLES, CONTINUED

decedent's attorney-in-fact, Mr. Larson. The argument continues that Mr. Larson had the power to designate who would possess and enjoy the cash-surrender values of the policies. The Court easily swats down this argument by pointing to the fiduciary duties owed to the ILIT's beneficiaries by Mr. Larson, both decedent's daughter, son-in-law, and grandchildren. And doing as the Commissioner contends would violate Mr. Larson's duties owed to the grandchildren. The Court therefore found that Mr. Larson's fiduciary duties were not illusory.

The last argument the Court dealt with is related to §2703. The argument is a Hail Mary, and like the Hail Mary at the end of Super Bowl LII, it misses its mark. §2703 refers only to property held by the decedent at their death. As I discussed earlier in the article, the policies were not held by the decedent at any point. The Commissioner also asked the Court to reimagine what the contract between the ILIT and the revocable trust said to read into it a requirement that both parties could consent to an early termination of the policies. The Court decided not to do so. The Court concluded that what the estate held was a split-dollar receivable. Further, both parties stipulated that the receivable had a value of $2,283,195.

The implication for split-dollar insurance going forward is still somewhat unclear, though there are some broad points we can pull from these cases. The prior two cases, *Estate of Cahill* and *Morrissette II*, were somewhat inconclusive. The estate in *Cahill* tried to claim a 99% discount and the estate in *Morrissette* tried to claim a 75% discount. The estate here picked a, relatively, small discount of 65%. The Court does not directly address this difference in treatment or couch their decision on this difference. But as is usually the case in tax law, pigs get fat and hogs get slaughtered. Estate planners though should not expect that the IRS will not litigate discounts in the future just because they agreed to stipulate as to the receivable's value here.

The Court's reasoning in much of this case rests, nearly solely, on the presence of an independent trustee, Mr. Larson. As well as the fact that the decedent had no right whatsoever to terminate the agreement, independently or in conjunction with another. Though it is worth cautioning against choosing a family friend to be your independent trustee as it could raise issues such as the trustee lacking true independence. The Commissioner could not convince the Court in this case that they had crossed the line, but it would be wise for estate planners in the future to not even give this avenue of attack. Better to appoint a truly independent outside trustee and avoid this altogether. The independence of the trustee was not the only deciding factor, but also the independence of the ILIT. It was great estate planning to ensure that the decedent never technically owned the policies in any way, and that the decedent had no power over the trust that did own it. In previous cases the decedent had been given power to use in conjunction with another, causing the policies' cash-surrender value to fall into the estate.

It would behoove any estate planning attorneys to not put a plan like this into place only six months prior to a client's death. Of course, none of us have a crystal ball, tarot cards, or can read tea leaves, but her waning health was a cause for concern. This type of planning being done within a year of her death raises the specter of deathbed planning. The estate likely succeeded in this case because this plan had been in the works as far back as late 2007, early 2008, and thus was not something slapped together while she was moribund.

A new case is before the Tax Court now involving the founder of J. Crew. The case, *Estate of Cinader*, involves a split-dollar life insurance

continued on page 6

BEWARE THE PHILADELPHIA REALTY TRANSFER TAX TRAP

BY ANDREW J. BARRON, ESQUIRE | WHITE AND WILLIAMS LLP

Trusts and estates and real estate lawyers should have a good understanding of Realty Transfer Tax ("RTT"). Without a full grasp of the technical rules and the key distinctions between state and local taxes (Philadelphia in particular), a transfer to or from a trust could end up with an unexpected and significant tax liability. This article highlights the inconspicuous but important differences between the Pennsylvania and Philadelphia rules and the traps to avoid while dealing with Philadelphia real estate.

RTT is a tax on the value[1] of real property transferred from one party to another. All transfers are subject to RTT unless the transaction is specifically excluded. Taxable transfers are subject to a 1% Pennsylvania tax. Transfers of Philadelphia property are hit with an additional 3.278%, while other localities impose their own RTT, ranging from 1% to 4%. Although local RTT rules are often similar or equivalent to the state statute, they have different bases in law and should be treated separately. The parallel sets of rules frequently cause confusion among attorneys and other real estate professionals.

Both Pennsylvania and Philadelphia exclude transfers for no or nominal consideration by testamentary or intestate succession.[2] Also excluded are transfers between spouses (including divorced spouses in some cases),[3] between lineal ascendants and descendants (or their spouses),[4] between siblings (or their spouses),[5] and between stepparents and stepchildren (or their spouses).[6] For the purpose of this article, let's call this group "Qualified Family Members."

The tax becomes more complicated when a transfer is made to or from a trust. Defined terms play a crucial role. Pennsylvania defines "ordinary trust" as

> [a]ny trust, *other than a business trust or a living trust*,

1 Determining the "value" of transferred property is another complex issue beyond the scope of this article.

2 72 P.S. § 8102-C.3(7); Phila. Code § 19-1405(7).6.

3 72 P.S. § 8102-C.3(6); Phila. Code § 19-1405(6).

4 61 Pa. Code § 91.193(b)(6); Phila. RTT Reg. § 503(b)(6).

5 72 P.S. § 8102-C.3(6); Phila. Code § 19-1405(6).

6 *Id.*

continued on page 7

SPLIT-DOLLAR INSURANCE RECEIVABLES, CONTINUED

arrangement deficiency of $12.9 million. The terms of the trust prohibited the decedent, Cinader, from having any power or authority regarding the administration of the trust, including "any incident of ownership in any insurance policy on his life owned by the Trust." He also didn't have any right to income, revisionary interest, or right to control beneficial interests. In contrast with *Cahill*, *Morrissette II*, and *Levine*, Cinader had an entirely different method of cancellation though. The petition claims that either the trust or Cinader had the right to terminate the agreement at the end of any policy year, so it arguably goes further than any of the previous cases in regard to the power the decedent held at their death. It remains to be seen whether being unable to cancel 364 days of the year will suffice to keep the cash-surrender value out of Mr. Cinader's estate, but the reasoning in *Cahill*, *Morrissette II*, and *Levine* do not help the matter.

PHILADELPHIA REALTY TRANSFER TAX TRAP, CONTINUED

which takes effect during the lifetime of the settlor and for which the trustees of the trust take title to property primarily for the purpose of protecting, managing or conserving it until distribution to the named beneficiaries of the trust. An ordinary trust does not include a trust that has an objective to carry on business and divide gains, nor does it either expressly or impliedly have any of the following features: the treatment of beneficiaries as associates, the treatment of the interests in the trust as personal property, the free transferability of beneficial interests in the trust, centralized management by the trustee or the beneficiaries, or continuity of life.[7]

"Business trust" is not directly defined, but the second sentence in the above definition of "ordinary trust" delineates its features.[8] A "living trust" is "any trust, other than a business trust, intended as a will substitute by the settlor which becomes effective during the lifetime of the settlor, *but from which trust distributions cannot be made to any beneficiaries other than the settlor prior to the death of the settlor.*"[9]

Be careful assuming your revocable trust counts as a "living trust." As the emphasized language above indicates, the definition does not include trusts that allow distributions to anyone other than the grantor. Revocable trusts typically give the grantor-trustee unlimited discretion to distribute. Then again, the Pennsylvania regulations do contemplate lifetime transfers from a living trust to someone other than the grantor.[10] Go figure.

Pennsylvania excludes transfers to ordinary trusts for no or nominal consideration where the transfer of the same property would be exempt if the transfer was made directly from the grantor to "all of the possible beneficiaries that are entitled to receive the property or proceeds from the sale of the property under the trust, whether or not such beneficiaries are contingent or specifically named."[11] The inclusion of a "takers of last resort" clause in the trust does not trigger the tax as long as the clause is limited to the grantor's intestate heirs.[12]

Transfers from ordinary trusts are excluded if the beneficiary is specifically named in the recorded trust document, or to a contingent beneficiary if a direct transfer from the grantor to that contingent beneficiary would be excluded.[13]

7 72 P.S. § 8101-C (emphasis added).

8 *See Kosco v. Commonwealth,* 987 A.2d 181, 184 n.4 (Pa. Commw. Ct. 2009) (noting the definition of "business trust" can be extrapolated from the definition of "ordinary trust"); *see also* 15 Pa.C.S. § 9501, et seq. (Pennsylvania statute governing business trusts).

9 72 P.S. § 8101-C (emphasis added).

10 61 Pa. Code § 91.156(e)(1) provides that transfers from the trustee of a living trust during the grantor's lifetime to a grantee other than the grantor will be treated as if the transfer were made directly from the grantor to the grantee.

11 72 P.S. § 8102-C.3(8).

12 *Id.* 61 Pa. Code § 91.156(b) Be aware that a last resort clause benefiting a charity does not comply with this rule and may cause the imposition of RTT at both levels.

13 S72 P.S. § 8102-C.3(9).

continued on page 8

PHILADELPHIA REALTY TRANSFER TAX TRAP, CONTINUED

Remember that Pennsylvania differentiates "ordinary trusts" from "living trusts." Transfers to a living trust for no or nominal consideration are always excluded from tax, regardless of the trust beneficiaries.[14] After the grantor of a living trust dies, transfers from the trust to its beneficiaries are excluded.[15] Transfers from a living trust back to the grantor are not taxed.[16]

Philadelphia's RTT rules are in Chapter 19-1400 of the Philadelphia Code (the "Code") and its regulations.[17] The Code largely follows the state statute but has key differences:

1. Neither the Code nor its regulations define the term "ordinary trust" but, confusingly, the term is used throughout. Like Pennsylvania, Philadelphia does not tax transfers to ordinary trusts as long as direct transfers to all possible trust beneficiaries (including remote contingent beneficiaries) would be excluded.[18]

2. Philadelphia does not tax transfers from an ordinary trust (whatever that term means) to any "beneficiary specified in the original recorded trust agreement under which the property was initially conveyed into the trust."[19] On the other hand, Pennsylvania distinguishes between transfers to "specifically named" beneficiaries vs. "contingent" beneficiaries.[20]

3. Philadelphia makes no mention of living trusts or an analogous term.

4. Unlike Pennsylvania, Philadelphia does not carve out "takers of last resort" provisions.

Section 406 of the Philadelphia RTT regulations provides some limited guidance. The section covers transfers to and from "trusts" generally, although the term is not defined. First, a transfer to a trust is fully taxable unless the transfer of the same property would be wholly exempt if the transfer were made directly from the grantor to all possible beneficiaries. Second, a transfer from a trust is fully taxable except for transfers for no or nominal actual consideration from the trustee to the beneficiary specified in the original recorded trust agreement under which the property was initially conveyed into the trust. Third, transfers of beneficiaries' interests (i.e., by exercising a power of appointment) are taxable unless the transfer would be excluded if made directly from the beneficiary to the new beneficiary.[21]

---

14 72 P.S. § 8102-C.3(8.1).

15 72 P.S. § 8102-C.3(9.1). Since living trusts are often used as will substitute, this rule aligns with the exclusion of all transfers by testamentary or intestate succession. 72 P.S. § 8102-C.3(7).

16 72 P.S. § 8102-C.3(9.2).

17 Philadelphia RTT regulations can be accessed at https://www.phila.gov/media/20161003113934/Realty-Transfer-Tax-regulations-1989.pdf.

18 Phila. Code § 19-1405(8).

19 Phila. RTT Reg. § 406(b).

20 72 P.S. § 8102-C.3(9).

21 Phila. RTT Regs. § 406(a)-(c).

continued on page 9

PHILADELPHIA REALTY TRANSFER TAX TRAP, CONTINUED

There are at least four traps in the Philadelphia RTT rules to be aware of when planning and drafting trusts:

1. The temptation to use state definitions when interpreting Philadelphia RTT. Pennsylvania expressly defines the terms "ordinary trust" and "living trust." It does not define "business trust" but it has been described in case law. On the other hand, Philadelphia doesn't define "ordinary trust" or "business trust," fails to address living trusts, and has rules for "trusts," generally, in its regulations. Although it is tempting to use Pennsylvania definitions to fill in Philadelphia's various gaps, remember that the state and City rules stem from separate authority and are not binding on each other. Without further guidance, we can only guess what the City means when the Code and its regulations refer to ordinary trusts and business trusts.

2. Transfers to and from revocable trusts. At the state level, a transfer to a revocable (living) trust is always excluded from RTT, regardless of the possible beneficiaries. Transfers from the trust to any beneficiary are tax free after the grantor's death. Since Philadelphia does not account for living trusts, practitioners are left wondering whether the Philadelphia ordinary trust rules include living trusts. The author could find no published letter rulings, Tax Review Board decisions,[22] or court opinions providing any additional guidance. Until the City clarifies this issue, assume transfers to and from revocable trusts are "trusts" governed by Section 406 of the RTT regulations.

3. Takers of last resort clauses. Drafters often include a "takers of last resort" clause in their documents in the case all current and contingent beneficiaries are deceased. The default takers are often charities or the grantor's intestate heirs. The State carves out an exclusion for last resort clauses benefiting intestate heirs but the City does not. Since the class of Qualified Family Members (as defined above) is narrower than the group of possible intestate heirs, the inclusion of a last resort clause in a trust may inadvertently trigger Philadelphia RTT.[23] To avoid this issue, limit takers of last resort to Qualified Family Members or request a private letter ruling from the Philadelphia Department of Revenue.[24]

4. Accidental creation of business trusts. Philadelphia does not define business trust, directly or indirectly. However, business trusts are included in the definition of "corporation," which are not subject to the Qualified Family Rules. The City will look at facts and circumstances to determine whether a trust is sufficiently businesslike. Exercise caution and request a private letter ruling when in doubt.

Hopefully Philadelphia will release new regulations sorting out these issues and providing some certainty. Until then, estate planners and other real estate professionals should be advised of possible tax exposure.

22 The Tax Review Board has original jurisdiction to hear Philadelphia RTT appeals. Phila. RTT Reg. § 102.

23 20 Pa.C.S. § 2103. The intestacy statute includes aunts, uncles, nieces, nephews, and cousins, none of whom are Qualified Family Members.

24 More information on requesting private letter rulings can be found at https://www.phila.gov/services/payments-assistance-taxes/regulations-rulings/technical-private-letter-rulings/.

GILBOY & GILBOY LLP

A law firm offering
highly specialized
estate and tax planning,
trust and estate administration
and associated services in a
personalized atmosphere.

KEVIN P. GILBOY
BRIAN R. GILBOY
GEORGE C. DEENEY

Two Logan Square
100 N. 18th Street
Suite 730
Philadelphia, PA 19103
Phone: 267.861.0531
Fax: 267.861.0563

PAYING A CHARITABLE PLEDGE FROM A DONOR ADVISED FUND: WELCOME GUIDANCE FROM THE IRS

BY JENNIFER BRIER, ESQUIRE | JEWISH FEDERATION OF GREATER PHILADELPHIA

Donor advised funds ("DAFs") are the philanthropic vehicle of choice for a growing number of individuals. A great source of tension in the industry has been the issue of using DAFs to satisfy a charitable pledge. IRS Notice 2017-73 provided welcome guidance to donors and charities.

Several factors explain the rise in popularity of DAFs. The Tax Cuts and Jobs Act was signed into law by President Trump on Dec. 22, 2017. It doubled the standard deduction and capped deductions for state and local income taxes, leading many taxpayers to take advantage of "bunching deductions" through use of a DAF. Bunching involves making multiple years' worth of contributions in a single tax year to take advantage of itemizing. By making the contributions to a DAF, the taxpayer can spread out payments to charity over time. Large investor gains in the stock market, as well as the relative ease of use and advantageous tax treatment of a DAF as opposed to a private foundation, also make DAFs attractive.

The maze of rules governing DAFs, however, has created complications around paying a charitable pledge from a DAF. IRC Section 4967 imposes an excise tax if a donor-advised fund grant provides "more than incidental benefit" to a donor, donor advisor or related party and refers to IRC Section 4958. Section 4958 defines an "excess benefit transaction" as one in which a payment from the DAF results in an economic benefit to the donor, donor advisor or related parties defined in the Code. Relieving the donor, donor advisor or related party of a legal obligation, such as fulfilling a pledge, is considered a prohibited benefit. The consequences of this misstep can be severe: an excise tax to the donor/donor advisor/related party of 125 percent of the prohibited benefit resulting from the distribution, and an excise tax on the fund manager of 10 percent of the amount of the grant.

To avoid penalties, donors and fund advisors learned to not make pledges. Knowing how much a donor intends to contribute and for what purposes is important to nonprofits to be able to budget properly, however, so charities began asking their donors with DAFs to make a "non-binding pledge" or express a "gift intention." Distribution recommendation forms require the fundholder to certify that the grant is not in discharge of a legal obligation such as a pledge, and the receiving charities are asked to certify that the distribution does not satisfy a pledge before they cash the check.

Following passage of the Pension Protection Act of 2006, the IRS requested comments to help inform future guidance for DAFs. The philanthropic community has been eagerly awaiting such guidance. In December of 2017, in response to many comments it received, IRS released Notice 2017-73, titled "Request for Comments on Application of Excise Taxes with Respect to Donor Advised Funds in Certain Situations", which finally addressed some important questions. The IRS agreed that is difficult for a DAF sponsor to differentiate between a legally binding pledge (determined by state law) and a mere expression of charitable intent. While the Treasury Department and the IRS continue to develop comprehensive proposed regulations governing DAFs, Notice 2017-73 Section 4 provides some clarity with respect to pledges.

Section 4 states that proposed regulations are being considered which would provide that the distribution to a charity is not a prohibited benefit under Section

continued on page 12

TAX UPDATE

BY GEORGE C. DEENEY, ESQUIRE | GILBOY & GILBOY LLP

GUIDANCE FROM THE IRS

Internal Revenue Service Proposes Regulations on Certain Estate Expense Deductions

REG-130975-08: The IRS has issued proposed regulations on the use of present-value principals in determining what an estate can deduct for administration expenses, funeral expenses and other claims. The proposed regulations also address the deductibility of amounts paid under the personal guarantee of the decedent, interest expenses on tax and penalties the estate incurred and interest expenses on certain loan obligations the estate owes.

A public hearing on the proposed regulations is scheduled to occur on October 12, 2022. Written comments must be submitted by September 26, 2022.

Internal Revenue Service Proposes Regulations Addressing the Basic Exclusion Amount for Estate and Gift Tax

REG-118913-21: The IRS has issued proposed regulations which would amend the estate tax regulations basic exclusion amount for federal estate and gift tax purposes. By way of background, the Tax Cuts and Jobs Act of 2017 (the "Act") provided the Treasury Secretary with authority to issue regulations addressing tax consequences for an estate in which the decedent made gifts between $5 and $10 million (adjusted for inflation) during the time period between the implantation of the Act and its sunset (January 1, 2026). The final regulations issued by Treasury and the IRS in 2019 which allowed an estate to determine its estate tax credit using the greater of the (1) the basic exclusion amount applicable on the decedent's death, and (2) that applicable to gifts made during the decedent's lifetime.

The proposed regulations note that the current regulations do not distinguish between completed gifts treated as (1) testamentary transfers for estate tax purposes and included in the donor's gross estate, and (2) adjusted taxable gifts for estate tax purposes and not included in the donor's gross estate.

The proposed regulations would create an exception to the special rule for transfers that are includible in the gross estate or treated as includible in the gross estate for

DONOR ADVISED FUNDS, CONTINUED

4967 merely because the donor/advisor has made a pledge to the same charity if the following requirements are satisfied:

1. The Sponsoring organization makes no reference to the existence of a pledge when making the distribution;

2. No other benefit (more than incidental) is conferred directly or indirectly on account of the distribution and

3. Donor/Advisor does not attempt to claim a charitable deduction for the distribution, even if the charity erroneously sends the donor/advisor a written acknowledgement of the contribution.

This would only apply to distributions from DAFs, and would not extend to private foundations.

Section 4 is explicitly cited as official guidance which may be relied upon pending issuance of the proposed regulations. DAFs may now make distributions without having to determine whether they are being used to fulfill donor pledges.

continued on page 13

PRACTICE POINTS

CLIENT EDUCATION OPPORTUNITY: INTESTACY ISN'T ALWAYS WHAT YOU'D EXPECT

BY KATHERINE F. THACKRAY, ESQUIRE | ALEXANDER & PELLI, LLC

In the summer of 2020, the film world was rocked by the news that acclaimed actor Chadwick Boseman, who portrayed (among other important roles) Justice Thurgood Marshall in the 2017 movie "Marshall," had died. Mr. Boseman was only 43 years old, and it soon came to light that this young actor had died of colon cancer, a diagnosis which was kept private from the public. Mr. Boseman was survived by his wife, who he married months before his death, and his parents. He had no children.

Two years later, Mr. Boseman's estate is making headlines. Like many young people who die before their time, Mr. Boseman died without a will, causing his $2.3 million estate to pass under the intestate laws of California. The news sources indicate that Mr. Boseman's wife has asked the court to distribute the funds equally between her and his parents.

What if Mr. Boseman had died intestate in Pennsylvania? This distribution scheme—a split between the surviving spouse and the decedent's parents—is similar to what would happen under Pennsylvania law, but it is counter to what many married folks believe will happen if they die without a will.

For most, there is an expectation that when they die, their assets will pass to their spouse, and to their spouse alone. As estate planners familiar with the PEF Code, we know that this is not always the case. Under 20 Pa. C.S. §2102 (1), "[i]f there is no surviving issue or parent of the decedent," the intestate share of the surviving spouse is the entire intestate estate. But, "[i]f there is no surviving issue of the decedent but he is survived by parent or parents," the surviving spouse's intestate share is "the first $30,000 plus one-half of the balance of the intestate estate." §2102(2).

In this area of the law, it is not uncommon for clients, or potential clients, to make comments such as "I'll make a will when I'm old," or "I don't need a will until I have kids." This is an opportunity for us as counselors to provide guidance to our clients, especially those whose parents are still living, but whose spouses are the ones who would be most financially impacted by their death. There are, of course, other scenarios where similar types of client education could be helpful: the single client who does not realize that, without a will, his estate will pass to his elderly parent, or the expecting couple whose hands will soon be full enough without having to worry about whether a minor's guardianship will be necessary if one of them were to pass away. Many clients who believe they are content with letting the law handle their testamentary disposition would be surprised to learn that the intestacy provisions will not step in the way they might have hoped.

continued on page 14

TAX UPDATE, CONTINUED

Section 2001(b) purposes, including (1) transfers subject to a life estate or otherwise described in Sections 2035-2038 and 2042, regardless of whether it was deductible under Sections 2522 or 2523, (2) transfers subject to Section 2701 and 2702, (3) transfers made by an enforceable promise to pay, and (4) transfers that would be included above but for the elimination from the gross estate within 18 months of death.

The proposed regulations will apply to estates in which the decedent died on or after April 27, 2022 (after being published in final form).

INCOME AND TRANSFER TAX CONSEQUENCES OF EXPATRIATION[1]

BY DAVID R. ELWELL, ESQUIRE, AND JOSHUA E. RUNYAN, ESQUIRE | STONEHAGE FLEMING LAW US

Previous articles in this series provided a general introduction to international estate and tax planning, specific issues to consider with regard to foreign trusts, and how to report ownership of and distributions from foreign sources.[2] While these previous articles focused on the bulk of inbound activity practitioners face, this installment looks at an outbound dimension of international estate and tax planning. Clients who are considering relinquishing US citizenship or surrendering a green card after having held it for many years should be aware of the income and transfer tax consequences of doing so. If the client is a "covered expatriate" as defined in the Internal Revenue Code (the "Code"), then (1) under Section 877A of the Code, he or she will face an exit tax on the gain deemed to result from a hypothetical sale of his or her worldwide property for its fair market value, and (2) under Section 2801 of the Code, his or her future donees in the US will be taxed at the greater of the highest gift or estate tax rate on the value of the property received.

Code Section 877A – the Mark-to-Market Exit Tax

An expatriate is any US citizen who relinquishes his or her citizenship, and any long-term resident of the United States who ceases to be a lawful permanent resident within the meaning of Section 7701(b)(5) of the Code. For this purpose, a long-term resident is an individual who is a lawful permanent resident (i.e., a green-card holder) in at least eight taxable years during the period of 15 taxable years that ends with the taxable year that includes the individual's expatriation date.

For US citizens, the expatriation date is the earliest of four possible dates: (1) the date the individual renounces his or her US nationality before a diplomatic or consular officer of the United States pursuant to Section 349(a)(5) of the Immigration and Nationality Act, provided the renunciation

1 ©Stonehage Fleming Law US. All Rights Reserved.

2 David R. Elwell and Brittany A. Yodis, *Introduction to International Estate & Tax Planning,* PROB. AND TR. L. SEC. NEWSL. (Philadelphia Bar Association/Section on Probate and Trust Law, Philadelphia, Pa.), Aug. 2021, at 10; David R. Elwell and Joshua E. Runyan, *Introduction to the Use of Foreign Trusts,* PROB. AND TR. L. SEC. NEWSL. (Philadelphia Bar Association/Section on Probate and Trust Law, Philadelphia, Pa.), Nov. 2021, at 2; David R. Elwell and Joshua E. Runyan, *Reporting Ownership and Distributions from Foreign Sources,* PROB. AND TR. L. SEC. NEWSL. (Philadelphia Bar Association/Section on Probate and Trust Law, Philadelphia, Pa.), March 2021, at 18.

continued on page 15

PRACTICE POINT, CONTINUED

Unfortunately, in many of these scenarios, we do not meet with these clients until they, like Mr. Boseman's wife, are in the tragic position of having lost their loved one too soon. This makes it especially important for those in our line of work to consider our clients in their environment at every step of the way. One way to reach these potential clients is when contacted to prepare a prenuptial agreement, which may or may not dictate how certain assets will pass at death; perhaps there is an opportunity here to interject a moment of client education. Community outreach could be another venue; several local organizations have outreach committees which promote estate planning to the general public. And finally, let's give pause when we hear those "I'll make a will when old" remarks and recall the cautionary tale of Mr. Boseman's estate; as we all know from experience, it is never too soon to get your affairs in order.

is subsequently approved by the issuance of a certificate of loss of nationality by the State Department, (2) the date the individual furnishes to the State Department a signed statement of voluntary relinquishment of US nationality confirming the performance of acts of expatriation specified in Section 349(a)(1)-(4) of the Immigration and Nationality Act, provided the voluntary relinquishment is subsequently approved by the issuance of a certificate of loss of nationality by the State Department, (3) the date the State Department issues a certificate of loss of nationality, and (4) the date a US court cancels the individual's certificate of naturalization.

For long-term residents, the expatriation date is the date the individual's status of permanent resident has been revoked or administratively or judicially determined to have been abandoned, or the date the individual (1) commences to be treated as a resident of a foreign country under an applicable tax treaty with the United States, (2) does not waive the benefits of such treaty, and (3) notifies the Secretary of the Treasury of such treatment on IRS Forms 8833 and 8854.

An expatriate is a "covered expatriate" if any of the following apply: (1) the expatriate's average annual net Federal income tax liability for the five full taxable years ending before the expatriation date is more than an inflation-adjusted amount of (for 2022) $178,000 (the "Tax Liability Test"), (2) the expatriate's net worth is $2 million or more as of the expatriation date (the "Net Worth Test"), or (3) the expatriate fails to certify, under penalty of perjury, that he or she is compliant with all Federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date, including but not limited to obligations to file income tax, employment tax, gift tax, and information returns, if applicable, and obligations to pay all relevant tax liabilities, interest and penalties (the "Certification Test"). The certification must be made on Form 8854 and must be filed by the due date of the expatriate's Federal income tax return for the taxable year that includes the day before the expatriation date.

An expatriate is not subject to either the Tax Liability Test or the Net Worth Test if (1) the expatriate was born a citizen of the United States and a foreign country, is taxed as a resident of that foreign country as of the expatriation date, and has been a US resident for no more than 10 taxable years during the 15 taxable year period ending with the taxable year in which the expatriation date occurs, or (2) the expatriate relinquishes US citizenship before the age of 18 ½ and has been a US resident for not more than 10 taxable years before the date of relinquishment. In every case, however, failing the Certification Test will make an expatriate a covered expatriate.

Under the "mark-to-market" exit tax regime, a covered expatriate is deemed to have sold all of his or her worldwide property[3] for its fair market value[4] on the day before his or her expatriation date. Gain arising from the deemed

3 For purposes of the exit tax, a covered expatriate's worldwide property includes (1) any property that would be included in the expatriate's gross estate for federal estate tax purposes as if he or she had died a US citizen on the day before the expatriation date, (2) the expatriate's beneficial interest in any grantor trust to the extent the interest would not be included in his or her gross estate for federal estate tax purposes, determined under special rules that account for the facts and circumstances of the trust's prior distributions, letters of wishes and historical functions of key fiduciaries, and the principles of intestate succession.

4 For purposes of the exit tax, fair market value generally follows the valuation principles applicable for federal estate tax purposes, with some exceptions.

continued on page 16

TAX CONSEQUENCES OF EXPATRIATION, CONTINUED

sale is taken into account for the taxable year of the deemed sale notwithstanding any other provision of the Code. Loss is also taken into account to the extent otherwise permitted by the Code, except that the wash sale rules of Section 1091 do not apply. Generally, for purposes of determining such gain or loss, property held by a nonresident alien on the day he or she became a US resident is treated as having a basis of not less than the fair market value of the property on that date, but a covered expatriate may make an irrevocable election, on a property-by-property basis, not to have the basis adjustment apply.

The amount that would otherwise be included in the covered expatriate's gross income by reason of the above deemed sale is reduced (but not below zero) by an inflation-adjusted amount. For 2022, the exclusion amount is $767,000. The covered expatriate may make an irrevocable election to defer the tax due on an asset-by-asset basis until the earlier of the due date of the covered expatriate's income tax return for (1) the taxable year in which disposition of the asset occurs, or (2) the taxable year that includes the date of death of the covered expatriate.[5]

Alternative tax regimes apply to a covered expatriate's deferred compensation items, tax deferred accounts such as individual retirement plans and health savings accounts, and interests in nongrantor trusts.

Code Section 2801 – the Transfer Tax

Gifts and bequests from covered expatriates to US citizens or residents are generally subject to transfer tax equal to the fair market value of the gift or bequest multiplied by the highest federal estate or gift tax rate in effect at the time of the gift or bequest. The tax is imposed only to the extent that the value of the gift or bequest exceeds the so-called "annual exclusion" under Section 2503(b) of the Code ($16,000 in 2022). The tax is reduced by the amount of any foreign gift or estate tax incurred with respect to the transfer.

Unless the donor or executor reports the gift or bequest on a timely-filed gift or estate tax return and pays the tax by the due date, the US recipient of the gift or bequest must pay the transfer tax. If a charitable or marital deduction would have been available with respect to the gift or bequest had the covered expatriate been a US citizen or resident, then the recipient is not subject to the transfer tax.

For purposes of the transfer tax, a domestic trust in receipt of a gift or bequest from a covered expatriate is treated as a US citizen and must pay the tax. US beneficiaries of foreign trusts that receive gifts or bequests from covered expatriates are generally liable to the extent of any distributions received from the trust attributable to the gifts or bequests.

The foregoing is a general summary of the rules regarding expatriation and as with many other areas of the tax law, the devil is in the detail. Exceptions and counterintuitive rules abound. Anyone considering relinquishing citizenship or surrendering a green card should seek advice first.

5 Establishing adequate security, either by furnishing a bond to the Secretary of the Treasury or obtaining another form of security (including letters of credit) is required.

FOR SPECIAL NEEDS CLIENTS, THE SETTLEMENT IS ONLY THE BEGINNING.

L. to r.: Felicia D. Butler; Teresa R. Colleran; Stephanie E. Smith; Susan L. Bartels; Eileen F. Carroll

Our team offers effective and creative solutions for the administration of special needs trusts and guardianships as families cope with complex and challenging situations. We provide hands-on help and access to a wealth of resources that minimize burdens on your clients and their families before, during, and after resolution of litigation.

PENNSYLVANIA TRUST IS NOW

Fiduciary Trust International

INVESTMENT MANAGEMENT • TRUST, ESTATE & TAX SERVICES • SPECIAL NEEDS TRUSTS AND GUARDIANSHIPS • WEALTH PLANNING

RADNOR, PA
fiduciarytrust.com/radnor

We invite you to call Teresa R. Colleran at 610-975-4308

DIVERSITY COMMITTEE UPDATE

BY CHLOE MULLEN-WILSON, ESQUIRE | TIMONEY KNOX LLP

The Diversity Committee of the Philadelphia Bar Association Probate Section has been working on increased programming related to diversity, equity and inclusion in 2022. On May 17, the Diversity Committee meeting included a presentation by LGBTQ+ Inclusion Consultant, Amelia Michael. Amelia discussed the best ways to respect and understand the gender identities and expressions of diverse clients. She explained intersectionality, which is the overlapping characteristics of a person, including their race, gender, class and other distinct factors, which makes each person's experience and categorization as "diverse" unique. Amelia discussed how to make estate planning documents gender neutral and addressed questions from practitioners regarding planning for a person who is transitioning from one gender to another. Amelia's expertise and openness presented an opportunity for attendees to ask practical questions to better serve the needs of diverse clients.

On June 7, the Probate Section quarterly meeting, co-sponsored by the Diversity Committee, the Solo & Small Firm Management Committee and the Philadelphia Bar Office of Diversity presented a CLE entitled "Cultural Competence in Life and Estate Planning." The four panelists, the Honorable Judge Sheila Woods-Skipper of the Philadelphia Orphans' Court, Shabrei Parker of the National MS Society, Kristine Calalang of the Law Office of Kristine L. Calalang and Angela Giampolo, of the Giampolo Law Group, assisted by moderator, Tara Phoenix of the Philadelphia Bar, explored the best ways to communicate with clients from various backgrounds to prepare their estate plans.

The panelists touted the importance of effective communication with clients, and emphasized the five "C"s, or: clarity, correctness, courtesy, consistency and compassion. If estate planners apply all five, they can be sure they are effectively communicating with clients from all backgrounds to best serve their interests. The panel was also able to advise attendees about the processes by which practitioners can obtain translators, both for estate planning purposes and in Court. They also discussed more creative planning options for diverse clients, including the use of pet trusts for same-sex couples before they were legally able to be married in Pennsylvania. Judge Woods-Skipper explained attorneys' responsibility to advocate for the accessibility tools required by clients, including translators, work-arounds for clients with mobility issues and other disabilities, and she highlighted the Court's role to make the courts accessible to all clients.

The Diversity Committee has another CLE scheduled for its meeting on Tuesday, August 16 at noon via Zoom. At the August meeting, Dr. Jonathan Kanter, behavioral scientist and current Director of the Center for the Science of Social Connection at the University of Washington will speak to the Committee about the psychology of bias, including the innate curiosity experienced by humans when they encounter people who appear to be different from them. Dr. Kanter will explain the science behind micro-aggressions and unconscious bias to allow attendees to avoid unintentionally pre-judging others, and to encourage inclusivity in all contexts.

Another upcoming program of the Diversity Committee is a virtual Life Planning Clinic co-hosted by the Diversity Committee and the Pro Bono Committee, facilitated by SeniorLAW Center. Practitioners will be partnered up to appear in Zoom meetings with clients to assess their needs and prepare simple estate planning documents for them. SeniorLAW Center advisors will be on call in case practitioners have any questions

continued on page 19

CASE SUMMARY FROM THE ORPHANS' COURT LITIGATION COMMITTEE[1]

In Re: Trust Established Under Agreement of Sarah Mellon Scaife, Deceased Dated May 9, 1963 Appeal of: PNC Bank, 2022 PA. Super. 93 (2022)

BY MADISON A. MORTON[2] | HECKSCHER, TEILLON, TERRILL & SAGER, P.C.[3]

In Re: Trust Established Under Agreement of Sarah Mellon Scaife, 2022 PA. Super. 93 (2022), presented the Superior Court of Pennsylvania with the question of whether the "fiduciary exception" to attorney-client privilege and the work product doctrine is contrary to Pennsylvania law.

Important to this Court's decision were four prior cases that questioned the existence of a fiduciary exception in Pennsylvania. In *In re Rosenblum's Estate*, 459 Pa. 201 (1974), the Pennsylvania Supreme Court held that the ability to access trust records is an "essential part of a beneficiary's right to complete information concerning the administration of the trust," and adopted the Restatement (Second) of Trusts, Section 173.[4] In *Follansbee v. Gerlach*, 56 Pa. D. & C. 4th 483 (C.P. Allegheny), the Allegheny County Court of Common Pleas relied on *Rosenblum*'s adoption of Section 173 and upheld the beneficiaries' right to access documents related to the administration of their trust, even if trustees claimed them to be protected by attorney-client privilege. In an alternative holding in *In re Estate of McAleer*, 194 A.3d 587 (Pa. Super. 2018) (*McAleer I*), the Pennsylvania Superior Court held that, in accordance with *Rosenblum* and the Restatement (Third) of Trusts Section 82, comment f,[5] trustees have a duty to share with beneficiaries "complete information concerning the administration of the Trust." On appeal to the Pennsylvania Supreme Court in *In re Estate of McAleer*, 248 A.3d 416 (Pa. 2021) (*McAleer II*), a plurality affirmed the "alternative holding" of *McAleer I*.[6]

Sarah Mellon Scaife created a trust on May 9, 1963, for the benefit of her grandchildren, their descendants and spouses, and charitable organizations.

continued on page 20

1 The Orphans' Court Litigation and Dispute Resolution Committee will provide summaries of recent litigation cases in each quarterly newsletter.

2 Summer Associate at Heckscher, Teillon, Terrill & Sager, P.C., J.D. expected May 2023.

3 © 2022 Heckscher, Teillon, Terrill & Sager, P.C. All Rights Reserved.

4 "The trustee is under a duty to the beneficiary to give him upon his request at reasonable times complete and accurate information as to the nature and amount of the trust property, and to permit him or a person duly authorized by him to inspect the subject matter of the trust and the accounts and vouchers and other documents relating to the trust." RESTATEMENT (SECOND) OF TRUSTS, § 173 (AM. L. INST. 1957).

5 "A trustee is privileged to refrain from disclosing to beneficiaries or co-trustees opinions obtained from, and other communications with, counsel retained for the trustee's personal protection in the course, or in anticipation, of litigation (e.g., for surcharge or removal)." RESTATEMENT (THIRD) OF TRUSTS § 82, cmt. F (AM. L. INST. 2003).

6 In *McAleer I*, the Superior Court held that the trustee's appeal was not appealable as a collateral appeal. In the alternative, the Superior Court held that the fiduciary exception applied and that the trustee had a duty to turn over unredacted time records. The Supreme Court concluded that the Orphans' Court order directing the trustee to turn over documents was immediately appealable as a collateral appeal, but affirmed the Superior Court by plurality.

DIVERSITY COMMITTEE UPDATE, CONTINUED

during the process. The virtual clinic will include an online training beforehand, so no prior knowledge of estate planning is required. If you are interested in volunteering for the Virtual Life Planning Clinic, please email the author at CMullen-Wilson@timoneyknox.com. Spots are limited so secure your volunteer spot today!

CASE SUMMARY, CONTINUED

Until March 31, 1984, trustees were required to make annual distributions of the Trust's income to charitable organizations (the "charitable period"). Following the charitable period, Trust income could be distributed to, and separate trusts could be created for, any income beneficiary. The Trust began distributing to the only two income beneficiaries at that time, Jennie K. Scaife and her brother, David N. Scaife. David married in 1997 and later had two children, both of whom, along with his wife, became income beneficiaries. When Jennie died on November 29, 2018, she had never been married and had no children. The trustees of the Trust consisted of one corporate trustee and several individual trustees.

Following Jennie's death, the personal representative of her Estate created the Jennie K. Scaife Charitable Foundation and asked the trustees to transfer Jennie's beneficial share of the Trust to her Estate. However, the personal representative soon discovered that the trustees never created a separate trust for Jennie as permitted by the Trust. The personal representative requested documentation from the trustees justifying their decision not to create a separate trust, but never received any. On April 27, 2020, he filed a complaint against the trustees alleging that their failure to create a separate trust for Jennie's benefit was a breach of fiduciary duty.

The trustees filed an Account of their administration of the Trust from March 22, 1994 through December 31, 2019, along with a Petition for Adjudication on the issue of whether their failure to create a separate trust for Jennie's benefit was a breach of fiduciary duty. Jennie's Estate alleged that trustees violated their fiduciary duty by failing to determine if separate trusts were necessary and by favoring David's interests over Jennie's. The trustees filed answers denying a breach of fiduciary duty and maintained that Jennie and David never asked for the termination of the Trust or for the creation of separate trusts.

Between October 2020 and February 2021, Jennie's Estate filed three motions to compel production of many documents, including, inter alia, documents spanning the entire Accounting Period and documents regarding the legal services provided by the counsel for the trustees, and the appointment of that law firm's shareholders as trustees. Jennie's Estate argued that because all of these documents were related to the Trust's administration, there were no grounds for the trustees to withhold them from the beneficiaries. The trustees objected, claiming that many of the documents were protected by attorney-client privilege and the work product doctrine.

Additionally, the corporate trustee withheld or redacted 767 documents from Jennie's Estate. Jennie's Estate raised concerns over these documents, arguing that the redactions were "heavy-handed and insufficiently justified," and some withheld documents were neither written nor received by an attorney.

After the Pennsylvania Supreme Court's decision in *McAleer II*, the Orphans' Court granted the motion to compel discovery, stating that "a fiduciary exception is not inconsistent with Pennsylvania law." The Court directed that the documents involving the trustee and beneficiaries be produced within twenty days. The corporate trustees, individual trustees and law firm for the trustees all filed appeals. The Orphans' Court issued three separate opinions, one for each Appellant.[7] The decision

7 *In re Trust Agreement Established Under Agreement of Sarah Mellon Scaife, Deceased Dated May 9, 1963, Appeal of: Matthew A. Groll, Blaine F. Aikin, Frederick G. Wedell, Corbin P. Miller, and Laura B. Gutnick*, No. 696 WDA 2021, 2022 WL 1617129 (Pa. Super. Ct. May 23, 2022) [hereinafter Appeal of Individual Trustees]; *In re Trust Agreement Established Under Agreement of Sarah Mellon Scaife, Deceased Dated May 9, 1963, Appeal of: Strassburger McKenna Gutnick & Gefsky*, No. 697 WDA 2021, 2022 WL 1617128 (Pa. Super. Ct. May 23, 2022).

continued on page 21

CASE SUMMARY, CONTINUED

on the corporate trustee's appeal is a published opinion, while the appeals of the individual trustees and the law firm are unpublished and non-precedential, although they are all virtually identical.

Each Appellant adopted the argument set forth in the corporate trustee's brief. The only difference appears in the opinion for the individual trustees' appeal, stating that in addition to the corporate trustee's argument, the individual trustees also argued that a fiduciary exception would "forc[e]" trustees to use personal money to retain separate counsel in order to preserve confidentiality, and would penalize trustees who ask the Trust to reimburse their counsel fees.[8]

Appellants argued that there is no fiduciary exception because no statute recognizes such exception, Pennsylvania law provides no basis for the exception, and most jurisdictions reject a fiduciary exception. Appellants argued that attorney-client privilege and the work product doctrine protect qualifying documents "without exception," and the scope of attorney-client privilege actually "sweeps broader than the [statute's] literal language." They further argued that this leads to better representation because clients feel more comfortable disclosing information to counsel, and counsel feels more comfortable documenting legal theories because they know the information is protected.

Jennie's Estate asked the Superior Court to recognize the fiduciary exception because transparency is important to a fiduciary relationship, and transparency comes from a beneficiary's access to trust administration documents. The Estate further argued that: (1) the alternative holding in *McAleer I* is binding precedent and was "affirmed by operation of law;" (2) the fiduciary exception is established law in Pennsylvania and holdings from other jurisdictions do not override it; (3) the trustees waived their ability to challenge the exception because they did not raise the issue in the Orphans' Court; and (4) the trustees waived their argument for prospective application of the fiduciary exception.

Like the trustees and their law firm, the income beneficiaries argued in favor of the fiduciary exception, maintaining that it properly balances the rights of fiduciaries and beneficiaries, and that trustees have a duty to disclose to the beneficiaries all information that is relevant to trust administration. They also argued that the fiduciary exception is consistent with Pennsylvania law, and that communications between trustees and trust counsel are neither confidential nor privileged.

Finally, the Commonwealth of Pennsylvania (through the Pennsylvania Office of Attorney General) also argued in favor of a fiduciary exception, asserting that the alternative holding in *McAleer I* is binding precedent. Additionally, it argued that Pennsylvania's trust law requires the disclosure of trust administration information to beneficiaries and recognizes beneficiaries as the "real clients" in trust administration cases.

In reaching its decision, the Superior Court first noted that the fiduciary duty of a trustee is to "administer the trust in good faith" and in accordance with the law and the interests of the beneficiaries. This duty also includes promptly responding to beneficiaries' requests for information relating to the administration of their trust. The Court discussed Pennsylvania's attorney-client privilege and work product doctrine, noting that the former is codified into law and the latter into Pennsylvania's Rules of Civil Procedure. Attorney-client privilege is highly revered, but still construed narrowly and only applied where necessary to prevent too much relevant information being withheld from factfinders.

The Superior Court ultimately affirmed the Orphans' Court

8 *Appeal of Individual Trustees,* 2022 WL 1617129, at *5.

continued on page 22

CASE SUMMARY, CONTINUED

decision, holding that "a fiduciary exception to the attorney-client privilege is consistent with Pennsylvania law." The Court affirmed the rationale of the *Rosenblum* court, agreeing that although attorney-client privilege is codified into law, Pennsylvania's codified trust law also imposes a duty on trustees to provide documents related to trust administration to the beneficiaries, even when those documents include the opinions of trust counsel. This fiduciary exception is not conditioned on whether the trust paid counsel fees, and it is not limited to only prospective applications.

However, the Court did limit this fiduciary exception, holding that trustees will be privileged from disclosing to beneficiaries or co-trustees "opinions obtained from, and other communications with, counsel retained for the trustees' personal protection in the course, or in anticipation, of litigation."[9] Because the documents requested by Jennie's Estate were from the Accounting Period, during which there was no pending litigation against the Trustees, the Orphans' Court order compelling discovery was affirmed without limitation.

9 *The limitation to the fiduciary exception was also recognized in Follansbee and McAleer.*

JOIN A COMMITTEE

The Section's committees depend on the steady flow of people, energy and ideas.
Join one!

Contact the section chair:

Kathryn H. Crary, Esquire
Gadsden Schneider & Woodward LLP

1275 Drummers Lane, Suite 210
Wayne, PA 19087-1571

484-683-2624

kcrary@gsw-llp.com

Sotheby's EST. 1744

Property from a Distinguished
Private Collection, Philadelphia
ALEXANDER CALDER
Flower necklace, circa 1938
Estimate $200,000–300,000
Sold for $612,900

Selling Great Estates since 1744

NOW INVITING CONSIGNMENTS.

Understand the value of your Client's Collection.
We make selling easy and rewarding.
Contact us to schedule a confidential appointment.

ENQUIRIES +1 610 649 2600 CAROLYN.NAGY@SOTHEBYS.COM
SOTHEBYS.COM/CONSIGN
© 2021 CALDER FOUNDATION, NEW YORK / ARTISTS RIGHTS SOCIETY (ARS), NEW YORK
SOTHEBY'S, INC. LICENSE NO. 1216058. © SOTHEBY'S, INC. 2021

DOWNLOAD SOTHEBY'S APP
FOLLOW US @SOTHEBYS

PLANNING AND ETHICAL CONSIDERATIONS IN LIGHT OF *MOHEN v. MOHEN*

BY LYDIA TERRILL, ESQUIRE | TERRILL FAMILY LAW
AND LANCE S. LACHEEN, ESQUIRE | HECKSCHER, TEILLON, TERRILL & SAGER, P.C.

Case Summary

The Pennsylvania Superior Court in *Mohen v. Mohen* upheld a trial court's determination that gifts made by a husband for estate planning purposes were a fraudulent transfer of marital assets. A brief summary of the facts are as follows:

As part of his estate planning, and in reliance upon the advice of his estate planning attorney, Husband created three trusts for his children to shelter some of his assets from federal estate tax upon the prospect that estate tax exemptions might be lowered. Husband filed a gift tax return to report the gifts. Recall that in October 2012, when Husband made the gifts, the federal estate and gift tax exemptions were $5.12 million each and scheduled to revert to approximately $1 million each absent legislation. Estate planning attorneys will remember the flurry of activity in 2012 as clients made significant gifts to "lock in" potentially expiring exemption. On January 1, 2013, Congress passed the American Taxpayer Relief Act ("ATRA"), which made the $5 million exemption amounts, subject to annual inflation adjustments, permanent.

Husband had a series of meetings with his estate planning lawyer without Wife present. By the time Husband executed the trusts, he had begun a relationship with his Fiancée. After executing a new will and the trusts, Husband gave Wife a copy of the new will but did not provide her with copies of the three trusts. Twenty-six months after Husband met with his estate planning attorney and fourteen months after Husband executed the trusts, Husband and Wife separated.

As part of Husband and Wife's divorce proceedings, Wife filed a petition to set aside Husband's transfer of marital assets into the trusts for their three joint children averring that the transfer was fraudulent and/or a dissipation of their marital assets, and that the value of the trusts should be charged against Husband in the parties' equitable distribution scheme.

Husband asserted that the trusts were in reliance upon the advice of his estate planning attorney and had nothing to do with the parties' eventual separation, the value of the gifts to the trusts was a small fraction of Husband's substantial assets and the creation of the trusts occurred months before the parties' separation. Husband claimed that the parties had defined roles; Husband was responsible for the family's finances and Wife was responsible for caring for the children. Husband further claimed he disclosed the creation of the trusts to Wife on a walk home from lunch one day and again at a dinner where the parties discussed the appointment of trustees. Two of the parties' children testified to this conversation.

Wife asserted that she did not learn of the existence of the trusts until after the parties separated upon discovering the federal gift tax return filed by Husband. Wife regularly prepared the parties' tax returns, which they filed jointly. However, because Husband and Wife did not elect to split gifts, a gift tax return was not required to be filed by Wife. Wife further asserted that Husband never had a conversation with her regarding the existence of the trusts. Wife testified that the conversation she had with Husband was about the appointment of an executor of his will, not a trustee of the trusts.

The trial court found Wife's testimony credible and rejected Husband's testimony and deemed Husband's transfer of marital property to be fraudulent and void and chargeable against Husband in equitable distribution. The trial court

continued on page 25

relied on section 3505(e) of the Divorce Code, which states that "[a]n encumbrance or disposition of marital property to third persons who paid wholly inadequate consideration for the property may be deemed fraudulent and declared void." The trial court found that Husband concealed the transfer from Wife as part of an overall plan to separate from Wife and to dissipate the assets available to Wife upon their eventual separation.

The Superior Court upheld the trial court's decision that Husband's transfer of marital property was a fraudulent transfer and chargeable against Husband in equitable distribution, giving great weight to the trial court's credibility assessment and refusing to re-weigh the evidence to address Husband's argument that the trial court abused its discretion by declining to accept his testimony.

Husband's appeal addressed several other errors, including the trial court's failure to deduct taxes associated with the sale of Husband's business holdings (upheld), the trial court's failure to deduct taxes from the value of the trust assets (upheld), the specific amount of interest added to the value of the trust assets (remanded to recalculate proper amount), and the timing and manner of payment of the equitable distribution award (declared to be moot due to recalculation on remand).

Divorce Considerations Related to Fraudulent Transfer

Marital property, as defined in the Divorce Code, includes all property acquired by either party during the marriage and the increase in value of certain non-marital property during the marriage. At divorce, it is the trial court's job to determine what property constitutes marital property and to fashion an equitable distribution scheme that achieves economic justice between the parties.

In creating the trusts at issue, Husband transferred shares of common stock from two of his business entities into trusts for the children during the marriage, allegedly without Wife's consent. Because the business entities were started during the marriage, shares of common stock of the business entities constitute marital property within the meaning of the Divorce Code. It was therefore up to the trial court to determine how the shares should be divided at divorce. Generally speaking, at divorce, Wife should receive some portion of these shares, or other marital assets of equal value.

The issue in this case is that Husband, presumably without Wife's consent, transferred the shares of common stock (marital property) into trusts for the children during the marriage. The trial court determined that this transfer was intended by Husband to shield these assets from Wife and was therefore a fraudulent transfer pursuant to section 3505(e) of the Divorce Code (titled "Disposition of property to defeat obligations"). Presumably it was not possible to return these shares from the trusts to the marital estate, so the trial court "charged" Husband with the value of these shares, plus interest. The overall result was that Wife received substantially more assets than if the trial court had found that the transfer was just part of the parties' joint estate planning and therefore no longer part of the martial estate.

The trial court gave great weight to the fact that Wife was not present at Husband's meeting with the estate planning attorney. The trial court also found it significant that Husband had already begun a relationship with the Fiancée at the time of his meetings with the estate attorney. The trial court found Husband's testimony that he had discussed the creation of the trusts with Wife inconsistent and not credible, while finding Wife's testimony that she was unaware of the trusts credible and convincing. The trial court was not convinced by Husband's arguments that the trusts were for estate planning purposes, not divorce planning purposes. Ultimately, it was the testimony of the parties that caused the trial court to find that the

continued on page 26

creation of the trusts was intended as an overall plan by Husband to separate from Wife and defeat his obligations to her, and the Superior Court declined to disturb the trial court's credibility determination.

This case has interesting implications for family lawyers. Family lawyers should be advising clients that are thinking about transferring assets prior to divorce that they should be sure to get the other spouse's consent first, or risk having those assets charged to them in equitable distribution. Family lawyers should also be explicitly questioning clients about any and all property that was transferred during the marriage, specifically via trust , and if so, whether or not the other spouse knew about it and/or consented. In *Mohen*, the Superior Court opines that the statute does not place any temporal restrictions of fraudulent transfers, although it appears that to be successful on a claim that a transfer is fraudulent, the party needs to prove that the fraudulent party had an overall plan to separate from the other party. Family lawyers should also be sure to include questions leading to the discovery of potential fraudulent transfers in their discovery requests, as well.

Estate Planning- Ethical Considerations

The Court's holding in *Mohe*n has implications for estate planning attorneys when undertaking a joint representation of a married couple. As in *Mohen*, when jointly representing a married couple, it is not uncommon that one spouse is the "point person" for communicating with the estate planning attorney and takes the lead when making decisions regarding the estate plan for the couple.

Often, this type of representation will begin with drafting or updating an estate plan for both spouses. Of course, each spouse must sign his or her own estate planning documents. Once the core planning documents are in place, the joint representation may evolve into more advanced planning such as the creation of gift trusts for descendants, as in *Mohen*. The spouse who is the "point person" may call the estate planning attorney on the couple's behalf and discuss the desired provisions of the trust. If he or she is settlor of the trust, it is not implausible – although certainly not advisable – that the estate planning attorney might never communicate with the other spouse directly regarding the creation of the gift trust for the couple's descendants or other beneficiaries.

In an environment where estate planning attorneys are working quickly to draft trusts for clients clamoring over a possible reduction in the federal estate/ gift tax exemption, often the estate planning attorney is discussing the planning with one spouse over the phone or by Zoom. The settlor spouse may come into the estate planning attorney's office alone to execute the trust or execute the trust offsite. The non-settlor spouse may not become aware of the gift when filing the couple's gift tax returns to report the gift because the settlor spouse may not elect to split the gift with his or her spouse as to use his or her entire federal estate tax exemption.

When engaging in a joint representation, an attorney cannot withhold information that is material to the representation from one of the spouses at the request of the other, and attorney-client privilege does not protect conversations that one spouse may have with the attorney from disclosure to the other. Query whether an attorney engaged in a joint representation has an ethical obligation to proactively and independently inform the "non participating" spouse of the other spouse's gifts. The model rules do not address the situation where one spouse fails to participate or fails to actively request updates regarding the representation.

The Court's holding in *Mohen* in no way implicated the estate planning attorney for any wrongdoing for failing to communicate with Wife or for failing to confirm with Wife that she was aware of Husband's

continued on page 27

use of marital assets to fund the trusts for their children. However, estate planning attorneys should consider *Mohen* when jointly representing a married couple and communicating with only one spouse. Of course, the responsibility ultimately falls on both spouses to keep each other informed when undertaking estate planning that will alter the couple's financial situation, especially when using marital assets. That notwithstanding, below are suggestions on how to proceed.

When creating a trust where one spouse as the settlor without the participation of the non-settlor spouse, the safest course is to have verbal or, ideally, written confirmation that the non-settlor spouse has received adequate disclosure and agrees with the planning being undertaken by the settlor spouse.

When using marital assets to fund a gift of any kind, and where one spouse has not materially participated in the planning meetings, the attorney may consider having both spouses sign a consent to making such gift and using marital assets to do so. These documents can be executed contemporaneously with the trust or other estate planning documents and kept with the couple's other original estate planning documents.

At a minimum, when communicating with one spouse without the other spouse present, estate planning attorneys may wish to advise their clients on the implications of *Mohen* so that the clients understand that if he or she withholds information from his or her spouse and later divorces, any planning that diminishes marital property could be considered a fraudulent transfer and charged against that spouse in equitable distribution.

Of course, the best practice is to meet with both spouses. The trial court in *Mohen* gave great weight to the fact that Husband had a series of meetings with the estate planning lawyer without Wife present.

SMALDINO: A LESSON IN WHAT NOT TO DO

BY BEN LEE | TEMPLE UNIVERSITY BEASLEY SCHOOL OF LAW, LL.M. CANDIDATE.

Facts

In an effort to provide for his children and grandchildren while maintaining separate assets to provide for his wife, Mr. Smaldino established an irrevocable Dynasty Trust on December 21, 2012. On the same day, Mr. Smaldino transferred 10 of his real estate holdings (with an aggregate value of over $25,000,000) to Smaldino Investments LLC, which was owned and operated through the revocable Smaldino Family Trust.

The Smaldinos then implemented a gifting plan in which Mr. Smaldino would transfer a portion of the ownership interest in Smaldino Investments LLC from the Smaldino Family Trust to Mrs. Smaldino, who would then gift the interest to the newly created Dynasty Trust for the benefit of Mr. Smaldino's children and grandchildren. Structuring the transfers in this way was advantageous because Mrs. Smaldino had not yet used any of her $5,250,000 gift tax exemption. In exchange for the use of her gift tax exemption, Mr. Smaldino also agreed to increase Mrs. Smaldino's interest in the Smaldino Family Trust.

Mr. Smaldino, as the trustee of The Smaldino Family Trust, transferred interests in the LLC to Mrs. Smaldino, "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be Five Million Two Hundred Forty Nine Thousand One Hundred Eighteen and 42/100ths Dollars ($5,249,118.42)." The assignment was signed by both Mr. and Mrs. Smaldino and lists April 14, 2013, as its "effective date", but does not indicate the date on which the parties actually signed.

Mrs. Smaldino later executed an identical document, transferring the units she received the day before to the Dynasty Trust. At the same time Mr. Smaldino, as trustee for the Smaldino Family Trust, executed a document transferring an additional number of Class B units to the Dynasty Trust, "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be One Million Thirty One Thousand Eight Hundred Eighty One and 58/100 Dollars ($1,031,881.58)." The documents were signed by Mrs. Smaldino and Mr. Smaldino respectively as transferors, and by the trustee of the Dynasty Trust, with an "effective date" of April 15, 2013, but again, neither document indicates the date on which it was actually signed. The LLC's operating agreement was amended to reflect the changes in ownership, as seen on the Schedule K1 of the LLC's 2013 partnership tax return which listed the Smaldino Family Trust as owning 51% of the LLC and the Dynasty Trust as owning 49% of the LLC, as of April 15, 2013. Nowhere on the partnership's 2013 Schedule K-1 does it report Mrs. Smaldino as having owned any portion of the LLC.

Mr. Smaldino hired an appraiser to value a 49% ownership interest of Class B nonvoting shares of the LLC. The appraiser submitted his report on August 22, 2013, and determined that on April 15, 2013, the 49% ownership interest was worth $6,281,000. Both Mr. and Mrs. Smaldino filed gift tax returns for 2013. Mr. Smaldino reported a taxable gift of $1,031,882. Mrs. Smaldino reported making a gift of $5,249,118 and elected to allocate it towards her $5.25M unified credit. The IRS took issue with both the valuation of the transferred LLC interest and the allocation of the gift tax.

Upon audit, the IRS issued Mr. Smaldino a notice of gift tax deficiency in the amount of $1,154,000, finding that all of the 2013 transfers of LLC interests were attributable to Mr. Smaldino, and none to his wife. Additionally, the IRS concluded, and the court agreed, that after accounting for lack of control and marketability discounts the 49% LLC interest transferred to the Dynasty Trust was worth $7,820,000, not the $6,281,000

continued on page 29

Smaldino reported. However, most of the tax deficiency was due to a mischaracterization of the transactions and not the valuation.

Analysis

A. The timing and interconnectedness of the various transactions make them all a part of a single transaction under the step transaction doctrine.

There are three different tests used to determine if a set of transactions can be unified by the step-transaction doctrine; 1) the "end result" test, 2) the "mutual interdependence" test, and 3) the "binding commitment" test.

1. The end result test is applied by viewing each transaction as a single step in a prearranged set of transactions designed to achieve a particular result. This test condenses what, on the surface, appear to be independent transactions into a single transaction, recognizing how easy it is to formally break apart a transaction into its pieces and their associated tax consequences.

2. The mutual interdependence test again views all of the seemingly separate transactions as parts of a single transaction if the individual steps appear to have little-to-no significance without the completion of all of the transaction steps.

3. The binding commitment test is considered the most strict of the three tests, because it only applies to a series of transactions when, at the time the first step is entered into, there is a binding agreement to complete the later steps. A binding commitment can be found to exist when a party only enters into the first transaction with an understanding, and in reliance on, the subsequent transaction occurring.

At its simplest, the Smaldino transaction can be broken down into two parts, first a tax-free transfer of the LLC Interest from Mr. Smaldino to Mrs. Smaldino, followed by a transfer of that LLC Interest from Mrs. Smaldino to the Dynasty Trust. Applying the various step-transaction tests to Smaldino it is apparent that the transfer to Mrs. Smaldino lacked any business purpose beyond allowing Mrs. Smaldino to use her unified credit when making the gift to the Dynasty Trust. This runs afoul of the end result test because the desired result, using up Mrs. Smaldino's unified credit in order to pass the LLC interest from Mr. Smaldino to the Dynasty Trust free of gift tax, was the first step in a prearranged plan and thus condensable to a single transaction. Moreover, Mrs. Smaldino testified at trial that prior to the transfer of the LLC interest from Mr. Smaldino to herself, she had verbally committed to subsequently transfer the interest to the Dynasty Trust and that she made this commitment in reliance on a promise from Mr. Smaldino that he would increase her interest in the Smaldino Family Trust.

Although the Smaldinos drafted formal documentation for each individual transaction and gave them "effective dates" a day apart, there is no indication of the date the documents were actually signed. The expert valuation, upon which the transfers rely, wasn't completed until August 22, 2013, over four months after the "effective date" listed on the documents. All of this evidence supported the court's conclusion that the two transactions could be merged under the step transaction doctrine. However, the court forewent deciding the case on the grounds of the step transaction and instead determined that the purported transfer from Mr. Smaldino to Mrs. Smaldino lacked economic substance.

B. The IRS may disregard transactions, and series of transactions, that lack economic substance.

The economic substance doctrine, a second embodiment of "substance over form," is the common law doctrine under which tax benefits under subtitle A are not allowable if the transaction does not have economic substance or lacks a business purpose. IRC 7701(o)(5)(A). A transaction is only treated

continued on page 30

as having economic substance if; (A) the transaction changes in a meaningful way (apart from federal income tax purposes) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. Although the economic substance doctrine applies "only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income," courts sometimes impute the economic substance doctrine into the estate planning context. *Estate of Bies v. Commissioner*, T.C. Memo. 2000-338 (determining the gift of stock from the decedent to her daughter-in-law, and granddaughter-in-law, followed by the immediate transfer from them to the decedent's son and grandson, to be taxable indirect transfers from the decedent to the decedent's sons and grandson). This is particularly acute in the case of Smaldino, where the transaction in question relates directly to the transfer of his interest in Smaldino Investments LLC to his wife and then ultimately to the Dynasty Trust.

Application of the economic substance doctrine to estate planning is controversial among academics, some claiming a strict interpretation of the Code requires the substance over form doctrine applies only to transactions contemplated to reduce income tax and not to reducing estate and gift tax. [*Elaine Hightower Gagliardi, Economic Substance in the Context of Federal Estate and Gift Tax: The Internal Revenue Service Has It Wrong*, 64 Mont. L. Rev. (2003). (arguing nearly all estate planning is directed towards reducing estate and gift tax, making the economic substance doctrine applicable to essentially the whole field.)] The tax court nonetheless applies the economic substance doctrine to Smaldino.

When Mr. Smaldino, as trustee of the Smaldino Family Trust, transferred the 40.95% LLC interest to Mrs. Smaldino he did so in violation of the LLC operating agreement. The LLC operating agreement creates two distinct membership classes, "Members" and "Assignees." A "Member" has an economic interest as well as the right to participate in the LLC's business affairs, whereas an "Assignee" holds only the economic interest of the assigning Member.

The LLC Board never approved Mr. Smaldino's assignment of a portion of his membership interest to Mrs. Smaldino as required by the agreement. Additionally, Mrs. Smaldino never executed an instrument adopting the terms of the LLC operating agreement which was required to become a new member. The Smaldinos' failure to adhere to the formalities to properly transfer a membership interest resulted in Mrs. Smaldino only being recognized as an assignee of the membership interest. Because Mrs. Smaldino was only ever an assignee she could not have transferred a membership interest to the Dynasty Trust. Schedule K-1 on the LLC's Form 1065 partnership tax return further supports the conclusion that Mrs. Smaldino never possessed a membership interest by listing Mr. Smaldino as holding a 51% partnership interest and the Dynasty Trust as holding a 49% partner interest for the entire year, failing to list Mrs. Smaldino as a partner for the one day she purportedly was.

The facts that: Mrs. Smaldino's membership was never formally approved by the LLC's Board; she never received any payments or exercised any rights on account of her purported membership interest; and the Schedule K-1 never listed her as a partner, are all indicative that the transfer from Mr. Smaldino to Mrs. Smaldino lacked economic substance or a valid business purpose. Section 6662 of the Internal Revenue Code creates harsh penalties for substantial estate and gift tax valuation understatements (up to 40%), and excepts undisclosed economic substance transactions from the good faith exception to the penalty. Although there have not yet been any instances of courts imposing the deficiency penalty on

continued on page 31

THE SECURE ACT PROPOSED REGULATIONS PROVIDES CLARIFICATIONS AND UNEXPECTED DEVELOPMENTS FOR ESTATE PLANNING CLIENTS

BY PETER E. MOSHANG, ESQUIRE, AND THOMAS O. HISCOTT, ESQUIRE | HECKSCHER, TEILLON, TERRILL & SAGER, P.C.

Effective January 1, 2020, the SECURE Act implemented sweeping changes to retirement assets that fundamentally altered many aspects of administering retirement assets during the lifetimes of plan participants, as well as after their deaths. However, the sweeping changes implemented in the SECURE Act created many questions regarding how to interpret the new provisions. In February 2022, the U.S. Treasury Department issued proposed regulations addressing many of the changes introduced by the SECURE Act. This article highlights some of the key discussion points based on the SECURE Act for estate planning clients.

Changes to the "10 Year Rule"

Retirement assets (including IRAs, 401(k)s, Roth IRAs and other retirement accounts) have special income tax considerations that differ from other assets passing as part of a client's estate plan, in particular the ability of the beneficiary to "stretch" distributions after death in order to defer the income tax due. However, the SECURE Act greatly altered the ability of beneficiaries to "stretch" these distributions.

Under pre-SECURE Act law, subject to certain exceptions, the general idea was that the distributions to an individual non-spouse beneficiary (and qualified trusts) must be made over the life expectancy of the designated beneficiary (or the life expectancy of the oldest beneficiary of the qualified trust). The beneficiary's or beneficiaries' first required minimum distribution ("RMD") had to be taken by December 31st of the year after the year of decedent's death, and would be taken each year thereafter.

However, the SECURE Act changed this so that, subject to certain exceptions for "Eligible Designated Beneficiaries" (discussed below) below, a new "10-year rule" applies. This 10-year rule requires that the account balance must be withdrawn by December 31st of the year containing the 10th anniversary of the participant's death. This applies to individual non-spouse beneficiaries (and qualified trusts) of decedents who died after December 31, 2019. Individual non-spouse beneficiaries and qualified trusts of individuals who died before January 1, 2020, may continue to take distributions over their life expectancy. Additionally, as before the SECURE Act, estates and non-qualifying trusts remain subject to the shorter "5-year" rule (for decedent's who died before their Required Beginning Date ("RBD") (the date by which the participant must begin taking annual RMDs – which the SECURE Act changed the Required Beginning Date from April 1st of year after the participant reached 70 ½ to April 1st of year after the participant reached age 72)) or the remaining "ghost" life expectancy of the decedent who died after their RBD.

When the SECURE Act was first adopted, it was thought in the case of non-spouse individual beneficiaries and qualifying trusts

continued on page 32

SMALDINO, CONTINUED

estate and gift tax deficiencies, IRS enforcement is subject to change.

The Smaldino court determined that the discounted value of the 49% LLC interest transferred to the Dynasty Trust was $7,820,008. Additionally, because the Smaldinos failed to respect the formalities of transferring the LLC interests, the transfers lacked economic substance and the entirety of the gift to the Dynasty Trust was attributable to Mr. Smaldino. This case stands as a warning to estate lawyers, encourage clients to begin planning early and stress the importance of following the formalities of closely held businesses, because if the client does not respect the formalities of the business, neither will the court.

subject to the 10 year rule that there was no requirement for annual distributions before the end of this 10 year period. Accordingly, although the beneficiary could not "stretch" distributions over his or her lifetime, the beneficiary would have the ability to pick and choose when to withdraw funds over the period.

However, the proposed regulations provide that if the plan participant dies after to his or her RBD, then the beneficiaries still must take annual RMDS in years one through nine of the period, and the balance in the final year of the period. For participants who died before his or her RBD, the individual beneficiaries do not need to take annual minimum distributions.

A question arises in the cases of decedents who died in 2020. Under the interpretation of the SECURE Act that prevailed prior to the proposed regulation, the beneficiaries did not need to take a distribution in 2021 under the 10 year rule. Now, the proposed regulations would require a distribution. The question is whether beneficiaries "missed" a distribution and, therefore, are potentially liable for a penalty. Hopefully the final regulations will clarify that no distribution needed to be taken in 2021. If not, the standard applicable in 2021 should be that a taxpayer's decision not to take a distribution in 2021 was a "reasonable, good faith interpretation" of the SECURE Act. We agree, in light of the language in the SECURE Act, that not taking a distribution in 2021 was a reasonable, good faith interpretation of the SECURE Act. In this regard IRS Publication 590-B appeared to take the position that no required distributions need to be taken until the end of the 10 year period. For 2022, however, in light of the proposed regulations, beneficiaries subject to the 10 year rule may want to take a minimum distribution (if the original participant died after his or her RBD).

Clarification on Eligible Designated Beneficiaries

The SECURE Act added the new concept of an "Eligible Designated Beneficiary" consisting of the (i) the surviving spouse of the plan participant, (ii) a child of the plan participant who has not reached the age of majority, (iii) a disabled or chronically ill beneficiary and (iv) a beneficiary not more than 10 years younger than the plan participant. These Eligible Designated Beneficiaries were an exception to the 10 Year Rule. Such Eligible Designated Beneficiaries could take distributions over their life expectancy, except for a minor child, who could take distributions over their life expectancy until the "age of majority," at which time the 10 year clock would start.

The proposed regulations provided some clarification on who falls into these categories. When the SECURE Act was first implemented there was a lack of clarity regarding when a child reached the age of majority. There also was a cross-reference in the SECURE Act that could allow a child still being educated to not reach majority until age 26. The proposed regulations now state that a child reaches the age of majority at age 21 to avoid confusion between state laws and other statutes and eliminates a possible extension to age 26 for beneficiaries still being educated.

With respect to disabled beneficiaries, the SECURE Act defines disabled as follows: "an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." However, the proposed regulations alter this provision for disabled beneficiaries under the age of 18 to be defined as a "medically determinable physical or mental impairment that results in marked and severe functional limitations and that can be expected to result in death or to be of long-continued and indefinite duration." Additionally, the proposed regulations provide

continued on page 33

that if the beneficiary is determined to be disabled for Social Security purposes, the IRS will defer to that determination. A custodian for a disabled or chronically ill beneficiary must be provided to the plan custodian by October 31st of the year following the plan participant's death.

Rules for Trusts

The proposed regulations include several helpful new rules regarding trusts that hold retirement assets that provide some clarity for determining the RMDs applicable to trusts. For example, the proposed regulations now include references to the two types of "see-through" trusts that practitioners commonly referenced, conduit trusts and accumulation trusts, but which had never been explicitly referenced in the Code or related regulations.

For multi-beneficiary trusts, there are two types of trusts: a "Type I" trust divides immediately upon death into separate trusts and a "Type II trust" which is for the sole benefit of disable or chronically ill beneficiary during his or her lifetime.

For a Type II trust, such trust will be treated as an Eligible Designated Beneficiary regardless of the other beneficiaries. This is helpful because it means that RMDs may be taken using the Eligible Designated Beneficiary's life expectancy, even if there is an older potential remainder beneficiary.

For a Type I trust, the general rule is that if at least one beneficiary is not an Eligible Designated Beneficiary the 10 year rule applies (unless any designated beneficiary – as determined below - is the a minor child of the participant, in which case the life expectancy rules would apply until the age of majority). In determining the beneficiaries of Type I trusts, there are no "tiers" of beneficiaries to consider. Specifically:

- First tier beneficiaries are current mandatory and discretionary beneficiaries of a trust;

- Second tier beneficiaries are beneficiaries who will become current beneficiaries of a trust only after the death of a first tier beneficiary.

- Third tier beneficiaries who will become current beneficiaries of a trust only after the death of a third tier beneficiary.

In determining who is a "beneficiary" of a trust for the purpose of determining RMDs:

- First tier beneficiaries are always counted.

- Second tier beneficiaries are counted, unless the trust is a conduit trust.

- Third tier beneficiaries never count.

This distinction is helpful in that "disaster" or "atomic bomb" beneficiaries can now largely be ignored in determining designated beneficiaries and RMDs. So, for example, consider a trust that provides income for life to a child (with no principal distribution provisions, and at the child's death, or, if none, outright to charity. The child is the first tier beneficiary, the grandchildren are the second tier beneficiaries, and the charity is the third tier beneficiary. The charity may be disregarded – and the trust is now a qualified trust eligible for the 10 year rule, not the potentially shorter distribution periods that would apply if the trust were not qualified (the 5 year rule if the decedent died before his or her RBD or the ghost life expectancy if the decedent died after his or her RBD).

However, practitioners should carefully consider certain situations where these contingent remainder beneficiaries might be second tier beneficiaries. If the trust in the example above was, during the child's lifetime, a sprinkle trust for the child and the grandchildren, and at child's death paid outright to the grandchildren, or, if none, to charity, the children and grandchildren

continued on page 34

THE SECURE ACT, CONTINUED

would be first tier beneficiaries and the charity would be a second tier beneficiary.

Additionally, the proposed regulations help to clarify " changes that could occur" that have long concerned practitioners from potentially disqualifying a "see through" trust, such as a broad limited power of appointment, decanting and other potential trust modifications. Based on the proposed regulations, the beneficiaries of a trust (and associated RMDs) will be determined based on the terms of the trust as of September 30th following the participant's death. If an event has not yet occurred, such as the exercise of a power of appointment, it will be ignored in determining the beneficiaries of the trust. However, if prior to the withdrawal of all retirement assets, a change occurs, the beneficiary status of the trust (and associated RMDs) will be re-evaluated based on any such change.

Moving Forward

Although the proposed regulations provided some unexpected decisions, on the whole, the proposed regulations help to provide some clarity moving forward on how the SECURE Act has changed the rules for retirement assets. However, practitioners will need to monitor the final form of the regulations in case there are additional changes.