Texas Tax Lawyer

A Tax Journal

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TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

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THANK YOU TO OUR SPONSORS!

- Interested in Becoming a Sponsor? Please Contact Tax Section Sponsorship Task Force Chair, Jim Roberts, at jvroberts@gpm-law.com

CHAIR'S MESSAGE

Dear Fellow Tax Section Members:

The fiscal year has come to an end and there is a lot of good news to report!

1. Brand New Updated 24/7 Free Online CLE Library

First, we have launched a newly updated version of our 24/7 Free Online CLE Library! As in years past, it is **FREE** to all Tax Section members. The new CLE Library contains over 65 audio and video programs, along with powerpoints and outlines. An easy and cost effective (it's free!) way to earn all of your CLE credit, accessible anytime, anywhere.

The Tax Section's 24/7 Free Online CLE Library was first launched in 2009 under the vision and leadership of former Tax Section Chair Dan Micciche. It was the first of its kind. This year, we made it a priority to make it even better for you!

We hope you like and it and find it useful to your practice! Check it out on the Tax Section website: http://www.texastaxsection.org

2. Member Outreach Initiatives and Networking Opportunities

In addition, this year we made it a priority to enhance our member communications to you by increasing the number of eblasts to you and including up-to-date information on our website. We also made it a priority to increase the number of networking opportunities. Tax law is difficult; we all need a network of support. We had five networking functions throughout the year. This includes, for the first time, a complimentary networking reception that was held at the State Bar Annual Meeting on June 16. We also have "mini-CLEs" in the works, where we will reach out to more remote locations (examples include El Paso, Lubbock, Amarillo, just to name a few) where we plan to offer a 1-2 hour CLE program with a networking event following. The goal is to reach out to members who practice outside the typical cities where "live CLEs" are offered.

3. Membership Drive

In conjunction with the rollout of the newly updated 24/7 Free Online CLE Library (see #1 above), we embarked on a membership drive. The membership drive reached out to State Bar members who are not tax lawyers, but who still utilize tax law in their practice. Some examples include solo and small firm attorneys, business law and corporate counsel attorneys, estate planners, and real estate attorneys. Because the Tax Section's 24/7 Free Online CLE Library contains many primer and "tax 101" courses, we thought these attorneys could receive a great benefit from a Tax Section membership.

Know anyone who might benefit from a Tax Section membership? Help spread the word! Here is a link to join the Tax Section: http://www.texastaxsection.org

4. Live CLE Events

We had some record attendance at our live CLE events this year, which included: (i) Texas Comptroller Annual Meeting and Legal Update; (ii) International Tax Symposium (hosted in two cities); (iii) Tax Law in a Day; (iv) Annual Property Tax Seminar (which had over 200 attendees and was standing room only!) In addition to these live events, as in years past, the Tax Section co-sponsored the TexasBarCLE Advanced Tax Law Course and Dallas CPA Society Convergence.

This year we also expanded our Annual Texas Comptroller Meeting to include a morning session CLE program.

5. **Tax Section Annual Meeting**

We hope you attended the Tax Section Annual Meeting, which was held in conjunction with the State Bar Annual Meeting in Fort Worth on June 16-17. The Tax Section offered a full day of CLE (7.5 hours) on topics including: New Partnership Audit Rules, International Tax Update, IRS Enforcement Update, Issues Every Tax Lawyer Should Know (But May Have Lost Track Of), Property Tax 101, and much more.

For the first time, the Tax Section also hosted a complimentary networking reception open to all Tax Section members.

Special thanks to David Gair, Annual Meeting Chair, for organizing a fantastic CLE program.

Attendance was great and we hope to see even more of you next year at the Annual Meeting in Dallas!

6. Louise Hytken Wins the 2016 Outstanding Texas Tax Lawyer Award

The Tax Section Council voted to award the 2016 Outstanding Texas Tax Lawyer Award to Louise Hytken. This is the highest award that the Tax Section gives. This award recognizes Louise for her outstanding reputation, expertise, and professionalism in the practice of tax law; her significant contributions through her work at the Tax Division of the Department of Justice; her reputation for ethics; and her mentorship of other tax professionals. The award was presented at the Tax Section Annual Meeting, which was held in conjunction with the State Bar of Texas Annual Meeting on June 16-17 in Fort Worth, Texas.

7. Great Year for Government Submissions

This year, through the leadership of the Tax Section Committee on Government Submissions ("COGS") (spearheaded by Bob Probasco, Henry Talavera, Jeff Blair, and Jason Freeman), the Tax Section submitted a record 12 comment letters on significant tax topics. Leading the charge was the Tax Controversy Committee (led by Richard Hunn), which submitted six comment projects this year.

Also significant is the recent comment project on the new partnership audit rules (spearheaded by the Partnership and Real Estate Tax Committee), which was singled out by an IRS speaker at the most recent ABA meeting as being particularly helpful.

This year we also saw some Tax Section recommendations implemented in final regulations. The Texas Comptroller's Office adopted recommendations from a comment project on timely filing and payment issues submitted by the State and Local Tax Committee. And the IRS adopted recommendations from a comment project submitted by the General Tax Issues Committee on raising the de minimis safe harbor for deducting, rather than capitalizing, the cost of tangible assets.

Getting involved on a comment project is a great way to help shape tax policy. All Tax Section members are encouraged to get involved! Please contact Henry Talavera: HTalavera@Polsinelli.com

8. Welcome to the 2016-2107 Leadership Academy Class

This year we welcomed our third Leadership Academy Class! The class will attend four sessions (the first was in March, and the second was in conjunction with the Annual Meeting) and will graduate in early 2017.

The Tax Section hosts its Leadership Academy program every other year to instill leadership skills and help guide the next generation of Texas tax lawyers in taking ownership of their careers.

This year we also started working on a promotional video for Leadership Academy. Stay tuned!

Please contact Christi Mondrik, Leadership Academy Program Director, if you're interested in learning how to apply for the next Leadership Academy program: CMondrik@mondriklaw.com

9. Congratulations to Our 2016 Student Scholarship Winners

The Tax Section awarded four student scholarships this year to students demonstrating academic excellence and commitment to the study and practice of tax law in Texas. The purpose of the scholarship program is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members in the State Bar of Texas Tax Section. Selection criteria include: merit, academic performance, financial need, and demonstrated experience and interest in practicing in the field of tax law in Texas. We had a record number of applications this year!

The 2016 Tax Section Law Student Scholarship recipients include:

- Jessica Kirk, SMU Dedman School of Law
- Sharmeen Ladhani, Vanderbilt Law School
- Yang "Allyson" Li, University of Houston Law Center
- Julio M. Mendoza-Quiroz, Texas Tech School of Law

Please contact Rob Morris, Director of the Law Student Scholarship Program, if you would like to learn more: robert.morris@nortonrosefulbright.com

10. Brand New Updated Texas Tax Legends Library

This year we launched a brand new updated version of our Texas Tax Legends Library. The library is an honor roll of Texas tax attorneys whose careers have been most interesting, as captured in a video series of histories by former Tax Section Chair Bill Elliott. We hope you will check it out. The filmed interviews are truly captivating! The library can be found on the Tax Section website: http://www.texastaxsection.org

11. Expansion of Law School Outreach

This year, under the leadership of Abbey Garber, we expanded our law school outreach program to every law school in Texas. This program involves hosting "Tax Career Day" panels to talk with students about the practice of tax law and how to seek job opportunities. Want to talk to law students about becoming a tax lawyer? Please contact Abbey if you'd like to get involved in the Tax Section's Law School Outreach program: Abbey.B.Garber@IRSCOUNSEL.TREAS.GOV

12. Pro Bono

This year was another successful year for the Tax Section's award winning pro bono program under the leadership of Juan Vasquez, Jr. The Tax's Section's Tax Court Calendar Call Pro Bono Program assists pro se, low income taxpayers at Tax Court trial sessions in Dallas, El Paso, Houston, Lubbock, and San Antonio.

Want to get involved and volunteer? It's a rewarding experience! Please contact Juan Vasquez, Jr.: juan.vasquez@chamberlainlaw.com

13. Creation of Past Chair Advisory Board

This year we created a Past Chair Advisory Board in order to reach out to past Tax Section Chairs to build upon their expertise and keep them involved in the leadership of the Tax Section. Thank you to the 2015-2016 Past Chair Advisory Board for your leadership and continued service to the Tax Section!

Bill Bowers, Dallas
Brent Clifton, Dallas
Tyree Collier, Dallas
Elizabeth Copeland, San Antonio
Bill Elliott, Dallas
Tina Green, Texarkana
Andrius Kontrimas
Mary McNulty, Dallas
Dan Micciche, Dallas
Patrick O'Daniel, Austin
Cindy Ohlenforst, Dallas
Kevin Thomason, Dallas
Gene Wolf, El Paso

14. Creation of Sponsorship Task Force

This year we created an organized sponsorship task force effort under the leadership of Jim Roberts. This year we also created a sponsorship brochure similar to those seen at the ABA level. From these efforts we saw an 82% increase in sponsorship revenue. Want to become a Tax Section sponsor? Learn about sponsorship benefits and opportunities on our website: http://www.texastaxsection.org/

15. Creation of SALT Committee Unclaimed Property Discussion Group

This year the State and Local Tax Committee created an Unclaimed Property Discussion Group, which will have quarterly calls to discuss current events involving unclaimed property law – which isn't exactly state tax, but it can still be quite taxing! Contact Charolette Noel if you are interested in participating: cfnoel@JonesDay.com

16. Texas Tax Lawyer

This year also marked the inaugural year of the new cover of the Texas Tax Lawyer.

This is the last edition of the Texas Tax Lawyer for this fiscal year. We hope you enjoyed each of the three editions this year. This current edition and archives can always be found on the Tax Section website: http://www.texastaxsection.org/

Special thanks to Michelle Spiegel, Newsletter Editor, for her outstanding efforts and hard work in publishing the Texas Tax Lawyer!

17. Tax Section Member Awards

At the 2016 Tax Section Annual Meeting on June 17, 2016, the Tax Section had its annual Tax Section Member Awards ceremony. Award winners are listed below. Congratulations to all, and thank you for your dedication and service to the Tax Section!

Outgoing Elected Council Member Service Award: Ira Lipstet (Austin), Melissa Willms (Houston),

	Henry Talavera (Dallas)
Outstanding Council Member Award:	Michael Threet (Dallas)
Outstanding Leadership Award:	Christi Mondrik (Austin)
Outstanding Substantive Committee Award:	Richard Hunn (Houston) for Tax Controversy Committee
Outstanding Facilitator Committee Award:	Bob Probasco (Dallas) & Henry Talavera (Dallas) for Government Submissions Committee
Outstanding Facilitator Committee Award:	Abbey Garber (Dallas) for Law School Outreach
Extraordinary Service Award:	Jeff Blair (Dallas) & Chris Goodrich (Houston)
Outstanding Programming Award:	Lora Davis (Dallas) & Melissa Willms (Houston) for Tax Law in a Day CLE
Outstanding Programming Award:	Christopher Jackson (Austin) for Annual Property Tax Seminar
Outstanding Past Chair Award:	Bill Elliott (Dallas)
Rookie of the Year Award:	John Strohmeyer (Houston)

* * * *

Visit the Tax Section website at http://www.texastaxsection.org/ to learn more about the Tax Section and how to get involved.

It's been a great year. I hope you will continue to get involved in the Tax Section. It's fun! And a great way to meet new people and create a wonderful network of friends! Get involved today!

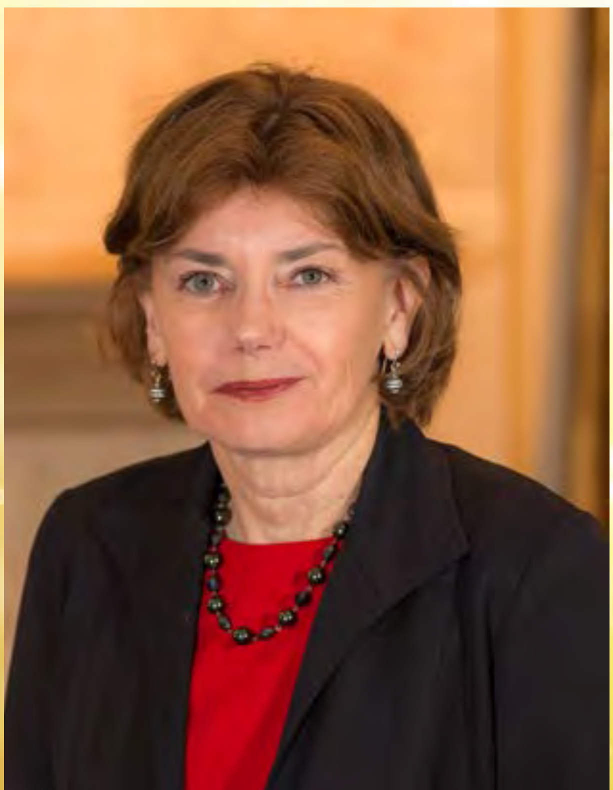
Alyson Outenreath
Chair, Tax Section

TAX SECTION
STATE BAR OF TEXAS

Congratulations

2016 OUTSTANDING TEXAS TAX LAWYER

Louise Hytken



Ms. Hytken worked for the Tax Division of the Department of Justice from 1976 until her retirement at the end of 2014. In 1984, she became the Attorney in Charge of the Dallas Field Office and continued in that role until the field office became the Civil Trial Section – Southwestern Region in 1994. She served as the Section Chief for the Southwestern Region of the Civil Trial Section and was responsible for tax cases in the district courts and bankruptcy courts in Texas and New Mexico. Her office handled some of the largest dollar and most sophisticated tax cases in the country. Louise is board certified in tax law, has been a licensed Texas lawyer for over 35 years, and has devoted her professional life to tax law. Truly an Outstanding Texas Tax Lawyer!

Previous Award Recipients
2015 Sander "Sandy" Shapiro | 2014 Hon. Juan F. Vasquez | 2013 Ira B. Shepard | 2012 Emily Parker
2011 Stanley M. Johanson | 2010 Charles O. Galvin | 2009 Stanley L. Blend | 2008 Steve Salch
2007 Ron Kalteyer | 2007 Buford P. Berry | 2006 Charles Hall | 2005 Vester T. Hughes, Jr.

Congratulations !!

THE FOLLOWING STUDENTS WILL RECEIVE THE LAW STUDENTS PURSUING TAX LAW SCHOLARSHIP:

Jessica L. Kirk – Southern Methodist University Dedman School of Law

Sharmeen Ladhani – Vanderbilt Law School

Yang “Allyson” Li – University of Houston Law Center

Julio Mendoza-Quiroz – Texas Tech University School of Law

SMU DEDMAN SCHOOL OF LAW

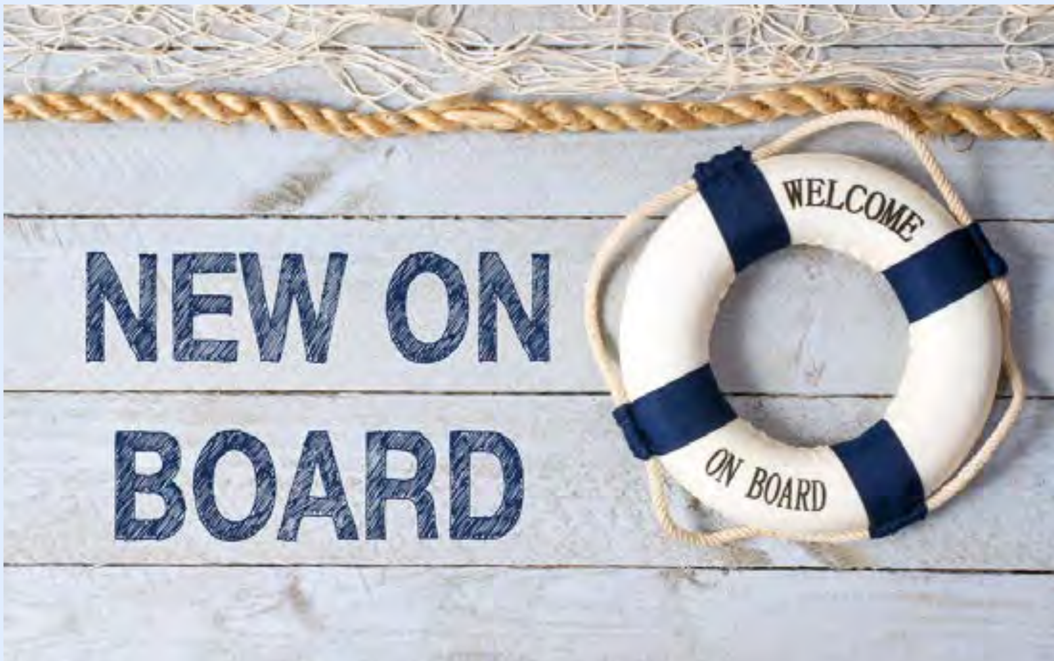
TEXAS TECH UNIVERSITY School of Law

VANDERBILT LAW SCHOOL

UNIVERSITY of HOUSTON LAW CENTER

TAX SECTION STATE BAR OF TEXAS

Get to Know the 2016-2017 Leadership Academy Participants



To Learn More About the Tax Section's Leadership Academy, visit http://www.texastaxsection.org
or contact Christi Mondrik, Program Director, at CMondrik@mondriklaw.com

TAX SECTION
STATE BAR OF TEXAS

2016-2017 State Bar Tax Section Leadership Academy Bios

	**Jeff Benson** is tax manager at PricewaterhouseCoopers, LLP in Dallas, TX. Since joining PwC in 2011, Jeff has practiced in the area of state and local taxation. Jeff assists his clients to identify and implement tax solutions and manage tax risks associated with their businesses. Specifically, he assists clients with refund claims, research and planning, audit defense and the administrative hearings process. Jeff is an active member of the Tax Section of the Texas Bar as well as the Dallas Bar Association. He received his B.S. in finance from Boston College and his J.D. from Marquette University Law School. When he's not on the job, you can find Jeff running or biking near White Rock Lake in Dallas.
	**Christopher Blackwell** serves as Assistant General Counsel within the Administrative Hearings Section of the Texas Comptroller of Public Accounts. In this position, he represents the Comptroller in redetermination and refund proceedings before SOAH. Prior to the Comptroller's office, Chris was an associate within the commercial litigation and international arbitration group of Salans' (now Dentons') New York office. Chris is a graduate of The University of Texas at Austin (B.B.A., Finance) and The University of Texas School of Law (J.D.). Among other distinctions, Chris was selected as a Super Lawyer Rising Star (New York—Metro) in 2014 and 2015.
	**Thomas "Bucky" Brannen** is an associate in Baker Botts' Dallas office. He advises and represents clients in planning and controversy matters related to taxes imposed by state and local jurisdictions around the country, including property tax, sales tax, income tax, franchise tax, severance tax, as well as others.
	**David Boudreaux, Jr.,** of Carr, Riggs, and Ingram, in Houston, is a tax attorney and licensed CPA. He represents clients in proceedings in front of the IRS and State taxing authorities. He also advises and assists clients with tax compliance and tax planning. He graduated from Mississippi State University summa cum laude with a Bachelor Degree in Accountancy and summa cum laude with a Masters in Taxation. He received his Juris Doctor degree from South Texas College of Law. His recent experience has been advising and representing large manufacturers and real estate developers with their tax compliance needs.

	**Michael Cannon** is an associate in the Dallas office of Gibson Dunn & Crutcher LLP. He currently practices in the firm's tax practice group. Mr. Cannon has significant experience with mergers and acquisition transactions, including cross-border matters. He also dedicates a significant part of his practice to tax-equity matters, including production, investment and historic tax credit transactions. He also represents real estate investors in a wide variety of transactions, including complex joint ventures. He represents investment fund sponsors in connection with structuring matters. Mr. Cannon earned his Juris Doctor *summa cum laude* from the J. Reuben Clark Law School at Brigham Young University, and was elected to the Order of the Coif. Prior to law school, he graduated *summa cum laude* from the Marriott School of Management at Brigham Young University. Outside of work, Michael enjoys spending time with his wife and two young daughters, working as a volunteer leader in his local congregation of the Church of Jesus Christ of Latter-day Saints and eating barbecue.
	**Austin Carlson,** of Gray Reed & McGraw, PC, Houston, focuses his practice on corporate transactions, tax planning and controversy and trust and estate planning. He works with multinational corporations, small businesses, and individuals to resolve their tax controversies with the IRS and State taxing authorities. Austin received his J.D., with honors, from The University of Texas School of Law, and B.B.A. in Accounting and M.S. in Taxation from Texas A&M University. He is a member of the Houston Society of CPAs and was recognized as a "Rising Star" by the Texas Society of CPAs in 2015.
	**Kacie Czapla** is an associate attorney for the Gardner Firm, PLLC, located in Tyler and Richardson. She specializes in three main areas: business transactions, including mergers and acquisitions; tax and business planning; and tax controversy. Most of the firm's clients are partnerships or S corporations. Prior to the Gardner Firm, Kacie worked for three years in Houston for PricewaterhouseCoopers primarily performing mergers and acquisitions as part of the international tax group. In addition to practicing law, Kacie currently teaches as an adjunct professor of tax and business law at the University of Texas at Tyler. Starting in 2016, she will teach at Stephen F. Austin as a Professional in Residence, which allows Kacie to split her time between teaching tax law at SFA and practicing law at the Gardner Firm. Although from Louisiana, Kacie received a Masters in Tax Law from the University of Florida and attended law school at the University of Wyoming. Kacie is an avid fisherman and snow skier, so she opted for a law school in the mountains of Wyoming.

	**James Dossey** is an attorney/partner at Dossey and Jones PLLC in The Woodlands, Texas, concentrating in complex business law, intellectual property, tax, estate planning, and probate matters. Jim is a registered patent attorney and is currently working toward his CPA designation. Prior to his legal career, Jim worked in Bank of America's Management Rotational Program and as a software consultant for a small oil and gas consulting firm in Houston. Jim holds a Bachelor of Science in Mechanical Engineering and a Master of Science in Electrical Engineering from the University of Texas. He also has an MBA in corporate finance and strategy from the MIT Sloan School of Management. Outside of his legal work, Jim is an adjunct professor of Business Law at Lone Star College; a legal advisor for the Legacy Foundation at the Ark Church in Conroe, Texas; an elected Trustee on the Montgomery ISD school board; and President and founding Board Member on the MISD Education Foundation. Jim lives with his wife Jennifer and their three children in the Walden Subdivision on Lake Conroe and is an avid golfer.
	**Preston "Trip" Dyer** is a member of Winstead PC's Taxation, Employee Benefits & Private Business Practice Group in Dallas. His practice focuses on federal and state tax planning for business transactions, including entity formations, mergers and acquisitions, real estate development and investments, and tax credit financing. He routinely assists investment managers in the formation of private investment funds and represents nonprofit corporations in connection with obtaining tax exemptions and operations.
	**Kathleen E. ("Katie") Gerber**, of Thompson & Knight, LLP in Houston, focuses her practice on corporate, partnership, and cross-border tax matters. She has significant experience advising clients on a variety of business transactions, including mergers and acquisitions, financings, debt restructurings and fund formation. She has extensive experience negotiating and drafting tax provisions in a variety of transactional documents including operating agreements, asset sale agreements, stock purchase agreements, merger agreements, credit agreements and disclosure documents for both public and private stock and debt offerings. Kathleen also advises nonprofit clients, including public charities, private foundations, social welfare organizations, Section 527 organizations, and social clubs. Throughout her legal career Katie has been dedicated to providing pro bono legal services with a primary focus on representing low-income taxpayers before the IRS and advising small charitable organizations regarding formation and applying for tax-exemption. Katie received her J.D. from Temple University Beasley School of Law in 2009, magna cum laude, and her LLM in Taxation from New York University School of Law in 2011. Katie began her career with Proskauer Rose LLP in both their New York and Los Angeles offices. Katie is licensed to practice law in Texas, California and New York.

	**Jeffrey M. Glassman** is an associate with McDermott Will & Emery LLP in Dallas, Texas. His practice focuses on defending clients in all stages of federal civil and criminal tax controversies, including matters before the IRS Examination Division and Appeals Office; litigation in the U.S. Tax Court, U.S. Court of Federal Claims, U.S. district courts, and U.S. Courts of Appeal; and voluntary disclosures. Mr. Glassman earned an LL.M. in Tax from Georgetown University Law Center, a law degree from The George Washington University Law School, and a bachelor's degree from the University of Florida. Mr. Glassman previously served as a law clerk for the Honorable Maurice B. Foley, U.S. Tax Court.
	**Sally Hartman,** a partner in Hartman & Moore's Austin office, has experience in both federal and state and local taxation, and has assisted with international and oil gas transactions, entity structuring, private equity offerings, and complex intellectual property planning. Ms. Hartman has developed a particularly deep understanding of tax law concerning artists, collectors, consignors, and purchasers of fine art. Before her legal career, Ms. Hartman worked at Sotheby's, New York, where she gained substantial insight to counsel clients on fine art valuation for income, gift, and estate tax purposes, and matters concerning property tax and sales and use tax relating to fine art. Ms. Hartman is a member of the Tax Sections of the California and Texas State Bars. She serves as. Secretary of the Board of Directors for Art Alliance Austin. Ms. Hartman received her B.A., magna cum laude, from Middlebury College and her J.D., cum laude, from The University of Texas School of Law. She earned her LL.M. in taxation from New York University School of Law.
	**Kelly Latta,** with Jones Day in Dallas, graduated from Harvard Law School in 2012 and began working as a tax associate at Jones Day in New York. In December 2014, she transferred to the Dallas office of Jones Day. She practices primarily in the areas of corporate tax, bankruptcy tax, taxation of international transactions, mergers and acquisitions, financings, securities offerings, and taxation of complex financial instruments, advising clients on a variety of federal tax issues, including planning, compliance, withholding, and reporting.

	**William LeDoux** is a state and local tax attorney in the Dallas office of K&L Gates LLP. William has broad experience in multistate tax planning and controversy matters, including extensive experience with matters related to Texas franchise, sales and use, and property taxes. He has assisted in representing taxpayers in administrative and judicial proceedings in various jurisdictions and has advised on the tax implications of various business transactions. He has assisted in representing taxpayers in various industries, including air carriers and private aircraft operators, e-commerce and brick-and-mortar retailers, energy and utility companies, health care companies, manufacturers, telecommunications companies, and travel companies. William also has experience assisting in matters related to federal income tax and tax-exempt and nonprofit organizations.
	**Leonora "Lee" Meyercord,** of Thompson & Knight, LLP, in Dallas, focuses her practice on federal, state, and local taxation of corporations, partnerships, individuals, and nonprofit organizations. She provides clients with tax planning advice on mergers and acquisitions, the operation and dispositions of partnerships and limited liability companies, private equity transactions, and tax controversies. Lee also counsels clients on the organization, operation, and termination of nonprofit corporations and trusts, and obtaining and maintaining exemptions for these organizations from federal income, state franchise, sales and use, and local ad valorem taxes. She serves as the Vice President of the Board of Directors for Mental Health America of Greater Dallas. Lee received her B.A., *magna cum laude*, from Tulane University and her J.D. with high honors from The University of Texas School of Law. She earned her LL.M. in taxation from New York University School of Law.
	**Michael B. Overstreet** is a tax and estate planning lawyer in Houston. Michael is also a Texas-licensed CPA. He is heavily involved with the Houston CPA Society, where he serves on the Membership Development Committee and is Vice-Chair of the International Tax Roundtable Group.

	**Alex Pilawski** is an associate in Meadows, Collier, Reed, Cousins, Crouch, & Ungerman, L.L.P.'s State Tax Planning and Litigation practice in Dallas. His practice focuses on representing both individuals and businesses in disputes with the Texas Comptroller of Public Accounts. He has worked with taxpayers to successfully resolve their disputes during audit, through the administrative hearings process, as well as in state district court. Mr. Pilawski received his J.D. from Southern Methodist University Dedman School of Law.
	**Mishkin Santa** is an attorney with bar certifications in Texas and Washington in addition to the United States Tax Court. He has over 8 years of domestic and foreign tax controversy, representation, and resolution experience. He is a Partner at Five Stone Tax Advisers. In addition to his practice as an International Tax Attorney, his role as Partner oversees twenty associates and five tax divisions. Mr. Santa graduated from Seattle University with a Juris Doctorate in 2008 and Boston University with an LLM in Tax Law in 2009. He has been with Five Stone Tax Advisers in Austin since June 2013. He is currently a member of the Austin Bar Association and Hispanic Bar Association of Austin. He is an author of the "Offshore Perspectives" blog and publications. He provides educational presentations on new and cutting edge areas of domestic and international tax law.
	**John R. Strohmeyer**, with Crady, Jewett & McCulley, LLP in Houston, is a Board Certified tax and estate planning lawyer, focusing on international tax and estate planning for individuals. When he's not practicing law, he spends his time with his wife Emily and their Pomeranian Wesley, runs marathons (34 as of January 1, 2016), and volunteers with the Boy Scouts.
	**Tracy Turner,** with Brusniak Law, PLLC in Dallas, represents clients in a wide range of ad valorem property tax controversies. She has thorough experience dealing with office buildings, multi-family housing, retail, oil and gas, and aircraft property tax litigation. She assists taxpayers with business personal property valuation and litigation, special valuation appraisals, tax exemption applications and litigation for religious organizations, schools, and charitable organizations. She also testifies before Texas Senate and House of Representatives committees on taxpayer issues. Tracy received her J.D. from South Texas College of Law, and her B.A. in Communications from University of Colorado-Boulder.

Joy Williamson is an associate in Baker & McKenzie's Tax Practice Group in Dallas. She has extensive experience in several key areas of domestic and international tax such as subpart F and transfer pricing. She routinely represents taxpayers at various stages of tax controversies, including audit, administrative appeals, and judicial proceedings. She also has experience in domestic and international tax structuring and planning.

In Memoriam

of some of our fellow Tax Members we have lost this year

Harvie Branscomb
Past Tax Section Chair
1947-2015

Ken Gideon
2014 Texas Tax Legend Designee
1947-2016

Ira B. Shepard
2013 Outstanding Texas Tax Lawyer Award Recipient
1937-2016

Phllip L. Mann
2013 Texas Tax Legend Designee
1940-2016

Sam Merrill
2015-2016 Tax Section
Corporate Tax Committee Co-Chair
1980-2016

AVOIDING THE GUARDIANSHIP ALTERNATIVE

WESLEY L. BOWERS
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State Bar of Texas
Intermediate Estate Planning and Probate Course
Chapter 2

June 21, 2016
San Antonio, Texas

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Wesley L. Bowers is a shareholder with Fizer Beck, practicing estate planning, taxation, and probate law. He is Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization and is named as a Super Lawyers Texas Rising Star. He advises clients with regard to complex trust and estate matters, including tax planning, probate and estate administration, fiduciary law, charitable giving, marital property issues, and business succession planning. Wes is licensed to practice law in the State of Texas, and is a member of the State Bar of Texas (Real Estate, Probate and Trust; Taxation Sections), the Houston Bar Association (Probate, Trust, and Estate; Taxation Sections), the American Bar Association (Real Property, Trust and Estate Law Section), the Houston Business and Estate Planning Council, the Houston Estate Planner's Association, and the Houston Estate and Financial Forum. He is a frequent speaker at professional meetings and legal conferences on topics related to estate planning and probate. He received his B.A. from Baylor University in 2002 (*summa cum laude*, Phi Beta Kappa) and his J.D. from the Baylor University School of Law in 2007 (*cum laude*, Baylor Law Review). Prior to joining Fizer Beck in 2011, Wes worked as an attorney in the Trusts & Estates section at Fulbright & Jaworski, L.L.P.

EDUCATION:

Baylor Law School, Waco, Texas
J.D., *with Honors*, 2007; Baylor Law Review (Managing Executive Editor and Articles Editor); Student Bar Association (Vice President and Executive Treasurer); Joe Cannon Professionalism Award

Baylor University, Waco, Texas
B.A. in Political Science, *summa cum laude*, 2002; Phi Beta Kappa

PROFESSIONAL EXPERIENCE:

Fizer, Beck, Webster, Bentley & Scroggins, P.C., Houston, Texas
Shareholder, 2014 – present; Associate Attorney, 2011-2013

Fulbright & Jaworski L.L.P., Houston, Texas
Associate Attorney, 2007-2011

PROFESSIONAL ACTIVITIES AND HONORS:

Board Certified in Estate Planning and Probate Law, Texas Board of Legal Specialization, 2012
Texas Rising Star, Super Lawyers and Texas Monthly (2014, 2015, 2016)
Vice-Chair, Estate and Gift Tax Committee, Tax Section of the State Bar of Texas, 2013-2014
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Course Director, State Bar of Texas Intermediate Estate Planning and Probate Course, Dallas, Texas, June 2015
Planning Committee, State Bar of Texas Advanced Estate Planning and Probate Course, Dallas, Texas, June 2015

Presenter, *Lost in Translation: How to Apply What You Heard Today to What You Do Everyday*, State Bar of Texas Intermediate Estate Planning and Probate Course, San Antonio, Texas, June 2014

Presenter and Co-Author, *Estate and Gift Tax – Where Are We Now?*, State Bar of Texas Tax Law Survey in a Day, Dallas, Texas, February 2014

Planning Committee, State Bar of Texas Intermediate Estate Planning and Probate Course, San Antonio, Texas, June 2014

Presenter and Author, *Pulling It All Together: Strategies for Intermediate Planning*, State Bar of Texas Intermediate Estate Planning and Probate Course, Houston, Texas, June 2013

Planning Committee, State Bar of Texas Intermediate Estate Planning and Probate Course, Houston, Texas, June 2013

Presenter and Co-Author, *Irrevocable Life Insurance Trusts*, State Bar of Texas Intermediate Estate Planning and Probate Course, San Antonio, Texas, June 2012

Presenter and Co-Author, *ILITs: Failed Assumptions, Underperformance, and Fiduciary Liability*, State Bar of Texas Advanced Drafting: Estate Planning and Probate Course, Dallas, Texas, October 2011

Presenter, *What Now? Estate Planning In Light of the 2010 Tax Relief Act*, Northwestern Mutual Wealth Management Co., Houston, Texas, February 2011

Author, *Revocable Trusts: A Flexible Alternative to the Traditional Will*, Fulbright & Jaworski L.L.P. Client Briefing, Winter 2010

Author, *Dealing with the Rogue Executor: A Page From the Fiduciary Litigation Playbook*, The Advocate, The State Bar Litigation Section Report, Fall 2009

Author, *Estate Planning Opportunities in an Uncertain Economic Market*, Fulbright & Jaworski L.L.P. Client Briefing, Winter 2008

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AVOIDING THE GUARDIANSHIP ALTERNATIVE

I. INTRODUCTION

As medical technology and capabilities progress, our population is living to reach older ages, and sometimes with this advanced age comes diminished capacity, alzheimer's, and various forms of dementia. The increasing incidence of incapacity has caused many families to carefully plan for incapacity. Alternatively, the onset of dimentia causes a need for individuals and families who have not adequately planned for incapacity to engage in some disability and estate planning. This Article will discuss the legal standards of incapacity, planning for existing incapacity or future incapacity, and some of the ethical concerns facing an estate planning attorney in these areas.

II. STANDARDS OF INCAPACITY

All too often the initial meeting between estate planning attorney and client takes place at a time when the client's mental facilities have become impaired; or, the attorney never even meets the actual client but, rather, is contacted by the concerned spouse, child or other relative who informs the attorney that the client will not be joining them. The excuse may be that the client is not well enough to come to the office or that the client is not even conscious. In these situations, it is critically important for the estate planning attorney to consider whether the client has capacity to execute the documents at issue.

Technically, almost every conscious adult has some degree of legal capacity. The only relevant question is whether the specific degree of capacity possessed by the individual at any particular time equals or exceeds the degree required for the act in question. The cases speak of two general types of capacity, contractual and testamentary, yet there is significant overlap between the two, particularly as to contractual endeavors, such as the execution of a beneficiary designation or a stand by revocable trust. Like the execution of a will, those acts have very little lifetime impact on the individual.

A. Testamentary Capacity

1. <u>Statutory Provision</u>

Section 251.001 of the Texas Estates Code sets forth a two part test for testamentary capacity. The first component is a status and age requirement: In order to have testamentary capacity, the individual must (i) have attained eighteen years of age, or (ii) be or have been lawfully married, or (iii) be a member of the armed forces of the United States or of the auxiliaries thereof or of the maritime service at the time the Will is made. Whether a particular individual satisfies this objective test is rarely an object of much controversy.

The second requirement of § 251.001 is that the testator be "of sound mind." This subjective component of the testamentary capacity test is the inquiry relevant to this article and is a frequent object of controversy. Frequently, the reporting cases simply reference the question of the testator's sound mind as one of "testamentary capacity," without mention of the status and age component.

2. <u>Judicial Development of the "Sound Mind" Requirement</u>

a. Five Part Test--Current Rule

In order for an individual to be of sound mind, the evidence must support a *jury finding* that the individual possesses the following characteristics:

- Sufficient ability to understand the business in which he is engaged;
- Sufficient ability to understand the effect of his act in making the will;
- The capacity to know the objects of his bounty;
- The capacity to understand the general nature and extent of his property; and
- "memory sufficient to collect in his mind the elements of the business to be transacted, and to hold them long enough to perceive, at least their obvious relation to each other, and to be able to form a reasonable judgment as to them."

Prather v. McClelland, 76 Tex. 574, 13 S.W. 543 (Tex. 1890).

b. Old Four Part Test--No Longer the Law

Numerous earlier decisions of the courts of civil appeals have approved a short form definition of testamentary capacity that ignores the fifth "memory requirement." *See, e.g., Gayle v. Dixon*, 583 S.W.2d 648, 650 (Tex. Civ. App.--Houston [1st Dist.] 1979, writ ref'd n.r.e.). However, the prudent practitioner should not attempt to rely on these cases.

One commentator has suggested that the fifth requirement is very important and that, if the testator is not able to realize that a relationship exists between the separate elements, he "is probably not competent to make a will." Marschall, Will Contests, TEXAS EST. ADMINISTRATION 204 (1975). Failure to use the long form, at the very least, present an argument for appeal. *See Gayle v. Dixon*, 583 S.W.2d 648 (Tex. Civ. App.-Houston [1st Dist.] 1979, writ ref'd n.r.e.). E. BAILEY, TEXAS PRACTICE - TEXAS LAW OF WILLS § 172, at 41 (Supp. 1982) ("the safer case would be to use the long form, where it is requested by either party at trial, or where either party objects to omission of the final element").

The more recent cases consistently use the long form. *Bracewell v. Bracewell*, 20 S.W.3d 14, 19 (Tex. App.—Houston [14th Dist.] 2000, no pet.); *Campbell v. Groves*, 774 S.W.2d 717, 718 (Tex. App.--El Paso 1989, writ den'd); *Alldridge v. Spell*, 774 S.W.2d 707, 774 (Tex. App.--Texarkana 1989, no writ); *Broach v. Bradley*, 800 S.W.2d 677, 680-81 (Tex. App.--Eastland 1990, writ denied); *Kenney v. Estate of Kenney*, 829 S.W.2d 888, 890 (Tex. App.--Dallas 1992, no writ); *but see Hoffman v. Texas Commerce Bank*, 846 S.W.2d 336, 340 (Tex. App.--Houston [14th Dist.] 1992, writ denied) (short form definition of testamentary capacity used).

c. Lucid Intervals

Testamentary capacity on *the day the will was executed* is all that is required, *Croucher v. Croucher*, 660 S.W.2d 55 (Tex. 1983) (medical evidence of incompetency could be considered regarding lack of capacity where the evidence was probative of testator's lack of testamentary capacity on the date of execution of the will), but evidence of incapacity at other times is generally relevant, *Lee v. Lee*, 424 S.W.2d 609, 611 (Tex. 1968) (evidence of incompetency at other times is admissible only if it demonstrates that the condition persists and has some probability of being the same condition which obtained at the time of the will's making); *Lowery v. Saunders*, 666 S.W.2d 226, 236 (Tex. App.--San Antonio 1984, writ ref'd n.r.e.); *Kenney v. Estate of Kenney*, 829 S.W.2d 888, 890 (Tex. App.--Dallas 1992, no writ). *Compare Alldridge v. Spell*, 774 S.W.2d 707, 710 (Tex. App.--Texarkana 1989, no writ) (evidence of incapacity at other times supported jury finding of lack of testamentary capacity notwithstanding direct evidence of capacity on the day the will was executed).

d. Lay Opinion Testimony Admissible

Lay opinion testimony of witnesses' observations of the testator's conduct, either prior or subsequent to the execution of the will, is admissible to show incompetency. *Kenney v. Estate of Kenney*, 829 S.W.2d 888, 890 (Tex. App.--Dallas 1992, no writ), citing *Campbell*, above, 774 S.W.2d at 719.

e. Prior Adjudication of Insanity--Presumption of Continued Insanity

A prior adjudication of insanity generally raises a presumption of continued insanity until the status of the individual has been changed by a subsequent judgment of the county court in a proceeding authorized for that purpose. *Bogel v. White*, 168 S.W.2d 309, 311 (Tex. Civ. App.--Galveston 1942, writ ref'd w.o.m.). A prior adjudication of insanity is admissible, but not conclusive, and the presumption of continuing insanity may be rebutted. Further, a prior adjudication of mental illness is also admissible, but not conclusive. *See Haile v. Holtzclaw*, 414 S.W.2d 916 (Tex. 1967). In *Haile*, fifteen days before the date he executed his will, the testator was determined to be mentally ill. He was committed to mental hospital, and the court appointed a temporary guardian for him. Nevertheless, the testator was found to have testamentary capacity. *Haile* was decided under TEX. REV. CIV. STAT. ANN. art. 5547-83, Acts 1957, p. 505, ch. 243, § 83, the predecessor to Health and Safety Code § 576.002. The current statute, unlike the statute applicable in *Haile*, specifically provides that the provision of mental health services does not limit the patient's mental capacity, the revised statutory language does not seem to alter the rule of admissibility.

f. Subsequent Adjudication of Insanity--Not Admissible

According to the Texas Supreme Court, an adjudication of insanity subsequent to the time of the execution of a will is not admissible. *See Carr v. Radkey*, 393 S.W.2d 806 (Tex. 1965) (appointment of guardian twenty-one days subsequent to execution of will inadmissable). *Compare Stephen v. Coleman*, 533 S.W.2d 444 (Tex. Civ. App.--Fort Worth 1976, writ ref'd n.r.e.). In *Stephen*, the trial court admitted evidence that, three days after the date he signed his will, the testator was adjudged incompetent to handle his affairs. The appellate court did not discuss whether this evidence was properly admissible, but simply noted that this subsequent adjudication did not raise a presumption of incapacity on the date the will was signed. The court upheld the trial court's finding that the testator had testamentary capacity. *See also* 9 LEOPOLD & BEYER, TEXAS LAW OF WILLS § 16.5 (Texas Practice 1992).

g. Insane Delusion

Even though the general requirements of testamentary capacity described above are satisfied, a will or an affected portion of a will may be held invalid on the basis of an "insane delusion" if (1) the testator was laboring under the belief of a state of supposed facts that did not exist, and (2) which no rational person could believe. While there is some authority that the second requirement may be satisfied only by showing that an organic brain defect or a functional disorder of the mind existed, *Spillman v. Spillman's Estate*, 587 S.W.2d 170 (Tex. Civ. App.--Dallas 1979, writ ref'd n.r.e.), there is also authority to the contrary, *Oechsner v. Ameritrust*, 840 S.W.2d 131, 134, (Tex. App.--El Paso 1992, writ denied) (court embraced Texas' 100 year old two-pronged definition of insane delusion, declining to adopt more detailed definition from other jurisdictions incorporating reference to, *inter alia*, organic brain defect and function disorder of the mind).

Examples of insane delusions are described by the court in *Lindley v. Lindley*, 384 S.W.2d 676,679 (Tex. 1964):

> Examples of such false beliefs are cases where the "testator believed, in spite of the fact that all of the evidence was to the contrary, that his son had been to the planet Mars and had conspired against the United States and should therefore be disinherited; or that his wife was plotting to kill him; or that his daughter had murdered his father; or that he was hated by his brothers and sisters who were bent on persecuting him."

Id. at 679. However, the clearly deluded client does not necessarily lack testamentary capacity. Rather, the delusion must affect the provisions in the will in order for the will to be invalidated based on insane delusion. *Bauer v. Estate of Bauer*, 687 S.W.2d 410, 411-12 (Tex. App.--Houston [14th Dist.] 1985, writ ref'd n.r.e.). The mere appearance of a delusion does not in and of itself prohibit a finding of testamentary capacity. *Campbell v. Groves*, 774 S.W.2d 717, 719 (Tex. App.--El Paso 1989, writ denied). ("A person could appear bizarre or absurd with reference to some matters and still possess the assimilated and rational capacities to know the objects of his bounty, the nature of the transaction in which he was engaged and nature and extent of his estate on a given date.")

B. Contractual Capacity

1. <u>In General</u>

Sections 41 and 42, *Contracts*, Texas Jurisprudence provides a concise summary of contractual capacity:

> To establish mental capacity to contract, the evidence must show that, at the time of contracting, the person appreciated the effect of what the person was doing and understood the nature and consequences of his or her acts and the business he or she was transacting. Mere mental weakness is not in itself sufficient to incapacitate a person; and mere nervous tension, anxiety, or personal problems do not amount to mental incapacity to enter into contracts. The fact that one has a firm belief in spiritualism is not sufficient to incapacitate a person, especially where the belief is founded on reading and other evidence deemed by the person to be sufficient.
>
> The provision of court-ordered, emergency, or voluntary mental health services to a person is not a determination or adjudication of mental incompetency, and does not limit the person's rights as a citizen, or the person's property rights or legal capacity. A person is presumed to be mentally competent, unless a judicial finding to the contrary is made. Absent proof and determination of mental incapacity, a person who signs a contract is presumed to have read and understood the document, unless the person was prevented from doing so by trick or artifice. In other words, it is presumed by law that every party to a valid contract had sufficient mental capacity to understand one's legal rights with respect to the transaction. The burden of proof with regard to overcoming this presumption rests on the person who asserts the contrary.

> Elderly persons are not presumptively incompetent. On the contrary, the disposition of property and the conduct of business affairs will be upheld where a grantor, though old and infirmed physically and mentally, nevertheless, responds to tests that are applicable generally to people in the ordinary experiences of life.

14 TEX. JUR. 3rd *Contracts* § 41-42 (Jan. 2016).

2. <u>Testamentary Capacity and Contractual Capacity Compared</u>

Less mental capacity is required for making a will than for entering into a contract. *Vance v. Upson*, 1 S.W. 179 (Tex. 1886); *Hamill v. Brashear*, 513 S.W.2d 602, 607 (Tex. Civ. App.--Amarillo 1974, writ ref'd n.r.e.). This statement of the general wisdom is certainly accurate, but it seems an oversimplification of the rule inasmuch as it implies that contractual capacity and testamentary capacity are substantively different.

A review and comparison of the respective authorities supports the view that the difference between contractual capacity and testamentary capacity is purely quantitative, not qualitative. Fundamentally, both tests look to the capacity of the individual to appreciate what he is doing and to understand the nature and effect of what he is doing. It is because of the differing nature and effect of contracts and wills that the requisites of this singular concept are different in the two circumstances.

Because a will has no legal effect until death and remains revocable during life, its execution cannot have any effect on the testator's own circumstances. The testator, therefore, need not have the capacity to understand the effect that signing a will has on his own circumstances (as there isn't any) in order to have the capacity to understand the effect of his act of making a will. On the other hand, the testator does need the capacity to know the objects of his bounty and the nature and extent of his property if he is to appreciate the nature and consequence of his making a disposition of his property at his death.

C. Capacity to Execute a Trust

Viewing contractual and testamentary capacity as two points on the same continuum of legal capacity not only helps put into perspective the level of capacity required to execute a trust, but is consistent with Texas Trust Code § 112.007, which provides that "[a] person has the same capacity to create a trust by declaration, inter vivos or testamentary transfer, or appointment that the person has to transfer, will, or appoint free of trust." It is the underlying effect of the trust that determines the requisite capacity to create the trust, which may be more analogous to the execution of a contract (e.g., the execution of an irrevocable gift trust) or a will (e.g., the execution of a nominally funded stand by revocable trust which, by its very nature, and until it is genuinely funded, has no more effect of the individual's property than a will). *See generally* Gibbs and Hanson, *Degree of Capacity Required to Create an Inter Vivos Trust*, TRUSTS AND ESTATES, December, 1993, p. 14; Bogert, Trusts & Trustees, 2nd Ed. Revised § 44 (1984); Fratcher, Scott on Trusts, 4th Ed. §§ 18 *et. seq* (1987).

Section 112.007 is not entirely clear on the standard for capacity to create a trust, however, it appears to say that the capacity to create an inter vivos trust is the same as the capacity to transfer; that the capacity to create a trust by testamentary transfer is the same as creating a will; and that the capacity to create a trust by appointment is the same as the capacity to appoint free of trust.

The capacity to transfer property is contractual capacity, thus the capacity to transfer property to a trust (e.g., an inter vivos trust) is arguably contractual capacity. The capacity to execute a will is testamentary capacity, therefore, the capacity to create a trust by will is testamentary capacity.

There is discrepancy among commenters and case law as to the requisite capacity for creating a trust (either inter vivos or testamentary). However, recent Texas case law seems to follow the trend that contractual capacity (as opposed to mere testamentary capacity) is needed to create a trust. *See Harrell v. Hochderffer*, 345 S.W.3d 652 (Tex. App—Austin 2011).

D. Capacity to Exercise Powers of Appointment

The donee of a power of appointment must have capacity to exercise such power. The donee has capacity to exercise the power if the donee has capacity to make a similar transfer of owned property. Restatement (Third) of Property: Wills & Other Donative Transfers § 19.8.

E. Capacity for Declaration of Appointment of Guardian

Tex. Estates Code § 1104.204 requires the witnesses of a Declaration of Guardian to attest that the declarant "appeared to them to be of sound mind," in the self-proving affidavit. Texas courts have defined "sound mind" to mean "testamentary capacity." *Bracewell v. Bracewell*, 20 S.W.3d 14, 19 (Tex. App.—Houston [14th Dist.] 2000, no pet.); *Tieken v. Midwestern State Univ.*, 912 S.W.2d 878, 882 (Tex.App.—Fort Worth 1995, no writ). Thus, it can be inferred that the capacity required to execute a declaration of appointment of guardian is testamentary capacity.

F. Adjudicated Incapacity

1. <u>Prior Law</u>

As indicated above, an existing adjudication of insanity generally raises a presumption of continued insanity. However, even under prior law, the fact that an individual had been adjudicated incompetent or that a guardian of his person or estate had been appointed did not necessarily mean that the individual was incapacitated for all purposes. Rather, the adjudication was simply evidence, albeit highly probative evidence, of incapacity.

2. <u>Current Law</u>

Effective September 1, 1993, the Texas statutes regarding guardianships were substantially modified. *See* Acts 1993, 73rd Leg., ch. 957, § 1. The underlying policy and purpose of the guardianship law now requires that the court grant authority to the guardian "only as necessary to promote and protect the well-being of the person." TEX. EST. CODE ANN. § 1001.001. An application for the appointment of a guardian must state "the nature and degree of the alleged incapacity, the specific areas of protection and assistance requested, and the limitation of rights requested to be included in the court's order of appointment." TEX. EST. CODE ANN. § 1001.001. When a guardian is appointed, the ward "retains all legal and civil rights except those designated by court order as legal disabilities by virtue of having been specifically granted to the guardian." TEX. EST. CODE ANN. § 1151.001.

It appears that the effect of an adjudication entered after September 1, 1993, but before the execution of the will (or other instrument) is dependent upon the content of the court's order. For instance, if the order specifically takes away the right to make a will and the right to execute a trust or beneficiary designation (as unlikely as this may be), then it seems that a strong presumption of incapacity would exist. On the other hand, if the order's enumeration of disabilities is silent as to testamentary capacity, there should be no resulting presumption of lack of capacity; rather, the fact that the individual's mental capacity was before the court yet the court declined to take away his or her right to make a will could even help to support the opposite conclusion. Where the order simply recites that the guardian has full authority, the general rules applicable prior to September 1, 1993 should still apply.

G. Tools to Evaluate Capacity

Determining whether a client has capacity can be very tricky, especially for an attorney who is not a licensed medical or healthcare professional. Moreover, one must be cognizant that the client may be having a "good day" or moment of clarity at the time of the consultation (which could call for follow-up meetings, possibly at varying times of the day, to help gauge true capacity).

The American Bar Association has a detailed publication titled "Assessment of Older Adults with Diminished Capacity: A Handbook for Lawyers" that is very helpful resource for attorneys to use as they work through various incapacity issues: https://www.apa.org/pi/aging/resources/guides/diminished-capacity.pdf.

The American Bar Association also publishes the "Judicial Determination of Capacity of Older Adults in Guardianship Proceedings", which provides a framework that judges may find useful and effective in capacity determination (and which may be instructive to the practitioner):https://www.apa.org/pi/aging/resources/guides/judges-diminished.pdf.

Other assessment tools out there (among many) are "The Mini-Mental State Examination", the "PARADISE-2 Protocol" (designed to be used by people who are not healthcare professionals), and "CLOX: Clock Drawing Executive Test."

It is also important to remember that the setting of any client meeting could impact a person's performance or behavior, so the environment in which you conduct your meeting should be accommodating. For example, be mindful of temperature settings, loud background noises, proper lighting, etc. Also, speak slowly and enunciate, talk directly to the client, gauge whether written communication or oral communication works best, consider having an extra pair of reading glasses available, start with simple concepts and build at a slower pace, circle back to difficult material and check periodically that the client is retaining and understanding key concepts.

III. CREATION OF A GUARDIANSHIP

A guardianship can be an expensive and intrusive process. As part of the 1993 Texas legislation, there was a fundamental shift with respect to the philosophy on instituting a guardianship. Now, the central objective is to avoid placing a full guardianship over an incapacitated person if a less intrusive guardianship can be employed. See Stanley M. Johanson, Johanson's Texas Estates Code Ann., Tex. Estates Code § 1001.001 commentary (2014 ed.).

A court may appoint a guardian with either full or limited authority over an incapacitated person, as indicated by the incapacitated person's actual mental or physical limitations and only as necessary to promote and protect the well-being of the incapacitated person. Tex. Est. Code § 1001.001.

Tex. Estates Code § 1002.017 defines an "Incapacitated person" for purposes of a guardianship proceeding to include an adult who, because of a physical or mental condition, is subsequently unable to provide food, clothing, or shelter for himself or herself; care for the person's own physical health; or manage the person's own financial affairs.

Additionally, a reference in Texas law to any of the following means an incapacitated person:

1) A person who is mentally, physically or legally incompetent;
2) a person who is judicially declared incompetent;
3) an incompetent or an incompetent person;
4) a person of unsound mind; or
5) a habitual drunkard.

Recent legislation in 2015 goes even further to expand the policy of avoiding a full guardianship if less intrusive options are available. One goal behind exploring alternatives to guardianships is to allow the proposed ward to receive help but maintain as much independence and freedom from court supervision as possible.

Before a guardianship proceeding is filed, the applicant must now certify to the court that alternatives to guardianship have been explored. The application must now state whether alternatives and supports and services were considered, and whether any that are available to the proposed ward are feasible and would avoid the need for a guardianship. TEX. EST. CODE ANN. § 1101.001. In addition, in describing the alleged incapacity, the application should state whether the proposed ward's right to make personal decisions regarding a residence should be terminated. *Id*. (Another new requirement is that the applicant's attorney must now successfully complete the ad litem certification course, which is increased from three to four hours, with one hour devoted to alternatives and supports and services - TEX. EST. CODE ANN. § 1054.201).

Before appointing a guardian, the court must find by clear and convincing evidence that alternatives and supports and services were considered but are not feasible. TEX. EST. CODE ANN. § 1101.101. A finding that the proposed ward lacks capacity to do some, but not all, necessary tasks requires the court to specifically state whether the proposed ward lacks the capacity, with or without supports and services, to make personal decisions regarding residence, voting, operating a motor vehicle, and marriage. *Id*. The order must include these findings and must state the specific rights and powers retained by the ward either with the need for supports and services, or without that need. *Id*.

Section 1002.0015 of the Texas Estates Code provides that alternatives to guardianship *include* the following:

- execution of a medical power of attorney;
- appointment of an agent under a durable power of attorney;
- execution of a declaration for mental health treatment;
- appointment of a representative payee to manage public benefits;
- establishment of a joint bank account;
- creation of a Chapter 1301 management trust;
- creation of a special needs trust;
- designation of a guardian before a need arises; and

- establishment of alternate forms of decision-making based on person-centered planning.

Subtitle I of the Texas Estates Code (Chapters 1351 through 1356 set various special proceedings and alternatives to guardianship (several of which are addressed in this paper), which include:

- Sale of minor's interest in property without guardianship (Chapter 1351)
- Sale of ward's property without guardianship of the estate (Chapter 1351)
- Mortgage of minor's interest in residence homestead (Chapter 1352)
- Management and control of incapacitated spouse's property (Chapter 1353)
- Receivership for estates of certain incapacitated persons (Chapter 1354)
- Payment of certain claims without guardianship (Chapter 1355)

Rather than focus on the creation of a guardianship, this paper will explore options available to avoid a guardianship through other mechanisms that are available (both after incapacity has occurred and prior to such time), which include some of those less restrictive alternatives outlined above. For a more comprehensive listing of less restrictive alternatives to guardianship, see the attached Appendix B (reprinted with permission from *The Role of the Ad Litem (The Ad Litem Manual 2016)*, by the Honorable Steven M. King, Judge, Tarrant County Probate Court Number One).

IV. EXISTING INCAPACITY: PLANNING BY COMPETENT SPOUSE - CHAPTER 1353

Where the incapacitated individual is married, there are several planning opportunities available, involving both the competent spouse's management rights over the community estate, as well as the competent spouse's ability to plan with his or her own property in such a manner as to take advantage of the incapacitated spouse's tax elections.

A. Community Property Management by Competent Spouse--Family Code Provisions

Texas Family Code Chapter 3, Section 3.102, Managing Community Property provides a framework for the management of marital property. The code provides for the joint management and control of community property other than the sole management community property of the other spouse; however, these provisions are much more limited and restrictive than the Probate Code provisions dealing with the same subject matter, which are discussed below.

1. Competent Spouse's Sole Management Community

The competent spouse always has the sole authority to manage what is commonly referred to as "his" or "her" sole management community property, that is, that portion of the community estate that he or she would have owned if single. Texas Family Code §3.102(a).

A separate section of the Texas Insurance Code essentially provides that a spouse's life insurance issued in his or her name is sole management property. TEX. INS. CODE ANN. § 1113.001.

2. Remaining Community Estate: General Rule

Where sole management community of one spouse has been co-mingled with the other spouse's sole management community, the result is "joint management" community. Neither spouse acting alone can dispose of joint management community; both spouses must act jointly. *Williams v. Portland State Bank*, 514 S.W.2d 124 (Tex. Civ. App.--Beaumont 1974, writ dism'd). However, the spouses can agree that the joint management property can be managed by one spouse. Texas Family Code §3.102(c).

3. Management Rights in "Unusual Circumstances"

Under the previous version of the Texas Family Code § 5.25, "Unusual Circumstances," set forth a detailed set of rules and procedures that one spouse can follow in order to obtain sole management rights over both the joint management community and the sole management community of the incapacitated spouse. This provision was removed from the Family Code in 1997. The family code no longer provides for management of community property in the event of incapacity, with the exception of management of the homestead. Texas Family Code §5.003.

a. Applicability to Homestead

A procedure is available to empower the competent spouse, acting alone, to dispose of the couple's homestead, whether it be the competent spouse's separate property or the couple's community property, if the other spouse has been judicially declared incapacitated. See Texas Family Code § 5.002 (where homestead is the separate property of the competent spouse) and § 5.003 (where the homestead is community property).

4. Fraud on the Community

Where community property is gifted away by one spouse acting alone, the other, non consenting spouse may have the right to void the transaction as a constructive fraud upon the community. *See, e.g., Givens v. Gurard Life Ins. Co.*, 480 S.W.2d 421 (Tex. Civ. App.--Dallas 1972, writ ref'd n.r.e.), *reversed on other grounds by State Farm Ins. Co. V. Martinez*, 216 S.W.3d 799 (Tex. 2007). However, in circumstances other than divorce, the rule is generally applicable only where the gift was made to an unrelated individual and only where the non-consenting spouse is not otherwise adequately provided for in the transferring spouse's will. *See id*; and *Korzekwa v. Prudential Ins. Co.*, 669 S.W.2d 775 (Tex. App.--San Antonio 1984, writ dism'd w.o.j.) (changing community owned life insurance policy beneficiary designation from wife to daughter from a prior marriage held not constructively fraudulent where wife was residuary beneficiary under the will).

The fraud on the community doctrine should not generally be a problem with regard to appropriate transfers by the competent spouse. Generally, the donative transfers involved will be to the couple's children and to trusts for them. Practically speaking, the incompetent spouse is likely to be the first to die, and if the competent spouse is the executor, it seems unlikely that there will ever be a challenge.

Nevertheless, the arguable voidability rights of the incapacitated spouse should be addressed in all proposed transactions. The same voidability issues applicable to powers of attorney should be applicable to the competent spouse's unilateral transfer of his or her own sole management community.

B. Community Property Planning by the Competent Spouse--Estates Code Chapter 1353

Effective September 1, 1993, and as amended in 2001 (to remove references to similar provisions of the Family Code which were no longer in existence), and again in 2003, Texas Estates Code Chapter 1353 allows a spouse with capacity to manage the entire community estate independently when the other spouse is judicially declared incapacitated.

1. Complete Community Management Rights Upon Declaration of Incapacity—Chapter 1353

a. Statutory Provision

Texas Estates Code § 1353.002 provides, *inter alia*, as follows:

> Except as provided by Section 1353.004, when a spouse is judicially declared to be incapacitated, the other spouse, in the capacity of surviving partner of the marital partnership, acquires full power to manage, control, and dispose of the entire community estate, including the part of the community estate that the incapacitated spouse legally has the power to manage in the absence of the incapacity, without an administration, as community administrator with an administration.

The impact of this provision is hard to overstate. Without any qualification, without any bond, without any need to provide an accounting to anyone, § 1353.002 gives the competent spouse complete power over the community estate, as if the entire estate were his or her sole management community (subject to the provisions of § 1353.051, discussed below). Even where a guardianship is created on behalf of the incapacitated spouse (either because there is separate property, over which the competent spouse cannot obtain management rights, or for other reasons), the statute clearly provides that "[the] qualification of a guardian of the estate of the separate property of an incapacitated spouse does not deprive the spouse who is not incapacitated of the right to manage, control, and dispose of the entire community estate as provided by this title." Texas Estates Code § 1353.003(b).

There are limits, however, to the qualification of the spouse as community administrator. If that spouse is removed as community administrator, if the court finds that such spouse would be disqualified to serve as guardian under Subchapter H, Chapter 1104 of the Estates Code, or if the court finds the spouse not suitable to serve as community administrator for any other reason, then the court is to appoint a guardian of the estate of the incapacitated spouse and may order delivery of the incapacitated spouse’s one-half of the joint management community property to the guardian of that spouse’s estate. Texas Estates Code § 1353.004(c). Furthermore, during the incapacity determination, the court is required to appoint an attorney ad litem to represent the interests of the incapacitated spouse. Texas Estates Code § 1353.151. The community administrator is required to notify the court of any suit for dissolution of the marriage of the incapacitated spouse and the community administrator, as well as any lawsuit which names the incapacitated spouse as a defendant. Texas Estates Code § 1353.053.

b. Accounting and Inventory by Community Administrator

Section 1353.051 of the Estates Code provides that, on its own motion or on the motion of an interested person for good cause shown, the court may order a community administrator to file a full, verified and detailed inventory. Additionally, at any time after the expiration of 15 months from the date the incapacity is judicially declared, the court may, on its own motion or that of an interested party showing good cause, order the community administrator to file a full accounting. Texas Estates Code § 1353.052. Accountings may not be required more frequently than once every twelve months. Texas Estates Code § 1353.052.

c. Temporary Guardianship Insufficient

There must be an actual judicial determination of incapacity in order to trigger Chapter 1353. For this purpose, the appointment of a temporary guardian is not a judicial determination. In *Houston Bank & Trust Company v. Lee*, 345 S.W.2d 320 (Tex. Civ. App.--Houston 1961, writ dism'd), which interpreted the prior statute, the probate court had appointed a temporary guardian and, in its order, had recited that the spouse was not mentally competent to conduct his own business and personal affairs. Nevertheless, this was not sufficient to activate Chapter 1353 because the probate court's appointment of the temporary guardian was not a final judgement and, as such, did not constitute a judicial declaration that the spouse was incapacitated. *Lee*, 345 S.W.2d at 324.

d. Potential Uncertainty in Less Than Full Guardianships

A judicial declaration of incapacity or an appointment of a guardian may be for a traditional full guardianship or for a guardianship in which the ward retains certain enumerated rights and powers. In the latter case, and depending on the wording of the order, it may be that the court's order is not broad enough to constitute a judicial declaration of incapacity for purposes of Chapter 1353. Suffice it to say that the practitioner should carefully review the order and, where possible, ensure that the wording of the order includes language strong enough (perhaps via a specific reference) to invoke Chapter 1353.

2. <u>Delivery of Property to Competent Spouse</u>

Whenever any guardian, temporary or otherwise, has been appointed for a married person, Texas Probate Code § 1353.054 directs the guardian to deliver all community property in his possession to the competent spouse, on demand, if the spouse becomes a community administrator pursuant to Chapter 1353.

3. <u>Homestead Property</u>

In the case of a community owned homestead, Texas Family Code § 5.002 flatly provides that, where one spouse has been judicially declared incapacitated, the other spouse "may sell, convey, or encumber the homestead without the joinder of the other spouse."

C. Gift Splitting by Competent Spouse

Under I.R.C. § 2513, a gift to a third party made by one spouse may be treated as having been made equally by both spouses. The most common use of this provision, especially in common law states, is to make two annual exclusions available for present interest gifts, thus allowing up to $28,000 per donee to pass tax free. *See* I.R.C. § 2503(b). (In community property states, gift splitting is less important because gifts of community property are already "split"). As to gifts that exceed the combined annual exclusion limits of the spouses, or which for other reasons do not qualify for the exclusion, gift splitting has the effect of utilizing the unified credits (*see* I.R.C. §§2505 and 2010) and GST Exemptions (*see* I.R.C. § 2631) of both spouses.

Under the facts in a private letter ruling, the wife was terminally ill. One month before her death, the husband made a transfer into what appears to have been essentially a QTIP style trust (for the wife for life, remainder over to issue). *See* I.R.C. § 2513(a). The Service held that the husband, as the executor of the wife's estate, could make the gift splitting election, thus causing the wife to be treated as the donor/transferor of one-half and triggering automatic allocation of the wife's unified credit as well as her GST Exemption to the trust. Letter Ruling 9404023.

1. <u>Gifts of Competent Spouse's Property are Sheltered by Incompetent Spouse's Credits and Exemptions</u>

The competent spouse needs no special authority to make the gift, inasmuch as the gift is of his or her own property. (If the gift will be of community property, see Parts VI,B and VI,C of this Article.) Of course, the competent spouse must have sufficient separate property of his or her own.

The technique is especially useful (i) where an ongoing program of annual present interest gifts (out of the competent spouse's property) is contemplated, (ii) where the incompetent spouse does not have sufficient properties of his or her own to fully utilize his or her unified credit or GST Exemption, and (iii) where the competent spouse does not have authority under a durable power of attorney, revocable trust, or applicable state law to make donative transfers of the incompetent spouse's property. Note, however, that a spouse cannot make a gift to the community estate. *Higgins v. Higgins*, 458 S.W.2d 498 (Tex. Civ. App.--Eastland 1970, no writ). If the competent spouse desires to enhance the wealth of the incapacitated spouse, it must be by a gift to his or her separate estate.

2. <u>Election (and Return) Required</u>

Unlike the case with community property gifts, gift splitting must be affirmatively elected by both spouses on a return. Treas. Reg. § 25.2513-2. Thus, the competent spouse's actual making of the gift is only the first required step. Subsequently, someone acting on behalf of the incompetent spouse must make the gift splitting election, either on a return for the incompetent spouse or on the return for the competent spouse. Treas. Reg. § 25.2513-2. In the author's experience, most often this is achieved by separate returns for each spouse, since only one return is allowed only if all gifts are under the annual exclusion (for both spouses) and are present interest gifts. If GST Exemption is to be allocated, it is best to have both spouses do a complete, formula GST Exemption allocation on their own return. See IRS Form 709 instructions: http://www.irs.gov/pub/irs-pdf/i709.pdf.

a. Election by Attorney in Fact

It appears clear that the competent spouse, if duly authorized by a valid durable power of attorney, may signify the consent of the incompetent spouse. Treasury Regulation § 25.6019-1(h) implicitly authorizes the filing of a gift tax return (and the making of, *inter alia*, the gift splitting election) by another individual--even where the individual is not acting under a durable power of attorney signed by the donor--whenever the donor is not able to file the return due to illness, absence, or nonresidence, but provides that the donor must ratify the return within a reasonable time after regaining his health, etc. *See* Rev. Rul. 54-6 1954-1 C.B. 205. Whether this ratification requirement applies to returns filed under a valid power of attorney is unclear; the risk-averse client may want to obtain such a ratification, if and when the incompetent spouse regains his or her capacity.

If a client has planned effectively for incapacity, thus obviating a need for a guardian, the regulation noted above can be very troubling to the estate planning attorney if the incapacitated person is not expected to regain capacity. The following is language that the author has previously used in this scenario, **<u>but please understand there is no legal authority for the agent ratifying a gift tax return.</u>**

The Donor's enclosed year xxx United States Gift (and Generation-Skipping Transfer) Tax Return was signed by Jane Doe, as attorney-in-fact. Pursuant to IRC Regulation §25.6019-1(h), Jane Doe, as attorney-in-fact, hereby notifies the IRS that due to severe illness, the Donor lacked the capacity to make or file the year xxx return. The Donor does not have a court appointed guardian. Accordingly, the only individual with the authority to act on behalf of the Donor is Jane Doe, as Donor's attorney-in-fact. Further, due to Donor's continuing incapacity, Donor is unable to ratify such year xxx return. On behalf of Donor, as his attorney-in-fact, Jane Doe, under penalties of perjury, does hereby declare that she has carefully examined Donor's year xxx United States Gift (and Generation-Skipping Transfer) Tax Return, including any accompanying schedules and statements, and to the best of her knowledge and belief, such returns are true, correct, and complete, and does hereby ratify the returns as the Donor's.

Attached is a true and correct copy of the Donor's Durable Power of Attorney, which grants Jane Doe, as attorney-in-fact, the ability to make gifts and file gift tax returns on his behalf. (See Article xxx section xxx thereof.)

b. Election by Executor

The regulations clearly allow the executor of a deceased spouse to make the election where the spouse died and no previous election has been made. Treas. Reg. § 25.2513-2(c). However, gift splitting is possible only with respect to gifts made prior to the spouse's death. Rev. Rul. 55-506, 1955-2 C.B. 609. *See also* Rev. Rul. 67-55, 1967-1 C.B. 278 (where no executor is appointed for the spouse's estate, the surviving spouse may act as administrator and effectuate the consent), and Treas. Reg. § 25.6019-1(g) (executor of a deceased donor shall file any required gift tax return).

D. Provisions for Surviving Spouse's Will

After the incapacity (or death) of one spouse, changes to the overall estate plan can be exceedingly difficult because only one of the two Wills providing for the distribution of the combined assets can be changed. The difficulties in achieving the revised overall distribution can be mitigated if the surviving spouse has a power of appointment over the assets held in trust for his or her benefit, after the death of the first spouse to die. However, where there is no power of appointment, or where it is unclear in what order the spouses will die (e.g. whether the incapacitated spouse will die second, leaving his or her will to be final and controlling for one-half of the community property), creative drafting in one spouse's Will could allow you to achieve the client's wishes. In these cases, it is important to look at the overall assets, the distributions provided for in the Will that cannot be changed, and adjust the Will that can be changed accordingly. Included as Appendix A is language for reaching the intended distributions of the combined estates after the death of one spouse where the surviving spouse did not have a power of appointment over the bypass trust.

V. EXISTING INCAPACITY: RECEIVERSHIP FOR ESTATES OF CERTAIN INCAPACITATED PERSONS – CHAPTER 1354

A judge of a probate court in the county in which an incapacitated person resides or in which his endangered estate is located shall, with or without application, enter an order appointing a suitable person as receiver to take charge of the estate if:

• it appears all or part of the estate of the incapacitated person is in danger of injury, loss, or waste and in need of a guardianship or other representative;
• there is no guardian of the estate who is qualified in Texas; and
• a guardian is not needed.

Tex. Estates Code § 1354.001(a).

The court order must specify the duties and powers of the receiver the judge considers necessary for the protection, conservation and preservation of the estate. § 1354.001(b). The receiver appointed under § 1354.001 must give a bond, as in ordinary receiverships, in an amount the judge considers necessary to protect the estate. Tex. Estates Code § 1354.002.

If during the receivership, the needs of the incapacitated person require the use of the income or corpus of the estate for the education, clothing, or subsistence of the person, then the judge shall, with or without application, enter an order in the judge's guardianship docket that appropriates an amount of income or corpus sufficient for that purpose. Tex. Estates Code § 1354.004.

If the receiver has possession of an amount of money belonging to the incapacitated person in excess of the amount needed for current necessities and expenses, then he may, under direction of the judge, invest, lend, or contribute all or part of the excess money in the manner, for the security, and on the terms provided by this title for investments, loans or contributions by guardians. Tex. Estates Code § 1354.005.

All necessary expenses incurred by a receiver in administering the estate may be reported monthly to the judge in a sworn statement of account. Tex. Estates Code § 1354.006(a). A receiver is compensated for services provided in the receiver's official capacity in the same manner and amount for similar services provided by a guardian of an estate. Tex. Estates Code § 1354.006(c).

When the threatened danger has abated and the estate is no longer liable to injury, loss, or waste because there is no guardian or other representative of the estate, the receiver shall report to the judge and file a full and final sworn account. Tex. Estates Code § 1354.007.

VI. EXISTING INCAPACITY: PAYMENT OF CERTAIN CLAIMS WITHOUT GUARDIANSHIP – CHAPTER 1355

Where a person ("debtor") owes money to an incapacitated person or the former ward of a guardianship that was terminated ("creditor"), the debtor may pay the money he owes to a county clerk for the benefit of the creditor. See Tex. Estates Code §§ 1355.001 and 1355.002.

For Ch. 1355 to apply, the debt owed must be $100,000 or less, and the right to the money must be liquidated and uncontested in any pending lawsuit. Tex. Estates Code § 1355.001(a); § 1355.002(a).

If the creditor is a resident of Texas, then payment should be made to the county clerk of the county in which the creditor resides, to the account of the creditor. § 1355.001(c).

The debtor of a non-resident creditor may pay the money to (i) the creditor's guardian that is qualified in the creditor's domiciliary jurisdiction; or (ii) the county clerk of any county in Texas in which real property owned by the creditor is located, or, if the creditor is not known to own real property in Texas, then in the county in which the debtor resides. Tex. Estates Code § 1355.002.

The receipt for the money signed by the county clerk is binding on the resident creditor as of the date of receipt and to the extent of the payment. § 1355.001(d); § 1355.002(e). Upon receipt of the money, the county clerk must mail a letter to the creditor apprising him that the deposit was made and bring the payment to the court's attention. § 1355.001(e); § 1355.002(f). On receipt of the payment, the county clerk must invest the money under court order in the name and for the account of the creditor. Tex. Estates Code § 1355.051.

No later than March 1 of each year, the court clerk must make a written report to the court of the status of an investment made by the county clerk. Tex. Estates Code § 1355.052.

If the incapacitated person is a resident creditor, then the following persons may serve as custodian of the resident creditor: a parent of the creditor, an unestranged spouse of the creditor, or if there is no spouse and both of creditor's parents are dead or nonresidents of Texas, then the person who resides in Texas and has actual custody of the creditor. § 1355.102.

The resident creditor's custodian may withdraw the money from the county clerk for the creditor's use and benefit if the custodian files with the clerk an application and a bond approved by the county judge. § 1355.103(a). The bond, which is twice the amount of the money to be withdrawn, must be conditioned that the custodian will use the money for the resident creditor's benefit under the court's direction. § 1355.103(b). The custodian may not receive a fee or commission for handling the money withdrawn. § 1355.103(c). The custodian must file with the county clerk a sworn report of the custodian's accounting. § 1355.104.

Under § 1355.105, which applies to both residents and non-residents, if the money is not withdrawn by an authorized person, then on presentation to the court clerk of an order of a county or probate court of the county in which the money is held, the money may be withdrawn by: (i) the creditor, after termination of his disability; (ii) a subsequent personal representative of the creditor; or (iii) the creditor's heirs. § 1355.105.

VII. EXISTING INCAPACITY: TAX MOTIVATED, CHARITABLE, AND NONPROFIT GIFTS ON BEHALF OF ADJUDICATED INCAPACITATED PERSONS -- CHAPTER 1162

A. Tax Motivated Gifts

1. <u>Conditions Precedent</u>

In order to take advantage of Texas Estates Code Chapter 1162, the guardian of the estate (or any interested party) must convince the court:

- that the ward will probably remain incapacitated for life;
- that any property proposed to be transferred from the ward's estate will not be required for the support of the ward or his or her family during the ward's life time;
- that income, estate, inheritance, or other taxes payable out of the ward's estate will be saved by the implementation of the proposed plan OR that the transfer will allow the ward to qualify for governmental benefits (the tax savings and any other benefits must be specifically outlined for the court); and

- that the proposed plan is consistent with the ward's intentions, if those intentions can be ascertained (if his intentions cannot be ascertained, it will be presumed that the ward favors reduction in the taxes payable out of his estate and the qualification for government benefits).

- note that the court **may** appoint a guardian ad litem for the ward or any interested party at any stage of the proceeding if it is deemed advisable for the protection of the ward or the interested party. Texas Probate Code §865(c)

Note also that a person making an application under Chapter 1162 must send a copy of the application, by certified mail, to all devisees under the ward's estate plan, the ward's spouse and dependents, and any other person directed by the court. Texas Estates Code § 1162.003.

2. <u>Planning Permitted</u>

If the court is persuaded, it may authorize the guardian to makes gifts, either outright or in trust, of real or personal property, to any of the following:

- a charity in which it is shown the ward "would reasonably have an interest;"

- the ward's spouse, descendant, or other person related to the ward by blood or marriage who are identifiable at the time of the order; and

- any devisee named in the ward's last validly executed will, trust, or other beneficial instrument if any. Section 1162.005 provides a procedure for the applicant under Chapter 1162 to obtain an inspection of certain instruments for estate planning purposes.

If the guardian qualifies under any of the above, he or she may be a donee. Implicitly, the court may authorize such transfers to take place at death, for instance, via a trust which is includable in the ward's estate (and thus available for the support of the ward and his family); however, the literal wording of the statute speaks in terms of present gifts rather than testamentary substitutes. The creative attorney might consider combining a Chapter 1162 application with the termination provisions for a Chapter 1301 trust (the old 867 management trust).

Chapter 1162 was amended in 2005 to include section 1162.004, which provides for the guardian to obtain approval of a gifting plan which spans several years without subsequent application to the court. This is available if the court finds it to be in the best interest of the ward or the ward's estate. Such an order can be set aside if the court finds the ward's financial condition has changed in such a manner that continuing the gifts is no longer in the best interest of the ward or the ward's estate.

B. Charitable Contributions

Subchapter B of Chapter 1162 provides detailed procedural steps and specific qualifications for making charitable gifts out of the ward's property; however, the subject matter of the statute seems completely covered by Subchapter A (as discussed above), inasmuch as Subchapter B authorizes, *inter alia*, charitable gifts. Arguably, the provisions of Subchapter B could be bootstrapped to any application under Subchapter A for a charitable gift; however, if the practitioner can proceed under Subchapter A, the requirements are less strenuous.

VIII. EXISTING INCAPACITY: MANAGEMENT TRUSTS FOR INCAPACITATED PERSONS--ESTATES CODE CHAPTER 1301

A. Overview of Uses of Chapter 1301 Management Trusts

1. <u>Generally</u>

Chapter 1301 management trusts will be appropriate whenever fees and expenses can be reduced by terminating the guardianship of the ward's estate in favor of a management trust, or if there is no guardianship, to reduce future fees and expenses by possibly avoiding a guardianship. This will be true in a broad range of circumstances.

Chapter 1301 now allows for a creation of a management trust where a guardian has not yet been appointed. Under the statute, an applicant for creation of the trust can be a person interested in the welfare of an alleged incapacitated person who does not have a guardian of the estate, and the statute provides for a procedure for determining incompetency prior to creation of the trust. Except in cases where an application is filed by a person who has only a physical disability, the appointment of an attorney ad litem, and possibly a guardian ad litem, is required to represent the interests of the alleged incapacitated person in the proceeding. Texas Estates Code § 1301.054.

If the value of the trust exceeds $150,000, the Chapter 1301 management trust will gain the advantage of professional, corporate management (except in cases where an application is filed by a person who has only a physical disability). Note, however, the court may appoint an entity or individual other than a financial institution as trustee if the court finds the applicant for creation of the trust, after the exercise of due diligence, has been unable to find a financial institution in the geographic area willing to serve as trustee. Texas Estates Code § 1301.057. Without regard to the value of trust assets, the Chapter 1301 management trust will allow the ward's property to be managed without the constant need for court approval of discretionary distributions, payment of expenses, and other day to day administrative actions.

If the guardianship or the incapacitated person's estate is large or if it is small, the utilization of a Chapter 1301 management trust will have the potential for a significant reduction in legal fees and court costs for the simple reason that administrative decisions that would otherwise require court approval may be made in the sole discretion of the trustee without the regular trips to the courthouse required in guardianships.

2. <u>Complete Termination of Guardianship</u>

The savings from a Chapter 1301 management trust can be fully realized only if *all* the property of the guardianship is transferred to the trustee and the ward's estate is closed, thus eliminating the need for further court supervision of the day to day administration of the ward's estate. Thus, although the statute permits the transfer of less than all of the property in the guardianship (and, implicitly, the continued court supervised administration of the ward's estate alongside the ward's Chapter 1301 management trust), this option will generally not be economically justifiable.

B. Creation of Chapter 1301Management Trusts

1. <u>Technical Requirements</u>

Texas Estates Code Chapter 1301 sets forth a few, but important, technical requirements.

a. Requirements of Applicant

Section 1301.051 provides that the person applying for the creation of the trust must be one of the following individuals:

i. Guardian of the estate of a ward;

ii. Guardian of the person of the ward;

iii. Guardian of both the person and estate of the ward;

iv. An attorney ad litem or guardian ad litem appointed to represent a ward or the ward's interests;

v. A person interested in the welfare of an alleged incapacitated person who does not have a guardian;

vi. An attorney ad litem or guardian ad litem appointed to represent an alleged incapacitated person who does not have a guardian; or

vii. A person who has a physical disability.

Note that amendments in 2013 liberalized the rules applicable to Chapter 1301 trusts for persons with only a physical disability, such that the disabled person may himself make application for establishing the trust, the court need not appoint an attorney ad litem or guardian ad litem, the trustee need not be a bank or trust company, and no fiduciary bond or accountings are required. See Stanley M. Johanson, Johanson's Texas Estates Code Ann., Tex. Estates Code § 1301.051 commentary (2014 ed.).

Where the guardian of the person, the guardian of the estate, and any guardian ad litem and/or attorney ad litem are in agreement, the whole issue can be avoided by having them all join in the application or by having one, preferably the guardian of the estate, file the application and having the others file a waiver indicating his or her approval of the creation of the Chapter 1301 management trust. Where one person is serving as guardian of the person and estate of the ward, that person should file the application in both capacities, and have any other parties named in § 1301.051 file a waiver.

b. Venue

It is no surprise that where a guardianship has been created, the only court authorized to entertain an application for creation of a Chapter 1301 trust for a ward is the probate or other court in which the ward's guardianship is pending. *See* § 1301.052.

Where a proceeding for the appointment of an incapacitated person is not pending on the date the application is filed, venue for the creation of the Chapter 1301 must be determined in the same manner as venue for a proceeding for the appointment of a guardian is determined under § 1023.001 of the Estates Code. *See* Texas Estates Code § 1301.052.

c. Trustee Qualifications

Chapter 1301 specifically requires except as provided by the statute, the court shall appoint a financial institution to serve as trustee if the value of the trust exceeds $150,000. As noted above, the exceptions to this are that the court may appoint an entity or individual other than a financial institution as trustee if (i) the management trust is for the created for a person who has only a physical disability; or (ii) the court finds the applicant for creation of the trust, after the exercise of due diligence, has been unable to find a financial institution in the geographic area willing to serve as trustee. Texas Estates Code § 1301.057.

If a corporate trustee is not required, the following are eligible for appointment as trustee of a Chapter 1301 management trust: (1) an individual, including an individual who is certified as a private professional guardian; (2) a nonprofit corporation qualified to serve as a guardian; and (3) a guardianship program.

d. Trust Must Be In Ward's Best Interest

The Court must be satisfied and must specifically find that the proposed management trust is in the best interest of the ward, and the application for creation of the trust should allege specific facts which are sufficient to support this finding.

Chapter 1301 does not specifically address what factors or circumstances the court may consider in making its finding that a Chapter 1301 management trust is in the best interest of a particular ward. In one sense, the creation of such a trust should always be presumptively in the ward's best interest simply by virtue of the significant savings in court costs and legal fees to the ward's estate, coupled with the fact that the trustee will be a trust company or bank. In most cases, these circumstances should be sufficient evidence to support the court's best interest finding.

Where the ward is a minor and the applicant desires to extend the trust beyond the ward's 18th birthday, additional considerations should be presented to the court in order to justify a court order keeping the money from the ward for 7 years beyond the date that he or she would otherwise be legally entitled to it (*i.e.*, extending the trust until age 25). *See* Texas Estates Code § 1301.203. Some of the more obvious considerations would include: the ward's physical condition and needs; the degree of emotional maturity of the ward; the size and kind of the property in the guardianship; the family situation of the ward; the desirability to provide more flexible investment powers over the guardianship assets; and the relative safety of the trust versus leaving the ward to his own devices upon attaining age 18.

e. Proper Trust Terms Must Be Included

The terms of a management trust under Chapter 1301 must conform to the requirements set forth in Texas Probate Code §§ 1301.101 - 1301.103. These requirements are discussed in detail in this article.

2. <u>Procedural Steps</u>

Many guardianship and probate practitioners have described the Chapter 1301 management trust as a § 142 trust that is available for an individual with a legal guardian or who the court finds to be incapacitated. (Under § 142.005 of the Texas Trust Code, if a minor or other incompetent is entitled to receive an award in a lawsuit, the guardian ad litem may request that the court create a § 142 trust to which the award will be paid. However, a § 142 trust is not available for a minor if the minor has a legal guardian.) Certain aspects of the two trusts are similar. However, while the creation of a § 142 trust involves a relatively simple process, the creation of a Chapter 1301 trust can be relatively detailed and complex. Over time, as local practices develop, the following steps may prove to be either too simple or too complex. For instance, it may become common practice to include the application to create the trust within the final account, rather than filing this application first (and separately) as set forth below. In any event, an advance telephone call to the judge or his or her staff attorney to determine the appropriate steps that need to be followed will be advisable.

Where no guardianship is in place, the funding of the trust should be more straightforward as no guardianship needs to be closed. *See* Texas Estates Code §§ 1301.053–1301.056.

The following steps for the most part presume that a guardianship is in place, and all interested parties are in favor of the creation of a Chapter 1301 management trust and that all of the property in the guardianship will be transferred into the trust.

a. Timing

Typically, upon the creation of a Chapter 1301 trust, the guardianship of the ward's estate can and should be terminated. This will necessitate a final accounting for the estate. Assuming that there is no compelling reason for haste, it may help reduce legal expenses to coordinate the application for a Chapter 1301 trust with the due date of the next annual accounting in the guardianship by filing the application a few weeks before the date that the annual accounting is due. In this manner, the information gathering and accounting efforts can be directed solely to the preparation of the final accounting and the estate can be closed before the letters of guardianship expire.

b. Application For Creation Of Chapter 1301 Management Trust And For Discharge Of Guardian Of Estate

The legal guardian of the ward should file an Application For Creation Of Chapter 1301 Management Trust And Discharge Of Guardian Of Estate. If the Applicant is also the ward's natural guardian or the court appointed guardian of the Ward's person, he or she should file the application in both capacities but expressly state in the Application that he or she will continue to serve as guardian of the person.

(1) *Detailed Prayer Outlining Steps To Follow*

A road map of the anticipated steps involved in creating a Chapter 1301 trust and terminating the estate will be a big help to the court. The Application should include a prayer for the following relief:

(a) that the court enter its order (i) creating a Chapter 1301 management trust for the ward, and (ii) directing the guardian to submit a Final Accounting;

(b) that upon the court's approval of the guardian's Final Accounting, the court enter its order (i) directing the guardian to pay his or her commission as well as any other outstanding debts, expenses, etc., of the guardianship as may be set forth in the Final Accounting; and (ii) directing the guardian deliver all the remaining property of the guardianship to the trustee; and

(c) that upon the guardian's delivery of all the remaining guardianship property to the trustee and the trustee's filing of its receipt of all the guardianship property, the court enter its order (i) discharging the guardian of the estate and the sureties on such guardian's bond from all future liability, and (ii) expressly holding the guardianship open for purposes of accepting, reviewing and approving the trustee's annual accountings and fee applications, and for the continued administration of the guardianship of the ward's person, if any. Also, as noted below, if the Applicant will continue as the guardian of the ward's person, this Order will need to specify (and the Application will need to so state) that the guardian of the person must obtain a new bond in an appropriate (presumably reduced) amount (to replace the single bond covering him or her as guardian of the person and estate).

(2) *Waiver Of Notice Of Hearing On Application For Creation Of Chapter 1301 Management Trust*

If the Applicant is not the guardian of the ward's person, a Waiver Of Notice Of Hearing On Application For Creation Of Chapter 1301 Management Trust, signed by the guardian of the person, if any, should be filed with the Application. If there is a natural guardian of the ward (other than the Applicant), a waiver from him or her should also be included. As discussed above, if no guardian has been appointed, waivers should be obtained from the persons described in Section 1301.051. Filing the waivers shows the court that there is no controversy among the interested parties as to the desirability of the trust and may be enough to persuade the court to create the trust without a hearing.

As an alternative to filing waivers, the guardian of the ward's person, the ward's natural guardian, the attorney ad litem or guardian ad litem if any, may join the guardian of the estate as Co-Applicants.

(3) *Terms of Trust*

The terms of the proposed trust should be attached to the Application. Optionally, the proposed trustee may sign the proposed terms of trust; however, the court could always appoint a different trustee and it is possible that the particular court may find it somewhat presumptuous to have a trustee accept the trust before the court has made its decision as to who the trustee will be. On the other hand, the court may prefer that the trustee sign off in advance so that the court may be assured that, once created, the trust will not lack a trustee.

c. Hearing on Application

The statute does not require a hearing if a guardian has already been appointed; however, the judge could well decide that a hearing is appropriate, especially if there is any indication of disagreement among the interested parties or any doubt as to whether the trust is in the ward's best interest. Likewise, the judge could appoint a guardian ad litem to assist the court in determining whether the trust would be in the ward's best interest.

If a guardian has not been appointed, the Court is to conduct a hearing to determine incapacity using the same procedures and evidentiary standards as required in a hearing for the appointment of the guardian for a proposed ward, and also find at the hearing that the trust is in the incapacitated person’s best interest.

d. Order Creating the Trust

If all goes well, the court will enter its Order (i) creating a Chapter 1301 management trust for the ward or incapacitated and (ii) directing the guardian to file his or her Final Accounting. Note that this particular order does not fund the trust, nor should the trustee's duties commence at this time. The court will not direct the guardian to fund the trust until after the court's approval of the final accounting.

e. Guardian's Final Accounting

The guardian should file his or her Final Accounting, in proper form. Typically, the final account will also include an application to receive commission. Note that the account must be posted for the minimum statutory period before proceeding.

f. Waiver of Notice of Hearing on Final Accounting

A file stamped copy of the Final Accounting, together with a proposed Waiver Of Notice Of Hearing On Final Accounting should be sent to the proposed trustee and to the guardian of the ward's person or the ward's natural guardian, if any, and possibly the other persons described in § 1301.051. These Waivers should be filed with the Court. (Note that, frequently, Courts insist that the Waivers be dated after the date that the Account is filed.)

g. Hearing on Final Accounting

There is no statutory requirement for a hearing prior to the Court's approval of a final accounting unless an objection has been filed; however, most courts will hold a hearing if any interested party has failed or declined to file a Waiver.

h. Order Approving Final Accounting and Directing Funding Of Chapter 1301 Management Trust

Again, if all goes well, the court will enter its Order (i) approving the Final Accounting; (ii) approving all expenses incurred and the requested commission; (iii) directing the guardian to pay all such approved expenses and commissions as well as any other outstanding debts, etc., of the guardianship as may be set forth in the Final Accounting; (iv) directing the guardian to deliver all the remaining property of the guardianship to the trustee; and (v) directing the guardian, upon delivery of the guardianship property to the trustee, to file his or her Application To Discharge Guardian Of Estate.

Section 1301.056 provides that the order creating the trust shall direct a person or entity holding property belonging to the person for whom the trust is created or to which that person is entitled to deliver all or part of such property to person or corporate fiduciary appointed as trustee of the trust.

i. Delivery of Property to Trustee; Trustee Receipt

The guardian will pay himself or herself the approved commission and make the other payments, if any, ordered by the Court, and then deliver the remaining property to the trustee. Upon receipt of the property as set forth in the Final Accounting, the trustee should file its Receipt of such property with the Court.

j. Application to Discharge Guardian of Estate

After the property of the guardianship has been fully distributed and the trustee has filed its Receipt, the guardian should file his or her Application to Discharge Guardian of Estate with the Court.

k. Order Discharging Guardian

The Court should then enter its Order discharging the guardian of the ward's estate and the sureties on such guardian's bond from all future liabilities. However, in order to avoid the risk that the case may be inadvertently closed (closing an estate is the typical next step after approval of a final accounting and discharge of the guardian), the Order should expressly hold the guardianship open for purposes of accepting, reviewing and approving the trustee's annual accountings and fee applications, and for the continued administration of the guardianship of the ward's person, if any. (Local practices of the court clerk may vary as to how the guardianship is kept active after the guardian is discharged.) Also, if the guardian of person and guardian of estate are the same person, a new bond in an appropriate (presumably reduced) amount (to replace the single bond covering him or her as guardian of the person and estate) will be required.

C. Terms of Chapter 1301 Management Trusts

The following discussion addresses the mandatory and optional terms and provisions of Chapter 1301 management trusts, as well as some of the areas of uncertainty in the law.

1. Distributions

a. Generally, Ward or Incapacitated Person Is Sole Beneficiary

The terms of trust *must* provide that "the ward, incapacitated person, or person who has only a physical disability is the sole beneficiary of the trust." Texas Estates Code § 1301.101. Thus, a single Chapter 1301 management trust may not be created for the benefit of more than one ward. For example, if three minor siblings have pending guardianships, three separate Chapter 1301 management trusts would have to be created, one for each of them.

On the other hand, even though the ward is the "sole" beneficiary of his or her own trust, distributions from the trust may be made for the benefit of any individuals whom the ward is legally obligated to support. Texas Estates Code § 1301.102.

b. Discretionary Distributions of Principal and Income for Ward or Incapacitated Person

The terms of the trust *must* provide that "the trustee *may* disburse an amount of the trust's principal or income as the trustee determines is necessary to spend for the health, education, maintenance, or support of the person for whom the trust is created." Texas Estates Code § 1301.101(a)(2) (emphasis added). Note that the trustee has discretion to distribute trust property in accordance with the standard; the trustee is not required to make distributions (as indicated by the use of "may" rather than "shall"). Thus, the trustee should have some latitude in declining to make a distribution.

On the other hand, the trustee is authorized to make distributions only where the trustee determines that the distribution is "necessary" in accordance with the distribution standard; the trustee is not allowed to make distributions on a mere determination that it would be "reasonable or appropriate." Thus, the trustee has less leeway in making generous distributions which could arguably exceed the amounts necessary for the ward's health, education, support, or maintenance. There is no authority on point; however, if the trustee ever desires to make a distribution that arguably is not "necessary" for the beneficiary, the trustee may be able (required?) to apply to the court for specific authority.

c. Optional Additional Discretionary Distributions Under Section 1301.102 To Ward's Guardian Or A Person In Possession Of The Ward

In addition to the mandatory provisions of Section 1301.101, Section 1301.102 authorizes inclusion in the trust instrument of provisions authorizing the trustee to distribute trust funds to the ward's guardian, to a person who has physical custody of the beneficiary (or a person the beneficiary is legally obligated to support), or to a person providing a good or service to the beneficiary (or a person the beneficiary is legally obligated to support) for the health, education, support, or maintenance of the beneficiary (or another person whom the beneficiary is legally obligated to support). The apparent dual purpose of this provision is (i) to allow the trustee to reimburse certain persons who have expended (or plan to expend) funds in caring for the ward, and (ii) to allow distributions for the ward's dependents.

(4) *Comparing § 1301.101 and § 1301.102 Distributions*

Both sections 1301.101 and 1301.102 provide for distributions for "health, education, maintenance, or support." However, (i) § 1301.101 distributions are for the ward or incapacitated person only, while § 1301.102 distributions may be made for either the ward or incapacitated person or any person whom the ward or incapacitated person is legally obligated to support; (ii) § 1301.101 is silent as to the method of payment, while § 1301.102 payments are to be made only to the ward's guardian, to a person who has physical custody of the trust beneficiary or another person to whom the trust beneficiary is legally obligated to support, or to a person providing a good or service to the trust beneficiary or another person whom the trust beneficiary is legally obligated to support; (iii) § 1301.101 allows for distributions of "income or principal," while § 1301.102 provides for distribution of "trust funds"; and, of course, (iv) § 1301.101 is mandatory while inclusion in the trust instrument of the distribution options under § 1301.102 is purely optional.

(a) *Distributions To Satisfy Ward's Support Obligations*. If, and only if, the trust instrument includes the optional provisions allowed by § 1301.102, the trustee will be authorized to make distributions for the benefit of the beneficiary's minor children and other individuals whom the beneficiary is legally obligated to support. Further, any such distributions must be made in a manner than complies with the form of payment restrictions applicable to § 1301.102, as discussed above.

(b) *No Income Distributions Under § 1301.102.* Section 1301.101 provides for discretionary distributions of principal and income. Section 1301.101(a)(3), as noted below, requires that all income not distributed under § 1301.101 be added to principal. Thus, all distributions under § 1301.102 are necessarily out of principal. (§1301.102 provides for distributions of "trust funds" and does not specify whether distributions under that section may be made out of principal, income or both). However, as noted below, the distinction appears to be purely technical, with no effect on beneficial rights or trustee discretion.

(5) *Changes From Prior Law*

Prior to September 1, 1995, § 1301.101 included the additional distribution standard of the ward's "benefit" in the case of a minor ward, and that section allowed for distributions to the ward's children (as opposed to persons whom the ward was legally obligated to support), but only where the ward was an adult.

(a) *Elimination Of "Benefit" Standard.*--Inclusion of the term "benefit" made the former § 1301.101 a very broad distribution standard, authorizing distributions for any purpose that the trustee may have deemed reasonable--so long as the ward was a minor. For instance, the trustee should have been able to make distributions to the guardian of the person to pay for movies, trips to the zoo, vacations, video games, a new personal computer, etc., so long as it genuinely "benefitted" the ward. Note, however, that distributions to a minor ward whose parents were living may have been limited by the provisions of Texas Probate Code § 1156.051. In any event, with the elimination of the benefit standard, it appears that Chapter 1301 management trusts are now available only for the ward's basic needs. In smaller trusts this may be appropriate. In larger trusts, where the resources are far greater than necessary to provide for the ward's basic support and maintenance, it seems entirely unjustified to implicitly prohibit distributions for luxuries.

(b) *Broader Authority To Provide For Ward's Dependents.*--Under the former statute, § 1301.101 allowed for distributions to the ward's children, not the broader classification--provided for under current law--of all persons whom the ward is legally obligated to support. Further, the former version allowed distributions for the ward's children only when the ward was an adult, while the current statute applies without regard to the ward's age and thus provides for the event of a minor ward with children.

d. Education and Maintenance Distributions to Minor Ward; Possible Applicability of § 1156.051

If the ward is a minor and the ward's parents are living, it may be that the trustee's authority to make distributions for the support, education, or maintenance of the ward is limited. Texas Probate Code § 1156.051 prohibits the use of any property out of a minor ward's estate by a parent of the ward for the ward's support, education, or maintenance, unless the court determines that the parents are "unable, without unreasonable hardship, to pay for all of the expenses related to the ward's support." The extent to which this section applies to the trustee of a Chapter 1301 trust and overrides or otherwise limits §§ 1301.101 and 1301.102 is not clear.

Arguably, the trustee should be required to apply to the court for specific authority to make the distribution, in the same manner required of a guardian of the ward's estate. Or, arguably, the trustee should at least make its own determination that the ward's parents are "unable, without reasonable hardship, to pay for all of the expenses related to the ward's support" before making the distribution.

On the other hand, the specific distribution authority of §§ 1301.101 and 1301.102 and their specific application to Chapter 1301 trusts may render § 1156.051 inapplicable.

The present, practical solution is to specifically address and resolve the issue via the terms of the management trust; i.e., give the trustee clear specific instructions as to its distribution authority. Because the trust is created by court order, the trustee who follows the terms of trust (and thus complies with the court's order) should be protected from liability, even though, due to subsequent judicial or statutory developments, those terms of trust may prove to be an improper application of the Chapter 1301 management trust provisions.

2. <u>Termination and Final Disposition of Trust</u>

a. Termination Where Beneficiary Is a Minor

Section 1301.203 sets forth the mandatory termination provisions. If the person for whom a trust is created is a minor at the time the trust is created and the court does not specify a later termination date, the trust must terminate on the person’s 18th birthday or earlier death. However, § 1301.203(a)(2) authorizes the court to extend the termination age up to 25. This is a crucial provision, especially where the guardianship contains a substantial sum of money, in that it allows the person an additional 7 years to gain maturity of judgement before being given the right to manage--or squander--his or her property.

It is unclear whether a Chapter 1301 trust may provide for "staged" termination, e.g., "1/3 at age 18, 1/2 of the balance at age 22, and the entire balance at age 25." The statute does not specifically authorize staged terminating distributions, but the statute does not prohibit it either. By way of comparison, trusts created under Texas Property Code § 142.005 (so called "§ 142 Trusts") are specifically authorized to provide for principal distributions "as the beneficiary attains designated ages and at designated percentages of the principal." Texas Property Code § 142.005(c)(1).

b. Termination Where Beneficiary Is an Incapacitated Adult

Under § 1301.203(b), if the person for whom a trust is created is an incapacitated person other than a minor, the trust terminates according to the terms of the trust, on the date the court determines that continuing the trust is no longer in the person’s best interest, or on the death of the ward or incapacitated person.

c. Disposition of Trust Upon Termination

If the court does not provide to the contrary, § 1301.204 provides that upon termination, the trustee shall file a final account (except in the case of a person who has only a physical disability), and upon approval, distribute the trust property (a) to the ward or incapacitated person when the trust terminates on its own terms, (b) to the successor trustee on appointment of a successor trust, or (c) to the representative of the deceased ward’s or incapacitated person’s estate on the ward’s or incapacitated person’s death. There is no express limitation as to the extent to which the court may "provide to the contrary." For instance, the court could conceivably provide for a marital deduction by-pass plan, establish GST exempt and GST non-exempt trusts, etc. If the court is uncomfortable with any such planning options, the practitioner should consider structuring the requested disposition in a manner that complies with the Tax Motivated Gifts provisions of the Texas Probate Code.

d. Transfer of Management Trust Property to Pooled Trust

If the court determines it is in the beneficiary’s best interests, the court may order the transfer of all property in a management trust created under Chapter 1301 to a subaccount of a pooled trust established under Chapter 1302 of the Estates Code. Sometimes a pooled trust can accept smaller accounts than a traditional corporate trustee can effectively administer under a Chapter 1301 trust. An attorney ad litem is required for the person in the application for transfer (except in the case of a beneficiary who has only a physical disability, in which case such appointment is not required).

3. <u>Accountings</u>

Section 1301.154 obligates the trustee to file annual accountings with the court "in the same manner and form that is required of a guardian of the estate under this title," and upon termination of the trust, § 1301.204

requires the trustee to file a final accounting in the manner and form required of a guardian under §§ 1204.101 and 1204.102, which must be approved by the court prior to final distribution of the trust property. Again, the court may not require a trustee of a trust created for a person who has only a physical disability to prepare and file an annual or final accounting.

If a guardianship proceeding is pending, Section 1301.1535 also requires an initial accounting within 30 days after the date on which the trustee receives the property into the trust.

4. <u>Trustee Bond, Compensation and Reimbursement</u>

a. Corporate Trustee & Trustee for Physical Disability Only Serve Without Bond

Section 1301.058 provides that if the trustee is a corporate fiduciary, or any other trustee over a management trust created for a person who has only a physical disability, the trustee serves without giving a bond. However, where the trustee is a person, other than either of the forgoing, the court shall require the trustee to file with the county clerk a bond in an amount equal to the value of the trust's principal and projected annual income and with the conditions the court determines are necessary.

b. Annual Trustee Compensation

Section 1301.101 provides that the trustee is entitled to receive compensation "subject to the court's approval." (Note again, however, that a trustee over a trust for a person who has only a physical disability is entitled to receive compensation without the court's approval). The trustee's compensation is payable out of the property of the trust and is determined, paid, reduced and eliminated in the same manner as compensation of a guardian. Note that a 2009 law change removed the requirement that compensation only be paid on annual application to the court. Thus, the compensation paid to the trustee of a Chapter 1301 management trust for a ward is the same as the compensation that would be paid to the guardian of the ward's estate under Chapter 1155, both as to amount and frequency of payment.

(1) *Basic 5% Commission*

Texas Estates Code § 1155.003 generally provides that the guardian of the estate may be entitled to a commission not exceeding "five percent of the gross income of the ward's estate and five percent of all money paid out of the estate." This formula, which will generally produce a fee that is much lower than the typical corporate trustee fee schedule, has proved to be unsatisfactory to many corporate trustees who would otherwise be interested in serving as Chapter 1301 trust trustees.

(2) *Additional Reasonable Compensation*

Section 1155.006 provides that if the [basic five percent] fee is an unreasonably low amount, the court may authorize compensation for the guardian in an estimated amount the court finds reasonable that is to be paid on a quarterly basis before the guardian files an annual or final accounting if the court finds that delaying the payment of compensation until the guardian files an accounting would create a hardship for the guardian. Section 1155.007 provides that a court that authorizes payment of estimated quarterly compensation may later reduce or eliminate the guardian's compensation if, on review of an annual or final accounting or otherwise, the court finds that guardian (a) received more than the 5% allowed, (b) has not adequately performed the duties required, or (c) has been removed for cause. If a compensation reduction occurs, the guardian's bond is liable to the guardianship estate for any excess compensation received. Texas Estates Code § 1155.007(b).

(3) *Payment is allowed Quarterly - No Longer Annual and in Arrears*

The statute was changed in 2009 to eliminate the old rule of the trustee's annual compensation in arrears--only after a year's worth of services have been provided to the trust. *See* Texas Estates Code § 1155.006. Compensation can be paid quarterly if the court finds that the delay of payment would create a hardship for the trustee.

(4) *Drafting Solutions*

A literal reading of the applicable statutory provisions supports the rule of thumb that, in each and every matter relating to the amount, timing, and approval of compensation, Chapter 1301 trust trustees should be subject to exactly the same rules as guardians of ward's estates. From this viewpoint it seems unlikely that the court would approve any creative solution to the compensation issue.

On the other hand, there have been numerous cases in which the court has approved compensation arrangements that go beyond a strict reading of the statute. For instance, courts have approved fee schedules (or approved fees based on a discount from a trustee's published schedule), allowed compensation to be paid both in advance and more frequently than annually (but subject to annual review and approval by the court - prior to the law changing to allow this), and even promised (in so many words) to give every reasonable consideration to the trustee's anticipated request for compensation above the statutory commission rate. Where the proposed trustee is not satisfied with the 5% commission, the practitioner should discuss the issue with the court and attempt to strike an appropriate balancing of the trustee's desire to be assured a reasonable fee and the court's desire to retain reasonable control over questions of compensation.

c. Expense Reimbursement

There is no statutory provision for reimbursement of the expenses of a Chapter 1301 trust trustee; however, it seems absolutely reasonable to presume that a provision allowing reimbursement of all necessary and reasonable expenses would be valid. One could make an argument that expense reimbursement, because of its relation and similarity to the trustee's compensation, should be allowed only annually; however, this argument appears strained.

5. <u>Miscellaneous Provisions</u>

a. Modification and Revocation by the Court

Section 1301.201 provides that the court may modify or revoke the trust at any time before the trust's termination and specifically provides that none of the ward or incapacitated person, the ward's guardian, nor a person who has only a physical disability for whom the trust is created may revoke the trust. This continuing jurisdiction of the court should prove useful (i) where a minor for whom a trust was created, upon reaching the age of majority (or such older age as may have been specified for the trust's termination), does not have legal capacity; (ii) where an incapacitated adult regains sufficient capacity to manage his or her own affairs; or (iii) where statutory amendments or other changed circumstances make is desirable to amend the trust.

b. Liability of the Guardian and Bonding Company

Section 1301.156 provides that none of the guardian of the ward's estate, the guardian of the ward's person, nor the surety on the bond of the guardian is liable for an act or omission of the trustee of the management trust. Prior law did not address the liability of the guardian of the person; however, it seems the natural conclusion to assume that the guardian of the person would not be liable for the actions of the trustee any more than he or she would be liable for the actions of the guardian of the estate. Likewise, the current statute does not specifically state whether it is the surety on the bond for the guardian of the person or the guardian of the estate who is exonerated. Nevertheless, considering that neither guardian should be directly liable, it seems safe to presume that neither surety will be liable.

As a practical matter in the vast majority of cases, the issue may be one which affects the guardian of the ward's person (and his surety) only. When a Chapter 1301 management trust is established for a ward, all the property in the guardianship will generally be transferred to the trustee, and the guardian of the ward's estate and the surety on his or her bond will be discharged (as to future liability); however, if the ward remains incapacitated it stands to reason that there will remain a guardian of his or her person (for whom the liability issue will continue).

c. Accumulated Income Added To Principal--
Mandatory Provision

Section 1301.101(a)(3) requires that "the income of the trust that the trustee does not disburse under subdivision (2) of this subsection must be added to the principal of the trust." Why this provision is specified, much less mandatory, is not clear. No distribution or other provisions of a Chapter 1301 management trust make any consequential distinction between income or principal, so the recharacterization will not affect the ward's right or the trustee's discretion as to any distribution.

The statute does not indicate the applicable accounting period; that is, whether accumulated income is to be added to principal on a monthly, quarterly, annual, or more infrequent basis. Presumably, any reasonable period selected by the trustee would be appropriate.

d. Applicability of Texas Trust Code

Section 1301.002 expressly provides that Chapter 1301 management trusts are subject to the Texas Trust Code, but to the extent there is a conflict between the Trust Code and the provisions relating to Chapter 1301 trusts or the trust instrument, the instrument or the Chapter 1301 provisions will control.

6. Coordination with other Guardianship Statutes

There are numerous provisions in Title 3 of the Texas Estates Code that arguably are applicable to Chapter 1301 management trusts. A complete discussion of these potential applications is beyond the scope of this article, but care should be taken to analyze the interplay of the Chapter 1301 management trusts with the guardianship statutes.

7. Coordination with Federal Medicaid "(d)(4)" (Supplemental Needs) Trust

An individual seeking to qualify for Medicaid benefits must have sufficiently limited available financial resources (income and assets). If the individual has an ascertainable and enforceable beneficial interest in a trust, the property of the trust will generally be considered a resource and, considering the very low resource threshold for Medicaid qualification, the presence of the trust will typically disqualify the individual for Medicaid benefits. This circumstance can seem especially unfair where the individual has no significant assets other than the trust or where the property of the trust consists of personal injury damages awarded to the individual with respect to the very disability that gave rise to the need for Medicaid benefits. In the latter case, the only consequence of receiving a substantial personal injury award may be to disqualify the individual for Medicaid qualification until the award is depleted, at which time the individual will be indigent (once again), requalify for Medicaid, and have no further benefit from his or her award.

A detailed discussion of qualification as a "(d)(4)" trust is outside the scope of this paper. However, it is important to be aware of a recent statutory change to Chapter 1301 trusts which pertains to (d)(4) trusts. Under § 1301.101(c), in creating or modifying a trust, the court may omit or modify terms otherwise required by section 1301.101 if the court determines that such omission or modification is necessary and appropriate for the beneficiary to be eligible to receive public benefits or assistance under a state or federal program that is not otherwise available to the beneficiary and it is in his or her best interests.

IX. EXISTING INCAPACITY: MANAGEMENT OF PROPERTY RECOVERED IN SUIT – CHAPTER 142

As mentioned above, a next friend may represent and sue on behalf of an incapacitated person who has no legal guardian. Tex. R. Civ. P. 44. The next friend has the same rights concerning such suits as a guardian, but must give security for costs, or affidavits in lieu thereof, when required. *Id*. The next friend or his attorney of record may, with approval of the court, compromise suits and agree to judgments, and such judgments, agreements and compromises, when approved by the court, are forever binding and conclusive upon the party plaintiff in such suit. *Id*.

When a next friend or guardian ad litem recovers property during litigation on behalf of the incapacitated person, there must be a way to receive and manage such property on behalf of that person. Chapter 142 of the Texas Trust Code provides the mechanism to receive and manage property for an incapacitated person who recovers property in a lawsuit.

Where an incapacitated person is involved in a lawsuit, and that person is represented by a next friend or an appointed guardian ad litem, the court, on application and hearing, may provide by decree for the investment of funds recovered in the lawsuit on behalf of the incapacitated person. Tex. Prop. Code § 142.001. Additionally, the court in which a judgment is rendered may, by order entered of record, authorize the next friend, the guardian ad litem, or another person to take possession of money or other personal property recovered under the judgment for the person represented. Tex. Prop. Code § 142.002.

On application, any court with jurisdiction to hear a suit involving a minor or incapacitated person that is represented by a next friend or an appointed guardian ad litem or a person with a physical disability, may create a trust for the benefit of such individual to hold any funds accruing from a judgment. Tex. Prop. Code § 142.005. The court must find that the creation of a trust would be in the best interests of the beneficiary.

The order creating the trust must be in accordance with certain mandatory provisions listed in § 142.005(b):

- the beneficiary shall be the sole beneficiary of the trust;
- the trustee may disburse amounts of the trust's principal, income, or both, as the trustee in the trustee's sole discretion determines to be reasonably necessary for the health, education, support or maintenance of the beneficiary;
- the trustee may conclusively presume that medicine or treatments approved by a licensed physician are appropriate for the health of the beneficiary;
- the income of the trust that is not disbursed shall be added to the principal of the trust;
- if the beneficiary is a minor, the trust terminates on the beneficiary's death, on his attaining an age stated in the trust, or on his 25th birthday, whichever occurs first, or if the beneficiary is an incapacitated person, the trust terminates on the beneficiary's death or when he regains capacity;
- a trustee that is a financial institution shall serve without bond;
- the trustee shall receive reasonable compensation paid from the trust's income, principal, or both, on application to and approval of the court. 142.005(5-6).
- the first page of the trust instrument must contain the following notice: NOTICE: THE BENEFICIARY AND CERTAIN PERSONS INTERESTED IN THE WELFARE OF THE BENEFICIARY MAY HAVE REMEDIES UNDER SECTION 114.008 OR 142.005, PROPERTY CODE.

However, § 142.005(g) provides that the mandatory distribution language may be omitted or modified if the court finds that it would be in the best interests of the beneficiary and the court determines the omission or modification is necessary or appropriate to allow the beneficiary to be eligible to receive public benefits or assistance under a state or federal program.

The trust may provide that distribution of trust principal may be made periodically, as the beneficiary attains designated ages and at designated percentages of the principal. It also may provide that distributions, payments, uses and applications of all trust funds may be made to the legal or natural guardian of the beneficiary or to the person having custody of the beneficiary, or may be made directly to or expended for the benefit, support, or maintenance of the beneficiary without the intervention of any legal guardian or other legal representative of the beneficiary. Tex. Prop. Code § 142.005(c).

The court that creates the trust under Chapter 142 has continuing jurisdiction and supervisory power over the trust. Tex. Prop. Code § 142.005(d). The trust is not subject to revocation by the beneficiary or a guardian of the beneficiary's estate. The trust will continue in force until terminated or revoked, notwithstanding the appointment of a guardian of the estate or the person. Tex. Prop. Code § 142.005(f).

On termination of the trust under its terms or on the beneficiary's death, the trust principal and any undistributed income are to be paid to the beneficiary or the representative of his estate. Tex. Prop. Code § 142.005(e). However, if the trust is to qualify as a special needs trust, it must provide for repayment to the state of Medicaid benefits that are paid on behalf of the beneficiary before distribution of assets to the beneficiary or his representative.

If the value of the trust's principal is $50,000 or less, then the court may appoint a person other than a financial institution to serve as trustee of the trust only if the court finds the appointment in the beneficiary's best interests. Tex. Prop. Code § 142.005(m). If the value of the trusts principal is more than $ 50,000, then the court may appoint a person other than a financial institution to serve as trustee only if the court finds that no financial institution is willing to serve as trustee, and the appointment is in the beneficiary's best interests. Tex. Prop. Code § 142.005(n).

Sections 142.008 and 142.009 also provide provisions which allow for structured settlements to be obtained on behalf of the beneficiary.

X. ANTICIPATING INCAPACITY: PLANNING BY AN ATTORNEY-IN-FACT UNDER A DURABLE POWER OF ATTORNEY

One of the simplest yet most powerful techniques to plan for incapacity is the execution of a valid durable power of attorney. A power of attorney will grant an agent the power to handle the financial affairs of the potentially incapacitated client. In addition, more sophisticated estate planning may be possible under the power of attorney, depending on its terms.

A. Threshold Question--Validity of the Power of Attorney

In order to be useful as a planning device for the incapacitated client, (i) the power of attorney must have been executed at a time when the client was not incapacitated, (ii) the form of the power of attorney must satisfy the statutory requirements for durability, and (iii) there must not have been an adjudication of incapacity and appointment of a permanent guardian subsequent to the execution of the power of attorney. This discussion assumes that the principal had the capacity to execute the power of attorney.

1. Durability Requirements Satisfied

In order for the power of attorney to be at all useful, it must be "durable," i.e., its validity must not be terminated by the principal's incapacity. Under common law, unless the power of attorney is coupled with an interest (and most donative powers of attorney executed for estate/incapacity planning purposes are not), the incapacity of the principal terminates the agent's powers under a power of attorney.

It is only by virtue of specific statutory provisions that durable powers of attorney are possible. Therefore, in reviewing old powers of attorney that the client may have executed, the practitioner must ascertain whether the instrument was valid under the particular statute applicable at the time of execution. There are basically three time periods, corresponding with the original legislation enabling durable powers (1972), the first major revision to the statute (1989), and the enactment of the current law (1993), as amended thereafter.

a. Pre August 28, 1989, Powers

Effective January 1, 1972, the Texas Legislature added § 36A to the Texas Probate Code, by Acts 1971, 62nd Leg., p. 971, Ch. 173, § 3. This original version of § 36A remained in effect until August 28, 1989. As originally enacted, § 36A provided as follows:

> **§ 36A. When Power of Attorney not Terminated by Disability**
>
> When a principal designates another his attorney in fact or agent by power of attorney in writing and the writing contains the words "this power of attorney shall not terminate on disability of the principal" or similar words showing the intent of the principal that the power shall not terminate on his disability, then the powers of the attorney in fact or agent shall be exercisable by him on behalf of the principal notwithstanding later disability or incompetence of the principal. All acts done by the attorney in fact or agent, pursuant to the power, during any period of disability or incompetence of the principal, shall have the same effect and shall inure to the benefit of and bind the principal as if the principal were not disabled or incompetent. If a guardian shall thereafter be appointed for the principal, the powers of the attorney in fact or agent shall terminate upon the qualification of the guardian, and the attorney in fact or agent shall deliver to the guardian all assets of the estate of the ward in his possession and shall account to the guardian as he would to his principal had the principal himself terminated his powers.

TEX. PROB. CODE ANN. § 36A (Vernon 1980), Acts 1971, 62nd Leg., p. 971, Ch. 173, § 3, *repealed* by Acts 1989, 71st Leg., Ch. 404, § 1. Section 2 of the repealing act specifically provides as follows:

> A durable power of attorney that was executed before the effective date of this Act is governed by the law in effect when the power of attorney was executed, and the former law is continued in effect for that purpose.

Acts 1989, 71st Leg., Ch. 404, § 2. (*See also* Acts 1993, 73rd Leg., Ch. 49, § 2, which continued this grandfathering beyond the 1993 repeal of § 36A.) Thus, in order to be durable, a power of attorney executed after January 1, 1972, and prior to August 28, 1989, simply has to meet the following requirements:

- it must be in writing, and
- it must contain the words "this power of attorney shall not terminate on disability of the principal" or similar words of durability.

b. Post August 28, 1989--Pre September 1, 1993, Powers

Effective August 28, 1989, the Legislature substantially revised § 36A, adding several significant requirements for durability. The 1989 version of § 36A read as follows.

§ 36A. When Power of Attorney not Terminated by Disability

(a) When a principal designates another his attorney in fact or agent by power of attorney in writing and the writing contains the words "this power of attorney shall not terminate on disability of the principal" or similar words showing the intent of the principal that the power shall not terminate on his disability, then the powers of the attorney in fact or agent shall be exercisable by him on behalf of the principal notwithstanding later disability or incompetence of the principal. All acts done by the attorney in fact or agent, pursuant to the power, during any period of disability or incompetence of the principal, shall have the same effect and shall inure to the benefit of and bind the principal as if the principal were not disabled or incompetent.

(b) A durable power of attorney does not lapse because of the passage of time unless a time limitation is specifically stated in the instrument creating the power of attorney.

(c) A durable power of attorney must be:

(1) in writing;

(2) signed by a principal who is an adult;

(3) witnessed and signed by two persons who are 18 years of age or older; and

(4) filed for record in the county in which the principal resides, except for a power of attorney executed for medical care.

(d) If a durable power of attorney contains language authorizing the attorney in fact or agent to indemnify and hold harmless any third party who accepts and acts under the power of attorney, then the third party shall recognize the authority of the attorney in fact or agent and transact with the person in the same manner and to the same extent as the third party would transact with the principal.

(e) If a guardian shall thereafter be appointed for the principal, the powers of the attorney in fact or agent shall terminate upon the qualification of the guardian, and the attorney in fact or agent shall deliver to the guardian all assets of the estate of the ward in his possession and shall account to the guardian as he would to be principal had the principal himself terminated his powers.

(f) A durable power of attorney may be revoked by the principal signing an instrument revoking the power of attorney and filing it for record in the county in which the power of attorney is recorded.

TEX. PROB. CODE ANN. § 36A (Vernon Supp. 1993), Acts 1989, 71st Leg., Ch. 404, § 1., *repealed by* Acts 1993, 73rd Leg., Ch. 49, § 2, which reads as follows:

Section 36A, Probate Code, is repealed. A power of attorney executed in compliance with that section before the effective date of this Act is valid according to the terms of that section as it existed at the time of the execution, and that section is continued in effect for that purpose.

Thus, in order to be durable, a power of attorney executed after August 28, 1989, and prior to September 1, 1993, has to meet the following requirements:

- it must be in writing;
- it must contain the words "this power of attorney shall not terminate on disability of the principal" or similar words of durability;
- it must be signed by a principal who is an adult;
- it must be witnessed and signed by two persons who are 18 years of age or older; and
- it must be filed for record in the county in which the principal resides (query whether this filing must be prior to the principal's becoming incapacitated?).

c. Post September 1, 1993, Powers

Effective September 1, 1993, the Legislature revoked § 36A, and added a new Chapter XII to the Texas Probate Code, the "Durable Power of Attorney Act." Acts 1993, 73rd Leg., Ch. 49, § 1. The text of the new Chapter XII can be found in the Texas Estates Code Chapters 751 and 752.

Under Texas Estates Code §751.002, in order to be durable, a power of attorney executed after September 1, 1993, has to meet the following requirements:

- it must be in writing;
- it must be designate a person to act as attorney in fact or agent;
- it must contain the words "this power of attorney is not affected by subsequent disability or incapacity of the principal" or "this power of attorney becomes effective on the disability or incapacity of the principal" or similar words of durability; and
- it must be acknowledged by the principal before an officer authorized under the laws of this state or another state to take acknowledgments to deeds of conveyance and administer oaths.

The recordation and witnessing requirements were eliminated (although powers of attorney may be recorded where appropriate, *see* TEX. EST. CODE § 751.151.

The statutory form Durable Power of Attorney is set forth in Texas Estates Code § 752.051. Note that the latest statutory durable power of attorney form change went into effective as of January 1, 2014.

2. <u>No Guardian Qualified</u>

Without regard to the date of execution, all durable powers of attorney terminate upon the qualification of a permanent guardian of the principal's estate.

Specifically, as to durable powers of attorney executed prior to August 1, 1989, upon the qualification of a guardian for the principal, "the powers of the attorney in fact or agent shall terminate." TEX. PROB. CODE ANN. § 36A (Vernon 1980), Acts 1971, 62nd Leg., p. 971, Ch. 173, § 3, *repealed by* Acts 1989, 71st Leg., Ch. 404, § 1. As to post August 1, 1989--pre September 1, 1993, powers of attorney, "the powers of the attorney in fact or agent shall terminate upon the qualification of the guardian." TEX. PROB. CODE ANN. § 36A (Vernon Supp. 1993), Acts 1989, 71st Leg., Ch. 404, § 1., *repealed by* Acts 1993, 73rd Leg., Ch. 49, § 2. As to post September 1, 1993, powers of attorney, the powers of the attorney "terminate on the qualification of the guardian of the estate." TEX. EST. CODE § 751.052(a). However, if only a temporary guardian is appointed, the power of attorney does not terminate but instead the court may suspend the power of attorney until the expiration of the temporary guardianship. TEX. EST. CODE § 751.052(b).

B. Types of Planning Possible

This article will make only brief mention of the question of the authority of an agent under a written power of attorney, and will generally proceed from the premise that the practitioner has reviewed the instrument carefully to determine if any particular act is authorized.

1. <u>Generally</u>

The issue of the extent of an agent's authority under a written power of attorney is a prime example of the disparity between the paradigm and the existential. Many old cases and discussions in legal encyclopedias indicate that general powers of attorney are presumed to grant unrestricted authority unless a contrary intention is clearly shown, yet most estate planning attorneys' personal experiences include an argument with a bank or other financial institution in which incredible arguments were dreamed up as grounds for that institution's refusal to honor the agent's authority (e.g., "I know it gives authority to convey real estate, but it doesn't give authority to sign documents in connection with the conveyance").

A good example of the "old" rule is *Dockstadar v. Brown*, 204 S.W.2d 352, (Tex. Civ. App.--Forth Worth 1947, writ ref'd n.r.e.), in which the plaintiff had given a short, broadly worded general power of attorney to her brother, but they had orally agreed that his authority was for a limited purpose (the resolution of their parents' estate). The plaintiff won her case against her brother (based on their oral agreement); nevertheless, the court held that such a broadly worded general power of attorney was to be presumed of unlimited scope and that the plaintiff had the burden to prove to the contrary. Her action to cancel the deeds that the agent signed failed. *See also* 3 TEX. JUR. 3d *Agency* §§ 31 *et seq*. (1980).

Thus, case law exists to support the argument that general (as opposed to limited) powers of attorney are to be broadly construed, *id*., and that extraneous evidence of the principal's intent to grant broad authority may be considered even where the language of the instrument itself may indicate a contrary intent, *see, e.g., Dockstadar*. Unfortunately, there is also case law in Texas and other jurisdictions supporting the view that all powers of attorney (not just limited powers of attorney) are to be strictly construed, *e.g., Gittings, Neiman-*

Marcus, Inc. v. Estes, 440 S.W.2d 90 (Tex. Civ. App.--Eastland 1969, no writ) and there are reasonable arguments that extraneous evidence should generally not be allowed to alter the meaning of an otherwise clear instrument. *See* Kathleen Ford Bay, *Repercussions of Gifts Under Powers of Attorney--the Ripple Effect*, 3 PROBATE & PROPERTY 6 (November/ December 1989). Financial institutions and, as noted below, the Internal Revenue Service, opting to embrace this later line of authority, continue to narrowly construe all powers of attorney, taking the position that any authority that is not specifically and clearly granted will not be presumed.

Note that the promulgated statutory form prior to 2014 provided the following statement: "If no power listed above is crossed out, this document shall be construed and interpreted as a general power of attorney and my agent (attorney in fact) shall have the power and authority to perform or undertake any action I could perform or undertake if I were personally present." The current form as it exists in Section 752.051 has no such provision. It permits the principal to initial line "N" – "all of the above powers listed in "A" through "M." However, this does not make the power of attorney a general power of attorney and there is no similar provision stating that it means the agent has the power to perform or undertake any action the principal could perform or undertake if personally present. Rather, the agent's authority apparently will be limited to the enumerated statutory powers even if "N" is initialed. For this reason, it is important for any attorney wishing for his or her client to have a general power of attorney to specifically add language to the form to accomplish this purpose.

2. <u>Power to Make Gifts</u>

There appear to be several Texas cases in which broad, general grants of authority were held to empower the agent to make gifts. *See* Mason S. Standley, *Texas Law Allows Gifts Under General Power of Attorney, the Hanna Case*, 33 REAL ESTATE, PROBATE & TRUST LAW REPORTER 42 (October 1994) (State Bar of Texas). Mr. Standley notes that, in two cases, the words "transfer" and "assign" have been construed to allow gifts, *Hayter v. Fern Lake Fishing Club*, 318 S.W.2d 912, 915 (Tex. Civ. App.--Beaumont 1958, no writ), and *Ditto Inv. Co. v. Ditto*, 302 S.W.2d 692, 694 (Tex. Civ. App.--Fort Worth 1957, rev'd on other grounds), and that a power of disposition has been construed to allow a gift, *Hanna v. Ladewig*, 73 Tex. 37, 11 S.W. 133 (1889).

Hanna, *Hayter* and *Ditto* may be consistent with the well settled (although not well honored) rule that true general powers are broadly construed. *See, e.g.*, *Dockstadar*, above. However, most powers of attorney encountered by the author contain lengthy enumerations of specific powers, included, no doubt, to overcome the perceived (albeit arguably incorrect) general rule that all powers of attorney--whether general or limited--are to be narrowly construed. It is ironic that this "cure" (the inclusion of specific enumerated powers intended to overcome the perceived limitations of an otherwise terse general power) may contribute to the very ailment sought to be alleviated.

The statutory form Durable Power of Attorney under Texas Estates Code Section 752.051 has a line for express authority for the agent to make gifts. Note, however, that the statutory form limits the ability of the agent to make gifts to individuals to amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift (currently, $14,000). Practitioners may want to change the statutory form to allow for gifts in excess of the annual exclusion for transfer tax planning.

It is important to be cognizant of the "general power of appointment" issues which can be associated with making gifts under a durable power of attorney. Where the agent has unlimited authority to make gifts to himself, there could be an argument that he has a general power of appointment over all assets subject to his control as agent. (See IRC §2041). To avoid this argument, often the power of attorney will limit the agent's ability to make gifts to himself each year to be the greater of $5,000 or 5% of the principal's estate.

C. Transfer Tax Considerations

A gift or other transaction that is beyond the scope of the agent's authority under the power of attorney will be voidable by the principal. Practically speaking, where acrimony among the interested parties is not a concern, voidability may not be a significant problem in and of itself. However, where federal transfer taxes are a concern, the fact that a particular act by the agent is voidable will generally eliminate the tax advantages otherwise resulting from the act.

1. <u>Voidable Transaction Under State Law</u>

Texas law is clear that, if the principal lacked legal capacity to execute the power of attorney, all actions by the agent are voidable by the principal. *Lucas v.*

Whiteley, 550 S.W.2d 767 (Tex. Civ. App.--Amarillo 1977, writ ref'd n.r.e.); *Smiley v. Johnson*, 763 S.W.2d 1 (Tex. App.--Dallas 1988, writ denied) (principal was found to be competent to execute the power of attorney, notwithstanding that he was diagnosed with Alzheimer's disease prior to the date of the power of attorney).

Likewise, actions taken by an agent that exceed the authority granted him under the power of attorney are voidable at the election of the principal. *See* e.g. 3 TEX. JUR. 3d *Agency* § 47 (2006).

2. <u>Incomplete Gift Treatment of Voidable Transfers--I.R.C. § 2038</u>

Under I.R.C. § 2038, if the decedent made a lifetime transfer but retained the right to revoke (or avoid) the transfer, then the transferred interest will be includable in the gross estate for federal estate tax purposes. The Internal Revenue Service has consistently held that actions by an attorney in fact that are not authorized by the governing instrument are voidable by the principal or his guardian and, therefore, are revocable transfers, includable in the gross estate under I.R.C. § 2038. In particular, where the governing instrument includes no grant of authority to make gifts, all donative transfers by the attorney have been held to be voidable, and therefore includable in the gross estate under I.R.C. § 2038.

For instance, in Letter Ruling 9347003, the power of attorney contained broad authority to "sell" and "convey" property, and "the power to take care of all my affairs and property as fully and completely as I could do." Applying Texas law, the Service determined that the agent did not have the authority to make gifts; therefore, the numerous gifts made by the agent were ruled incomplete and includable in the gross estate.

In Letter Ruling 9410028, the Service reached the same result on comparable facts, noting that "the omission of the authority to make gifts strongly suggested a positive intent on the part of the decedent not to give this power. Of the four means of transfer, a gift is the only means for which the donor receives no consideration."

a. Relevance of Prior Gifts

Texas law seems to permit consideration of extraneous evidence when ascertaining the extent of the agent's authority under a power of attorney. The Tax Court has recognized that an established pattern of giving by the principal may be indicative of an intent to authorize gifts by the agent, even where the power of attorney contains only the typical general authority to grant, convey, etc. *See, e.g., Bronston Estate v. Commr.*, T.C. Memo 1988-510 (no express gift authority given, but established pattern of giving sufficient to validate agent's gifts). However, inasmuch as the issue is more one of state substantive law rather than federal tax law, it is difficult to assign precedential value to *Bronston* or any other tax case addressing the issue.

The Service has steadfastly argued that only the language of the power of attorney is relevant, usually relying on *Casey v. Commr.*, 91-2 USTC ¶ 60,091 (4th Cir., 1991). In Casey, the Tax Court had construed a broadly worded general power of attorney which did not contain specific gifting authority and concluded that the agent did in fact have the authority to make the gifts at issue. The Tax Court based its holding on "the broad grant of authority in the power of attorney itself *and on the particular circumstances under which it was granted, as well as decedent's established pattern of giving*" 91-2 USTC at 90,289, quoting 58 T.C.M. 176, Dec. 46,035(M) (emphasis added). In reversing the Tax Court, the Fourth Circuit observed: "we believe [the Virginia Supreme] Court most likely would find the omission of a specific gift power in the power of attorney dispositive of the principal's intent on the subject, and hold the gifts here not authorized without resorting to any extrinsic circumstances for guidance as to the principal's intent." 91-2 USTC at 90,294.

However, the Fourth Circuit has limited the Casey decision thus adding credibility to the argument that extraneous circumstances are relevant to the determination of an agent's authority under a power of attorney. In *Ridenour Estate v. Commr.*, 94-2 USTC ¶ 60,180 (4th Cir., 1994), affirming 65 T.C.M. 1850, Dec. 48,847 (M), the court observed as follows: "In Casey, this court found . . . that the appropriate method to resolve the question was to review the complete text of the particular instrument *and the circumstances of its execution* to determine whether we could infer in it a power, though unexpressed, to make the gifts at issue. . . . *Casey* thus stands for the proposition that to infer an implied gift power, the court must look to the intent of the person granting power of attorney." 94-2 USTC at 86,433 (emphasis added).

Before relying on *Ridenour* to the exclusion of *Casey*, the practitioner should consider the possibility that the above quote from *Ridenour* is dicta: in 1992, one year after *Casey* was decided but before *Ridenour*, the Virginia legislature enacted a statute specifically authorizing agents to make gifts in accordance with an established pattern of giving. *See Id*. Additionally, the Service still cites Casey for the proposition that the decedent's history of making gifts is irrelevant to the question whether the decedent intended to grant the power to make gifts to the agent, *see* Letter Ruling 9509034 (decedent's history of making gifts irrelevant to question of intent to grant gifting authority), and the courts seem willing to look to *Casey*.

One helpful letter ruling, which of course cannot be cited as precedent, is Letter Ruling 199944005, which dealt with gifts under an old fashioned Texas power of attorney. The service approved the gifts, noting the following factors: (a) very broad language of the power of attorney, (b) gifts were small in relation to principals overall assets, (c) principal not economically disadvantaged by gifts, and (d) principal had a history of substantial gifting.

In any event, the practitioner who chooses to rely on a past history of gifts by the principal or other extraneous evidence to validate otherwise unauthorized gifts by an agent should verify the size and circumstances of the past gifts and ensure that all gifts to be made by the agent are comparable. *See generally Casey*. *See also* Letter Ruling 9509034 (gifts by agent were incomplete because not expressly authorized by the power of attorney and agent's gifts were substantially larger than gifts principal had made; gifts were held incomplete and includable in gross estate; principal's history of making gifts held not relevant in determining extent of agent's authority). *But compare* Letter Ruling 9513001 (November 28, 1994) ("Direction to Make Gifts" authorizing and directing agent to make gifts and executed same day as power of attorney treated as a part of the power of attorney; agent held to have power to make gifts).

b. Relevance of the Three Year Rule

Several cases and rulings have noted that gifts by the decedent's agent were made within 3 years of death. *See, e.g.*, Letter Ruling 9513001 and *Townsend v. U.S.*, 95-1 USTC ¶ 60,192 (D.C., Nebraska, 1995). The practitioner might infer that inclusion of voidable gifts by an agent results from an application of the 3 year rule and that gifts made more than 3 years prior to death would not be includable. Such an inference might produce a rule for an agent's unauthorized gifts that is consistent with the rule applicable to gifts made from a revocable trust; however, there is no support for this conclusion.

Every case and ruling discussed above relies on the portion of I.R.C. § 2038(a)(1) dealing with revocable transfers, not the portion dealing with transfers with respect to which a power of revocation was released within 3 years of death. Likewise, none of the cases or rulings cites or relies upon the general 3 year rule set forth in I.R.C. § 2035. To the contrary, gross estate inclusion is founded on the continuing right of the decedent to void unauthorized gifts which, unless affirmatively released, would appear to continue indefinitely, subject only to limitations and/or laches (which aren't likely to be relevant where, as is usually the case, the principal is incapacitated).

D. Interaction with Revocable Trusts

Most long form general powers of attorney will expressly authorize the agent to transfer the principal's property into a revocable trust created by the principal. Additionally, Section 752.109(5) allows this very action in the statutory power of attorney.

The frequent question is: what if the principal never got around to creating his or her own management trust? Can the Agent create *and* fund the management trust under the power of attorney? The statutory form does not include creation of a management trust as a power of the agent. A recent case held that the Agent could not create the trust, since a trust can only be created if the *settlor* manifests an intention to create a trust. *Filipp v. Till*, 230 S.W.3d 197 (Tex. App.–Houston [14th Dist.] 2006, no writ.

Query whether the Agent could create the management trust if it was specifically authorized by the power of attorney? This specific grant of authority arguable evidences the necessary intent of the Seller.

There is little Texas law addressing the authority of an agent under a power of attorney to change the testamentary disposition of a principal. However, it is generally believed that this is an action that is personal to an individual and cannot be delegated to an agent. The Supreme Court of Texas has held that even a guardian, with court authority, does not have the right, without a prior agreement by the settlor, to revoke a revocable trust created by the settlor at a time when the settlor was competent. The Supreme Court in *Weatherly v. Byrd*, 556 SW2d 292 (Tex. 1978), held that the right to revoke a revocable trust is a purely personal right of the settlor and thus, could not vest in a guardian of an incapacitated settlor of the trust. This reasoning would lead to the conclusion that an agent under a power of attorney would not have the right, without specific authority, to change a principal's testamentary disposition or estate plan.

A word of caution in this area – if the agent is creating a management trust, or making any revisions or amendments thereto, make sure it is authorized by the power of attorney and it should in no way (or only minimally) affect the distribution of the principal's property at death. Making a true Will substitute, in the author's opinion, is clearly outside of the intended powers allowed in the durable power of attorney act, and is ripe for challenge.

E. Trigger Income Tax Liability

One option to carefully consider if an incapacitated principal is in very ill health is whether the agent, by exercising general asset management powers, should trigger some income tax liability for the principal, perhaps to capture deductions that may be lost and/or to reduce the estate taxes on the income tax laden assets. This is an area in which you should tread with caution, as triggering an income tax liability can have a significant ripple effect and greatly alter the overall estate plan. However, if the family is harmonious and they all share in all assets equally, this may be an item to consider.

F. Long Form vs. Statutory Form

The statutory power of attorney can be a wonderful estate planning tool, and includes many significant benefits over the long form power of attorney. The statutory form is easier to read, it is much shorter (its always awkward when the power of attorney is longer than the Will), and banks, brokerage and title companies are more accustomed to the form.

There are, however, significant enough drawbacks that the author prefers to use the long form power of attorney. In addition to some of the items previously mentioned, a few of the drawbacks of the statutory form are as follows: (a) it requires significant explanation of powers granted by reference to the code; (b) it frequently does not contain all of the powers the long form allows for; (c) if the gifting box is not specifically checked, the power to make gifts can be omitted; (d) clients are often confused by the method of choosing whether the power is springing or effective immediately; (e) use of successive statutory forms to make changes may not revoke previous powers of attorney, unless a revocation is specifically added to the subsequent power of attorney forms; and (f) in other states, there may be a requirement that a power of attorney be both witnessed and notarized.

When drafting powers of attorney, also note recent developments affecting the ability to obtain a home equity loan through a power of attorney. In June of 2013, the Supreme Court decided *Finance Com'n of Texas v. Norwood, 418 S.W.3d 566 (Tex. 2013)*, which impacted the use of powers of attorney in home equity lending transactions. As a result of a Texas constitutional amendment in 1997, equity loans are required to be closed "only at the office of the lender, an attorney at law, or a title company". Equity lending is overseen by the Texas Finance Commission, which decided a borrower could close on a loan through the mail or through an agent acting under a Durable Power of Attorney. Those procedures were challenged in court, and the Texas Supreme court in *Norwood* ruled that the Finance Commission procedure was unconstitutional. The court recognized that using a power of attorney is a well-established legal tool that can be used to close on an equity loan, so long as the constitution is honored. Since the constitution requires that closing the loan be at the lenders' office, an attorney's office, or a title company's office, and since execution of the power of attorney is part of the closing, the power of attorney itself can only be used if it was signed at the lender's office, an attorney's office, or a title company.

Practitioners should now consider whether to add such a statement to their power of attorney form to address this situation. For all prior transactions, one solution may be for the attorney to enter into an affidavit reciting the power of attorney was executed in his or her office (if indeed this was the case, and if the title company will accept such an affidavit). Another option is to obtain a reverse mortgage, as these are outside the scope of this Constitutional language (however, reverse mortgages have their own inherent complications). In addition, if one spouse is incapacitated, the other can institute a community administration under Texas Estates Code Chapter 1353 (discussed above), which allows the latter spouse to manage, control and dispose of the entire community estate, including the part of the community estate that the incapacitated spouse legally has the power to manage. This is a bit less cumbersome than a guardianship of the estate, but still involves a court proceeding, and is not available if any part of the home is the incapacitated spouse's separate property. Lastly, a temporary or permanent guardianship may be instituted (which adds additional costs and complexities, assuming the court and lender would even sign off on such an approach).

G. Medical Power of Attorney Designation of Health Care Agent

Execution of a Medical Power of Attorney is imperative to planning for a client's incapacity. The statutory form is set forth in Texas Health & Safety Code § 166.164. Basically, an individual utilizes a medical power of attorney to designate who will make his medical treatment decisions in the event of his incapacity and inability to communicate with his doctors. This medical power of attorney is only effective if the client is unable to make his own decision.

The statute provides that the Medical Power of Attorney form must be substantially similar to the one promulgated in the statutory form. Texas Health & Safety Code § 166.164. Accordingly, limited modifications geared toward specific wishes and desires regarding health care may be included. Care must be taken however, not to change the statutory form too much or it may be difficult to have the health care provider accept the power without more complicated negotiations of the client's intent.

H. Directive to Physicians and Family or Surrogates

The Texas Directive to Physicians and Family or Surrogates is Texas' version of a Living Will. The intention of this Directive is to set forth a statement of a client's intent not to be placed on life-sustaining treatment in the event of a terminal or irreversible condition. The Texas legislature promulgated a standard Texas form and it is set forth in Texas Health & Safety Code § 166.033. The new statute was effective September 1, 1999. Many clients find the language very confusing. In addition, the language is quite broad, so care must be taken before advising every client to execute this document. Many clients prefer to have only a Medical Power of Attorney and forego the execution of the Directive to Physicians.

I. HIPAA Power of Attorney

The Health Insurance Portability and Accountability Act (HIPAA) attempts to provide privacy of personal health information. From an estate planning and personal care-taking perspective, it is difficult for a client's family to receive information from a doctor or hospital about a loved one's medical condition. One answer to this is a short HIPAA Power of Attorney that authorizes certain individuals (typically those also designated on a Medical Power of Attorney) to receive an individual's health care information if such agent requests it. The document would provide authorization by the individual to release medical information to certain individuals designated in the HIPAA Power of Attorney. The document would also be especially helpful to a family member assisting with medical insurance matters.

XI. ANTICIPATING INCAPACITY: PLANNING BY A TRUSTEE UNDER A REVOCABLE TRUST

If incapacity is a concern, especially if it is unavoidable (as in the case of early stages Alzheimer's disease), planning through a revocable management trust is another fairly straightforward planning technique.

A. The Basics

1. <u>Creation Options</u>

A revocable management trust is an inter vivos trust, set up by a client at the time he prepares his estate planning. At that point, the client has a choice as to how much of his estate he will transfer into the trust. Many plans are left unfunded until a client's incapacity. That is, he will create the trust with $1, but leave all of his assets in his individual name. Upon his incapacity, he agent, via a power of attorney, can transfer his assets into the trust for management assistance and control by the Trustee. (See X, D, above, for a discussion of whether the agent can create a management trust under the power of attorney).

Another option is to fully fund the trust upon the creation. If incapacity is looming in the near future, this would be the better option for immediate management help. A client can name himself or anyone else as the Trustee or Co-Trustees to manage the affairs of the trust.

In either event, the client's Will would typically be a so-called "pour-over Will" which would pour any assets remaining in the client's name into his management trust upon his death, for a cohesive estate plan.

2. <u>Benefits Over A Will.</u>

One of the most important attributes of an estate plan designed through a revocable management trust is that the terms of the trust can provide for modification or amendment to the trust after the client's incapacity. Unlike a Will, which cannot be altered after a client loses testamentary capacity, a management trust can be drafted to grant someone (the trustee, a majority of the Grantor's adult children, etc.), the power to amend the trust in the event laws or family situations change. The drafter of such a provision should be extremely careful to outline which types of provisions may be modified in accordance with the client's wishes.

3. Planning Opportunities

Like a power of attorney, a management trust should include specific provisions to enable the trustee of the trust to engage in advanced estate planning opportunities if that is the client's wish. It is beyond the scope of this article to address the scope of a trustee's authority under any trust, revocable or otherwise. In any proposed planning, the drafter should include in the document a specific provision authorizing a particular transaction, particularly donative transactions (which should generally be authorized in terms of identified permissible beneficiaries).

B. Transfer Tax Considerations

1. Voidable Transactions

It appears that the same concerns applicable to powers of attorney are relevant here; that an act by the trustee that exceeds his authority will be voidable, and thus revocable and includable in the gross estate under I.R.C. § 2038.

2. Gifts Within Three Years of Death

a. Prior Rule

In 1986, the Service issued two letter rulings concluding that, when revocable trust property is distributed as a gift to a person other than the grantor, the effect is to terminate the grantor's power of revocation with respect to that property. Under I.R.C. § 2035, property with respect to which a power of revocation has terminated within three years of death (which would have been included in the grantor/donor's gross estate under I.R.C. § 2038, had the revocation power existed at death) is includable in the gross estate. Such property would additionally be included under a separate three year rule in I.R.C. § 2038. According to the Service, it follows that gifts of revocable trust property are subject to the three year rule requiring inclusion of the gift in the gross estate if death occurs within three years of the gift. Letter Rulings 8609005 (November 26, 1985) and 8635007 (May 19, 1986). *See also* Letter Rulings 9015001 (December 29, 1989), 9016002 (December 29, 1989), 9032002 (April 30, 1990), 9049002 (August 29, 1990), 9016002 (December 29, 1989), 9117003 (October 16, 1990), and 9226007 (February 28, 1992) ("the form of the transaction necessarily dictates the application" of the three year rule).

b. Current Rule

Effective for estates of decedents dying after August 5, 1997, IRC § 2035(e) is applicable. Subsection (e) provides for the following:

TREATMENT OF CERTAIN TRANSFERS FROM REVOCABLE TRUSTS. --For purposes of this section and section 2038, any transfer from any portion of a trust during any period that such portion was treated under section 676 as owned by the decedent by reason of a power in the grantor (determined without regard to section 672(e)) shall be treated as a transfer made directly by the decedent.

As a result, as long as a trust is treated as owned by a grantor in the event of incapacity under IRC section 676, the bringing back of gifts made from the revocable trust within three years of death should not be an issue.

XII. ANTICIPATING INCAPACITY: PLANNING THROUGH THE USE OF A FAMILY LIMITED PARTNERSHIP

A. Overview of FLP Benefits

There has been increasing interest over the last few years in the use of limited partnerships as an estate planning tool for the discounts taken in gifting partnership interests as well as discounts in the estate of a holder of an FLP interest. The unique status that limited partnerships occupy under state law, and the flexibility afforded partnerships in the income tax area, make limited partnerships an attractive device in many family planning situations, particularly as a vehicle for the ownership of family assets. Limited partnerships can be structured to provide administrative convenience, income, estate and gift tax benefits, as well as a measure of asset protection. Because of all of these factors, the formation of an FLP should also be a technique considered when a family member is faced with incapacity.

B. Limited Partnership Basics

A limited partnership is formed by filing a certificate with the Texas Secretary of State and entering into a limited partnership agreement among the partners. At least one general partner must be designated to accept personal liability and manage the affairs of the partnership. The limited partners must agree to take no active role in the day-to-day management of the business of the partnership. By doing so, the "limited" partners will be protected from personal liability for the actions of the partnership. The liability protection afforded to limited partners is similar to the protection afforded the shareholders of a corporation. However, unlike corporations, limited partnerships are pass-through entities for federal income tax purposes and are not currently subject to state franchise taxes in Texas.

Because the general partner is in control of the management of the partnership, as long as the incapacitated individual is not designated as the general partner, he or she will have no management ability over the partnership. As a limited partner, his or her interest will be managed by the general partner.

In the case of an individual who is already incapacitated, the holder of the power of attorney for the incapacitated client could use the power of attorney to either create an FLP, designating someone else as the general partner of the partnership or to transfer the incapacitated client's assets into the partnership for the management of such assets by the existing general partner.

C. Reasons for Forming Family Limited Partnerships

A "family limited partnership" is simply a limited partnership in which all or substantially all of the partners are family members. Family limited partnerships are commonly used to achieve a variety of business and tax objectives.

1. <u>Common "Business" Reasons for the Formation of a Family Limited Partnership</u>

It is important that a family limited partnership be formed for valid business purposes and not merely to reduce estate and gift taxation. Some of the more common "business" purposes are discussed below. Aid for a family member with incapacity is an excellent business reason for the formation of an FLP.

a. Centralized Management of Family Assets and Assistance in Management of Assets

The nature of a limited partnership is that the management is consolidated in a general partner or partners. The limited partners may not participate in management. In the case of incapacity, as long as the incapacitated individual is divested of any general partnership interest, his limited partnership interest will be managed for him by the partnership's general partner. Accordingly, a family limited partnership allows the general partner to control the partnership and its assets, while at the same time effectively transferring indirect ownership of portions of the assets to second and third generation family members who are limited partners, if that is the desire. Additionally, the general partner will have the power to control distributable cash flow of the partnership. For example, the general partner could choose to reinvest significant portions of the earnings of the partnership into new investments, or reinvest in a family business. A few court decisions have called into question the amount of control that can be vested in the senior generation. Unless and until these cases are overruled, caution should be exercised in the control rights of the senior generation; and it may be advisable in certain situations to permit the junior generation to control the general partner interests in a family partnership, and/or to severely restrict discretionary distributions.

b. Transition of Power Upon Death or Incapacity of Senior Generation; Avoidance of Family Disputes

Texas partnership law allows for great flexibility in drafting a limited partnership agreement, so that it can be tailored to fit the specific needs of a family. This flexibility allows for provisions directing how the partnership will be managed after the death of the senior generation. For example, the agreement could provide for an automatic succession upon the death of the primary general partner, for succession to be determined by a vote of the remaining general or limited partners, for a designated "manager" to take over upon the death of the patriarch, or a variety of other possible provisions. Also, a limited partnership agreement can be drafted with a provision which requires the partners to settle disputes by arbitration. In many situations, arbitration will be preferable to jury trials between family members. Often arbitration will be quicker, less expensive, and the dispute will be resolved by an arbitrator who is an experienced business person, rather than a judge and jury.

c. Avoidance of Co-Tenancies

Direct gifts or bequests of interests in family assets, even in trust, can create co-tenancies among family members and trusts. Over time, these co-tenancies can expand to involve more and more co-tenants. This often leads to frustration in decision making, keeping up with the investments for multiple investors and trusts, and dealing with undivided ownership of real estate, oil and gas properties and other assets. For example, real estate owned in a co-tenancy would require the unanimous agreement of all parties to sell the property. A family limited partnership would permit the investments to be consolidated into one partnership, thereby providing for a formal decision-making mechanism and avoiding a multiplicity of investment accounts and co-tenancy. Also, consolidation into the partnership may allow a family investment portfolio to be professionally managed by achieving minimal investment amount levels often required by professional money managers, which otherwise may not be reached because of the multiple accounts caused by separate trusts or co-ownership.

d. Simplification of Gifting

Many assets, particularly real estate, are not susceptible to being easily divided into multiple shares for purposes of gift giving. Additionally, breaking up the family assets into small pieces for gift giving fragments the assets leading to some of the management and co-tenancy problems discussed above. These problems can be solved through the use of a family limited partnership, since gifts of fractional partnership interests are easily made. Each donee simply receives a fractional partnership interest, but the underlying assets remain consolidated. Often a limited partnership will be preferable to a trust as a vehicle for making gifts because limited partnership agreements are more flexible than irrevocable trusts, which are difficult, if not impossible, to amend. Remember if gifts of limited partnership interests owned by an incapacitated individual are desired, the incapacitated client's power of attorney should specifically allow an agent to make gifts.

e. Keeping Family Assets in the Family

Under Texas partnership law, a transferee of an interest in a limited partnership becomes an "assignee" of that interest unless and until expressly admitted as a partner. An assignee is not a partner and has no voting rights. An assignee's only right is to receive the transferor's share of partnership distributions if and when the general partner decides to make a distribution. Therefore, the very nature of a limited partnership restricts the transferability of the partnership interests and thus the indirect ownership of the assets. Additionally, family limited partnerships can be drafted with buy/sell provisions which further restrict transferability of the partnership interests. The partnership agreement will generally provide that the other partners or the partnership will have the right to purchase any partnership interest sought to be transferred outside family before the interest can be so transferred.

f. Protection from Future Creditors of Partners

A creditor who attaches a partner's interest in a limited partnership does not become a partner and cannot vote or cause the dissolution of the partnership. Rather, the creditor becomes an "assignee" of the partnership interest. As an assignee, the creditor's only right is to receive distributions from the partnership at such times and in such amounts as the general partner may determine. On the other hand, an assignee's share of the partnership's income is taxable to the assignee, regardless of whether such income is actually distributed. As a consequence, a creditor may find itself in a situation where it must pay tax on income that it cannot reach. This exposure may deter a creditor from seeking to attach a partnership interest or may encourage a creditor to make a favorable settlement.

g. Protection of Family Assets Upon Divorce

An interest in a family partnership given to a child or grandchild should be separate property and not susceptible to much dispute over characterization. Use of a family limited partnership also simplifies characterization issues and avoids complicated tracing problems as family assets are bought and sold over the years. Additionally, the partnership agreement may provide that an involuntary transfer, such as a divorce court award, may be subject to the buy/sell agreement so that the partnership interest can be purchased by the other partners, or the divorced partner, at its fair market value, if the interest should be awarded to the "non-family spouse."

If a partnership is created during marriage, the assets contributed to the partnership become the assets of the partnership, and the partners receive partnership interests. The marital character of a spouse's interest in a partnership created during marriage should depend on the separate or community nature of the assets contributed in exchange for the interest itself. If an interest in the partnership was acquired as a gift, the interest itself is the separate property of the donee spouse. The assets of the partnership, including undistributed income and profits, belong to the entity, and do not take on a separate or community character under normal circumstances. See Tex. Bus. Org. Code §

152.056; (see also) *Harris v. Harris*, 765 S.W.2d 798 (Tex. App.–Houston [14th Dist.] 1989, writ denied). Caution should be taken in the day-to-day management of the partnership to avoid claims for reimbursement because of the expenditures of uncompensated time, talent or labor or contributions of community property to the separate property business. *Jensen v. Jensen*, 665 S.W.2d 107 (1984).

When the partnership distributes profits to its partners, the profits distributed to a married partner are community property, whether the partner's partnership interest is separate or community property. This result can work a conversion of what would ordinarily be the separate property into community property. For example, if a spouse contributes separately owned oil and gas royalty interests into a partnership, the royalties collected by the partnership and then distributed to the partners as partnership profits are community property. Had the spouse not contributed the royalty interest to the partnership, the royalties received would have been the owner's separate property. *See Marshall v. Marshall*, 735 S.W.2d 587 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). The Marshall case has been cited for the proposition that all partnership distributions during marriage are community property. However, some commentators argue that a distribution in excess of current or retained earnings or other distributions of capital should be separate property. *See* Jack Marr, Business and Divorce, 34th Annual Marriage Dissolution Institute (2011).

h. Pass-Through Income Tax Treatment; Franchise Taxes

A limited partnership is a "pass-through" entity for federal income tax purposes and generally may be terminated without adverse income tax consequences. This contrasts to the often severe income tax consequences that may result on the termination of a corporation.

The Texas Franchise Tax, also referred to as the margins tax, applies a 0.375% or 0.75% tax on the gross revenue of most taxable entities in Texas for granting those entities limited liability protection. The tax rate is 0.75% for all taxpayers except a narrowly defined group of retail and wholesale businesses who pay a 0.375% rate. Corporations, limited partnerships and other liability protected entities are all subject to the tax. In a nutshell, the franchise tax rate applies to the lesser of a taxable entity's (or affiliated group's) (x) gross receipts less-certain compensation, or (y) gross receipts less cost of goods sold. There is also a safety net so that the margin tax base may not exceed 70 percent of a business's total revenues, and currently, an entity with gross receipts of less than $1,110,000 does not pay the margin tax. An affiliated group must use the same deduction for the entire group. An affiliated group's tax base is apportioned to Texas using a single-factor gross receipts apportionment formula with no throwback rule.

Limited partnerships are exempt from the gross margins tax if at least 90% of its income is "passive." Rent is not defined as "passive" income, but dividends, interest, capital gains from the sale of real property, commodities, and securities, and royalties, bonuses or other delay rental income from mineral properties and other income from nonoperating mineral interests are passive. Thus FLPs that fall within the 90% passive category can enjoy limited liability protection without paying the tax. Other entities, such as corporations and LLCs are not eligible for the passive income exception.

i. Simplification of Probate

The assets held by a family limited partnership will not be part of the decedent's probate estate; rather, the decedent's estate will include the partnership interest. Thus, a lengthy probate inventory can be avoided and a greater degree of confidentiality achieved. As discussed below, this may be particularly important in the area of real property.

j. Facilitation of Post-Death Sales of Real Estate

When an estate is selling real property, title companies routinely require "IRS closing letters" before the title company will insure a clear title to a buyer purchasing property from a decedent's estate. This often means that property cannot be sold out of a decedent's estate for a considerable period of time following the date of death, until the IRS audit procedures can be cleared and a closing letter obtained. On the other hand, if real property is held in a limited partnership that does not dissolve upon the decedent's death, the typical title company requirement for a closing letter would not apply and the property should be available for immediate sale.

2. <u>Tax Objectives in Forming a Family Limited Partnership</u>

If a limited partnership can be formed for valid business reasons, a valuation "discount" may be available for partnership interests for federal estate and gift tax purposes. Due to provisions of the Texas Business Organizations Code and restrictions contained in the partnership agreement, and depending on other facts and circumstances, the value of the limited partnership interests may be "discounted" as compared to the underlying value of the partnership's assets. The value of an asset for estate and gift tax purposes is its fair market value; that is, what a willing buyer would pay a willing seller for the asset in an arms-length transaction. In a limited partnership, no limited partner would have the right to compel the liquidation of the partnership at any time prior to the expiration of the stated term of the partnership (which would be a considerable period of time, such as 50 years). Also, the partnership agreement generally would not guarantee any specified cash flow to a partner. Limited partners have very limited voting rights, and the limited partnership interests would generally lack marketability. Therefore, a third-party purchaser generally would not be willing to pay a price for a limited partnership interest that would equal the pro rata value of the underlying partnership assets. Rather, the price would be discounted substantially due to the foregoing considerations. Congress has legislated in this area with IRC §§ 2701-2704. These Code sections limit the availability of a discount under certain circumstances. However, in most cases a family limited partnership can be structured in such a manner which accomplishes the family's business objectives and still maintains the possibility of achieving at least some valuation "discount" as compared to the liquidation value of the underlying assets. There is always the possibility that Congress and the Internal Revenue Service, will seek legislation and/or administrative regulations that could place more server limitations on the availability of discounts on intra-family transfers. We will have to “wait-and-see” how this develops over the next months and years.

XIII. ANTICIPATING INCAPACITY: ADVANCED ESTATE PLANNING TECHNIQUES TO CONSIDER

First and foremost, it is imperative that a client who anticipates having additional estate planning done through a power of attorney or a management trust vehicle in the event of her incapacity grant specific instructions in these documents for the agent and/or the trustee to pursue the additional estate planning techniques. If specific estate planning techniques are contemplated, they should be mentioned with specificity. Of course, this should be balanced with how much discretion to give one’s attorney-in-fact or trustee. Providing for the client’s needs should be the estate planner’s first goal. However, assuming that the client will be well provided for and may have an estate tax problem in the future, various planning techniques might be considered.

A. Annual Exclusion Gifts

Maximizing a client’s annual exclusion gifts available under Internal Revenue Code Section 2503(b) is one of the most simple and easiest estate planning techniques to implement. Consistent and broad gifting over years of a client’s incapacity can be extremely effective in reducing a client’s taxable estate. I.R.C. § 2503(b) provides that annual gifts of up to $10,000, now indexed for inflation (resulting in a $14,000 gift for calendar year 2016), may be made to any person without any reduction in a client’s applicable exemption amount. I.R.C. 2053(b). As discussed earlier in the outline, a client’s power of attorney should contain a specific provision allowing an agent operating under a power of attorney to make such gifts in order for them to be respected by the I.R.S. Care should be taken in drafting to ensure that an unlimited power to gift to oneself by an agent/attorney in fact does not exceed the $5,000 or 5% safe harbor found in I.R.C. § 2041(b)(2) so that it might be considered to be a general power of appointment held by the attorney in fact.

When choosing the assets with which to make the annual exclusion gifts from a client’s estate, careful attention should be paid to the client’s basis in the assets being gifted as the recipient receives a carry over in basis for the gifted assets. If the gifted assets were instead held until the client’s death, the recipient would have received a step-up in basis to the date of death value in the asset.

B. Medical and Educational Expense Payments

Similarly, I.R.C. § 2503(e) also allows the gift exclusion for an unlimited amount paid on behalf of an individual for tuition to an educational institution and medical expenses. These amounts must be paid directly to the educational or medical institution. Again, consistent use of this exclusion can result in significant estate planning opportunities and the reduction in a client’s taxable estate. The gifting provision contained in a client’s power of attorney should be sufficiently broad to ensure that these gifts are included in the ambit of the gifting power.

In this context, also consider the possibility of prepaying tuition to an educational institution. See PLR

200602002 which concluded that prepayments to an educational institution for future tuition payments qualified for the unlimited tuition exception. An important fact in this PLR, though, is that the payments are irrevocable and cannot be returned to the student if the student leaves the school. The contract in this PLR did not state whether or not the school would allow the use of the funds by another grandchild if the student at issue left the school. In PLR 200602002, donor gave $750,000 for several young grandchildren to attend a private school in which they were enrolled.

C. Sophisticated Gift or Sales Techniques

As long as the client's power of attorney or management trust allows the agent to engage in sophisticated planning techniques on behalf of the client, techniques such as creation of GRATs or QPRTs should be considered. Sales to Intentionally Defective Trusts (IDGTs) should also be considered. Although the details of these types of transactions are beyond the scope of this outline, any current estate tax planning techniques should be considered for use by the incapacitated individual through his or her attorney in fact or the trustee of his or her management trust as long as the power of attorney or trust agreement contemplates such actions. Care should be taken when drafting such instruments to ensure that these provisions are carefully considered.

D. Creation of a Family Limited Partnership

The management benefits involved in the use of a family limited partnership when an individual is incapacitated are discussed above. The management of family assets is a valid and important business purpose for the creation of such a partnership. In addition, an FLP also provides important potential discounting opportunities. Utilizing FLPs to make annual exclusions gifts, taxable gifts or even sales of partnership interests to other family members or trusts for family members may enable more effective gifting and transfers to occur. Further, discounts may be available in the estate of a client who dies owning FLP interests. The I.R.S. is adverse to the so-called "death bed" partnership and may challenge such a partnership as lacking a valid business purpose. However, in the case of an incapacitated individual, the management assistance provided though the use of an FLP can be quite helpful and provide the business purpose needed for an FLP to be respected by the I.R.S. As usual, the terms of the partnership must be respected and treated like a business in order to obtain the benefit of the creation of an FLP.

Again, the power of attorney or management trust of an incapacitated individual should contain instructions allowing for the transfer of assets to a partnership or other management vehicle.

E. Inclusion of Powers of Appointment in Trusts

If appropriate to the client's situation, the Will or a management trust created by an individual with potential incapacity issues, should grant a power of appointment in favor of family members. This will allow the family greater flexibility at a later date. For example, if Husband becomes incapacitated and unable to change his Will, granting his Wife a testamentary power of appointment in the Bypass Trust or QTIP trust created for her benefit under his estate planning documents will give Wife the flexibility to amend the overall estate plan if Husband dies first. In this case, Wife will be able to take a second look at the overall family situation after Husband's death and make any necessary changes. If husband was incapacitated for a number of years prior to his death and did not possess the testamentary capacity to alter his Will or management trust, this provision can be especially powerful.

XIV. TERMINALLY ILL CLIENTS

There are additional advanced estate planning techniques that one can consider if the potential incapacity involves a terminal illness. Typically, a client is considered terminally ill if he or she is expected to die in the somewhat immediate future and much sooner than his normal life expectancy. More and more clients are walking into our offices with cancer and dim prognosis for survival. In these situations, there are a variety of estate planning options one should consider.

Keep in mind that there may come a point where a terminally ill client also suffers from traditional incapacity as his health declines further. Because of this, it is imperative to include provisions in his power of attorney or management trust to allow his agent in fact or trustee to continue the estate planning techniques implemented, as discussed at length above.

A. Applicability of I.R.C. §7520

I.R.C. §7520 provides that standard actuarial tables prescribed by the Treasury Secretary shall be used to value annuities, life interests, term interests, remainders and reversions. These tables are found in Treas. Reg. §20.2031-7(d)(6). However, Treas. Reg. §1.7520-3(b)(3) provides that these standard tables cannot be used if an individual is "terminally ill" at the time of the transfer. Under the regulations, the term "terminally ill" means that the individual must have an incurable illness or other deteriorating physical condition, and that there must be at least a fifty percent (50%) probability that the individual will die within one year. If an individual is considered to have been "terminally ill" as defined in that regulation, then the actuarial value of his or her life expectancy must be the actual life expectancy and not the Treas. Reg. §20.2031-7(d)(6) rates. If a client lives for eighteen months after the transfer, the client is deemed to have not been "terminally ill" at the time of the transfer. Treas. Reg. §1.7520-3(b)(3) In *Estate of McLendon v. Commissioner*, T.C. Memo 1993-459, *rev'd and remanded*, 77 F.3d 477 (5th Cir.) 1995, *decision on remand*, T.C. Memo 1996-307, the factors to review in ascertaining the likelihood of terminal illness are discussed at length.

Because of the applicability of I.R.C. §7520 and Treas. Reg. §20.2031-7(d)(6), if a terminally ill client is determined to have a greater than 50% probability of surviving the year, it might be worthwhile to utilize the tables in estate planning techniques which are typically designed to pay out over the client's life expectancy. A client's earlier death will result in a greater amount passing to his or her beneficiaries in a more tax efficient manner.

B. Private Annuities

A private annuity is basically structured like a commercial annuity between family members. A parent, for example, would transfer cash or other property to her children in exchange for the children's unsecured obligation to pay the parent a fixed annuity for the remainder of the parent's lifetime. For gift tax purposes, the present value of the annuity, calculated based on I.R.C. §7520 and Treas. Reg. §20.2031-7(d)(6), would equal the value of the transferred property and thus no gift will result. However, upon the parent's premature death, the annuity terminates and the children would be left with a windfall based on the actuarial table calculations. The amount included in the parent's estate would be the annuity payments that the parent received prior to her death. If it is later determined that the parent was actually terminally ill, as defined in Treas. Reg. §1.7520-3(b)(3), then the value of the annuity would be recalculated using the client's actual life expectancy, and the amount of the gift would increase, resulting in no benefit of the transaction. In fact, interest and penalties on any unpaid gift tax might result. In addition, if appreciated assets were involved in the transaction, the family would not receive the step-up in basis which they would have received if our client had died holding the appreciated assets.

I.R.C. Sections 72 and 1001 and Rev. Rul. 69-74 control the income tax consequences of private annuities. If appreciated property were exchanged for a private annuity, the annuitant would be able to his or her basis in the property over her life expectancy in a proportionate manner, and any capital gain would be postponed and recognized by the annuitant over his or her lifetime as a portion of each annuity payment received. The balance of the annuity payment would be taxed as ordinary income. The IRS approved of this result in Revenue Ruling 69-74. As a result, a private annuity was a particularly useful strategy to transfer highly appreciated property with a large built-in capital gain and defer recognition of that gain.

However, on October 18, 2006, the IRS issued proposed regulation Sections 1.72-6(e) and 1.1001-1(j) that generally would require gain (or loss) to be recognized immediately when the property is exchanged for the annuity contract (unless the property exchanged is cash). The new regulations would override Rev. Rul. 69-74 and require immediate recognition of gain under I.R.C. Section 1001 where the present value of an annuity exceeded the annuitant's basis in the transferred property. In essence, the deferral of gain over the annuitant's life expectancy would be denied in exchange of an immediate recognition upon entering the private annuity transaction. When finalized, the proposed regulations would be applicable to private annuity transactions after October 18, 2006, or after April 18, 2007 where an unsecured annuity contract is issued by an individual. The new rules would significantly undermine the utility of traditional private annuity sales by requiring that all gain from the annuity sale be recognized on the date of the exchange, to the extent of the actuarial fair market value of the annuity contract. However, this is relevant only with respect to the exchange of substantially appreciated assets for an annuity. Private annuities would still be valuable in exchange for assets with little or no appreciation because they would generate very little taxable gain, as purchases of a private annuity for cash will generate no taxable gain and are expressly excluded from the operation of the proposed regulations.

One way to avoid the proposed regulations would be to have the private annuity transaction involve the transfer of assets to an IDGT (intentionally defective grantor trust), instead of a client's children directly, in exchange for the private annuity. Because the IDGT is treated as the client for income tax purposes, the client will not have to recognize gain upon the creation of the transaction nor upon the receipt of the annuity payment. Care must be taken if the IDGT has no assets other than the assets exchanged for the private annuity. Treas. Regs. §20.7520-3(b)(2)(i) may prevent the use of the standard actuarial tables and require the treatment of the exchange as a gift. Personal guarantees by the children (the beneficiaries of the IDGT) should help alleviate this risk.

C. Charitable Lead Trusts

Creating a charitable lead trusts ("CLT") for a client who has a terminable illness is similar in technique to a private annuity. A CLT can be either an annuity trust (a "CLAT") or a unitrust (a "CLUT"). The annuity payment or unitrust payment is made to a charity (which could be the client's private foundation), with the remainder to children or other similar beneficiaries. In the case of a client with a significant illness (but who is not actually terminally ill, as defined in Treas. Reg. §1.7520-3(b)(3)), this technique can be a great estate planning tool. The client's taxable gift is based on the value of the remainder passing to children or other non-charitable beneficiaries. Based on the actuarial factors, the client can create an almost zeroed-out CLAT for his or her lifetime, with remainder to children. If the client dies sooner than the actuarial life tables would contemplate, the charity would receive less than contemplated by the tables, with more passing to the client's family members.

Attention must be paid, however, to Treas. Reg. 20.7520-3(b)(2)(i) which makes it impossible to actually zero out the gift to the value of the remainder interest to children or other beneficiaries in the case of a CLT based upon a life expectancy. This regulation provides that the present value of the stream of annuity payments to be paid for the lifetime of an individual (our ill client) must contemplate that the individual will actually live longer than his life expectancy. This means that the annuity payments to the charity will exhaust the trust corpus, leaving nothing for the remainder beneficiaries.

In 2008, the service released forms for inter vivos and testamentary charitable lead unitrusts, both of which are incredibly helpful in the drafting process. See Rev. Proc 2008-45, 2008-46.

D. Income Tax Basis Planning

I.R.C. Code § 1014 provides that property received from a decedent acquires a step-up in basis equal to the date of death value of the asset. However, I.R.C. Code § 1014(e) further provides that if the property had been acquired by the decedent within one year of his date of death, and the property passes back to the original donor (or his or her spouse) upon the decedent's death, then no step up in basis is received in the asset. Obviously, this is to prevent death-bed transfers to a terminally ill individual in order to gain the step up in basis. Keep in mind that the one year test is a bright line test. Thus, such a transfer in order to receive a step up in basis may succeed if the patient lives more than one year. This planning opportunity has less implication here in Texas where the entire community estate receives a step up in basis upon one spouse's death.

XV. ETHICAL CONSIDERATIONS

Rule 1.02(g) of the Texas Disciplinary Rules of Professional Conduct imposes a duty on attorneys to seek assistance for clients they believe to have impaired faculties. In addition, the commentaries to the rule bring into question whether an attorney who represents an impaired individual does in fact have an attorney client relationship with that individual. As previously discussed, the capacity to contract requires that the client appreciates the effect of what he is doing and understands the nature and consequences of his acts and the business he is transacting. If it is not clear that the client has capacity to contract, then other arrangements may need to be made, including having a court appoint the lawyer or another person, such as a guardian, to represent the client's interests.

Rule 1.02(g) specifically states the following:

> A lawyer *shall* take reasonable action to secure the appointment of a guardian or other legal representative for, or seek other protective orders with respect to, a client whenever the lawyer reasonably believes that the client lacks legal competence and that such action should be taken to protect the client. (emphasis added).

Thus, the lawyer must take action to protect the client if: (i) the lawyer reasonably believes the client lacks legal competence, and (ii) the lawyer reasonably believes action should be taken to protect the client.

The official commentary to the rule states the following:

> 12. . . . The usual attorney-client relationship is established and maintained by consenting adults who possess the legal capacity to agree to the relationship. Sometimes the relationship can be established only by a legally effective appointment of the lawyer to represent a person. *Unless the lawyer is legally authorized to act for a person under a disability, an attorney-client relationship does not exist for the purpose of this rule.*
>
> 13. *If a legal representative has already been appointed for the client, the lawyer should ordinarily look to the representative for decisions on behalf of the client. If a legal representative has not been appointed, paragraph (g) requires a lawyer in some situations to take protective steps, such as initiating the appointment of a guardian.* The lawyer should see to such appointment or take other protective steps when it reasonably appears advisable to do so in order to serve the client's best interests. (emphasis added).

The argument can be made that the purpose of including subsection (g) was to deal with the problem mentioned in Comment 12, namely what happens when a client loses contractual capacity and the attorney-client relationship ceases to exist. The rule does not create a "bridge" relationship whereby an attorney can continue to represent an incapacitated former client; rather, it imposes a duty on the lawyer to take whatever action is necessary to see that a legal representative is appointed for the former client when there is no such legal representative. Nowhere does the rule state that the attorney can or should apply to become the legal representative of the former client himself.

The commentary to rule 1.02(g), cited above, appears to raise serious questions about the advisability of preparing estate plans for individuals who are already the subject of a guardianship. Certainly the practitioner should carefully weigh his or his client's abilities.

In line with the Texas Disciplinary Rules of Professional Conduct, Section 1102.001 of the Texas Estates Code provides that if a court has probable cause to believe a person is incapacitated, the court *shall* appoint a guardian ad litem or court investigator to investigate the person’s condition and circumstances to determine whether the person is an incapacitated person and if a guardianship is necessary. Probable cause can be established by an informational letter pursuant to Section 1102.003 written by an interested person, or through a written letter or certificate from a physician pursuant to Section 1102.002.

A common ethical issue that arises when representing clients who may lack capacity involves situations where the client is brought in by a third party, which in many cases is a family member. In such cases, the lawyer should be careful to guard against any undue influence by the family member (which many times is intentional, but the practitioner should also be cognizant of any unintentional undue influence). The attorney should always: (i) remember who he or she is representing; and (ii) make a point to speak with the client in person and alone for an extended period of time in order to gauge their capacity and gain their confidence.

If the individual is already a client, the attorney must also be mindful of his duties of confidentiality. Texas Disciplinary Rules of Professional Conduct Rule 1.05 covers the ethics rules regarding client confidentiality. Confidential information includes both privileged client information (communications protected by the attorney-client privilege by Rule 503 of the Texas Rules of Evidence, of Rule 503 of the Texas Rules of Criminal Evidence, or by the principles of attorney-client privilege governed by Rule 501 of the Federal Rules of Evidence for United States Courts and Magistrates) and unprivileged client information (all non-privileged information relating to or furnished by the client that is acquired by the lawyer during the course or by reason of the representation of the client). The attorney-client privilege, as set forth in Texas Rules of Evidence 5.03, protects from disclosure confidential communications made for the purpose of facilitating the rendition of professional legal services to the client.

The ethics rules provide that a lawyer is prohibited from knowingly revealing confidential information of a client or former client to a person the client has instructed is not to receive the information or anyone else, other than the client, the client’s representatives, or the members, associates or employees of the lawyer’s firm. Additionally, the lawyer cannot use confidential information to the disadvantage of the client unless the client consents after consultation. The attorney cannot use confidential information of a former client to the disadvantage of the former client after the termination of representation unless the former client consents after consultation or the confidential information has become generally known. Finally, the attorney cannot use privileged information of the client for the advantage of the lawyer or of a third person, unless the client consents after consultation.

However, a lawyer can reveal confidential information:

(1) When the lawyer is expressly authorized to do so to carry out the representation;

(2) When the client consents after consultation;

(3) To the client, the client's representatives, or the members, associates, and employees of the lawyer's firm, except when otherwise instructed by the client;

(4) When the lawyer has reason to believe it is necessary to do so to comply with a court order, a Texas Disciplinary Rule of Professional Conduct, or other law;

(5) To the extent reasonably necessary to enforce a claim or establish a defense on behalf of the lawyer in a controversy between the lawyer and the client;

(6) To establish a defense to a criminal charge, civil claim or disciplinary complaint against the lawyer or the lawyer's associates based upon conduct involving the client or the representation of the client;

(7) When the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act; and

(8) To the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in the commission of which the lawyer's services had been used.

Rule 1.05(c).

A lawyer may reveal *unprivileged* client information in several circumstances, including when impliedly authorized to do so to carry out the representation or when the lawyer has reason to believe it is necessary to do so in order to carry out the representation effectively. Rule 1.05(d).

Before communicating with any family member, doctor, or other professional advisor, the attorney must determine whether the information he seeks to disclose is "privileged" or "unprivileged" information.

Privileged information includes confidential communications made for the purpose of facilitating the rendition of professional legal services to the client. Unprivileged information is all other information relating to a client or furnished by the client that was acquired by the lawyer during the course of representing the client.

If the information is unprivileged, then the attorney is impliedly authorized to reveal such information in order to carry out the representation or when the lawyer believes it is necessary to do so in order to carry out the representation effectively. Tex. Rule 1.05(d)(1) and (2)(i).

If the information is privileged information, then the lawyer may reveal the information without the client's consent when the lawyer has reason to believe it is necessary to do so to comply with a Texas Disciplinary Rule of Professional Conduct, or other law (or if any of the enumerated instances above are applicable).

If the lawyer is having difficulty communicating with a client regarding the scope and objectives of the representation (Rule 1.02) because of a client's potential diminished capacity, then the lawyer may be required to take action to protect such person. Rule 1.02(g).

Appendix A

Language to Achieve Desired Overall Distribution After Death of One Souse (no power of appointment for surviving spouse)

ARTICLE IV-A – DISTRIBUTION OF RESIDUE TO DESCENDANTS

My wife, JANE DOE, passed away on January 1, 2016. Her Will created a trust for my primary benefit, known as the "JANE DOE Family Trust – Exempt" (the "Trust" for purposes of this Article IV-A). At my death, the assets which remain in such Trust will pass in certain shares to my descendants pursuant to the provisions of my wife's Will, and I do not have a power of appointment allowing me to alter the distribution set forth at the termination of such Trust. However, I intend in this Will, under the distribution provision below, to achieve a particular division of the combined assets of my estate passing under this Will (including any insurance policies payable to my testamentary trustee) and the assets remaining in and distributed from the Trust. The assets passing under this Will pursuant to this Article and the assets remaining in and distributed from the Trust shall be referred to collectively as the "Property" for purposes of this Article, with a certain percentage of the Property passing to each of the individuals (or trusts for their benefit) listed below. In calculating the distribution below, the following shall be applicable: (i) any discount associated with any of the Property (such as discounts regularly associated with partnership interests) shall be disregarded in valuing a beneficiary's share, (ii) any assets passing from the Trust to another trust for the primary benefit of an individual shall be allocated to such individual's share of assets received from the Trust, and (iii) all values shall be calculated as if being valued for federal estate tax purposes at the time of my death (except with respect to the disregarding of any discounts as noted in (i) above), prior to any estate tax liability associated with such assets. Accordingly, the residue of my estate shall be distributed as follows:

(a) I give to my daughter, ANNE DOE, an amount equal to the smallest portion of the residue of my estate which, when added to the property passing to ANNE from the Trust, will result in ANNE receiving SIXTY PERCENT (60%) of the net value of the Property; provided, however, that if ANNE fails to survive me, her share shall instead pass to her descendants who survive me, per stirpes; otherwise this gift shall be distributed to my descendants who survive me, per stirpes; and

(b) I give to my daughter, BETTY DOE, an amount equal to the smallest portion of the residue of my estate which, when added to the property passing to LYNN from the Trust, will result in BETTY receiving FORTY PERCENT (40%) of the net value of the Property; provided, however, that if BETTY fails to survive me, her share shall instead pass to her descendants who survive me, per stirpes; otherwise this gift shall be distributed to my descendants who survive me, per stirpes.

(c) Notwithstanding any provision herein to the contrary, the foregoing gifts to the primary beneficiary (and such beneficiary's descendants) are to be calculated prior to any addition due to a lapsed gift. For example, if ANNE fails to survive me, her descendants shall receive the share otherwise passing to ANNE by formula. However, if ANNE and all of her descendants fail to survive me, such gift is to be added to the gift passing under subsection (b), above, and the addition of such lapsed gift shall not affect the calculation of the gift passing pursuant to (b). [*note this section c is included for use with an unequal division among more than two children/beneficiaries*].

(d) All gifts to my descendants under this Article IV-A and section 4.1 are subject to the trust provisions of Article V of this Will.

APPENDIX B and B-1

LESS RESTRICTIVE ALTERNATIVES
TO GUARDIANSHIP

In addition to the policy statement contained in TEX. EST. CODE §1001.001 mandating the use of a less restrictive alternative, there is now a statutory definition of "Alternatives to Guardianship" TEX. EST. CODE §1002.0015, which offers a non-exclusive list of alternatives:

1. medical power of attorney (14 below);
2. durable power of attorney(18 below);
3. declaration for mental health treatment (46 below);
4. representative payee (37, 38 below);
5. joint bank accounts (convenience accounts) (19 below);
6. guardianship management trust(24 below);
7. special needs trust (26 below);
8. pre-need designation of guardian(45 below); and
9. person-centered decision-making (6 below).

The alternatives suggested herein are, in some instances, designed to provoke further thought. They are certainly not an exclusive list.

Closely allied to the concept of less restrictive alternatives is the idea of Supports and Services, addressed in Appendix B-1.

I. AVOIDING GUARDIANSHIP OF THE PERSON

1. Emergency Protective Order ("EPO") or Emergency Order for Protective Services ("EOP") TEX. HUM. RES. CODE § 48.208 - A procedure to remove a person lacking capacity to consent to medical services from a situation posing an immediate threat to life or physical safety. Adult Protective Services files a verified petition and an Attorney Ad Litem is appointed. On a finding of probable cause by the probate court of the threat and lack of capacity, the person is removed to treatment and examined within 72 hours. The removal may last no longer than 72 hours unless extended by the court for up to 30 days. An application for temporary and permanent guardianship usually follows.

2. Surrogate Decision -Making ("SDM") – TEX. HLTH. & SAF. CODE § 313.001-.007 – For non-emergency medical decisions to be made for incapacitated individuals who are either in a hospital or nursing home without the necessity of a guardianship.

Decision–Maker Priority: 1) the patient's spouse; 2) an adult child of the patient with the waiver and consent of all other qualified adult children of the patient to act as the sole decision-maker; 3) a majority of the patient's reasonably available adult children; 4) the patient's parents; or 5) the individual clearly identified to act for the patient by the patient before the patient became incapacitated, the patient's nearest living relative, or a member of the clergy.

Limitations on consent: Surrogate decision-maker cannot consent to: 1) voluntary inpatient mental health services; 2) electro-convulsive treatment; 3) the appointment of another surrogate decision-maker; 4) emergency decisions; or 5) end- of-life decisions (extending or withdrawing life support).

SDM does not: 1) replace the authority of a guardian nor an agent under a medical power of attorney; 2) authorize treatment decisions for a minor unless the disabilities of minority have been judicially removed; 3) authorize patient transfers under Chapter 241 of the Health and Safety Code.

Withdrawal of Life Support: for provisions concerning withdrawal of life support where no Directive to Physicians has been executed, and in situations where there is no guardian, see TEX. HLTH. & SAF. CODE § 166.039.

3. Surrogate Decision Making for Intellectually Disabled (MR) - TEX. HLTH. & SAF. CODE § 597.041 – A more specialized form of surrogate decision-making, this statute allows SDM Committees to act for MR persons who reside in an intermediate care facility for the mentally retarded (ICF/MR) – Allows medical and non-medical decisions to be made by the committee.

4. Surrogate Decision Making for Minors When Parent Unavailable TEX. FAM. CODE § 32.001ff - consent to dental, medical, psychological, and surgical treatment of a child by persons authorized in statute.

5. Authorization Agreement for Non-Parent Relative – TEX. FAM. CODE Ch. 34 - A parent may authorize a grandparent, adult sibling or adult aunt or uncle to have decision-making authority for a minor child for: healthcare, insurance coverage, school enrollment, school activities, driver's education, employment and application for public benefits. This essentially authorizes the designee to do anything a guardian of the person could do.

The official form, promulgated by the Texas Department of Family and Protective Services and identified as "Form 2638", can be accessed at: www.dfps.state.tx.us/documents/Child_Protection/2638.pdf

6. Supported Decision-Making Agreements - TEX. EST. CODE Ch. 1357 - Somewhat similar to a Power of Attorney, it is an agreement between 1) an adult with disabilities regarding his or her Activities of Daily Living ("ADLs"), but who is not incapacitated and 2) a "Supporter" who is willing to assist in:

1) understanding the options, responsibilities, and consequences of the life decisions, without actually making those decisions for the disabled adult and without impeding the adult's self-determination; 2) obtaining the relevant information necessary (health, financial, or educational - the adult may execute HIPAA or similar releases to facilitate the information gathering); 3) understanding the information gathered; and 4) communicating those decisions to the appropriate persons.

The "life decisions" could include decisions regarding obtaining food, clothing, and residence and cohabitation choices; the supports, services, and medical care to be received; financial management assistance; and workplace choices.

Such an agreement extends until terminated by either party or by the terms of the agreement or if the Department of Family and Protective Services validates findings of abuse, neglect, or exploitation by the Supporter against the adult or the Supporter is found criminally liable for such actions.

A permissive form is supplied in the statute. The agreement must be signed by both the disabled adult and the Supporter either in the presence of two or more subscribing witnesses (above age 14) or a notary public.

7. Emergency Medical Treatment Act - TEX. HLTH. & SAF. CODE § 773.008 - In certain limited circumstances involving emergency situations, consent to medical treatment does not have to be given, it is implied. Hospital emergency rooms could not function if consent had to be secured beforehand.

Emergency treatment of minors - Consent is also implied for the treatment of a minor who is suffering from what reasonably appears to be a life-threatening injury or illness (even if they can communicate) if the minor's parents, conservator, or guardian is not present. TEX. HEALTH & SAFETY CODE § 773.008(3).

8. Managing Conservatorships TEX. FAM. CODE Ch. 153 - **Functional equivalent to Guardian of the Person** Especially for families involved in a divorce context, a conservatorship may be used in place of a guardianship of the person for a minor, but only when there is no issue of assets belonging to the minor children.

Check the small print - The divorce decree, if there is one, should be carefully examined regarding any management powers granted either spouse regarding property of the children. TEX. FAM. CODE §153.132 grants a parent appointed sole managing conservator essentially the full rights of a guardian of the person and in TEX. FAM. CODE §153.073, the right to manage the property of the child "to the extent that the estate has been created by the parent or the parent's family." The Family Code provides no monitoring mechanism for property management.

9. School Admission Procedures - TEX. EDUC. CODE §25.001(d) – Under §25.001(d) of the Education Code, a school district may adopt guidelines to allow admission of non-resident children to school without the need for a guardianship. You may want to find out who in the school district administration possesses this information before you need it.

10. School Admission Procedures (Grandparents) - TEX. EDUC. CODE § 25.001(b)(9) – A school district may adopt guidelines to allow admission of non-resident children to school if a grandparent of the child resides in the school district and the grandparent provides "a substantial amount" of after-school care for the child. The local school board is to adopt guidelines to implement this provision. No cases yet as to how this might square with TEX. EDUC. CODE § 25.001(d) if there is a guardian, but the child wants to live with the grandparent.

11. Court-Ordered Mental Health Services - TEX. HLTH. & SAF. CODE §§ 462.001, 571.001, 574.001 – In the case of a chronically mentally ill person, a temporary involuntary commitment may well be preferable to a guardianship. A guardianship, with its attendant removal of functional rights, might well be much more restrictive once the patient/ward has become stabilized on medication. Commitment provisions for the chemically dependent, mentally retarded, persons with AIDS and tuberculosis are also available in limited circumstances.

12. Driving Issues: Katie's Law and the Re-Test Request - Effective September, 1, 2007, Texas drivers aged 79 or older can no longer renew a driver's license by mail or electronic means, but must renew the license in person at an authorized license renewal station. In addition, drivers aged 85 and older will now have to renew every two years, rather than every six years. TEX. TRANSPORT. CODE § 521.2711

"Re-Test Request" A potential ward who refuses to stop driving may be reported to the DPS by a physician, a family member, or even a stranger, if the person's driving capability is impaired. Although physicians are somewhat reticent to report their patients because of the physician-patient privilege and HIPAA, it is possible for the applicant in a guardianship or the ad litem to request the court to make a request to the Department of Public Safety for the proposed ward to be re- tested under DPS regulations to determine the proposed ward's suitability to continue to drive.

A relatively new concept is the "Family Driving Agreement" a type of advance directive for driving decisions. The driver agrees in writing to designate someone to advise him or her when it is time to "give up the keys." For more information, see keepingussafe.org.

13. Mental Illness Diversion Programs (Criminal Courts) Persons with mental health issues are often jailed for crimes over which they had little or no control.

In a mental illness diversion program, individuals with a documented mental health problem are treated as patients, not criminals.

In the program, individuals are placed on a strict, supervised probation with regular court check-in dates to document and receive progress updates. Psychiatrists and other professionals develop a mental health treatment program, customized to meet the specific needs of the participants.

Following completion of the program, the charges are dismissed and may be eligible for expunction.

II. ADVANCED MEDICAL DIRECTIVES

The Federal Patient Self-Determination Act 42 USCA § 1395cc(f) requires health care providers, to be eligible for Medicare and Medicaid payments, to supply patients with information regarding Medical Powers of Attorney as well as Directives to Physicians. Patients are to be given information regarding their rights under Texas law to make decisions regarding medical care (including the right to accept or refuse treatment) and the right to formulate advance directives. TEX. HLTH. & SAF. CODE Ch. 166 consolidates the location of the law regarding the 1) the Medical Power of Attorney, 2) and the Directive to Physicians. and 3) the "Out of Hospital Do Not Resuscitate" form. The chapter also provides common definitions to be used among all three documents

14. Medical Power of Attorney - TEX. HLTH. & SAF. CODE § 166.151 The most commonly used tool to avoid guardianship, the Medical Power of Attorney (formerly the Durable Power of Attorney for Health Care) is a creature of statute and should be prepared and executed with close attention to the statutory scheme set out in the Health & Safety Code. Most prudent estate planners will include the Medical Power of Attorney along with a Will and Durable Power of Attorney in a basic estate plan.

The Medical Power of Attorney is not automatically revoked upon the appointment of a guardian. The court may choose to suspend or revoke the power of the agent or to leave the Medical Power of Attorney in place as a less restrictive alternative.

CAVEAT: Nursing homes and hospitals may be reluctant to accept Medical Powers of Attorney which are executed made close to the time they are needed, particularly if the patient's capacity is questionable.

15. Directive to Physicians and Family or Surrogates ("Living Will") – TEX. HLTH. & SAF. CODE § 166.031

The newly revised and renamed form also now requires a disclosure statement (much like in the medical power of attorney), a place to indicate a choice between two treatment options, and a place for designation of an agent. The Directive interrelates to the Medical Power of Attorney in that it instructs the principal not to designate an agent on the Directive if a Medical Power has been executed. The new Directive form is **permissive**.

Intractable Pain Treatment Act. - TEX. REV CIV. STATS Art. 4495c. This act, adopted in 1995, was the first state statute in the nation designed to protect doctors for prescribing morphine to terminal patients for pain management during end-stage treatments without fear of professional disciplinary action for addicting the patients. See www.medsch.wisc.edu/painpolicy. the website for the Pain & Policy Studies Group of the University of Wisconsin Medical School for additional information and discussion on pain management policy.

16. Out-of Hospital DNR ("EMT-DNR") - TEX. HLTH. & SAF. CODE § 166.081 – requires the ambulance personnel to let you die if that is your expressed wish. The tricky thing is having the right document or indicator available. This is one form that you cannot prepare. The forms are actually printed by the Texas Department of Health. Only the officially printed forms (with red ink in the right places) will be honored by the EMTs. The Texas Department of Health has information on ordering the forms and necessary identifying bracelets at http://www.tdh.state.tx.us/hcqs/ems/index.htm#EMSRESOURCES.

17. End-Stage Planning: The Patient's Intent, If Known With or without legal assistance, a person may express his or her wishes and desires as to treatment decisions as disability or death approach. The oldest and most widespread of these is the "Five Wishes," a pamphlet developed in Florida and used in 33 states. It combines 1) surrogate decision making, 2) a medical power of attorney and 3) palliative care choices, many of which are sufficiently thought-provoking to promote some discussion on the topic with the one considering such choices.

CAVEAT: Because of the stringent witnessing requirements under the Advanced Medical Directives Act (TEX. HLTH. & SAF. CODE Ch. 166) and the mandatory nature of the form of the Texas Medical Power of Attorney, the universal Five Wishes™ pamphlet has not been implemented in Texas, however, Texas law does require that the patient's wishes, if known, are to be followed, (e.g.: TEX. HLTH. & SAF. CODE § 166.152(e)(1)). As a result, the Five Wishes may still function as a statement of the patient's intent. www.agingwithdignity.com

III. AVOIDING GUARDIANSHIP OF THE ESTATE

18. Durable Power of Attorney - TEX. EST. CODE § 751.001ff – provides for all acts done by the attorney in fact (agent) to have the same effect, inure to the benefit of, and bind the principal and the principal's successors in interest as if the principal were not disabled. The statutory form allows the grant of broad authority. **If** the Proposed Ward still has enough capacity to grant the power, this is virtually a "no- brainer".

Will the Bank accept it? If you have a client who is planning to use a durable power of attorney and you have some special provisions that have been requested, it is really a good idea to check with your client's banker, stockbroker and other people who are gatekeepers with respect to the client's assets. If they are not prepared to accept those special provisions, you probably want to go a different direction.

Other drawbacks – Because there are no real checks-and- balances on the attorney-in-fact, anecdotal evidence of fraud and abuse often comes "too little, too late" for effective relief. Amendments in 2001 impose a duty on the agent to inform and account to the principal of actions taken under the power and to maintain complete records of actions taken. TEX. EST. CODE § 751.101.

Patriot Act – Know Your Customer – A further complication hampering the use of Durable Powers of Attorney comes as a result of the "Know Your Customer" provisions of the "Patriot Act" (Public Law 107-56 – Oct. 26, 2001). Because the bank must aggressively verify identities, if the attorney in fact presents the power of attorney in question after the incapacity of the principal, there will most likely be insurmountable problems.

19. Convenience Accounts - TEX. EST. CODE § 113.102

- allows a depositor to name a co-signer on his or her account without giving the co-signer ownership rights before or after the depositor's death.
- creates a straightforward agency relationship for a potential ward to allow a family member or friend to help them pay bills and handle other banking business.
- a Convenience Signer cannot pledge the assets of the account. TEX. EST. CODE § 113.251.

Convenience Signer On Other Accounts TEX. EST. CODE § 113.106 – Account owner may designate "Convenience Signers" on other types of multi-party accounts such as joint tenancy with right of survivorship, pay-on-death and trust accounts.

Beware of unintended consequences.

20. Sophisticated Tax Planning

This alternative is included by way of issue recognition, rather than as an attempted exposition. Non-tax-planners might consult their tax planning brethren if a situation presents itself where there is a potential to employ tax planning as a part of disability planning/guardianship avoidance.

21. Inter Vivos ("Living") Trusts - TEX. PROP. CODE §§ 111-115 – Like any tool in the toolbox, a revocable inter vivos trusts has its particular applications. It is an excellent and highly flexible tool when drafted by a knowledgeable, competent estate planning lawyer, working with a full understanding of the client's needs, objectives, and circumstances, and when coordinated with other appropriate estate planning tools and techniques. The trustee can be given much more freedom that a guardian would enjoy, especially in such areas as investments and distributions.

Scam Trusts - IRS - The See IRS Pamphlet 2193 for the attempts of the IRS to educate the public about trust scams. It gives consumers some simple ways to help decide if the trust they are contemplating is "too good to be true."

Irrevocable Trusts – To protect clients from themselves.

22. §142 Trusts – TEX. PROP. CODE § 142.005

In a suit in which a minor who has no legal guardian or an incapacitated person is represented by a next friend or an appointed Guardian Ad Litem, the court may, on application by the next friend or the Guardian Ad Litem and on a finding that the creation of a trust would be in the best interests of the minor or incapacitated person, order the clerk to deliver any funds accruing under the judgment to a trust company or a state or national bank with trust powers. TEX. PROP. CODE § 142.005.

Drawback: These trusts generally fail to provide for any accountability on the part of the trustee. A burgeoning number of fiduciary breach suits are being brought as a result.

Advance Planning: If the suit in question has not already gone to judgment, consider instituting a guardianship proceeding and requesting that the suit be transferred into the probate court.

If you are not in a statutory probate court, ask for a Statutory Probate Judge to be appointed under TEX. GOVT CODE § 25.0022. The Statutory Probate Judge brings with him or her all of the jurisdiction of a statutory probate court, including the transfer power under TEX. EST. CODE § 1022.007. TEX. GOVT CODE § 25.0022(n).

Once you are in the probate court, a Guardianship Management Trust may be created without the necessity of also creating a guardianship. TEX. EST. CODE § 1301.051.

23. Testamentary Trusts

Testamentary trusts can be used to avoid a guardianship for the Testator's spouse, any family members with special needs and children and grandchildren of the Testator. When combined with traditional disability and tax planning, the potential for avoiding guardianship (and most of probate altogether) is great. As always, getting the client in to start the planning process is the hardest part.

24. Guardianship Management Trusts – TEX. EST. CODE § 1301.051 - An effective property management tool while protecting the property from malfeasance.

- may be established whether a guardian is ultimately appointed or not.

- Applicants can include a guardian, an Attorney Ad Litem, a Guardian Ad Litem or a person interested in the welfare of the ward.

The ability to continue the administration of the trust until age 25 (TEX. EST. CODE § 1301.203) can be particularly advantageous to provide a few more years of professional money management during an extended "training wheels" period for the ward/beneficiary.

- Distribution to Pooled Trust Subaccount – In light of the global economic downturn since 2008, the Guardianship Management Trust assets can be transferred to a subaccount of a Master Pooled Trust for more economic management of assets that might otherwise be too modest for a bank trust department. TEX. EST. CODE §§ 1302.001ff. See infra.

25. Pooled Trust Subaccounts TEX. EST. CODE §§ 1302.001ff - As an alternative to a Guardianship Management Trust, funds otherwise appropriate for a Management Trust to be transferred to a pooled trust, such as that operated by the Association for Retarded Citizens (ARC). It will preserve Medicaid qualification. It requires that an annual report be filed, but not a guardianship-style accounting. The trustee may assess its standard fees against the subaccount.

26. Special Needs/ Medicaid Qualification Trusts - 42 USC 1396p (1)(d)(4)(A)

Medicaid is a federal, means-tested program health program for eligible individuals and families with low incomes and resources. It is jointly funded by the state and federal governments, and is managed by the states. In Texas, an individual whose resources or income exceed certain limits cannot qualify for Medicaid benefits. However, certain resources, or assets, do not count for Medicaid eligibility purposes.

The enabling statute, "OBRA 93", allows the use of very specific trusts which may be established with an individual's own assets, but which will not count against the resource limit for that individual for Medicaid purposes.

Although there are three types of such trusts, it is the trust for disabled persons under age 65, authorized pursuant to 42

U.S.C. § 1396p(d)(4)(A) which typically involves the courts. These are most often called "Special Needs Trusts" or "Supplemental Needs Trusts."

Personal injury attorneys are only recently appreciating the utility of these trusts in preserving assets for the permanently disabled client who will remain institutionalized.

Be aware of the potential exposure for an Attorney Ad Litem in a P.I. case who fails to consider the appropriate use of the supplemental needs trust, resulting in a much smaller net benefit for the disabled client.

27**. Trusts for Intellectually Disabled (MR) Persons** TEX. HLTH. & SAF. CODE § 593.081 - Up to $250,000 may be placed in a trust for the benefit of MR individuals in certain residential-care facilities without disqualifying them from receiving state benefits and without the need for a guardianship.

A copy of the trust must be provided to Texas Department of Aging and Disability Services.

DADS may request current financial statements.

Guardianship funds - Ch. 142 trusts, patient's trust fund's in a residential-care facility, child support, an interest in a decedent's estate, and funds in the registry of the court are not considered trusts and are not entitled to the exemption.

28. Community Administrator - TEX. EST. CODE § 1353.002 - Upon a declaration of incapacity of one spouse, the other spouse, in the capacity of "community administrator" (no the decedent's estates kind) has the power to manage, control and dispose of the entire community estate without the necessity of a guardianship upon a finding by the Probate Court that: 1) it is in the best interest of the ward for the capacitated spouse to mange the community property, and 2) the capacitated spouse would not be disqualified to be appointed as guardian of the estate under §1104.351ff.

An ad litem may be appointed, the administrator required to return an inventory and accountings and a guardian of the estate may retain management rights over some specified varieties of real and personal property. These matters are considered in the context of a guardianship application and are not freestanding applications.

TEX. FAM. CODE § 3.301ff (the corollary provision to TEX. EST. CODE § 1353.002) was drastically amended in 2001. It is no longer possible to have the capacitated spouse manage or sell the community property under the Family Code, absent highly unusual circumstances.

29. Court Registry - TEX. EST. CODE § 1355.001 - This provision is often viewed as simply an administrative deposit mechanism and is often overlooked as an opportunity to avoid administration of a minor's or other incapacitated person's guardianship estate. Up to $100,000 may be deposited into the court's registry during the period of incapacity. The clerk is to bring the matter to the judge's attention and the funds are to be ordered invested in an interest-bearing account.

"Mini-administration:" Certain specified persons are permitted to withdraw all or a portion of the funds in the registry under bond to be expended for the benefit of the incapacitated person. After an accounting to the court, the bond may be released. This provides a very simple alternative to guardianship, particularly in a rural county. Upon attaining majority, minors are able to withdraw the funds upon proof of age and an order of the court. TEX. EST. CODE § 1355.105.

CAVEAT: TEX. LOC. GOVT. CODE §§ 117.054 & 117.055 authorize the county clerk to charge investment management fees on funds in the court's registry: a) 10% of any interest earned on interest-bearing accounts and b) 5% (but not to exceed $50.00) on non interest bearing accounts. Where funds are interplead because of a settlement but no probate case is pending, make sure the order specifies that the funds are to be deposited in an interest-bearing account. Institutionalized incapacitated individuals: TEX. EST. CODE § 1355.151ff allow funds being held for an incapacitated individual who is institutionalized by the State of Texas to be paid to the institution for a trust account for the benefit of the individual, up to a maximum of $10,000.

30. Payment to Non-Resident Creditor TEX. EST. CODE § 1355.002 Permits money payable to a non-resident minor, a non-resident adult ward or a non-resident former ward of a terminated Texas guardianship ("non-resident creditor") to be paid either to the guardian of the non-resident creditor in the domiciliary jurisdiction or to the county clerk where the non- resident creditor owns property or in the county of the debtor's residence.

31. Sale of Minor's Interest in Property - TEX. EST. CODE § 1351.001- This relatively simple procedure allows the interest of a minor in realty to be sold and deposited into the court's registry if the minor's interest is less than $100,000. The minor's interest needs to be cash only, so it sometimes is necessary to do a bit of structuring to "cash out" a minor's undivided interest.

The sworn application, which must contain the name of the minor and a legal description of the property, is filed and then is supposed to sit for five days. Citation is optional with the court. Most courts will want to see some indication of value beyond a contract and tax statement. Venue for this procedure is the same as for a guardianship. Court approval is subject to a 'best interest' test on behalf of the minor.

Upon approval by the court (check your local practice as to whether a hearing is actually required), the sale is closed and the proceeds deposited into the court's registry. The funds are available for withdrawal as described above.

If the minor is not a ward and does not have a parent or managing conservator willing or able to file the application, the court may appoint an attorney ad litem or guardian ad litem to act on the minor's behalf for the limited purpose of applying for an order to sell the minor's interest in the property.

32. Sale of Adult Incapacitated Ward's Interest in Property - TEX. EST. CODE § 1351.051

Until this section was enacted, adult incapacitated individuals with meager personal property but with undivided interests in real property were often required to have somewhat meaningless guardianships of the estate. This provision allows adult incapacitated individuals to proceed with a guardian of the person only where their interest in real property is valued at less than $100,000.

This provision is now also available for a ward of a guardian appointed by a foreign court.

33. Mortgage of Minor Interest/ Minor Ward's Interest in Property - TEX. EST. CODE §§ 1352.051, 1352.101

These provisions allow the parents, managing conservator or guardian of the person (as applicable), to obtain a home equity loan secured by the minor's interest in homestead property for the payment of education and medical expenses , for repairs to the homestead property, and for repayment of the loan.

A bond set in twice the amount of the loan amount is required, as well as a hearing on the front end and annual accountings while the loan is being paid off.

34. Uniform Transfers to Minors Act - TEX. PROP. CODE § 141.001 et. seq. - The ability of a donor to make transfers of various types of assets to a minor by the donor's appointment of a custodian has broad coverage and far-reaching implications. The custodian has authority to invest and expend the transferred assets – without court order – for the support, education, maintenance and benefit of the minor.

Again, the lack of supervision may dictate against this as a vehicle of choice unless the custodian is sophisticated enough to really understand fiduciary responsibility.

35. Receivership TEX. EST. CODE § 1354.001, TEX. CIV. PRAC. & REM. CODE §§ 64.001ff, - Of particular interest is where the incapacitated person owns an interest in a going business or commercial property which is in danger of injury. The court may appoint a receiver, who is subject to the same compensation and bonding provisions under the Estates Code as a personal representative. The Receiver administers the property until the need for the receivership is over.

In 1999, the provisions for guardianship for missing persons were repealed. Receivers are now to be appointed for missing persons.

36. Order of No Administration TEX. EST. CODE §§ 451.001ff

If your object is simply to transfer title to estate assets to a disabled surviving spouse or minor children and your facts meet the criteria specified, this somewhat archaic procedure, sort of an amalgamation of a small estate affidavit and an application for family allowance, may be employed if there is otherwise no necessity for administration. The court may dispense with notice or may prescribe the quality and quantity of notice required. TEX. EST. CODE § 451.002.

The court's order reads like the "facilitation of payment" language in a muniment of title proceeding and acts as authority to effect the transfer of the property involved. TEX. EST. CODE § 451.003. Such an order may be "undone" within one year if other information comes to light showing a necessity for administration. TEX. EST. CODE § 451.004.

37. Representative Payee 42 USC § 1383(a)(2)

A Representative Payee may be appointed by the Social Security Administration to manage Social Security benefits without the appointment of a guardian. Potentially available to all of the 50 million individuals receiving some sort of Social Security benefits, close to 7 million people currently receive Social Security benefits under the representative payee program. This is approximately ten times greater than all active court-supervised guardianships in the United States.

38. Veteran's Benefits Fiduciary - 38 USC § 5502(a)(1) Very similar to the Social Security rep payee program, the Department of Veteran's Affairs allows the appointment of a person to handle the administration of veteran's pension benefits without the appointment of a guardian. www.vba.va.gov/bln/21/Fiduciary/index.htm

39. Payment of Employees Retirement System Funds to Parent of Minor - Op. Tex. Att'y Gen. No. H-1214 - a parent may receive and manage a minor child's Texas Employees Retirement System (ERS) benefits without guardianship. This opinion relies on two propositions:

- a parent has authority to manage the estate of a minor child without court appointment of a guardian. TEX. FAM. CODE § 151.001(a)(4).
- A parent may also receive, hold, and disburse funds for the minor's benefit. TEX. FAM. CODE § 151.001(a)(8).

40. International Treaty

There is at least one international treaty between Mexico and the united States that provides for judgments benefitting minors who are Mexican Nationals to be paid to the Mexican Government to as trustee. E-mail from Judge Guy Herman, April 12, 2002 to Texas Probate Listserve www.texasprobate.net

Similarly, Memoranda of Understanding are frequently executed between governmental agencies providing for international cooperation regarding minors in cross-border situations. See Memorandum of Understanding Between the Monterey County Department of Social and Employment Services, Family and Children Services and the Consulate General of México in San José, California Regarding Consular Involvement in Cases Involving Minors www.f2f.ca.gov/res/pdf/Monterey MOUMexicanconsulate.pdf Accessed February 16, 2011

41. Suit by Next Friend - TEX. RULES CIV. PROC. 44

A minor without a legal guardian may sue by next friend. A next friend has the same rights concerning such suits as guardians have. These rights include seeing that the funds or other property recovered is placed in the court's registry, placed in a § 142 Trust under the Property Code or a Guardianship Management Trust under the Estates Code.

Under no circumstances should a non-parent next friend be allowed to seeks to manage the funds personally, as neither the Property Code nor the Rules of Civil Procedure provide for any oversight mechanism for next friend management of a minor's property.

CAVEAT: Next Friends are subject to the same restrictions as guardians re contingent fee agreements. *Massey v. Galvan* 822 S.W.2d 309 (Tex. App. – Houston – [14th District] 1992, wr. den.) In *Stern v. Wonzer* 846 S.W.2d 939 (Tex. App. – Houston - [1st District] 1993, no pet.).

CAVEAT #2: When a P.I. case settles and little or no thought is given to the allocation of the award between the survival cause of action and the wrongful death cause of action, some sticky tax issues and angry creditors (and probate judges) may have to be faced. Texas Health Insurance Risk *Pool v. Sigmundik*, 315 S.W.3d 12 (Tex. 2010); *Elliott v. Hollingshead*, 327 S.W.3d 824 (Tex. App. Eastland, 2010, no pet.).

42. Social Service Agencies - Many social services agencies provide a variety of services specifically tailored to the needs of children, the disabled and elderly. A quick check of the yellow page listings under "social service agencies," will reflect literally dozens of organizations existing to this purpose. Many will have a particular emphasis toward a target group: veterans, the elderly, intellectually disabled, etc.

Beyond the Order for Emergency Protection (supra) the ability of either Adult Protective Services or Child Protective Services to investigate a potential exploitation or neglect situation is vital.

43. Geriatric Care Manager

A Geriatric Care Manager (GCM) is a health and human services professional, such as a gerontologist, social worker, counselor, or nurse, with a specialized body of knowledge and experience on issues related to aging and elder care issues.

GCMs are able to coordinate and manage eldercare services, which often includes conducting an assessment to identify problems, eligibility for assistance and need for services; coordinating medical services, including physician contacts, home health services and other necessary medical services; screening, arranging and monitoring in-home help or other services; reviewing financial, legal, or medical issues and offering appropriate referrals to community resources; providing crisis intervention; ensuring everything is going well with an elder person and alerting families to problems; and assisting with moving an older person to or from a retirement complex, care home, or nursing home.

While California has developed a state registry of Geriatric Care Managers, Texas does not yet have any central registry. The National Association of Professional Geriatric Care Managers, the non-profit association of these professional practitioners, has promulgated a Pledge of Ethics and Standards of Practice. Their website has a locator database. www.caremanager.org

IV. LIMITING THE EFFECT OF THE GUARDIANSHIP

44. Pre-Need Designation of Guardian For Self – TEX. EST. CODE § 1104ff

An adult with capacity may, by written declaration designate those persons whom the declarant wishes to serve as guardian of the person or of the estate of the declarant in the event of later incapacity. The declaration may be in any form adequate to clearly indicate the declarant's intention to designate a guardian for the declarant's self in the event of the declarant's incapacity. The designation may be holographic, acknowledged before a notary or attested to by two witnesses, age 14 years of age or older and who are not designees to be guardian. In the case of attestation, a self-proving affidavit should be executed and attached.

A declaration that is not written wholly in the handwriting of the declarant may be signed by another person for the declarant under the direction of and in the presence of the declarant.

The court is required to follow the designations in the declaration, unless the court finds such designee to be disqualified or their appointment not to be in the ward's best interest.

A new form to allow simultaneous execution, attestation, and making the designation self-proving a is available Tex. Est. Code § 1104.205(a).

Pre-Need Disqualification - Perhaps more importantly, the declarant may also indicate those persons who are to be specifically <u>disqualified</u> from serving as guardian, either of the person or estate. Such a disqualification is binding on the court and is among the listed reasons for disqualification under TEX. EST. CODE § 1104.202.

Revocation/Nullification - The designation may be revoked by execution of another designation or by following the same formalities as revoking a will. Divorce will serve to nullify a designation of a former spouse.

<u>45. Pre-Need Designation of Guardian by Parent</u> - TEX. EST. CODE §§ 1104.103, 1104.151

Similarly, a parent may designate, either in by separate written declaration or in the parent's will, those persons (in preferential order) whom they desire to be guardian of the person and/or estate of their child or children. The designation may specify that the court waive bond as to a guardian of the person, but not as to a guardian of the estate. This designation may be for either minor children or for adult incapacitated children.

Like the designation for one's self, the designation for a child may be in any form adequate to clearly indicate the declarant's intention to designate a guardian for the declarant's child in the event of the declarant's death or incapacity.

Unlike the Pre-Need Designation for Self, the Pre-Need Designation of Guardian by Parent does not contain the provision to expressly disqualify others as guardian.

A new form to allow simultaneous execution, attestation, and making the designation self-proving a is available Tex. Est. Code § 1104.154(a).

<u>46. Pre-Need Declaration for Mental Health Treatment</u> -
TEX. CIV. PRAC & REM. CODE § 137.007

A capacitated adult may, by written declaration, indicate his or her preferences or instructions for mental health treatment, including the right to refuse such treatment. Such a declaration is effective on execution and expires on the third anniversary of its execution or when revoked, whichever is earlier.

Witnesses - The declaration is to be witnessed by two qualified witnesses (similar to other advanced directives). Physicians or other health care provider are to follow such declaration, however, as long as the declarant is capable for giving informed consent, such informed consent is to be sought.

Does not apply – The declaration is ineffective if the declarant, at the time of making the designation, is under a temporary or extended commitment and treatment is authorized under the Mental Health Code or in the case of an emergency when the declarant's instructions have not been effective in reducing the severity of the behavior that has caused the emergency.

<u>47. Safekeeping or "Freeze" Agreements</u> - TEX. EST. CODE § 1105.155 **-** Where the personal representative deposits estate cash or other assets in a state or national bank, trust company, savings and loan association, or other domestic corporate depository, to be held under an agreement that the depository will not allow withdrawal or transfer of the principal of the assets and/or interest on the deposit except on written court order. (See example in Appendix Ad.) The amount of the bond of the personal representative may then be reduced in proportion to the cash or other assets placed in safekeeping.

<u>48. Restoration of Ward</u> - TEX. EST. CODE § 1202.051 **-** A Guardian Ad Litem must be appointed and everyone noticed similar to the original grant of guardianship.

<u>49. Annual Determination</u> - TEX. EST. CODE § 1201.052 - Each year, the probate judge is required to review each guardianship file created after September 1, 1993,and may review annually any other guardianship files to determine whether the guardianship should be continued, modified, or terminated. This provision appears fairly innocuous, but is in reality very powerful. It was recently used in a very large guardianship with massive pending litigation to restore the ward's capacity and terminate the guardianship. Because the standards for the court are somewhat of a blank slate (i.e. discretionary), especially in courts other than statutory probate courts, this provision could be employed in a number of creative ways. Even though the procedure and standards for modification under § 1202.051 are fairly restrictive (see above), the annual determination under § 1201.052 contains no such procedural requirements.

50. Emancipation of Minor Ward - TEX. FAM. CODE § 31.01ff - Where a minor who is over 16, self-supporting (or married) and living apart from parents, a conservator or guardian may ask the court to legally remove the disabilities of minority for either limited or general purposes. The petition is decided on a "best interest" standard and the order is to specify whether the removal of disabilities is limited or general in scope and the purposes for which disabilities are removed.

51. Enumeration of Powers in Guardianship Order TEX. EST. CODE § 1101.151ff - If the guardianship is to be a plenary guardianship, it is perhaps best to simply reflect in the order that "*The guardian is to be granted all power and authority allowed under Texas law and the rights of the ward are limited to the extent not inconsistent therewith.*" Otherwise, attempting to cover everything by an exhaustive listing may leave the guardian with specific deficits. Some attorneys feel that a listing of eight or ten powers is complete, while others can go on for pages.

However, if the ward is partially capacitated, a careful enumeration of those areas in which the ward's rights are not to be limited can have a great effect on the ward's functioning ability and self-esteem.

52. Interstate Guardianships TEX. EST. CODE § 1253.001ff - Where a guardianship exists in another state and the ward has been moved to this state, it can be advisable to allow a part of the guardianship to remain in the other state until affairs (pending litigation, etc) are resolved before all of the remnant is transferred.

53. Negligible Estate TEX. EST. CODE §§ 1204.001 - When the ward's estate is exhausted or when the foreseeable income accruing to a ward or his estate is so negligible that maintaining the guardianship would be a burden, the court may authorize the income to be paid to a parent or other person acting as guardian, to assist as far as possible in the maintenance of the ward, and without any liability for future accountings as to the income.

54. Minor Ward's Estate <$100,000 TEX. EST. CODE §§ 1204.001(d) & 1355.102 - Unlike the adult ward's estate, which is needed for the upkeep and maintenance of the ward, a minor ward's guardianship estate is less likely to be called upon for day-to-day living expenses. If the guardian of the estate is a parent of the ward, the court is usually going to want to see some proof that the guardian/parent cannot make the expenditures out of his/her own pocket rather than out of guardianship assets. The mindset here is more of asset preservation and maybe some college planning, assuming of course that the minor ward has no special needs to deplete the estate. If the estate cash falls below $100,000 (up from $50,000 in 2001), the guardianship of the estate may be closed and the remaining funds paid into the court registry. Withdrawals are then possible under the procedure set out under TEX. EST. CODE § 1355.102 above.

55. Mediation and Family Settlement Agreements TEX. EST. CODE § 1055.151 - Rarely on a guardianship contest is issue of incapacity the real issue. Most often, decades of unresolved conflict among the family members of the proposed ward spark the contests. Perceived favoritism, sibling rivalry, jealousy of a stepparent or step-children or step-siblings, unresolved grief, etc. are all manifested in the guardianship arena.

While resolution of a guardianship contest might remove the procedural obstruction in granting a guardianship, it rarely resolves the family disputes and wounded relationships which led to the contest. Mediation can provide a level playing field for the family to resolve those issues behind the guardianship fight. The long-standing "burrs under the saddle" that so often give rise to fights in the probate arena can be aired and often resolved. TEX. EST. CODE § 1055.151 allows those settlements to be made irrevocable.

"A family settlement agreement is a favorite of the law." *Shepherd v Ledford*, 962 S.W.2d 28 (Tex. 1998).

56. Mother Nature and Father Time -

Spontaneous Remission - It is not unusual - once a person gets adequate nutrition/ hydration/ socialization / therapy/ medication for a few weeks or months - for many symptoms of delirium/ confusion/ diabetic conditions to clear up. In some instances, it is a question of employing successive alternatives in an effort to forestay the inevitable, whether a guardianship or death.
It is rarely in the best interest of a terminally-ill proposed ward to go through successive independent medical examinations and for extensive litigation to exhaust an already beleaguered estate, only to have the ward die the day after letters are granted.

APPENDIX B-1

Supports and Services

<u>Examples of Entities or Organization providing Supports or Services:</u>

Adult Protective Services
Agency Guardianship Providers:
Family Eldercare
Friends for Life
Guardianship Services
Area Agency on Aging
Area food banks
Association of Retarded Citizens of Texas
DADS (Texas Department of Aging and Disability Services)
Ombudsman programs
Mental Health Association
Mental Health Mental Retardation Centers
Network of Care ("Tarrant Cares")
Organizations/ Support groups regarding specific diseases or conditions
Alzheimer's Association
Goodrich Center for the Deaf
Lighthouse for the Blind
Public Charities
United Way
Resource Connection
Religiously-Affiliated Charities
Buckner International
Catholic Charities
Lutheran Social Services
The Service Connection
Volunteers of America

Food, Clothing, or Shelter TEX. EST. CODE § 1002.031(1)

Adult Day Care
Adult Foster Care
Assisted Living Facilities / Apartment-Like Settings or Private Residences
Case Management
Church Groups – Organized Provision of Food
Dietary Services/ Meals (Noon Meal and Snacks
Home Management: Housekeeping Activities to Support Health & Safety
Cleaning
Laundry
Shopping
Other Household Tasks.
In-Home Attendant Services - Assistance in ADLs
Meals on Wheels
Residential Assistance
Respite Care
Physical or Mental Health; TEX. EST. CODE § 1002.031(2)
Adaptive Aids (Eye Glasses, Hearing Aids, Orthotics)
Behavioral Support Services
Rehabilitation Therapy (Cognitive, Occupational, Physical
Dental Treatment
Health-Related Tasks Prescribed by a Physician
Personal Care: Physical Health
Bathing
Dressing
Grooming
Hair & Skin Care
Feeding
Exercising
Self-Administered Meal Preparation Assistance
Medication
Toileting
Transferring/Ambulating

Medical Services
Audiology
Dental
Nursing
Physicians
Speech & Language Pathology
Medical Supplies/ Prescription Drug Assistance Therapy
Occupational
Physical
Speech
Hearing
Language

Manage Financial Affairs TEX. EST. CODE § 1002.031(3)

Bill Paying Programs
Employment Assistance
Homebound School Instruction
Supported Employment
Utility Bill Assistance

Personal Decisions: Residence, Voting, Operating a Motor Vehicle, & Marriage TEX. EST. CODE § 1002.031(4)

Assisted Living (licensed up to six beds)
Benefits Counseling/Legal Assistance
Chore Provider
Court Visitor Programs
Day Care Services
Orientation & Mobility /Assisted Transportation & Escort
Mobility Impaired Transportation Services
Minor Home Modifications
Intervention/ Ombudsman Program
Social, Educational & Recreational Activities
Transition Assistance Services
Organized Friendly Visits

DRAFTING CLTs – WHAT YOU CAN AND CAN'T DO

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This outline is for educational purposes only. Nothing herein shall constitute legal advice by the author or Davis Stephenson, PLLC. Each case varies depending upon its facts and circumstances. Anyone seeking tax advice should consult with his, her, or its tax advisor. The sample provisions included in this outline are intended only to provide guidance to a practitioner in drafting the provisions of a trust intended to accomplish the indicated objective(s) and are not to be relied upon by any practitioner for any other purpose. Additionally, the author cautions any practitioner using the sample provisions of this outline for guidance purposes of the need to consider all other provisions of the governing instrument that may be affected by or have any effect on the interpretation and suitability of the sample provisions.

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DRAFTING CLTs – WHAT YOU CAN AND CAN'T DO

By

LAUREL STEPHENSON

I. INTRODUCTION.

This article highlights the rules that apply to charitable lead annuity trusts and charitable lead unitrusts, cautions when a departure from the suggested structure for either trust outlined in the corresponding IRS sample form might be worth considering, and explains the circumstances in which either trust might be a beneficial planning technique.

II. HISTORY OF THE CHARITABLE LEAD TRUST.

Prior to 1969, a charitably minded individual could create a trust designed to distribute its income to charity for a designated period of time and ultimately distribute the assets remaining upon the expiration of the charitable term to noncharitable beneficiaries (typically, descendants or trusts for them). At the time of the gift, the grantor would secure a charitable gift or estate tax deduction for the value of the charitable income interest and use gift or estate tax exemption (and/or pay gift or estate taxes) on the value of the remainder interest.

Congress ultimately decided that trusts of this type were often being inappropriately administered in a manner designed to deny the charitable beneficiaries a "true" income interest, with the goal of maximizing the amount of value passing upon the expiration of the charitable term to the remainder beneficiaries. This result was commonly achieved by investing the trust estate in investments producing little to no income but with significant appreciation potential.

Consequently, Congress enacted IRC §§ 2522(c)(2)(B) and 2055(e)(2)(B), which provide that a contribution to a trust providing for (i) payments to charity for a period of time and (ii) distribution of the trust assets at the expiration of that period to noncharitable beneficiaries will only qualify the charitable interest for the gift/estate tax/applicable income tax deduction if that interest takes one of two forms.[1] Such a trust must either be a (i) charitable lead annuity trust (or a "CLAT") providing for a "guaranteed annuity interest" payable to a charity or charities or (ii) charitable lead unitrust (a "CLUT") providing for a charity or charities to receive at least annually "a fixed percentage of the net fair market value, determined annually, of the property" held by the CLUT. In either event, the value of the noncharitable beneficiaries' remainder interest will be a taxable gift or bequest, as applicable.

As discussed later in this outline (and in particular, in Section VII), a CLAT or CLUT facilitates a tax free transfer of value to the remainder beneficiaries to the extent that the assumptions made in valuing the remainder interest at the time of the gift/bequest to the trust are ultimately proven to have underestimated the value eventually passing to the remainder beneficiaries. This will occur if the CLAT/CLUT assets grow at a rate in excess of the growth rate assumed in valuing the remainder interest at the time of the trust's creation (the IRC § 7520 rate) and/or if the person who serves as the measuring life (if any) for the trust fails to live out his/her actuarial life expectancy.

III. IRS SAMPLE FORMS.

The Internal Revenue Service has issued annotated sample trust instruments creating grantor and nongrantor inter vivos CLATs and CLUTs, as well as testamentary CLATs and CLUTs (which are inherently nongrantor trusts).[2] Those forms also provide alternate text for certain trust provisions.[3]

A CLT with terms "substantially similar" to the corresponding sample trust instrument (whether using the default or any alternate provisions) operated in a manner consistent with the terms of the trust instrument will qualify the charitable lead annuity/unitrust interest for deduction pursuant to (as applicable)

[1] All references to "IRC" in this outline are references to the Internal Revenue Code of 1986 (as amended).

[2] Rev. Proc. 2007-45, 2007-2 CB 89 (June 22, 2007) (inter vivos grantor and nongrantor CLATs), Rev. Proc. 2007-46, 2007-2 CB 102 (June 22, 2007) (testamentary CLATs), Rev. Proc. 2008-45, 2008-2 CB 224 (July 24, 2008) (inter vivos grantor and nongrantor CLUTs), and Rev. Proc. 2008-46, 2008-2 CB 238 (July 24, 2008) (testamentary CLUTs). The term "nongrantor CLT" is used in this outline based upon the use of that term by the IRS in its sample forms. However, a "nongrantor CLT" necessarily must be a complex trust. See IRC § 651.

[3] While a testamentary CLAT or CLUT can be created via a will, this outline discusses CLTs in terms of being created by trust instruments.

IRC §§ 2522(c)(2)(B), 2055(e)(2)(B), and IRC § 170(a) (if structured as a grantor trust) and will also qualify the annual payments to charity for the income tax charitable deduction pursuant to IRC § 642(c)(1) (if structured as a nongrantor trust).[4] If a trust instrument does not sufficiently track the IRS issued corresponding form, it may nevertheless qualify for the applicable deductions but will not achieve the "safe harbor" status secured via a closer adherence to the corresponding IRS form.[5] It is therefore generally recommended that the trust instrument for a CLT be drafted to be as similar to the corresponding IRS sample CLT as is possible.

Consequently, the conservative planner may wish to make as few alternations to the IRS sample forms as possible and limit those alterations to those strictly necessary to incorporate the sample text into his/her own form agreement. However, other planners may be more willing to incorporate certain of the alternate or supplemental provisions to the IRS sample forms suggested in this outline that may (but are not guaranteed to) secure additional benefits or flexibilities not otherwise provided by the default or alternate provisions provided in the IRS forms.

<u>Drafting Tip</u>: Ensure that the provisions in the CLT article in your trust instrument are properly coordinated with the remaining articles of your form instrument:

- Check your "Notwithstandings" to ensure those in the CLT article trump those in other sections.
- Consider having the grantor sign a simple document outlining his/her intentions in creating the CLT that can be used in the event of a construction or reformation proceeding designed to secure qualification for the desired tax treatments.
- If a trust protector or other independent fiduciary is to be given the discretion to modify the trust instrument, narrow the scope of that discretion to prevent it from being exercised in a manner that would disqualify a CLT for the desired tax treatment.[6]

<u>Sample Language – Defining Scope of Amendment Authority Provided to Independent Fiduciary for Grantor CLT</u>: "Notwithstanding the preceding [referencing the amendment authority granted to the fiduciary] or any other provision of this instrument to the contrary, the Special Trustee shall have no power to amend this instrument in any manner that would prevent (i) payments to the Charitable Organization in accordance with Section ___ [referencing the annuity/unitrust payments, but not any payments of excess income] from being treated as [a guaranteed annuity interest][a unitrust interest] under Internal Revenue Code §§ 2055(e)(2)(B) and 2522(c)(2)(B) and the regulations thereunder or (ii) the deduction by the Grantor pursuant to IRC § 170(a) and the regulations thereunder of the present value of such payments at the time of the Trust's receipt of the Grantor's contribution of property [and the deduction for payments of income to the Charitable Organization pursuant to Section ___ - add if allowing for income in excess of the annuity/unitrust payment to be paid to charity; delete if accumulated income will be added to principal]."

<u>Sample Language – Defining Scope of Amendment Authority Provided to Independent Fiduciary For Nongrantor CLT</u>: "Notwithstanding the preceding [referencing the

[4] Note, the typical deductibility requirements applicable to any charitable gift must also be satisfied (e.g., "qualified appraisals" for certain contributed property with a value in excess of $5,000, as required pursuant to IRC § 170(f)(11)). Also, there is no set-aside deduction for trusts established after October 9, 1969, unless an election is made pursuant to IRC § 645.

[5] While the IRS generally will not issue a private letter ruling on whether a particular CLT trust instrument in its entirety will qualify for the desired tax deductions, it will generally issue letter rulings on the tax consequences associated with the inclusion of a particular trust provision not incorporated in the applicable IRS sample form. See the "Scope" Section in each of Rev. Proc. 2007-45, Rev. Proc. 2007-46, Rev. Proc. 2008-45, and Rev. Proc. 2008-46.

[6] Note, each IRS sample form CLT provides the trustee with a limited ability to amend the trust instrument to secure the desired tax results. The following text is modeled after that suggested text.

> amendment authority granted to the fiduciary] or any other provision of this instrument to the contrary, the Special Trustee shall have no power to amend this instrument in any manner that would prevent (i) payments to the Charitable Organization in accordance with Section ___ [referencing the annuity/unitrust payments, but not any payments of excess income] from being treated as [a guaranteed annuity interest][a unitrust interest] under Internal Revenue Code §§ 2055(e)(2)(B) and 2522(c)(2)(B) and the regulations thereunder or (ii) the deduction from the gross income of the trust pursuant to Internal Revenue Code § 642(c)(1) and the regulations thereunder of such payments [and the deduction of any payments of income to the Charitable Organization pursuant to Section ___ - add if allowing for income in excess of the annuity/unitrust payment to be paid to charity; delete if accumulated income will be added to principal]."

IV. STRUCTURE OF THE CHARITABLE LEAD TRUST.

CLATs and CLUTs share certain common characteristics but also have distinct differences, as discussed below. If a CLAT and CLUT share a characteristic, then the following discussion will address that characteristic in the context of a "CLT," which should be interpreted in that event as a reference to either a CLAT or a CLUT. If a characteristic that differs between CLATs and CLUTs is discussed, then each of a CLAT and CLUT will be separately addressed in that regard.

A. Charitable Term. As discussed in more detail below, a CLT may be structured to last for (i) a term of years, (ii) the life or lives of certain individuals living and identifiable at the time of the contribution to the CLT, or (iii) the life or lives of certain individuals living and identifiable at the time of the contribution to the CLT plus a term of years.[7] Note, if a CLT is structured to last for an individual's lifetime, then the CLT must be funded in a manner designed to pass the "110 year exhaustion test."[8]

1. Charitable Term Based Upon Term of Years. Unlike a charitable remainder trust, there is no limitation on the number of years for which a CLT established for a terms of years may exist. The regulations clarify that a trust instrument's savings clause designed to ensure compliance with the rule against perpetuities should accordingly be crafted to maximize, rather than limit, the CLT's existence (subject to the stated term) so as to accommodate a charitable term in excess of 21 years.[9]

> **Query**: Should a CLT terminated in compliance with a perpetuities savings clause be required to distribute to the designated charity or charities the full value of any future annuity or unitrust payments, consistent with the prohibition on commutation of the annuity/unitrust payments discussed in Section IV.B.4? Alternatively, may those payments be made based upon a discounted present value, given that the commutation prohibition is intended to avoid discretionary early terminations of CLTs designed (for example) to prevent currently underperforming trust assets from undermining prior growth by assets that consequently created value to

[7] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a)(testamentary CLATs), 25.2522(c)-3(c)(2)(vi)(a)(inter vivos CLATs), 20.2055-2(e)(2)(vii)(a)(testamentary CLUTs), 25.2522(c)-3(c)(2)(vii)(a)(inter vivos CLUTs); Rev. Proc. 2007-45, Rev. Proc. 2007-46, Rev. Proc. 2008-45, Rev. Proc. 2008-46. Note, Section 5.02(4) of each Rev. Proc. (and Section 8.02(4) for the inter vivos grantor CLTs) provides for the term described in (iii), which is not discussed in any of the referenced Treasury Regulations.

[8] Treas. Reg. §§ 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i), 25.7520-3(b)(2)(v), Example (5). If a CLAT is established for the life of an individual or individuals, it is assumed each will survive to age 110. Consequently, if the annuity payout rate exceeds the 7520 rate in effect at the CLAT's creation, a calculation check is necessary to confirm that the trust assets will not be exhausted prior to the term's expiration. That calculation requires multiplying the annual annuity amount by the Table B annuity factor for 110 years minus the age of the youngest individual used as a measuring life. If the result exceeds the contribution amount, then a special 7520 annuity factor must be calculated that takes into account the potential for exhaustion of the CLAT assets during the term (alternatively, the CLAT would need to be overfunded in order to pass the exhaustion test using the annuity rate from Table B).

[9] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 20.2055-2(e)(2)(vii)(a); Treas. Reg. §§ 25.2522(c)-3(c)(2)(vi)(a), 25.2522(c)-3(c)(2)(vii)(a).

pass free of transfer taxes to the remainder beneficiaries?[10] The safer approach is to direct that a distribution to charity of the full amount of the remaining payments be made without any discounting to account for the acceleration of those payments.

2. Charitable Term Based Upon Measuring Lives. If the charitable term is based upon the life of an individual or individuals, only the grantor, the grantor's spouse, a lineal ancestor of all the noncharitable remainder beneficiaries, or the spouse of a lineal ancestor of all the noncharitable remainder beneficiaries may be used as a measuring life.[11] Contingent beneficiaries with a less than 15% probability of receiving trust assets may be disregarded for that purpose.[12]

B. Charitable Payments. A CLT must make an annual payment to charity during its charitable term and provide for the assets remaining at the expiration of the charitable term to pass to noncharitable beneficiaries. As discussed below, a CLAT and a CLUT differ in the manner in which each trust's payment amount is determined.

1. CLATs/Guaranteed Annuity Interest. A CLAT must provide each year during its charitable term for a distribution of a "guaranteed annuity" to a qualified charitable organization or organizations.[13] The Regulations provide that a "guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually" throughout the charitable term. The Regulations go on to provide that an "amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date."[14] A CLAT is not subject to any minimum or maximum payout requirements.[15]

a. Annuity Payment Defined as Percentage of Initial Fair Market Value of Trust Property. The guaranteed annuity amount is often set at a fixed percentage of the initial fair market value of the assets contributed to the CLAT as finally determined for the applicable transfer tax. This is the default approach taken in the IRS issued CLAT forms, and is the generally recommended approach. Each of those IRS forms consequently provides for a correcting payment in the event of an undervaluation or overvaluation of the trust assets in establishing a charitable payment amount.[16] Curiously, none of the IRS sample forms provide for interest to be paid in conjunction with a correcting payment. In contrast, the IRS issued testamentary CLAT form provides for interest compounded annually at the IRC § 7520 rate in effect at the decedent's death to be paid upon the delayed funding of a testamentary CLAT.[17]

A payment equal to the lesser of a sum certain or a fixed percentage of the annually re-determined net fair market value of the trust assets is not a guaranteed annuity interest.[18] In addition, the charitable interest in a

[10] See Section IV.B.1.b for a discussion of this concept.

[11] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), Treas. Reg. 25.2522(c)-3(c)(2)(vi)(a) (CLATs); Treas. Reg. §§ 20.2055-2(e)(2)(vii)(a), Treas. Reg. 25.2522(c)-3(c)(2)(vii)(a) (CLUTs).

[12] The probability is determined at the time of the trust contribution by the actuarial tables referenced in Treasury Regulation § 20.2031-7 in effect at the time.

[13] IRC §§ 2055(e)(2)(B), IRC 2522(c)(2)(B); Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

[14] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 25.2522(c)-3(c)(2)(vi)(a).

[15] Rev. Proc. 2007-45 (Sections 5.02(2) and 8.02(2)) and Rev. Proc. 2007-46 (Section 5.02(2)).

[16] See paragraph 2 of each of the IRS sample forms in Rev. Proc. 2007-45 and paragraph 1 of the IRS sample form in Rev. Proc. 2007-46.

[17] Compare and contrast paragraph 2 of each of the IRS sample forms in Rev. Proc. 2007-45 (providing inter vivos forms) and paragraph 1 of the IRS sample form in Rev. Proc. 2007-46 (providing testamentary form) with paragraph 2 of the sample form in Rev. Proc. 2007-46. With regard to the testamentary CLAT, the IRS sample form provides that while the annuity payments of a testamentary CLAT are required to commence upon the grantor's death, the actual payments may be postponed until the year after the year in which the CLAT is funded.

[18] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(b), 25.2522(c)-3(c)(2)(vi)(b).

CLAT will not be a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the charitable term.[19]

b. Increases to Annuity Payment Amount. The Regulations do not require that the annual payments from a CLAT remain equal from year to year. Instead, they require that each annual payment be "determinable" so that the present value of all payments to charity may in turn be determinable as of the applicable valuation date for the CLAT's funding.[20] The Regulations clarify that a set amount may be payable for a term of years or an individual's lifetime and thereafter be adjusted by a specific amount (but not by reference to a fluctuating index, such as a cost of living index). Rev. Proc. 2007-45 and Rev. Proc. 2007-46 add further clarity by expressly providing that an annuity may increase during the charitable term, so long as the value of the annuity amount is ascertainable at the CLT's funding.[21]

While there is little doubt that payments from a CLAT may increase in amount from year to year, there has been a good deal of debate among practitioners as to whether there is a cap on the amount by which the charitable payments may increase annually. While Treas. Reg. 25.2702-3(b)(1)(ii) caps the permitted annual increase to a GRAT's payments at 20% each year, the Regulations do not provide a corresponding cap on the annual increases to charitable payments from a CLAT, nor is there a discussion of such in either Rev. Proc. 2007-45 or Rev. Proc. 2007-46.[22] There was also no discussion of a cap in PLR 201216045, which addressed a reformation of a testamentary CLAT for which there was no ascertainable means of calculating the charitable payments designed to accommodate the decedent's stated intent of creating a "zeroed-out" CLAT.[23] The IRS blessed the state court's reformation of the testamentary CLAT providing for a 20% annual increase in the charitable payments throughout the 10-year charitable term. Notably, the IRS in no way indicated in the PLR that it found the proposed 20% annual increase to the CLAT's payments to charity to be controversial or that it would challenge a CLAT providing for an even greater annual adjustment.

Conservative planners may wish to structure a term of years CLAT to provide for a 20% annual increase to the charitable payment based upon the result in PLR 201216045 and Treas. Reg. § 25.2702-3(b)(1)(ii) by analogy, leaving it to more aggressive planners to test the IRS' tolerance for a CLAT providing for a greater annual increase in the annuity amount. The truly aggressive planners may take matters further and structure a CLAT to provide for only modest annual payments during the initial years of the charitable term (say, $1,000) and require a balloon-like payment in the CLAT's final year in an amount designed to "zero-out" the CLAT so that either a modest or nontaxable gift/bequest will occur upon its creation.[24] This aggressive form of a CLAT is commonly referred to as a "Shark Fin CLAT" based upon the

[19] Rev. Proc. 2007-45 (Sections 5.02(1) and 8.02(1)) and Rev. Proc. 2007-46 (Section 5.02(1)), each citing to Rev. Rul. 88-27, 1988-1 CB 331. See Section IV.B.4 below.

[20] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a), 25.2522(c)-(c)(2)(vi)(a).

[21] Rev. Proc. 2007-45 (Sections 5.02(2) and 8.02(2)) and Rev. Proc. 2007-46 (Section 5.02(2)).

[22] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(a) and 25.2522(c)-3(c)(2)(vi)(a).

[23] PLR 201216045 (April 20, 2012).

[24] Technically, a "zeroed-out" CLAT will not provide for a taxable gift (if an inter vivos CLAT) or a taxable bequest at death (if a testamentary CLAT). A true "zeroed-out" CLAT may make allocation of GST exemption at creation problematic, in that there is no taxable transfer to which GST exemption may be allocated. For that reason, it may be preferable to structure a CLAT to result in a nominal taxable gift or bequest.

graphic depiction of a modeling of the payments.

<u>Sample Language – Defining the Annuity Amount for a Shark Fin CLAT (Assumes Quarterly Payments)</u>: "The annuity amount shall be (i) for each taxable year of the trust other than the taxable year in which the annuity period ends, One Thousand Dollars ($1,000), and (ii) for the taxable year in which the annuity period ends, an amount that will result in the remainder interest of the trust having a present value equal to One Hundred Dollars ($100.00), taking into consideration for such purpose the present value of the annuity payments described in (i) above and the proration thereof in the initial year of the annuity period and the proration of the payment described in (ii) in the final year of the annuity period. For purposes of the preceding, the establishment of a "present value" shall be determined [as of the date of contribution to the trust/as of the appropriate valuation date for federal estate tax purposes] based upon the initial net fair market value of all property transferred to the trust, valued as finally determined for [federal gift tax purposes/federal estate tax purposes], using the lowest rate then available for such purpose in accordance with Code Section 7520(a)."

Both the remainder beneficiaries and the designated charity/charities may be benefitted to a greater extent by the use of a Shark Fin CLAT than the use of a more conventional CLAT providing for even annual payments or even a CLAT providing for modest annual increases to the annuity amount. With a more conventional CLAT, poor investment performance during the earlier years coupled with more sizeable annual payments could result in an exhaustion of trust assets prior to the end of the charitable term, leaving not only the noncharitable beneficiaries with nothing but also depriving the charitable beneficiaries of annuity payments in those later years of the charitable term. In contrast, a Shark Fin CLAT minimizes the impact of poor short-term performance by CLAT assets or short-term liquidity issues in the initial years of the charitable term by postponing the payment of more than modest amounts until the final year of the charitable term. By that final year, a long-term investment strategy will ideally provide the CLAT with the means to accommodate the final, large payment to charity and also pass significant value to the remainder beneficiaries.

c. <u>Valuation of Guaranteed Annuity Interest</u>. The present value of a guaranteed annuity interest is generally to be determined under Treas. Reg. § 20.2031-7 (or Treas. Reg. § 20.2031-7A, for certain prior periods), with the value affected by the charitable term, the 7520 rate, the payment amounts, and the timing and frequency of the payment(s) made during each year. However, if the circumstances at the time of a contribution to a CLAT indicate that the charity may not receive the entire guaranteed annuity interest, a deduction will be allowed under IRC § 2055 or IRC § 2522 only for the minimum amount that the charity will clearly receive.[25] The income tax deduction will be similarly limited in that event.[26] Consequently, if a term of years CLAT provides for payments with a present value in excess of the value of the assets contributed to the CLAT, the income and transfer tax charitable deductions are understandably limited to the value of the CLAT assets as determined for the applicable transfer tax.[27]

Curiously, the CLT forms do not address the consequences of the payment of estate taxes by the CLT. In contrast, it is clear that payment of estate taxes by a trust intended to be a charitable remainder trust (or "<u>CRT</u>") will disqualify it from being respected

[25] Treas. Reg. §§ 20.2055-2(f)(2)(iv), 25.2522(c)-3(d)(2)(iv).
[26] Treas. Reg. § 1.170A-6(c)(3)(iii).
[27] See the examples for Treas. Reg. §§ 20.2055-2(f)(2)(iv), 25.2522(c)-3(d)(2)(iv). See also Section IV.C.3 for a discussion of the potentially limited charitable deduction in the event of a contribution to a CLAT with a charitable term measured by an individual's life. See also footnote 8.

as such, based upon the prohibition of payments being made to or for the benefit of noncharitable recipients other the initial or successor individual beneficiaries entitled to annuity or unitrust payments for a term of years (not to exceed 20 years) or the life/lives of such individual(s). Consequently, estate taxes and other amounts to be borne by a residuary estate passing to a testamentary CRT should be paid prior to the CRT's funding and not with assets already held in the CRT. Similarly, any estate taxes resulting from the inclusion of an inter vivos CRT in the grantor's estate pursuant to IRC § 2036 or otherwise must be assumed by the successor noncharitable beneficiary of the CRT to prevent forfeiture of his/her interest in the CRT.[28]

Some planners have suggested that similar concerns may apply with regard to CLTs, given the general prohibition on payments being made for private purposes during the charitable term. However, there are no examples in the Treasury Regulations regarding CLTs nor text in the sample IRS CLT forms that expressly confirm that CLTs are subject to the previously described restrictions on payment of debts/expenses/taxes applicable to CRTs. For example, while the IRS sample form CLTs do discuss the possibility of inclusion of an inter vivos CLT's assets in the grantor's estate (e.g., if the grantor retains the ability to remove and replace the charitable beneficiary), they do not require that the CLT instrument include a provision directing that the resulting estate taxes be paid by the noncharitable remainder beneficiary to prevent forfeiture of his/her/its interest(s), as is the case with the IRS sample CRT forms.[29] Also note that while IRC § 2207B provides for a general right of recovery of any estate taxes resulting from the inclusion of a trust in the grantor's estate under IRC § 2036, it waives recovery of those estate taxes from a CRT. It, however, does not waive the recovery of those estate taxes from a CLT, suggesting that different rules apply in that regard to the different charitable split-interest trusts.

Of course, payment of estate taxes, debts, and expenses from a bequest to a testamentary CLT will reduce the accompanying estate tax charitable deduction and create a circular calculation.[30]

Drafting Tip: The IRS sample CLT forms serve as "safe harbors." Consequently, it is arguably unnecessary to import the previously described provisions in the IRS sample CRT forms into a CLT instrument, given that the IRS CLT forms have not done so. Of course, providing for all estate taxes/expenses/debts to be paid prior to the funding of a CLT in receipt of the residuary estate is a fairly conventional approach in any event. On the other hand, requiring that the remainder beneficiaries of a CLT pay any estate taxes resulting from an inclusion of the CLT assets in the Grantor's estate is quite a departure from the IRS sample "safe harbor" CLT instrument and could even be considered a prohibited contribution.[31] Consequently, inclusion of such a provision is arguably unnecessary and potentially even detrimental to securing the status of a CLT.

2. CLUTs/Unitrust Interest. A CLUT must provide at least annually during the charitable term for a distribution to charity of a "unitrust amount" equal to a designated percentage of the net fair market value of the trust assets determined annually as of a date specified in

[28] Treas. Reg. § 1.664-1(a)(6), Examples 3, 4, and 5; Section 4, Paragraph 3 and Section 5.03(1) of each of Rev. Proc. 2003-55, 2003-2 CB 242 (August 1, 2003) and Rev. Proc. 2003-56, 2003-2 CB 249 (August 1, 2003); Section 4, Paragraph 3 and Section 5.03(1) of each of Rev. Proc. 2005-54, 2005-2 CB 353 (August 19, 2005) and Rev. Proc. 2005-55, 2005-2 CB 367 (August 19, 2005).

[29] Sections 9.02(1) and 9.03(1) of Rev. Proc. 2007-45; Sections 5.02(5) and 6.02(1) of Rev. Proc. 2008-45.

[30] IRC § 2055(c).

[31] See Sections IV.D.1 and IV.D.2 of this outline.

the trust instrument.[32] Alternatively, the net fair market value of the trust assets for such purpose may be based upon an average of the valuation of those assets determined at multiple dates in the year specified in the trust instrument. In any event, the same valuation date or dates and method of valuation must be used each year.[33] If the trust instrument does not provide a valuation date or dates, then the trustee is to select a date or dates and indicate the date(s) selected on the first Form 1041 filed by the CLUT.[34]

None of the IRS sample forms for CLUTs provide for interest to be paid in conjunction with a correcting payment necessitated by a valuation error impacting the amount of the unitrust to be paid in any year. In contrast, the IRS issued testamentary CLUT form provides for interest compounded annually at the IRC § 7520 rate in effect at the decedent's death to be paid upon the delayed funding of a testamentary CLUT.[35]

a. Increases to Applicable Percentage. The applicable percentage may increase or decrease over the charitable term so long as the value of the unitrust interest is ascertainable at the Grantor's death or initial lifetime contribution, as applicable.[36] Unlike a charitable remainder unitrust, a CLUT cannot provide for the payment of the lesser of its net income or the unitrust payment in any year, nor may it provide for the payment of the lesser of a sum certain amount or a fixed percentage of the annually re-determined net fair market value of the trust assets.[37] A CLUT is not subject to any minimum or maximum payout requirements.[38] In addition, the charitable interest in a CLUT will not be a unitrust interest if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the charitable term.[39]

b. Valuation of Unitrust Interest.[40] The present value of a unitrust interest is to be determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the contributed property.[41] If estate taxes/ estate debts/ estate administration expenses are to be borne by property bequeathed to a testamentary CLUT, the IRC 2055 deduction necessarily must reflect that the charitable bequest is reduced by those items, which should be paid from the property bequeathed to the CLT before the remaining property is distributed to the CLT.[42]

Unlike a CRUT, there is no requirement that an independent trustee or qualified appraiser re-value the CLUT assets annually. However, it has been suggested on occasion that it may be prudent to adopt the standards that

[32] Treas. Reg. §§ 20.2055-2(e)(2)(vii)(a), 25.2522(c)-3(c)(2)(vii)(a).

[33] The IRS sample CLUTs used January 1st as the valuation date. If a different valuation date is used or an average of multiple valuation dates is used, then the provisions of the applicable IRS sample CLUT may need to be modified in regards to the timing of the payment of the unitrust amount and the proration of such in the initial and final years of the charitable term (as may the provision regarding additional contributions, if permitted with regard to an inter vivos CLUTs). Rev. Proc. 2008-45 (Sections 5.02(9) and 8.02(9)) and Rev. Proc. 2008-46 (Section 5.02(9)).

[34] Treas. Reg. §§ 1.170A-6(c)(2)(ii)(A), 20.2055-2(e)(2)(vii)(a), 25.2522(c)-3(c)(2)(vii)(a).

[35] Compare and contrast paragraph 2 of each of the IRS sample forms in Rev. Proc. 2008-45 (providing inter vivos forms) and paragraph 1 of the IRS sample form in Rev. Proc. 2008-46 (providing testamentary form) with paragraph 2 of the sample form in Rev. Proc. 2008-46. With regard to the testamentary CLUT, the IRS sample form provides that while the annuity payments of a testamentary CLUT are required to commence upon the grantor's death, the actual payments may be postponed until the year after the year in which the CLUT is funded.

[36] Rev. Proc. 2008-45 (Sections 5.02(2) and 8.02(2)) and Rev. Proc. 2008-46 (Section 5.02(2)).

[37] Treas. Reg. 1.170A-6(c)(2)(ii)(B), Treas. Reg. §§ 20.2055-2(e)(2)(vii)(b), Treas. Reg. 25.2522(c)-3(c)(2)(vii)(b).

[38] Rev. Proc. 2008-45 (Sections 5.02(2) and 8.02(2)) and Rev. Proc. 2008-46 (Section 5.02(2)).

[39] Rev. Proc. 2008-45 (Sections 5.02(1) and 8.02(1)) and Rev. Proc. 2008-46 (Section 5.02(1)), each citing to Rev. Rul. 88-27, 1988-1 CB 331. See Section IV.B.4 below.

[40] See Section IV.B.1.c for a discussion of the potential impact on a trust's qualification as a CLT in the event that debts, administration expenses, and/or transfer taxes may be paid with CLT assets.

[41] Treas. Reg. §§ 1.170A-6(c)(3)(ii), 20.2055-2(f)(2)(v), 25.2522(c)-3(d)(2)(v); 20.2055-2(f)(1), 25.2522(c)-3(d), 1.7520-2, 20.7520-2; 25.7520-2.

[42] IRC § 2055(c). See also Section IV.B.1.c of this outline.

apply in that regard with respect to CLUTs.[43]

3. Payment of Annuity or Unitrust Payment in Kind. If appreciated property is distributed in satisfaction of a required payment to charity, capital gains will be recognized, regardless of whether the CLT is a nongrantor trust or grantor trust. If the CLT is a nongrantor trust, the CLT will be entitled to an offsetting income tax charitable deduction under IRC § 642(c), even if capital gains are allocated under the trust instrument or local law to principal, so long as they are paid to the charitable beneficiary.[44]

A grantor retained annuity trust (or GRAT) is prohibited from issuing a note in satisfaction of an annuity payment, although it may distribute in kind an interest in a note held by it as an asset.[45] Curiously, the IRS CLT forms do not similarly restrict a CLT from issuing a promissory note in satisfaction of an annuity or unitrust amount. While the same concerns that led to the IRS' objections to GRATs issuing notes in satisfaction of annuity amounts would seem applicable with regard to CLTs, the IRS clearly did not prohibit the practice in its CLT forms. Arguably, if the IRS had objections to the issuance of notes by a CLT it would have prohibited such in its forms, given that at the time the CLT forms were issued by the IRS, it had long since formalized its objections to a similar practice by GRATs with the amendment to Treas. Reg. § 25.2702-3(d)(6) effective September 5, 2000. Of course, self-dealing issues would ensue if a CLT were to issue a note to the family private foundation as the designated charity and then fail to pay off the note prior to the CLT's termination and the distribution of its remaining assets to the noncharitable remainder beneficiaries (if disqualified persons) or at such earlier time at which the remainder beneficiaries (if disqualified persons) hold 20% (or 35%, if applicable) of the beneficial interest in the CLAT.[46] Short of those obviously problematic scenarios, it is not entirely certain that a CLT can issue a note in satisfaction of an annuity or unitrust payment, but the IRS' silence in that regard does provide some comfort that it is permissible.

> **Drafting Tip**: The IRS issued forms do not require that the issuance of notes in satisfaction of an annuity or unitrust payment be prohibited in the trust instrument, as is required for grantor retained annuity trusts. Consequently, there is no reason to include a similar prohibition on the issuance of notes in the CLT instrument. However, caution should be exercised before issuing a note in satisfaction of an annuity or unitrust payment and consideration given to seeking a private letter ruling confirming the appropriateness of the use of a note for that purpose.

4. Commutation of Charitable Payments. The IRS takes the position that the trustee of a CLT should not be permitted to commute and prepay the charitable interest prior to the termination of the charitable term.[47] In practice, the IRS has only taken issue with a prepayment of the charitable interest at a discounted value reflecting current payment. The IRS has ruled favorably when the full, undiscounted amount of the remaining charitable payments (or a greater amount) is distributed to charity in conjunction with an early termination of a CLT.[48]

In the most recent ruling, the IRS approved a plan to modify a charitable lead annuity trust (CLAT) that had performed significantly better than originally projected. Under the plan, the CLAT proposed a distribution of property equal in value to 110% of the undiscounted remaining annuity payments to a new trust that would pay an increased annual amount to charity for

[43] *See* Michael v. Bourland, Jeffrey N. Myers, and John W. Conner, Estate Planning with Charitable Lead Trusts, presented by Michael V. Bourland and Lora G. Davis at the ALI CLE, Estate Planning for the Family Business Owner, July 8-10, 2015.

[44] See Section 5.02(2) of each of Rev. Proc. 2007-45, Rev. Proc. 2007-46, Rev. Proc. 2008-45, and Rev. Proc. 2008-46 (all nongrantor CLTs), each citing to Rev. Rul. 83-75, 1983-1 C.B. 114. Note, IRC § 642(c)(4) provides that to the extent that the amount otherwise allowable as a deduction under IRC § 642(c)(1) consists of gain from the sale or exchange of "qualified small business stock," as defined in IRC 1202, the charitable deduction under IRC § 642(c)(1) must be adjusted for any exclusion allowed to the trust under IRC § 1202.

[45] Treas. Reg. § 25.2702-3(b)(1).

[46] Note, the mere fact that the foundation and the CLT might (i) be effectively controlled (directly or indirectly) by the same person(s) and/or (ii) have received substantially all of their contributions (directly or indirectly) from the same disqualified person(s) will only result in the CLT being considered a disqualified person with respect to the foundation for purposes of IRC § 4943. IRC § 4946(a)(1)(H).

[47] Rev. Proc. 2007-45 (Sections 5.02(1) and 8.02(1)), Rev. Proc. 2007-46 (Section 5.02(1)), Rev. Proc. 2008-45 (Sections 5.02(1) and 8.02(1)), and Rev. Proc. 2008-46 (Section 5.02(1)), each citing to Rev. Rul. 88-27, 1988-1 CB 331.

[48] See, e.g., PLR 9844027 (October 30, 1998) and PLR 200226045 (June 28, 2002).

a period of years equal to the original term of the original CLAT. The remaining CLAT property was to be distributed to the remainder beneficiary. The IRS concluded that, subject to approval by a court and the state attorney general, the plan would not result in the termination of the CLAT's private foundation status, nor would it be a taxable expenditure, constitute self-dealing, result in a tax on undistributed income pursuant to IRC § 4942 or excess business holdings under IRC § 4943, or constitute a jeopardy investment. The IRS concluded that the CLAT was honoring its obligations and that the charity was simply agreeing to accept more money.

> **Drafting Tip**: The IRS issued forms do not require that the trust instrument itself contain an express prohibition on the trustee commuting and prepaying the charitable interest prior to the expiration of the charitable term, although the annotations direct that an annuity interest will not be considered a guaranteed annuity interest if the trustee has the discretion to commute and prepay the charitable interest prior to the termination of the charitable term. Presumably, the requisite restriction in that regard is implicitly found in Paragraph 8, which generally prohibits the trustee from exercising any discretion inconsistent with the requirements for CLT status. That approach should be adopted in a CLT so that a desired distribution to charity of the undiscounted remaining annuity payments may be accommodated, if desired and sufficiently vetted.

5. Payment for Private Purposes During Charitable Term. The Regulations provide that generally no payments may be made by a CLT for private interests during the charitable term. However, two exceptions apply. First, one or more individuals may receive payments in the form of a guaranteed annuity interest (if a CLAT) or unitrust interest (if a CLUT) if the trust instrument does not provide for any preference or priority in the payment of the private annuity/unitrust interest over payment of the charitable annuity/unitrust interest. Second, the trust instrument may provide for the payment of amounts to an individual from a portion of the trust assets exclusively set aside for that purpose and to which IRC § 4947(a)(2) is inapplicable by reason of IRC § 4947(a)(2)(B).[49] Of course, payments made for full and adequate consideration (e.g., reasonable trustee fees) are not payments for a private purpose.[50]

C. Transfer Tax Charitable Deductions.

1. Lifetime Gifts. A lifetime gift made to a CLT will result in the grantor's receipt of a gift tax charitable deduction equal to the present value of the annuity or unitrust payments to charity to be made during the charitable term (but not for any excess income to be paid to charity in any year, even if mandated by the trust instrument).[51] Correspondingly, the grantor will make a taxable gift at the time of the trust contribution equal to the present value of the noncharitable remainder interest.

2. Bequests. A decedent's bequest to a CLT will result in the estate's receipt of an estate tax charitable deduction equal to the present value of the payments to be made to charity during the charitable term (but not for any excess income to be paid to charity in any year, even if mandated by the trust instrument).[52] Correspondingly, the present value of the noncharitable remainder interest as of the time of a decedent's death will be subject to estate tax.

3. Valuation Considerations. The value of the charitable interest and, consequently, the charitable deduction (and correspondingly the taxable value of the remainder interest) will be impacted by (i) the length of the charitable term, (ii) the annuity or unitrust amount payable to charity, and (iii) for a CLAT, the IRC § 7520 rate applicable in valuing the charitable and remainder interests (the charitable deduction amount for a

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[49] Treas. Reg. §§ 20.2055-2(e)(2)(vi)(f), 25.2522(c)-3(c)(2)(vi)(f) (CLATs); Treas. Reg. §§ 20.2055-2(e)(2)(vii)(e), 25.2522(c)-3(c)(2)(vii)(e) (CLUTs).

[50] For purposes of this outline, it is assumed that no payments for private purposes are provided for with regard to a CLT.

[51] Treas. Reg. §§ 25.2522(c)-3(d)(1), 25.2522(c)-3(d)(2)(iv), 25.2522(c)-3(d)(2)(v); 25.2522(c)-3(c)(2)(vi)(d), 25.2522(c)-3(c)(2)(vii)(d). Note, if the Grantor is serving as trustee and is given the discretion to distribute income to charity or accumulate it for ultimate passage to the noncharitable beneficiaries, incomplete gift issues and estate inclusion issues under IRC §§ 2036 and 2038 for the Grantor will arise, as will a potentially undesired grantor trust status with respect to at least a portion of the CLT.

[52] IRS 2055(e)(2)(B); Treas. Reg. §§ 20.2055-2(f)(1), 20.2055-2(f)(2)(iv), 20.2055-2(f)(2)(v), 20.2055-2(e)(2)(vi)(d), 20.2055-2(e)(2)(vii)(d).

contribution to a CLUT is generally not impacted by the interest rate).[53]

The grantor of a CLT/decedent's estate may use the IRC § 7520 rate applicable for the month of contribution to the CLT/date of death or the rate applicable in either of the two preceding months.[54] The grantor of a CLAT/executor should elect the lowest of those three available rates in order to minimize the annuity payment amount necessary to accommodate the desired charitable deduction amount to be obtained in conjunction with the trust contribution/bequest. This will best position the CLAT to achieve success via an outperformance of the IRC § 7520 rate.

A "zeroed-out CLAT" can be achieved at a 2.2% 7520 rate via the combinations of annuity payout rates and charitable terms indicated below:

- 21.34 % for 5 years
- 11.25 % for 10 years
- 7.90 % for 15 years
- 6.24 % for 20 years

Sample Language – Defining the Annuity Amount for a "Zeroed-Out" CLAT With a Set Annuity Amount:[55] "The annuity amount shall be for each taxable year of the trust (taking into account the proration thereof in the initial and final years of the annuity period) an amount calculated as a percentage of the initial fair market value of all property transferred to the trust, [for a gift: valued as of the date of transfer and as finally determined for federal gift tax purposes, that will result in the remainder interest of the trust having a value for federal gift tax purposes equal to One Hundred Dollars ($100.00) as of such date of transfer, calculating such by using the lowest rate available for such purpose in accordance with Code Section 7520(a)."][for a bequest: valued as finally determined for federal estate tax purposes, that will result in the remainder interest of the trust having a value for federal estate tax purposes equal to One Hundred Dollars ($100.00) as of the appropriate valuation date, calculating such by using the lowest rate available for such purpose in accordance with Code Section 7520(a)."]

As a caveat, the valuation tables issued in accordance with IRC 7520 cannot be used if a CLT is established for a lifetime of an individual who is "terminally ill," which is defined to mean (1) he/she has an incurable illness or other deteriorating physical condition and (2) there is at least a 50% probability that he/she will die within one year. If the measuring life actually survives for at least 18 months after the funding of the CLT, the measuring life will be presumed not to have been terminally ill at the time of the contribution,

[53] As a caveat, interest rate-sensitive adjustment factors are applied when the unitrust payments are adjusted based on frequency and timing of payments.

[54] IRC § 7520(a); Treas. Reg. §§ 1.7520-2(a)(2), 1.7520-2(b), 20.7520-2(a)(2), 20.7520-2(b), 25.7520-2(a)(2), 25.7520-2(b).

[55] It is not recommended that a CLAT to which GST exemption is to be allocated be "zeroed-out" completely. Instead, consider structuring the annuity payments to yield a nominal value for the remainder interest to which GST exemption may be allocated. Even if GST exemption is not to be allocated to a CLT, some planners find more comfort in assigning a nominal amount to the remainder interest, although this may be a distinction without a difference.

unless demonstrated to be otherwise by clear and convincing evidence.[56]

D. Additional Contributions.

1. CLATs. No additional contributions may be made to a CLAT after the initial contribution, and the governing document should accordingly prohibit additional contributions.[57] However, all assets bequeathed to a testamentary CLAT by a decedent are deemed to comprise a single contribution, even if the transfers of the various assets from the estate to the CLAT in satisfaction of the bequest do not all occur on the same day.

2. CLUTs. The grantor may make additional gifts to an inter vivos CLUT and may bequeath assets to it at death, but third parties may not make contributions.[58] Correspondingly, no additional contributions are permitted to a testamentary CLUT, although the entirety of the Grantor's bequest to a CLUT will be deemed a single contribution by him/her regardless of the time period over which the funding of the CLUT occurs.[59] Each additional contribution made to an inter vivos CLUT by the Grantor (or bequest to such a CLUT by the Grantor at death) will require an adjustment to the unitrust amount payable for the year of receipt.[60]

E. Designation of Charitable Beneficiaries.

The charitable beneficiary or beneficiaries may be designated in the trust instrument, or the trustee may be given the discretion to select the charitable organization(s) to receive the annuity or unitrust payments.[61]

If the charitable recipient(s) are designated in the trust instrument, provision should be made for the selection of an alternate charitable recipient in the event the originally designated charity either ceases to exist or loses its tax exempt status. In any event, the trust instrument should limit charitable beneficiaries to organizations to which gifts/bequests will qualify for the gift/estate tax charitable deduction.[62] Paragraph 2 of the IRS sample forms provides for the trustee to select alternate charitable recipients.

1. Estate Inclusion For Grantor Given Charity Selection Discretion.[63] As a caveat, the grantor cannot be given the discretion to select the charitable recipient without resulting in an incomplete gift of the annuity/unitrust interest for gift tax purposes and the inclusion of the CLT's assets in the grantor's estate pursuant to IRC §§ 2035, 2036 and/or 2038.[64] Consequently, if the grantor wishes to serve as trustee but avoid estate inclusion of the CLT assets, this discretion to select charitable recipients should be given to a co-trustee (or if the grantor wishes to serve as trustee, it can be given to an independent fiduciary vested solely with that narrow discretion).

> **Drafting Tip**: If the Grantor wishes to serve as the sole trustee and avoid estate inclusion, the designation of successor or alternate charitable recipients should be reserved exclusively to another fiduciary, and the Grantor should not be given the ability to remove and replace that fiduciary freely.[65] Ensure that fiduciary has the ability to resign without court approval, can appoint his/her own successors (if appropriate), receives compensation (if any) suitable to the duties imposed on him/her, and is subject to an appropriate standard of care.

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[56] Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3)(i), 25.7520-3(b)(3).

[57] See Paragraph 5 of each sample CLAT form provided in Rev. Proc. 2007-45 and Rev. Proc. 2007-46.

[58] Sections 5.05(1) and 8.05(1) of Rev. Proc. 2008-45.

[59] See Paragraph 5 of the sample testamentary CLUT form provided in Rev. Proc. 2008-46.

[60] See Paragraph 5 of the grantor and nongrantor inter vivos CLUT forms provided in Rev. Proc. 2008-45.

[61] Sections 5.02(5) and 8.02(5) of Rev. Proc. 2007-45; Section 5.02(5) of Rev. Proc. 2007-46; Sections 5.02(5) and 8.02(5) of Rev. Proc. 2008-45; Section 5.02(5) of Rev. Proc. 2008-46; Rev. Rul. 78-101, 1978-1 CB 301. Note, anyone (including the grantor) can be given this discretion without causing the CLT to be a grantor trust. IRC § 674(b)(4).

[62] Rev. Rul. 78-101, 1978-1 CB 301.

[63] See Section IV.B.1.c for a related discussion.

[64] Note, the grantor's retention of that discretion will not cause an incomplete gift for income tax purposes, nor will it result in grantor trust status for the CLT (see IRC § 674(b)(4)). In the event of inclusion, a full estate tax charitable deduction would not be available.

[65] The IRS will attribute to a grantor any discretion held by a trustee who can be removed by the grantor and replaced by an individual selected by the grantor who is "related or subordinate" to the grantor (including the grantor himself/herself), as described in IRC § 672(c). See Revenue Ruling 95-58, 1995-2 CB 191 confirming that estate inclusion will not result from a grantor having the ability to remove a trustee and replace him/her with an individual who is not "related or subordinate" to the grantor in accordance with IRC § 672(c).

Of course, estate inclusion may be acceptable to a Grantor who is creating a nongrantor CLT measured by his/her life primarily for income tax purposes and not for estate tax purposes and, consequently, may welcome the incomplete gift result and the accompanying estate inclusion of the remaining CLT property based upon a resulting adjustment of the basis of that property at death pursuant to IRC § 1014. For example, a Grantor may create a "zeroed-out" CLT measured by his/her own life to facilitate an income tax charitable deduction via IRC § 642(c)(1) otherwise unavailable to him/her under IRC § 170(a) because he/she is already exceeding his/her own income tax deduction limitations or because he/she wishes to obtain an income tax deduction for contributions to foreign charities. Of course, a Grantor who has reached the limits for deducting his/her gifts to charities under IRC § 170(a) is likely to be interested in minimizing estate taxes at his/her death as well, which will generally make estate inclusion an unattractive result.

Inclusion of an inter vivos CLT in the grantor's estate pursuant to IRC §§ 2035, 2036 and/or 2038 could also occur if the benefitted charity is a private foundation for which the grantor serves in a capacity giving him/her discretion over the distribution of funds received from the CLT (e.g., a director or trustee).

> **Drafting Tip**: If the CLT instrument has already been signed but the grantor wishes to continue serving in that capacity, explore the possibility of amending the governing documents for the private foundation to prohibit the grantor from exercising any dispositive authority over funds received from the CLT. If the private foundation is a trust that cannot be amended along those lines, consider whether the grantor can release that aspect of his/her trustee discretion under the trust instrument without having to resign as trustee. If not, consider whether decanting to or merging with a trust that does not give the grantor that discretion over selection of the charitable beneficiaries may be a possible solution.

2. Limitation to Domestic Charities for Grantor CLTs. While a nongrantor CLT may make annuity or unitrust payments to a foreign charity and secure the IRC § 642(c)(1) deduction, a grantor CLT must limit its distributions during the charitable term to domestic charities in order to qualify the grantor's contribution for the charitable income tax deduction under IRC § 170(a). This is discussed in more detail below.

F. Income Tax Considerations. A CLT may be structured either as a grantor CLT or as a nongrantor CLT.

1. CLT as a Nongrantor Trust.

a. General. If the CLT is a nongrantor trust, then the grantor will not receive any income tax charitable deduction in conjunction with a contribution to the CLT.[66] All trust income will be taxed to the CLT based upon the compressed rates applicable for trusts.[67] However, a CLT that is a nongrantor trust will receive an IRC § 642(c)(1) deduction for payments to charity (including income paid in any year to charity in excess of that needed to satisfy the annuity or unitrust payment), including those made to foreign charities.[68]

> **Sample Language – Modify IRS Nongrantor CLT Form to Permit Distributions to Foreign Charities**: Note, the testamentary and inter vivos nongrantor trust CLAT and CLUT forms issued by the IRS limit distributions to "organizations described in IRC §§ 170(c), 2055(a) and 2522(a)" which has the effect of unnecessarily limiting the CLT distributions to domestic charities. If distributions to foreign charities may be desired, consider modifying Paragraph 1 of each sample testamentary and inter vivos nongrantor trust CLT form in the following manner:
>
> "…If [designated charitable recipient] is not an organization described in ~~§ 170(c), 2055(a), and 2522(a)~~ **IRC §§ 2055(a) and 2522(a) that is**

[66] IRC § 170(f)(2)(B).

[67] A nongrantor CLT will be subject to the alternative minimum tax only if that tax exceeds the CLT's regular tax. A discussion of the AMT exceeds the scope of this outline but should be considered in reporting the income from a CLT.

[68] Compare Treas. Reg. § 1.642(c)-1(a)(2) and IRC § 170(c).

organized and operated to further a purpose specified in IRC § 170(c), determined without regard to IRC § 170(c)(2)(A), at the time any payment is to be made to it, the Trustee shall instead distribute such payments to one or more organizations described in ~~§§ 170(c), 2055(a), and 2522(a)~~ **IRC §§ 2055(a) and 2522(a) that are organized and operated to further a purpose specified in IRC 170(c), determined without regard to IRC § 170(c)(2)(A),** as the Trustee shall select, and in such proportions as the Trustee shall decide, from time to time, in the Trustee's sole discretion. The term "Charitable Organization" shall be used herein to refer collectively to the organization(s) then constituting the charitable recipient, whether named in this paragraph or subsequently selected as the substitute charitable recipient. During the trust term, no payment shall be made to any person other than the Charitable Organization."

Of course, a grantor CLT must necessarily restrict distributions to organizations described in IRC §170(c) because individual charitable gifts made to foreign charities are not deductible under IRC § 170(a).

b. Election of Deduction Year. While the CLT trustee must make the required annual (or more frequent) payments to charity, the trustee is given the discretion for purposes of determining the amount of the income tax charitable deduction to elect to treat charitable payments in any year as having been made in the prior year by filing a statement with the Form 1041 for the taxable year in which the charitable contribution is to be treated as paid.[69]

c. Reductions to Deduction. As a caveat, the charitable deduction pursuant to IRC § 642(c)(1) is reduced by the amount of any exclusion for net capital gains allowable to the CLT pursuant to IRC 1202(a) and is not allowed to the extent the distribution is comprised (or deemed to be comprised under the sourcing rules) of tax exempt income.[70] The income tax charitable deduction under IRC § 642(c)(1) is also disallowed to the extent that any portion of the amount paid to a charity (or deemed paid under the sourcing rules) is allocable to the trust's "unrelated business taxable income" (or "UBTI") for the year (determined in accordance with IRC § 512 as though the CLT were an exempt organization).[71] However, a partial deduction is allowed under IRC § 512(b)(11) for the portion of a CLT's charitable contribution allocable to UBTI, effectively imposing the IRC § 170 rules for deductibility (including only permitting an income tax charitable deduction for distributions to domestic charities) other than the itemized deduction limitation rules.[72]

Example: If a CLT had income of $201,000 from the operation of a trade or business unrelated to its exempt purpose, it would have unrelated business income of $200,000 (that is, $201,000 less the $1,000 IRC § 512(b)(12) deduction). Assume the whole $201,000 is paid to the grantor's private nonoperating foundation (i.e., a 30 percent charity). Consequently, the CLT will be entitled to a $61,000 charitable income tax deduction, calculated as the sum of the (i) $1,000 unlimited charitable income tax deduction and (ii) the trust's $200,000

[69] IRC § 642(c)(1).

[70] IRC §642(c)(4).

[71] IRC § 681; Treas. Reg. § 1.681(a)-2. Generally, UBTI includes income derived from an active business unrelated to an organization's exempt functions and debt-financed income.

[72] Note, the examples in Treas. Reg. 1.681(a)-2 reflect calculations made when the contribution base limitation for gifts to private foundations was 20% and was 30% for gifts to public charity. The contribution base limitation for gifts to private foundations was raised from 20% to 30% pursuant to the Deficit Reduction Act of 1984. The contribution base limitation for gifts to public charities was raised from 30% to 50% pursuant to the 1969 Tax Act.

of unrelated business income multiplied by 30 percent (reflecting the same limitations applicable with regard to individual charitable contributions, excluding the itemized deductions limitations). A carryover of the $140,000 excess charitable deduction seems to be permitted, although the IRS has yet to formally confirm its agreement with that position.[73]

d. Charitable Payments Deemed Made Pro Rata From All Sources of Trust Income. On April 16, 2012, final regulations were issued confirming that for tax purposes, distributions to charity from a CLT are deemed to consist of a pro rata portion of all types of a CLT's income, including nondeductible tax exempt interest and nondeductible UBTI (calculated after the IRC § 170 deduction taken at the CLT level). The Preamble to those regulations concludes that a contrary sourcing provision for distributions to charity in the CLT instrument will not be respected for federal tax purposes because it can never meet the requisite criteria of having "economic effect independent of income tax consequences" due to the mandatory nature of the charitable payments.[74]

e. Charitable Deduction for Distribution of Accumulated Income. A nongrantor CLT is generally permitted to take an IRC § 642(c)(1) deduction for accumulated income distributed to charity.[75] As a caveat, distributions of accumulated unrelated business income are likely subject to the limitations of IRC § 681 otherwise applicable with respect to distributions of unrelated business income in the year it is earned.[76]

f. Timing the Funding of a Testamentary CLT. If it is an absolute certainty that income accumulated by an estate (or a revocable trust, if a IRC § 645 election is made) for the benefit of a testamentary CLT will ultimately be paid to charity in satisfaction of a charitable annuity or unitrust payment, the estate may be entitled to a set-aside deduction for that income under IRC § 642(c).[77] As a practical matter, it may just be easier for the estate/trust subject to the IRC § 645 election to fund the CLT with income earned by it and take a deduction for the distribution pursuant to IRC § 661(a)(2). The CLT can then take a charitable deduction for amounts it subsequently pays to charity pursuant to IRC § 642(c), which for tax purposes may be advisable sooner than later.

2. CLT as a Grantor Trust. A grantor will receive an income tax charitable deduction (subject to applicable limitations pursuant to IRC § 170(b)) for a transfer to a CLT if it is structured as a grantor trust and the charitable beneficiaries are limited to domestic charities (a requirement for deduction under IRC § 170 but not IRC § 642(c)).[78] Because a gift to a CLT is deemed to be a gift "for the use of" a charity, the grantor's charitable deduction will be limited to 30% of the grantor's contribution base.[79]

The grantor should be able to carry over any excess charitable deduction, although that is not entirely certain.[80] The grantor will receive no additional charitable income tax deduction for the annuity or unitrust payments as they are distributed to charity, as

[73] See footnote 81.
[74] Treas. Reg. § 1.642(c)-3(b)(2).
[75] Treas. Reg. § 1.642(c)-1(a)(1).
[76] Private Letter Ruling 8332049 (May 6, 1983).

[77] Absent an IRC § 645 election, there is no set-aside deduction for a trust established after October 9, 1969.
[78] IRC § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(3). The normal rules under IRC 170 regarding the substantiation of gifts will continue to apply in securing the income tax charitable deduction, including "qualified appraisals" required for large gifts.
[79] IRC § 170(b)(1)(B)
[80] The IRS took the controversial position in a 1988 private letter ruling that the 5-year carryforward of an excess charitable deduction was not available to a gift made to a CLT. That ruling was widely criticized and the IRS ultimately reversed its position, concluding in multiple later rulings that an excess charitable contribution may be carried forward, either pursuant to IRC § 170(b)(1)(B) (if the contributed property is not capital gain property) or pursuant to IRC § 170(b)(1)(D)(ii) (if it is capital gain property). See PLRs 8824039 (March 21, 1988), 199908002 (March 1, 1999), and 200010036 (March 13, 2000).

the charitable deduction secured at the time of contribution reflected the present value of those charitable payments.[81]

a. Amount of Charitable Deduction; Timing of Contributions. The charitable deduction will be equal to the present value of the annuity or unitrust payments to be distributed during the charitable term to charity (excluding any excess income that may be paid to charity, whether at the discretion of the Trustee or pursuant to a requirement in the trust instrument).[82] For this reason, structuring a CLT as a grantor CLT might be worth considering (for example) if the grantor is anticipating receiving an usually large amount of taxable income in a year and wants a large offsetting charitable deduction or if the grantor anticipates significantly lower tax rates for himself/herself going forward (e.g., if the grantor is retiring and plans on investing conservatively). The Grantor of a grantor CLT will also receive a charitable income tax deduction for any excess income paid to charity as those payments actually occur (subject to application limitations).[83]

Query: Should the Grantor of a grantor CLT be able to deduct any income distributed to a public charity in excess of the annuity/unitrust payment based upon the 50% limitation? That seems like the correct result, given that the grantor is deemed to own the income immediately prior to his/her deemed contribution of it to the public charity. However, the IRS sample grantor CLT forms do not address that question.

b. Contribution of Capital Gain Property. If the contributed property is capital gain property, then conventional wisdom dictates that the Grantor's income tax charitable deduction will be limited to 20% of his/her contribution base.[84] However, the annotation in Sections 8.01(3) and alternate text in 9.06 of Rev. Proc. 2007-45 curiously suggest that capital gain property contributed to a grantor CLT may be deductible subject to the 30% limitation if the charitable beneficiary and any alternate charitable beneficiaries named in the trust instrument or selected by the trustee are required to be organizations described in IRC § 170(b)(1)(A) (i.e., public charities). There is no corresponding annotation/text associated with the grantor CLUT form issued the following year in Rev. Proc. 2008-45, nor is there any explanation in Rev. Proc. 2008-45 as to why the annotation in Section 8.01(3) and text 9.06 of Rev. Proc. 2007-45 were omitted in Rev. Proc. 2008-45.

Note, that the "Scope" section of Rev. Proc. 2007-45 only provides that a deduction pursuant to IRC § 170 is secured for a grantor trust CLAT conforming to the grantor trust CLAT form in Rev. Proc. 2007-45. It does not expressly provide that the 30% limitation will apply for capital gain property contributed to a CLAT solely benefitting public charities during the charitable term, the implication of Sections 8.01(3) and 9.06 of Rev. Proc. 2007-45 to that effect notwithstanding. In light of that fact and the IRS' failure to carry over that same annotation and suggested text in Sections 8.01(3) and 9.06 of Rev. Proc. 2008-45 (providing the grantor CLUT form), it is generally recommended that it be assumed that a charitable deduction for capital gain property contributed to a grantor CLAT will be limited to 20% of the grantor's contribution base.[85]

[81] Treas. Reg. § 1.170A-6(d)(1).

[82] IRC § 170(f)(2)(B); Treas. Reg. §§ 1.170A-6(c)(3), 1.170A-8(a)(2). In addition, further reductions to the charitable deduction may be required pursuant to IRC § 170(e).

[83] Treas. Reg. § 1.170A-6(d)(2)(ii).

[84] Additional limitations may be potentially applicable. IRC §170(e); Treas. Reg. § 1.170A-4

[85] Note, the corresponding CLAT and CLUT forms and their annotations have obviously been drafted by the IRS to be as identical as possible, subject to differences inherent to the structure of a CLAT or a CLUT. It is difficult to interpret the omission of the subject discussion in the annotations to the grantor CLUT form (and the alternate text section) as anything

c. Consequences to Grantor of Grantor Trust Status. If the CLT is structured as a grantor trust, the grantor will then be responsible for reporting on the grantor's individual income tax return all of the CLT's taxable income, deductions, loss, gain, and credits.[86] However, because the grantor is unconditionally entitled to the initial charitable deduction at his/her individual tax rate regardless of the manner in which the CLT ultimately invests its assets, the grantor may ultimately pay little or no tax despite the CLT's grantor trust status if it invests in non-income producing or tax-exempt properties during the charitable term.[87] Of course, the CLT trustee has a fiduciary duty to the trust beneficiaries and cannot invest with the goal of minimizing the taxable income consequently taxed to the grantor to the detriment of the trust beneficiaries.

d. Gift Tax-Free Gift of Income Taxes Paid on Income Passing to Remainder Beneficiaries. It is also worth noting that the grantor's payment of income taxes on any excess trust income not distributed to charity is effectively an additional gift tax-free gift to the remainder beneficiaries.[88] Of course, a conventional grantor trust offers a more effective means of making gift tax-free gifts to descendants via the grantor's payment of income taxes on trust income.

e. Recapture. If the grantor dies or a CLT's grantor trust status is otherwise lost during the charitable term, the grantor will have ordinary income via a mandatory recapture of the benefit of the original income tax charitable deduction. The Code and Regulations differ in the calculation of that recapture amount. The Code defines the recaptured amount as the excess of the original charitable deduction pursuant to IRC § 170(a) over the discounted value of all income earned by the CLT and taxed to the grantor (without distinguishing between ordinary income and capital gains).[89] In contrast, Treas. Reg. § 1.170A-6(c)(4) defines the recaptured amount as the excess of the original charitable deduction over the discounted value of all trust income actually paid to charity while the CLT remained a grantor trust, computed by treating each charitable payment as a contribution of a remainder interest after a term of years and valuing the payment in accordance with Treas. Reg. § 20.2031-7 as of the date of the grantor's contribution to the CLT. While the Code's offset is more beneficial to the grantor, the Regulation's offset formula is arguably more consistent with the concept of recapture in that it only gives the grantor "credit" for amounts paid to charity, in keeping with the basis for the original charitable deduction. Interestingly, the annotations to the IRS sample grantor trust CLT forms regarding recapture reflect the statutory approach.[90]

In this instance, recapture is not necessarily a negative outcome, given that the CLT will be permitted to deduct payments to charity pursuant to IRC § 642(c)(1) once it is a nongrantor trust.[91] In theory, the relinquishment of the CLT's grantor trust status could be timed to occur at a point when recapture would result in little or no taxable income to the grantor (i.e., at a point when the grantor's benefit from the original charitable deduction has been

other than an indication that the IRS reconsidered and ultimately rejected its prior belief that the 30% limitation applied to contributions of capital gain property to a CLT solely benefitting public charities.

[86] IRC § 671.

[87] Note, in contrast, a nongrantor CLT investing in tax exempt assets will receive no charitable deduction under IRC § 642(c)(1) to the extent a distribution to charity is deemed to be comprised of tax exempt income.

[88] Rev. Rul. 2004-64, 2004-2 CB 7.

[89] IRC § 170(f)(2)(B).

[90] Section 8.01(5) of each of Rev. Proc. 2007-45 and Rev. Proc. 2008-45.

[91] Treas. Reg. § 1.170A-6(d)(2)(i).

offset by the present value of the trust income taxed to him/her) so that the CLT can take advantage of the IRC § 642(c)(1) deduction going forward, thereby providing an overall tax efficient outcome for the grantor and CLT beneficiaries as a group.

f. Mechanism Creating Grantor Trust Status. Rev. Proc. 2007-45 and Rev. Proc. 2008-45 provide for grantor trust status to be achieved pursuant to IRC § 675(4) via the ability to remove and replace trust assets in a nonfiduciary duty granted to an individual other than the grantor, the trustee, or another disqualified person.[92] While the grantor would typically be given that discretion for a conventional grantor trust, the excise taxes that would be incurred in the event of an exercise of that discretion by the grantor or another disqualified person might cause the discretion to be considered illusory and invalidate the CLT's grantor trust status.

3. Grantor vs. Nongrantor CLT. Absent the unique circumstances that may justify structuring a CLT as a grantor trust, a CLT structured as a nongrantor trust will generally make more sense because (1) it effectively provides an income tax charitable deduction to a grantor who has reached the charitable deduction limitations for gifts made personally (and who is willing to part with personal ownership of the income generating asset that will ideally remain intact for ultimate passage to the remainder beneficiaries) and (2) a CLT's grantor trust status can potentially create a cash flow issue for the grantor, who is required to pay income taxes on income unavailable to him/her for use in paying those taxes.

V. TREATMENT AS PRIVATE FOUNDATION.

IRC § 4947(a)(2) provides that a CLT is to be treated as a private foundation for purposes of IRC §§ 507 (relating to termination of private foundation status), 508(e) (governing instrument requirements), 4941 (self-dealing), 4943 (excess business holdings), 4944 (jeopardy investments), and 4945 (taxable expenditures).[93] However, neither IRC § 4943 nor IRC § 4944 will apply to a CLT for which the gift or estate tax charitable deduction does not exceed 60% of the value of the contributed property (as finally determined for the applicable transfer tax) and with regard to which all the income interest (and none of the remainder interest) of the CLT is devoted solely to one or more of the purposes described in IRC § 170 (c)(2)(B).[94]

A. IRC § 4943 Tax on Excess Business Holdings. The excess business holding rules of IRC § 4943 generally apply to CLTs.[95]

1. Overview. Subject to a 2 percent de minimis rule, a CLT is prohibited from holding more than 20% (reduced by the interests held by disqualified persons) of the (i) voting stock in a corporation holding an active business, (ii) profits interests associated with a partnership or joint venture holding an active business, or (iii) beneficial interest associated with any other structure for an entity holding an active business.[96] Any holdings over this limit are called "excess business holdings." Consequently, the following are permitted holdings for a CLT pursuant to IRC § 4943(c):

- Up to 2% of the voting and nonvoting stock of any active business;[97]
- Up to 20% (or 35%, if the IRS has agreed that effective control of the business is held by a nondisqualified person or persons) of the voting stock/profits interests/beneficial interest of an active business, reduced by the interests held by disqualified persons;
- Nonvoting interests (capital interests, in the case of a partnership or joint venture), if all disqualified persons together own 20% (or 35%,

[92] See Paragraph 11 of the IRS sample grantor CLAT and CLUT forms.

[93] Texas Property Code Section 112.055 provides the text required under IRC § 508(e) to be included in a CLT. However, it is good practice to include the language in the trust instrument itself.

[94] IRC § 4947(b)(3); Treas. Reg. §§ 53.4947-2(b)(1)(i), 20.2055-2(e)(2)(vi)(e), 20.2055-2(e)(2)(vii)(f), 25.2522(c)-3(c)(2)(vi)(e), 25.2522(c)-3(c)(2)(vii)(f). See the discussion in Section V.A.4 of this outline confirming that the latter limitation does not require that a CLT distribute to charity during the charitable term income in excess of that necessary to satisfy the annuity or unitrust payment.

[95] As previously noted, certain CLATs are exempted from the application of IRC § 4943. Zeroed-out CLATs are not eligible for this exemption.

[96] The 20% limitation is increased to 35%, if the IRS can be convinced that effective control of the active business is held by an individual or individuals who are not disqualified persons with respect to the CLT.

[97] Note, the 2% of permitted stock is reduced by any stock in the same business held by another CLT or foundation described in IRC § 4946(a)(1)(H).

if the IRS has agreed that effective control of the business rests with nondisqualified persons) or less of the voting stock/profits interests/beneficial interest of an active business; and

- Any interest in a functionally related business or a business for which at least 95% of the gross receipts consist of passive items (e.g., dividends, interest, royalties, and rents, if not tied to the profitability of the property).

2. Grace Periods. As a general rule, once a CLT has excess business holdings, the law imposes the penalty tax discussed below. However, if excess business holdings are acquired by gift or inheritance, the CLT has the following "grace period" during which it may avoid the tax by disposing of the excess business holdings other than to a disqualified person: (i) if the holdings were received as a gift, the CLT has up to five years to dispose of those holdings and (ii) if the holdings were received via a bequest under a will or revocable trust, a five-year grace period will not begin to run until the holdings are actually distributed to the CLT (or such earlier date upon which the estate or trust is deemed terminated for income tax purposes).[98] An additional five years may be granted by the IRS, if the CLT can demonstrate to the IRS' satisfaction that despite its diligent efforts to dispose of the holdings during the initial grace period that circumstances made a disposition of those holdings during the initial period impossible except at a price substantially below fair market value due to the size and complexity or diversity of the holdings. In order to secure an additional five years to dispose of the holdings, the CLT must submit a plan for disposition during that extension period to the state Attorney General and submit to the IRS that same plan and any response to it received from the Attorney General. The IRS must also determine that the proposed plan can reasonably be expected to be carried out before the close of the extension period.[99]

If a CLT's permitted holdings turn into excess business holdings other than by a purchase by the CLT or a gift or bequest to it (e.g., due to an acquisition of a business interest by a disqualified person), the CLT is given ninety days to dispose of its excess business holdings after the date it knew or had reason to know of the event which caused the CLT to have excess business holdings. If necessary, the ninety-day period can be extended to accommodate any federal or state securities laws that prohibit the CLT from disposing of its excess business holdings. [100] The CLT cannot dispose of its excess business holdings to any disqualified person.

Consequently, for a decedent with business interests leaving his/her estate to a zeroed-out CLAT, the only option may be a sale by the estate of the excess business holdings to a family member or a trust for family members pursuant to the estate administration exception discussed in Section V.B.2.

3. Taxation Rules. Once any grace period has expired, a CLT still in retention of excess business holdings will be subject to a 10% excise tax on the value of any excess business holdings held during any taxable year ending during the taxable period, which is defined to be the period beginning with the first day on which there are excess business holdings and ending with the earlier of (1) the date a deficiency notice is mailed with respect to the tax and (2) the date on which the tax is assessed. An additional tax equal to 200% of the value of the excess business holdings is imposed if the CLT does not dispose of its excess business holdings by the close of the taxable period.[101]

4. Exemption for Certain CLTs. IRC § 4947(b)(3)(A) provides that a CLT for which the annuity or unitrust payments have a present value of 60% or less than the value of the contributed assets as of the date of contribution will not be subject to the excess business holdings rules (and need not cite to them in the trust instrument), provided that "all the income interest (and none of the remainder interest) of such trust is devoted solely to one or more purposes described in IRC § 170(c)(2)(B).[102] This, of course, begs the question of whether a CLT that meets the 60% test can meet the second test if in any year its income in excess of that needed to satisfy the annuity/unitrust payment is to be accumulated and added to principal and, consequently, may potentially pass at the expiration of the charitable term to the remainder beneficiaries.

[98] Treas. Reg. § 53.4943-6(b)(1). There is no grace period for dispositions of excess business holdings purchased by the CLT.

[99] IRC 4943(c)(7).

[100] Treas. Reg. § 53.4943-2(a)(1)(iii).

[101] IRC § 4943(b).

[102] Treas. Reg. § 53.4943-2(b)(1)(i). Rev. Proc. 2007-45 (Sections 5.06(1) and 8.06(1)), 2007-46 (Section 5.07(1)), 2008-45 (Sections 5.06(1) and 8.06(1)), and 2008-46 (Section 5.07(1)) provide that the exemption from IRC § 4943 and IRC § 4944 requires that the trust instrument not provide for the payment of any of the income interest to a noncharitable beneficiary nor provide for the payment of excess income to a noncharitable beneficiary.

Fortunately, this issue was addressed in Revenue Ruling 88-82.[103] The Ruling addressed whether the accumulation and addition to principal in any year of a CLAT's income in excess of that necessary for satisfying that year's annuity payment (an approach also reflected in the IRS sample CLT forms) would be problematic in securing the exemptions from IRC §§ 4943 and 4943 pursuant to IRC § 4947(b)(3)(A) given the potential for the accumulated income to pass to the noncharitable remainder beneficiaries. The IRS concluded that the mere potential for the excess income to pass to the remainder beneficiaries was not problematic (as would be the case if it were to be distributed to them during the charitable term) because that excess income could also be applied (along with any other property held by the CLAT) in satisfaction of the guaranteed annuity interest during the remainder of the charitable term. The IRS concluded that the excess income accumulated and added to principal accordingly would not be available for any private purpose during the charitable term. Because none of the trust income was considered payable for a private purpose before expiration of the charitable term for purposes of Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(f), the IRS concluded that the amount payable to charity constituted a guaranteed annuity interest under IRC § 2522(c)(2)(B) deductible under IRC § 2522(a) notwithstanding the fact that the trust instrument contained no restrictions relating to IRC § 4943 and IRC § 4944.

B. <u>IRC § 4941 Tax on Self-Dealing</u>.

The private foundation self-dealing rules apply unavoidably to all CLTs. Consequently, a CLT cannot engage in any transaction with a disqualified person, unless the transaction falls within an exception to the self-dealing rules discussed below.

1. <u>Overview</u>. A disqualified person who participates in a self-dealing transaction with a CLT (other than in the capacity as the trustee) must pay a tax of 10% of the amount involved for each year (or part thereof) in the "taxable period." For this purpose, the "taxable period" is the period beginning with the act of self-dealing and ending with the earliest of (1) the date a deficiency notice is mailed with respect to the initial tax, (2) the date on which the initial tax is assessed, and (3) the date on which the correction of the act of self-dealing is completed. Additionally, a participating trustee who knows that act constitutes self-dealing will also be required to pay a tax of 5% of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period (subject to a cap of $20,000 for each self-dealing act), unless the trustee's participation is not willful and is due to reasonable cause. If the self-dealing act is not corrected within the taxable period, the disqualified person who participated in the act will be subject to a tax equal to 200% of the subject amount. If the trustee refuses to agree to part or all of the correction, an additional tax equal to 50% of the amount involved will be imposed on him/her (subject to a cap of $20,000 for each self-dealing act).[104]

Generally, self-dealing occurs when:

- A disqualified person and the CLT enter into a transaction with each other (e.g., sales, exchanges or leases of property; loans; or furnishing goods, services, or facilities);
- The CLT compensates or pays the expenses of a disqualified person;
- The CLT's income or assets are used by or for the benefit of a disqualified person; or
- Payments are made from the CLT to a government official.

A disqualified person with respect to a CLT notably includes:[105]

(1) the grantor;
(2) a trustee;
(3) a spouse, ancestor, child, grandchild, or great-grandchild of the grantor or a trustee, and the spouse of any such person (collectively, "family members"; individually, a "family member");
(4) a partnership in which persons described in (1), (2), or (3) own more than 35 percent of the profits interest;
(5) a corporation in which persons described in (1), (2), or (3), own more than 35 percent of the total combined voting power;
(6) a trust or estate in which persons described in (1), (2), or (3) hold more than 35 percent of the beneficial interest;
(7) for purposes of determining whether the CLT has excess business holdings, a CLT/private foundation (a) which is effectively controlled (directly or indirectly) by the same persons who control the CLT, or (b) substantially all contributions to which were made (directly or indirectly) by the same persons described in (1), (2), or (3), who made (directly or indirectly)

[103] Revenue Ruling 88-82, 1988-2 CB 336.

[104] IRC §§ 4941(a), 4941(b), and 4941(c).

[105] IRC § 4946(a)(1).

substantially all of the contributions to the CLT in question; and
(8) only for purposes of the restrictions on self-dealing, a government official.

For purposes of determining the total combined voting power in a corporation, the IRC § 267(c) constructive stock ownership rules apply, except that individuals who are a person's "family members" (as described above) are treated as the members of the person's family for purposes of applying IRC § 267(c) rather than defining "members of the family" pursuant to IRC § 267(c). Similarly, for purposes of determining whether the profits interest in a partnership or beneficial interest in a trust or estate meets the thresholds listed above, the concepts of IRC §267(c) also apply (except for the rule attributing ownership of stock owned by a partner), with the term "members of the family" once again having the meaning given above rather than the meaning given in IRC § 267(c).[106]

IRC § 267(c) provides:
(1) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries;
(2) an individual is treated as owning any stock owned, directly or indirectly, by or for a member of his/her family; and
(3) an individual who owns (other than through attribution from a family member) stock in a corporation is considered to own stock owned, directly or indirectly, by or for the individual's partner.

For the purpose of applying paragraph (1), (2), or (3), stock constructively owned by a person pursuant to paragraph (1) shall be treated as actually owned by such person. However, stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him/her for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

2. Exceptions to the Self-Dealing Rules. The two most common exceptions to application of the self-dealing rules are: (1) disqualified persons can furnish goods, services, etc. to the CLT for use in its charitable purposes on a no-charge basis[107] and (2) the CLT can pay reasonable compensation for services to a disqualified person other than a government official (e.g., a disqualified person can serve as trustee and receive reasonable compensation).[108]

A testamentary CLT may also benefit from a third exception to the self-dealing rules commonly referred to as the "estate administration exception," which provides that an estate may sell to a disqualified person estate assets otherwise to be used in funding a bequest to a testamentary CLT (a transaction that would constitute indirect self-dealing) without subjecting the estate to the self-dealing excise tax, provided the following apply:[109]
(1) estate is legitimately in administration;[110]
(2) the executor has the power of sale or the discretion to determine whether to fund the CLT with the subject property or allocate the property to a different estate beneficiary;
(3) the estate (or trust) receives an amount equal to or in excess of the fair market value of the property sold as of the time of the transaction;
(4) the CLT will receive an interest at least as liquid as that which it sells to the disqualified person; and
(5) the transaction is approved by a court of competent jurisdiction.

The estate administration exception can be a very useful means of avoiding the self-dealing issues that can result from sophisticated estate planning.

a. Potential Application of the Estate Administration Exception #1. The estate administration exception is a particularly useful tool for a high net worth individual with charitable interests who would like to avoid paying any estate taxes via use of a zeroed-out CLAT but who has interests in a family business that will be considered excess business holdings if held by the CLAT.[111] Obviously, it is not ideal to

[106] IRC §§ 4946(a)(3) and (4).

[107] IRC § 4941(d)(2)(C).
[108] IRC § 4941(d)(2)(E).
[109] Treas. Reg. § 53.4941(d)-1(b)(3).
[110] Treas. Reg. § 53.4941(d)-1(b)(3)(iii) specifically provides that the transaction must occur before the estate is considered terminated for federal income tax purposes (Treas. Reg. § 1.641(b)-3(a)), or in the case of a revocable trust, before it is considered subject to IRC § 4947.
[111] Even if the estate holds an interest in an entity owning purely passive investments, it is still generally advisable to use the estate administration period exception to avoid passage of

transfer the family business to the CLAT in part because interests in it may ultimately be necessarily distributed to the charity in satisfaction of the annuity or unitrust payments. Even if the family business were to be sufficiently successful to generate enough income to facilitate those payments, the excise taxes due on the CLAT's interest in the family business after the five-year (or potentially ten-year) grace period would be prohibitive (and inadvertent self-dealing can easily occur during the grace period). Once the assets are distributed to the CLAT, it cannot sell its interest in the business to a family member or trust for family members because sales to disqualified persons are prohibited under the CLAT's trust instrument consistent with IRC § 4941.

Fortunately, the estate administration exception provides the estate with the ability to avoid payment of the taxes under IRC § 4941 that would otherwise be incurred as a result of a sale of the estate's interest in the family business to one or more family members or trusts for their benefit in return for a note. A particularly tax efficient variation of this type of sale involves a purchase of the estate's interest in the family business by a GST exempt dynasty trust holding the remaining interests in the family business, whether acquired at the decedent's death via a bequest or acquired via a lifetime gift and/or sale by the decedent. In either event, the purchasing trust will need to have sufficient value to provide the 10% equity for the sale conventionally thought of as a "safe" seed amount substantiating the trust's ability to pay off the note provided to the estate. Alternatively, the purchasing trust will need to pay a guarantee fee to an individual or other trust willing to guarantee repayment of at least 10% of the note to be provided by the purchasing trust (and who has the financial means to honor that guarantee, if necessary).

The estate can then distribute the note it acquires from the sale to the CLT, which can in turn subsequently exercise any rights granted it under the note and any security agreement that secures payment of the note without those actions constituting an act of self-dealing. However, a failure by the CLT to enforce payment of the note will be an act of self-dealing if the trust has the means to pay the note at the time that enforcement is forgone.

b. <u>Potential Application of the Estate Administration Exception #2</u>. The IRS recently ruled favorably on another fairly creative application of the estate administration exception.[112] Decedent transferred during life a significant amount of stock in the family business to an intentionally defective grantor trust (the "IDGT") for the Decedent's children and grandchildren via a gift of stock in the amount of his gift and GST tax exemption amounts and a subsequent sale of his remaining stock in return for a note issued by the IDGT. Due to the success of his lifetime planning, Decedent decided to leave his entire remaining estate to a foundation.

Unfortunately, Decedent died while the note from the sale to the IDGT remained outstanding. In addition to having to decide how to address the income tax issues associated with the loss of the IDGT's grantor trust status while the note remained outstanding, the Decedent's executor was required to address the self-dealing concerns associated with a distribution from the estate to the foundation of a note for which the obligor (the IDGT) is a disqualified person due to the fact that the beneficial interest in it held collectively by the Decedent's descendants far exceeded 35%.[113]

that interest to a CLT due to the potential for inadvertent self-dealing issues to arise while the interest is held by the CLT.

[112] PLR 201446024 (November 14, 2014).
[113] IRC § 4941(d)(1)(B).

Decedent's bequest of his residuary estate to the foundation created a certainty of self-dealing simply via the foundation's acquisition of the note and ultimately its receipt of note payments from the IDGT.[114] Wishing to avoid that result, the executor (a family member and therefore a disqualified person) proposed to contribute the note to a newly created LLC in exchange for the estate's receipt of 100 voting units and 9,800 non-voting units, which would not be subject to any transfer restrictions. Simultaneously, the executor, in his individual capacity, proposed to contribute cash to the LLC in an amount equal to 1% of the value of LLC in exchange for 100 non-voting units. The executor also proposed to purchase the 100 voting units in the LLC owned by the estate in exchange for cash equal to the fair market value of those units as determined by a qualified appraisal. Consequently, the Foundation would ultimately receive cash and 9,800 non-voting units of the LLC instead of the note, which would be owned by the LLC. The LLC operating agreement required that the LLC take immediate action to foreclose on and collect payment of the note from the IDGT in the event it defaults in any manner on the note.

It was represented that the LLC would engage in only passive investment activities so that no excess business holdings concerns would apply and that all payments it received on the note from the LLC would be distributed annually to the Foundation. Amendments to the LLC's operating agreement would require the consent of all members. Consequently, the Foundation would be assured of the continuation of its rights in the LLC that qualified the contribution of the note to the LLC for the estate administration exception. Specifically, the Foundation would be assured of its receipt of annual distributions of payments received on the note, which was considered by the IRS to be a critical element for substantiating that the Foundation's interest in the LLC would be at least as liquid as the note it would have otherwise received but for the estate's contribution of the note to the LLC.

The executor proposed to seek court approval from the probate court regarding those various steps and also sought approval from the IRS. The IRS granted all of the requested rulings, most notably:

<u>Ruling #1</u>: The executor's contribution of the Note to the LLC in exchange for the voting and non-voting units in LLC, the estate's subsequent sale of the voting units for cash to the Executor in his individual capacity, and the estate's distribution to the Foundation of the non-voting units and cash received from the sale of the voting units met the estate administration exception provided in Treas. Reg. § 53.4941(d)-1(b)(3) and consequently did not constitute impermissible acts of self-dealing under IRC § 4941. In particular, the IRS noted that the Foundation's rights associated with the LLC units ensured that it would have essentially the same rights/liquidity as it would have had if it held the note directly.

<u>Ruling #2</u>: The LLC's retention of the Note, receipt of payments on it, and distributions of the received funds to the Foundation will not constitute acts of self-dealing described in Treas. Reg.§ 53.4941(d)-2 because:

(1) The Foundation will acquire the non-voting units in the LLC by bequest rather than through a self-dealing transaction;
(2) The arrangement between the Foundation and the LLC is neither a loan nor an extension of credit;

[114] Treas. Reg. § 53.4941(d)-(2)(c)(1) provides that self-dealing will occur when a note for which the obligor is a disqualified person is transferred by a third party (here, the estate) to a private foundation <u>unless</u> the note was received as part of the "estate administration exception" pursuant to Treas. Reg. § 53.4941(d)-(1)(b)(3).

(3) The Foundation's ownership of non-voting units provides it with a right to receive but not force distributions from the LLC;
(4) The Foundation cannot be forced to make capital contributions to or transfer any property to the LLC; and
(5) Any benefit or use of the Foundation's income that could be attributed to the executor's interest in the LLC was purchased as part of the estate administration exception under Treas. Reg. § 53.4941(d)-(1)(b)(3).

The IRS further noted that under Treas. Reg. § 53.4941(d)-1(b)(4), a transaction between a private foundation and an organization will not result in an act of self-dealing, provided the organization is neither controlled by the foundation nor an organization with regard to which disqualified persons own at least 35% of the beneficial interest. The LLC met both of those criteria in that (i) its voting units were owned by the executor in his individual capacity (the Foundation's non-voting units did not provide it with control of the LLC), and (ii) the only beneficial interest in the LLC owned by a disqualified person were the units owned by the executor in his individual capacity that amounted to a 2% beneficial interest (falling far below the 35% threshold that would have bestowed "disqualified person" status on the LLC).

Consequently, the IRS concluded that the Foundation's ownership of non-voting units in the LLC and its receipt of passive income from the LLC would not be acts of either direct or indirect self-dealing.

C. <u>IRC § 4945 Tax on "Taxable Expenditures."</u>

CLTs are subject to the rules on taxable expenditures (e.g., payments attempting to influence legislation or elections) applicable with regard to private foundations. Conventional wisdom dictates that the taxable expenditure penalty tax is easily avoidable by ensuring a CLT will only make distributions to a public charity. Of course, clients often wish to name the family's private foundation as the charitable beneficiary for a CLT. That arrangement should be fine, assuming the foundation is properly managed and the CLT exercises "expenditure responsibility." Expenditure responsibility entails conducting appropriate oversight to ensure the funds provided to the foundation are being spent for the intended purpose, obtaining the requisite reports from the foundation in that regard, and submitting the requisite reports with the IRS.

A CLT must pay a tax of 20% of the amount of a taxable expenditure, and a trustee agreeing to the making of the taxable expenditure (and knowing it is such) will also be required to pay a tax of 5% of the amount involved (subject to a cap of $10,000 for each taxable expenditure), unless the trustee's agreement is not willful and is due to reasonable cause. If the CLT does not correct the taxable expenditure by the earlier of (1) the date a deficiency notice is mailed with respect to the initial tax and (2) the date on which the initial tax is assessed, it will be subject to an additional tax equal to 100% of the subject amount. If that additional tax is assessed and the trustee had refused to agree to part or all of the correction that would have avoided the CLT being subject to that additional tax, then an additional tax equal to 50% of the amount involved will imposed as well on the trustee (subject to a cap of $20,000 for each taxable expenditure).

D. <u>IRC § 4944 Tax on "Jeopardizing Investments."</u>

A CLT will be taxed on its acquisition and retention of any investments that jeopardize the CLT's charitable purpose, unless the investment is acquired by gift or bequest. No investment is per se a jeopardizing investment, but certain types of investments will be closely scrutinized (e.g., puts, calls, straddles, working interests, etc.). Facts and circumstances will dictate whether an investment is a jeopardizing investment.

If a CLT holds a jeopardizing investment, it will be subject to a 10% excise tax on the value of the investment for each year (or part thereof) it is retained during the "taxable period," which is defined to be the period beginning with the CLT's acquisition of the jeopardizing investment and ending with the earliest of (1) the date a deficiency notice is mailed with respect to the initial tax, (2) the date on which the initial tax is assessed, and (3) the date on which the amount so invested is removed from jeopardy (i.e., the jeopardizing investment is sold/disposed of and the proceeds are not otherwise invested in another jeopardizing investment). Additionally, a trustee who knows that the investment is a jeopardizing investment but still participates in its acquisition will be required to pay an excise tax equal to 10% of the investment's value (up to a limit of $10,000 per jeopardizing investment) for each year (or part thereof) in the taxable period during which it is retained by the CLT, unless the trustee's participation was not willful and was due to reasonable cause. An additional excise tax of 25% may be imposed on the CLT if the initial 10% tax is assessed and the investment is not sold and the proceeds appropriately re-invested within the taxable period. In that event, a trustee who refused to agree to remove all or part of the investment from "jeopardy" may also be subject to an additional 5% excise tax (up to a limit of $20,000 per jeopardizing investment).

VI. GENERATION-SKIPPING TRANSFER TAX CONSIDERATIONS.

Because a charity is deemed to occupy the same generational level as the grantor of a trust, no GST will be due (if ever) on CLT assets until the expiration of the charitable term. If the remaining trust assets pass at that point to nonskip persons (e.g., the grantor's children or trusts for them), no GST will be due at that point either. However, GST will be due on any CLT assets that are not GST exempt when they are ultimately distributed to or for the benefit of grandchildren/trusts for them (including any distributions to a grandchild from a child's Trust), other than payments made directly to an educational institution for a grandchild's tuition or to the medical care provider for a grandchild's medical care (or payments made directly to the insurance company for a grandchild's health insurance premiums).

> **Example**: Grantor transfers $1,000,000 to a nonexempt CLAT. The CLAT earns and pays out exactly the annuity amount during the charitable term. At the end of the charitable term, $1,000,000 remains and passes to Grantor's grandchildren, which constitutes a taxable termination resulting in $400,000 of GST being due.

Of course, to the extent the Grantor allocates GST exemption to a CLT, the amount of GST ultimately due will be reduced.[115]

A. Allocation of GST Exemption to CLATs.

1. Overview. A grantor's GST exemption cannot be allocated to a CLAT at its creation in a manner that will guarantee that the CLAT will be completely GST exempt. The extent to which a CLAT will be GST exempt at the expiration of the charitable term (i.e., the earliest time at which a conventional CLAT may be subject to the GST) is determined by the following steps:

- Step 1: Determine the timing and the amount of the GST exemption allocated to the CLAT.
- Step 2: Compound the allocated exemption annually at the 7520 rate in effect at the time of the gift/death (or the rate in effect at the time of a late allocation) for the charitable term (or the remaining charitable term, if a late allocation is made).
- Step 3: Divide the number calculated in Step 2 by the fair market value of the CLAT assets at the expiration of the charitable term to determine the GST exempt portion of the CLAT at that time.[116]

Of course, the extent to which the remaining CLAT assets will be GST exempt at the termination of the charitable term depends upon the CLAT's earnings during the charitable term.

> **Examples**:
> Grantor gifts $1,000,000 to a CLAT paying a 2.2% percent annuity (or $22,000) for 10 years, with the remaining assets to pass at the expiration of the charitable term to trusts for the Grantor's grandchildren. The 7520 rate at the time of the gift is 2.2%. According to the tables, the value of the annuity is $195,565. Correspondingly, the value of the remainder interest is $1,000,000 - $195,565, or $804,435. Assume Grantor allocates $804,435 of Grantor's GST exemption to the CLAT on a timely filed Form 709. The

[115] The following discussion assumes that the grantor's GST exemption may be allocated at the desired time and consequently there are no ETIP concerns that would delay the effective date of that allocation.

[116] See IRC § 2642(e).

exemption amount at the end of the 10-year charitable term is consequently $999,999.81 ($804,435 compounded annually at 2.2% for 10 years).[117]

Scenario #1: The CLAT earns the annuity payout rate of 2.2%: Assume the CLAT earns exactly 2.2% for the charitable term. Consequently, each year it will distribute exactly the amount of its earnings in satisfaction of the annuity payment.[118] At the expiration of the charitable term, the exempt percentage of the trust is $999,999.81 ÷ $1,000,000, so that only $.19 of the trust would be subject to GST.

Scenario #2: The CLAT earns less than the annuity payout rate of 2.2%: Assume the CLAT earns less than 2.2% during the charitable term, say 1% annually. Therefore, its 2.2% annuity must be paid partly from principal. At the expiration of the charitable term, the exempt percentage would be $999,999.81 ÷ $874,453.40 or 100%. The CLAT assets would be fully exempt from GST, but part of the GST exemption Grantor allocated at the CLAT's funding was ultimately wasted, given that the exemption amount at the end of the 10-year charitable term exceeded the value of the remaining trust assets. Had Grantor allocated $703,441.06 of GST exemption to the CLAT at its creation it would have compounded annually at 2.2% for 10 years to grow to $874,453.40 at the end of the charitable term, resulting in the remaining assets being fully GST exempt. In the process, the Grantor would have saved $100,993.94 in GST exemption.

Scenario #3: The CLAT earns more than the annuity payout rate of 2.2%: Assume the CLAT earns more than 2.2% during the charitable term, say 5%. Therefore, it will accumulate earnings in excess of the charitable annuity. At the expiration of the charitable term, the exempt percentage would be $999,999.81 ÷ $1,352,181 or 73.95%. Consequently, $352,181 of the CLAT property would be exposed to GST (resulting in $140,872 of GST being due).

Sample Language – Formula GST Exemption Allocation To Deal with Audit Risk: "The [Donor/Executor] allocates to the Trust listed above an amount of the exemption provided to the [Donor/Decedent] pursuant to IRC § 2631 equal to the excess of (i) the value of the property [contributed to the Trust/bequeathed to the Trust] over (ii) the [guaranteed annuity interest/unitrust interest] (such amount so calculated, the "Remainder Interest Value"), with each of (i) and (ii) as finally determined for federal [gift/estate] tax purposes and (ii) valued using the lowest rate then available for such purpose in accordance with Code Section 7520(a) (or all of such exemption shall be so allocated, if less than the aforementioned calculated amount). The amount of such exemption allocated to the Trust based on values as computed on the basis of values as returned is $_______. However, should the Remainder Interest Value, as finally determined for federal [gift/estate] tax purposes differ from the value thereof reflected above, whether due to adjustments by the Internal Revenue Service, ruling by a court of competent jurisdiction or for any other reason, then the [Donor/Executor] hereby directs that the amount of such exemption allocated thereto be recomputed so that the amount of such

[117] Rounding in the table annuity factors prevent this number from being exactly $1,000,000 although in this example you would benefit from IRS permitted rounding.

[118] As discussed in Section IV.B.3, a nongrantor CLT may distribute appreciated assets in satisfaction of an annuity or unitrust payment and deduct the resulting capital gains pursuant to IRC § 642(c). However, for ease of illustration, the examples in this outline assume that all annuity/unitrust payments will be satisfied with income earned by the CLT assets and assets will remain in the CLT for ultimate passage to the remainder beneficiaries (unless indicated otherwise).

> exemption allocated thereto shall be equal to such value as so adjusted to the fullest extent possible."[119]

2. PLR 200107015. In PLR 200107015, the IRS indicated its disapproval of what to it appeared to be a proposed attempt at an end run around the GST exemption allocation rules for a CLAT provided in IRC § 2642(e).[120]

That ruling concerned a testamentary 25-year CLAT for which the remainder beneficiaries were trusts for the decedent's children. One of those children ("Child") proposed to assign to his children his interest in the CLAT, which would be vested in Child via an amendment to the trust instrument by the trustees. At the time, the remainder interest still had a low value.

The taxpayer requested a ruling that upon the CLAT's termination, the assets consequently passing to Child's own children (i.e., the decedent's grandchildren) would do so free of GST because Child would be the transferor with respect to those assets and his children would obviously be considered nonskip persons with regard to him. The IRS declined to rule in the manner sought, concluding that the proposed series of transactions "have the effect of circumventing the rules of section 2642(e) using the same type of leveraging [of the GST exemption amount] that prompted Congress to enact 2642(e)." The IRS correspondingly concluded that Child would only be deemed the transferor of a fraction of the trust assets passing to the grandchildren at the CLT's termination, the numerator of which would be the value of the remainder interest at the date of Child's assignment of his remainder interest and the denominator of which would be the value of all the trust assets as of the assignment. The IRS went on to conclude that the remaining assets passing at the expiration of the charitable term would be considered as still passing from the decedent. The IRS also cautioned that the decedent could instead be treated as the transferor of the entire trust, if the series of proposed transactions were to be disregarded via the step transaction doctrine and consequently viewed as an original designation by the decedent of the grandchildren as remainder beneficiaries.

Many estate planners have taken issue with the IRS' reasoning in PLR 200107015 and believe that Child's assignment of his remainder interest should result in a GST free passage of assets upon the CLAT's termination to Child's children. Although a sale of a remainder interest has been proposed as a possible variation of this technique, it seems likely that the IRS would similarly challenge such a sale as an inappropriate attempt to leverage the GST exemption in a CLAT transaction in direct contravention of IRC § 2642(e).

Although the viability of this technique remains in question, it may be prudent to ensure the spendthrift clause included in the CLAT instrument permits a remainder beneficiary to assign or sell his/her interest to trusts for his/her own descendants (but not to creditors, based upon IRC § 2041 concerns) in case the uncertainty regarding this technique is ultimately resolved in a favorable manner. Of course, most CLATs will provide for the assets remaining upon the expiration of the charitable term to pass in trust to the grantor's descendants, an arrangement that was in fact the original structure for the CLAT in PLR 200107015. Child ultimately held the remainder interest outright and was positioned to assign it because the trustees amended the trust instrument to vest the remainder interest in Child to accommodate the assignment. Correspondingly, it would be prudent to incorporate the means in the CLAT instrument to provide for a remainder interest in the CLAT to be held outright by a remainder beneficiary in the event this technique is validated by the courts in the interim.

> **Sample Language – Allowing for PLR 200107015-Type Planning**:
> "Spendthrift Protections. The interests of all beneficiaries of any trust created hereunder shall be held subject to a "spendthrift trust." No assignment, encumbrance or order by any beneficiary of income or corpus shall, by way of anticipation or otherwise, be valid, but all such corpus or income ever payable or distributable to such beneficiary shall be paid or distributed by trustee directly to such beneficiary, and no interest of any beneficiary in the corpus or income of the trust shall ever be subject to attachment, garnishment, execution or other legal or equitable process or writ brought by or in favor of any creditor of such beneficiary, and no beneficiary's interest in the corpus or income of the trust shall ever be an asset of such beneficiary in bankruptcy.

[119] Of course, additional GST exemption may be subsequently allocated to an inter vivos CLT, if the CLT assets outperform the 7520 rate, assuming that the grantor is still living (or has GST exemption that his/her executor may allocate to the CLT, as appropriate).

[120] PLR 200107015 (February 16, 2001).

Nothing herein shall, however, prevent the making of payments to another for the use of a beneficiary (if and as elsewhere herein permitted), nor be construed or interpreted to limit or restrict (i) any beneficiary's power to disclaim an interest at any time in any trust created by or pursuant to this Agreement or (ii) the right of a beneficiary to exercise any power of appointment created by or pursuant to this Agreement. Notwithstanding the preceding, an Independent Trustee (as defined below) shall have the sole and absolute discretion to (i) amend the terms of this Agreement to achieve the following results and (ii) release any ability under this Agreement to provide for a contrary result pursuant to a subsequent amendment to this Agreement or otherwise: (A) to provide that the share of the remaining trust property otherwise to be allocated to [CHILD] in trust upon the expiration of the annuity period pursuant to Section ___ [references Section providing for the allocation of the remaining property among trusts for the Grantor's descendants] shall instead vest in [CHILD] and (B) to provide [CHILD] with the discretion to assign [CHILD]'s remainder interest to any descendant or descendants of [CHILD], in such amounts and proportions, either outright to any one or more of such descendants or in trust to any trustee or trustees (even though such a trustee shall not previously have been trustee hereunder) for the benefit of any one or more of such descendants, with such special and general powers of appointment and such administrative, spendthrift and other lawful provisions as [CHILD] shall desire. For this purpose, an "Independent Trustee" shall mean a trustee who is not any of the following: (i) the Grantor, (ii) a beneficiary of the [CLIENT NAME] CHARITABLE LEAD TRUST, or (iii) an individual or entity related or subordinate (within the meaning of Section 672(c) of the Code) to any aforementioned person."

3. <u>Managing a CLAT's GST Nonexempt Status Via General Powers of Appointment and "HEET" Trusts.</u>

A less dramatic technique for avoiding GST being due upon the expiration of the charitable term of a GST nonexempt CLT might be providing for the remaining assets to pass to trusts for the grantor's children and providing an independent trustee with the discretion to grant the children testamentary general powers of appointment over their trusts so that the children may in turn allocate their own estate and GST exemptions to the assets held in their trusts at their death.

Alternatively, the grantor could provide for any GST nonexempt assets ultimately passing to trusts for grandchildren to pass to trusts for them structured as "HEET" trusts (nonskip persons) providing for GST free distributions of funds to service providers for their tuition and medical care expenses (including health insurance premiums) in accordance with IRC § 2642(c). Other distributions to grandchildren would simply incur GST as taxable distributions.

Generally, a HEET trust avoids being characterized as a skip person under IRC § 2613 via the provision of mandatory annual distributions to charity of an amount sufficient to ensure that the charity will be considered as having a bona fide interest in the trust and not an interest to be ignored as having been used primarily to "postpone or avoid" the GST tax under IRC § 2652(c)(2). There is little guidance as to what is a sufficiently meaningful interest for the charity. Some planners have proposed that 5%-10% of trust income is a sufficiently meaningful annual distribution. Other planners believe a unitrust payment is a more appropriate approach. In any event, if the charitable payment is based upon trust income, consider providing the charity with the means to make the trust assets productive or including some other mechanism designed to substantiate the charity's interest along the lines of the protections provided to the surviving spouse with regard to a QTIP trust.

While HEET trusts have not generally been greeted with much enthusiasm by planners in the past, they may be a more effective planning tool than previously considered in light of ever increasing tuition and medical care costs, including healthcare premiums.

<u>**Sample Language – Using a Savings Clause to Comply with IRC § 2652(c)(2)**</u>. Structure the amount to be distributed each year to charity in a manner similar to a guaranteed annuity interest (i.e., an annually distributable dollar amount, possibly subject to an

annual inflation adjustment) or a unitrust amount (i.e., an annual distribution of a set percentage of the annually revalued trust assets) – the "Charitable Payment" - but include as saving clause language: "It is the Grantor's intention that the Charitable Payment be sufficient in amount to avoid the Charitable Organization's interest in the Trust as being considered an interest described in IRC § 2652(c)(2). Should it ever be determined that the Charitable Payment is insufficient in amount to avoid such characterization of the Charitable Organization's interest, then the Charitable Payment shall be increased to such greater amount (effective as of the Trust's creation) as shall be necessary to avoid such characterization. In such event, the Trustee must pay to the Charitable Organization the difference between each Charitable Payment actually paid and the Charitable Payment as so recalculated, plus interest on the deficiency computed at the IRC § 7520 rate of interest in effect on the date of such original payment compounded annually until payment of the correcting amount."

B. <u>Allocation of GST Exemption to CLUTs</u>. Unlike the CLAT, we can ensure that the assets remaining in a CLUT at the end of the charitable term will be entirely GST exempt by allocating GST exemption to the CLUT at its creation in the amount of the present value of the remainder interest.

> **<u>Example</u>**: Grantor gives $2,867,976 to a CLUT structured without interest-rate-sensitive adjustments. The charitable term is 10 years, and the annuity amount is 10% of the value of the CLUT each year. The charitable deduction is $1,867,976, and the value of the remainder interest at the time of the CLUT's creation (i.e., the taxable gift) is $1,000,000. If $1,000,000 of Grantor's GST exemption is allocated to the CLUT at its creation, then the CLUT will be exempt from GST at the end of its charitable term, regardless of the value of the trust assets remaining at that time.

Because a CLUT cannot be structured to yield a charitable deduction equal to 100%, a CLUT will never be completely GST exempt without an allocation of GST exemption at the time of its creation. Of course, the Grantor's allocated GST exemption will be wasted if the assets remaining in the CLUT at the end of the charitable term are valued at less than the allocated GST exemption.

Of course, if GST exemption is not allocated to a CLUT, any transfers to grandchildren or other skip persons (or trusts for them) at the termination of the charitable term will be considered taxable terminations or taxable distributions, as the case may be, unless the type of planning described in Section VI.A.3 is implemented successfully.

C. <u>CLAT or CLUT - Which To Choose?</u>

If the CLT property is expected to appreciate, a CLAT is usually the better choice, because the annuity payable to charity remains fixed, resulting in the amount by which the CLAT outperforms the 7520 rate passing to the remainder beneficiaries. In contrast, the remainder beneficiaries and the charity/charities in receipt of the unitrust interest would share in that appreciation if a CLUT were used.

If the CLT is being used for GST planning, a CLUT may be preferable because of the ability to allocate GST exemption at the date of the CLUT's funding.

VII. WHEN SHOULD A CHARITABLE LEAD TRUST BE CONSIDERED?

A CLT is a particularly good technique in any of the following three scenarios.[121]

A. <u>Scenario 1: Factors and Assumptions Used in Valuing the Charitable and Noncharitable Interests Are Expected To and Ultimately Do Undervalue the Remainder Interest</u>. When a contribution is made to a charitable lead trust, the gift or bequest will be divided for transfer tax purposes into two portions: (i) the transfer tax deductible charitable portion, which can be thought of as the portion of the contributed assets that will ultimately fund the charitable payments made by the CLT, and (ii) the nondeductible, noncharitable portion, which can be thought of as the present value of the

[121] Of course, a CLT should only be considered when it is financially feasible for wealth to be reserved exclusively for the benefit of the designated charity or charities for the charitable term.

assets projected to pass to the remainder beneficiaries at the termination of the CLT.

Each of the charitable and noncharitable portions will be valued in accordance with tables found in Publications 1457 and 1458 (as applicable) using the IRC § 7520 rate in effect at the time of the CLT's creation (or the lowest of that rate and the IRS § 7520 rate for the preceding two months, if the CLT is a CLAT).[122] The value of each portion will be affected by the length of the charitable term, the applicable IRC § 7520 rate (CLAT only), and the amount of the payments to the recipient charity or charities.

If the factors and assumptions made that affect the valuation of the charitable and noncharitable interests do not ultimately prove true, then the amount of value transferred to the remainder beneficiaries will have been either overestimated (resulting in a waste of gift/estate tax exemption and/or unnecessary payment of gift/estate taxes) or underestimated (resulting in a transfer of value without payment of gift/estate taxes). The former result is to be avoided. The latter result is desirable and may be achieved in the following situations.

1. Scenario 1A: Property Expected to Outperform IRC § 7520 Rate. If the assets contributed to a CLT are expected to and subsequently do outperform the applicable IRC § 7520 rate, then the valuation tables will have ultimately undervalued the taxable gift/bequest (i.e., the remainder interest) by assuming that the contributed assets will grow at the prescribed IRC § 7520 rate. In that event, the noncharitable beneficiaries will ultimately receive a greater amount than that projected at the time of the contribution pursuant to the IRS actuarial tables. That excess amount will not be subject to transfer taxes.

> **Example**: Grantor gives $1,000,000 in cash to a CLAT with a term of 10 years.[123] The annuity payment is set at 2.2% of the initial funding amount, and the 7520 rate is 2.2%. Consequently, the taxable gift will be the present value of $1,000,000 payable at the end of the charitable term to the remainder beneficiaries, valued based upon the assumptions that the annual payments will be satisfied solely with earnings and that the initial $1,000,000 of trust corpus will correspondingly remain untouched throughout the charitable term. If, as projected, the property actually earns the 7520 rate, the noncharitable remainder beneficiaries will have $1,000,000 at the end of the term. If, however, the property performs better than projected and ultimately earns say 5%, the remainder beneficiaries will receive $1,352,181 at the end of the charitable term, but no gift tax will be due on the excess $352,181 in value transferred as a result of the CLAT having performed (5%) better than anticipated (2.2%).

As a caveat, it is not sufficient that the overall rate of return for the charitable term exceed the 7520 rate. If the CLT experiences significant negative returns in the initial years of the charitable term, there may be insufficient value remaining in the CLT to enable the CLT to "recover" and ultimately achieve the desired overall return necessary to leave the CLT with assets to transfer to the noncharitable remainder beneficiaries at the end of the charitable term. This aspect of a CLAT is manageable by structuring the CLAT to have increasing annuity payments that start out at a manageable level (or more aggressively, at a nominal level, as would be the case if the CLAT were structured as a Shark Fin CLAT).[124]

2. Scenario 1B: Measuring Life's Projected Life Expectancy Shorter than Actuarial Life Expectancy. If the charitable term for a CLT is based upon the life of an individual, then the value of the noncharitable remainder interest will be based upon projected annual payments to charity occuring each year for the remainder of that individual's actuarial lifetime. However, if that individual's actual life expectancy is shorter than his/her actuarially determined life expectancy, then fewer than

[122] As discussed below, there are circumstances in which the 7520 tables cannot be used in establishing these values. Changes in the interest rate have no affected on the value of the charitable and noncharitable interests in a CLUT that does not require the application of interest rate sensitive adjustments.

[123] If a charitable lead trust is being considered because the grantor is proposing to fund the trust with an asset expected to outperform the 7520 rate, then a CLAT is generally preferable to a CLUT because the overall return generated by that asset in excess of the 7520 rate will be preserved entirely for the noncharitable remainder beneficiaries. In contrast, the designated charity or charities will share in a portion of that excess return if the asset is contributed to a CLUT.

[124] See Section IV.B.1.b for a more detailed discussion of these types of structures for a CLAT.

the anticipated payments to charity will occur and additional value will remain in the CLT at the time of its early expiration for passage to the noncharitable remainder beneficiaries. In that event, the taxable gift made by the grantor upon creation of the CLT will have been understated.

> **Example**: Grantor has an actuarial life expectancy of 15 years but is believed to have an actual life expectancy of 4 years.[125] Grantor transfers $1,000,000 in cash to a CLAT designed to last for Grantor's lifetime (again, deemed for valuation purposes to be 15 years). The annuity payment is set at 2.2% of the initial funding amount, and the 7520 rate is 2.2%. Consequently, the taxable gift will be the present value of $1,000,000 at the end of the charitable term based upon the valuation assumptions that 15 annual payments to charity will be satisfied solely with trust earnings and the initial $1,000,000 of trust corpus will correspondingly remain untouched throughout the charitable term. If Grantor lives for only four years, the actual gift will have been the present value of $1,000,000 at the end of the actual termination of the charitable term after only four years' worth of annual payments to charity.

As a caveat, the measuring life for a CLT established to last for an individual's lifetime must be the Grantor, the Grantor's spouse, a lineal ancestor of all the noncharitable remainder beneficiaries who have a 15% or greater probability of receiving trust assets, or the spouse of such a lineal ancestor.[126]

B. <u>Scenario 2: Grantor Has Reached Limits On Charitable Income Tax Deductions.</u> Assume a Grantor is making sizeable charitable gifts that have caused him/her to reach the deductibility limitations under IRC § 170, but he/she would also like to make additional charitable gifts and receive an income tax deduction for them. The Grantor may effectively do so by creating a nongrantor CLT for which the Grantor is the measuring life and funding it with assets projected to earn income roughly equal to the amount of the desired additional charitable gifts, which will be facilitated by distributions to the favored charity by the CLT for which the CLT will receive an offsetting income tax charitable deduction pursuant to IRC § 642(c).[127] Of course, removing that income from the Grantor's contribution base may affect the future deductibility of the Grantor's own charitable contributions under IRC § 170. An inter-related calculation may be in order to determine the appropriate amount with which to fund the CLT. To the extent the CLT assets outperform the IRC § 7520 rate, value will be transferred free of gift taxes to the remainder beneficiaries at the expiration of the charitable term upon the Grantor's death, making the Grantor's transfer of property to the CLT also an estate planning success.

C. <u>Scenario 3: Grantor Wants An Income Tax Benefit For Contributions To Foreign Charities.</u> Estates and trusts may deduct for income tax purposes their charitable distributions to foreign charities, provided that the foreign charities can substantiate qualification under IRC § 501(c)(3). However, individual donors cannot receive an income tax charitable deduction for gifts to foreign charities. Nevertheless, if a Grantor contributes property to a nongrantor CLT, the CLT's income will be excluded from the Grantor's income. While the income from the contributed asset will consequently be taxable income to the CLT, the CLT will receive an income tax charitable deduction under IRC § 642(c)(1) for income it distributes to foreign charities. If Grantor can be reasonably certain that he/she will not need the income from the contributed asset going forward (or obviously the asset itself), placing an asset expected to generate income sufficient to fund the desired foreign charitable gifts in a CLT and providing for the assets remaining at the Grantor's death to pass to his/her descendants effectively puts Grantor in the same income tax position as he/she would be in if Grantor retained the asset and were able to deduct gifts to foreign charities facilitated by the income that asset generates. To the extent the contributed asset outperforms the IRC § 7520 rate, the Grantor will have achieved an estate planning benefit as well.

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[125] Note, an individual cannot be "terminal" and serve as the measuring life. See Section IV.C.3 of this outline.

[126] See Section IV.A.2 of this outline.

[127] As discussed in Section IV.B.3, a nongrantor CLT may distribute appreciated assets in satisfaction of an annuity or unitrust payment and deduct the resulting capital gains pursuant to IRC § 642(c). However, for ease of illustration, the examples in this outline assume that all annuity/unitrust payments will be satisfied with income earned by the CLT assets and appreciated assets will remain in the CLT for ultimate passage to the remainder beneficiaries.

VIII. CONCLUSION.

A CLT can be a very effective technique for a charitably minded individual wishing to benefit a favored charity or charities but also interested in facilitating a transfer tax-free passage to descendants of the future appreciation in the CLT assets in excess of that projected by the IRS via the 7520 rate. There are many complexities involved with establishing and administering a CLT, but the benefits achievable with a CLT often justify the associated burdens.

Traps for the Unwary in Assets Acquisitions by S Corporations

By Jeffry M. Blair*

Supreme Court Justice Learned Hand is attributed as saying that "[t]here are two systems of taxation in our country: one for the informed and one for the uninformed." This is sage advice for taxpayers. Although most taxpayers are just trying to complete their transactions within the confines of the applicable rules, the Internal Revenue Code[1] and other applicable tax authorities are rarely described as being written in a language that even approaches plain English. Taxpayers often complete a transaction only to find that some little known or arcane provision of the Code has resulted in tax consequences far different than those intended.

Even transactions as seeming straight forward as asset acquisitions can end up with surprising tax consequences due to traps for the unwary that lie in wait. Although this article cannot begin to describe all of the possible tax snares and pitfalls that an S corporation might encounter in an asset acquisition, I hope it will make you aware of at least a few of the hidden dangers.

There are at several compelling tax related reasons why an S corporation acquirer would favor an actual or deemed asset purchase over a stock purchase. One reason is to provide the acquiring S corporation with a step-up in the tax basis in the acquired assets. Another reason is to permit the S corporation acquirer to limit its exposure to certain liabilities of the seller. However, an S corporation must always be careful not to do anything that could impact its status as an S corporation. Accordingly, if a S corporation finances the acquisition with debt, the S corporation will need to make sure that any notes issued are respected as debt and not treated as an impermissible second class of stock. Care must be taken to make sure that all of these tax objectives are accomplished.

Step-up In Basis of Assets

In general, an S corporation purchaser will take a tax basis in the assets purchased equal to the amount paid for the assets.[2] In an asset purchase, the purchase price will be allocated between the acquired assets based on the relative fair market value of the assets purchased.[3] If the assets constitute a trade or business, then the allocation is done in accordance with the residual allocation method of Code Section 1060.[4] Under the residual allocation method, the

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, (the "Code').

2 §1012(a).

3 §1060(a).

4 §1060(a); Treas. Reg. §1.1060-1(a)(1) (referencing the residual method of allocation as described in Treas. Reg. §§1.338-6 and 1.338-7).

purchase price is allocated between seven categories of assets starting with cash and cash equivalent assets then moving through traded securities, accounts receivable, inventory, property plant and equipment and certain intangible assets, in each case allocating up to but not exceeding the fair market value of each class of assets.[5] The excess over the fair market value of these specified groups of assets will be allocated to goodwill and going concern value and can be amortized on a straight-line basis over 15 years.[6] There are some potential road blocks to achieve this benefit.

1. Acquisition of Interests. If any of the assets being acquired are interests in entities, then the purchase price will generally be allocated to the purchased interest in the entity rather than the underlying assets of the entity.[7] This is not beneficial to a purchaser because the interest will not be depreciable or amortizable. Although the additional tax basis could be used to offset a later sale of the interest, that sale is likely to be years in the future. Accordingly, an acquiring S corporation may want to look at various methods to achieve a step-up in the proportionate assets of the entity being acquired.

a. *Section 338(h)(10) or Section 336(e)*. If the acquired interest is at least 80% of the stock in a C corporation or an S corporation, then the acquiring S corporation may want to consult with their tax advisors to determine if the stock sale could qualify for deemed asset sale treatment under Code Section 338(h)(10) or Code Section 336(e).[8] If the acquisition meets the other requirements of Code Section 338(h)(10) or Code Section 336(e), the parties could agree to treat the transaction for federal income tax purposes as a deemed sale of assets by the target corporation to a new corporate subsidiary of the acquiring S corporation for the consideration paid for the stock and the assumption of the liabilities of the target corporation, followed by a liquidation of the old target corporation. Agreement of the parties is particularly important for making a Code Section 338(h)(10) election or a Code Section 336(e) election with respect to the purchase of an S corporation because the election will require unanimous consent of all of the S corporation shareholders.[9] If the parties agree to such an election, the deemed asset purchase can provide the purchaser with a step-up in the value of the assets, including the possibility of amortizable goodwill for any excess. However, a deemed asset sale may result in higher taxes to the seller due to tax basis and character differences in the gains from an asset sale compared to a sale of stock. A seller may only agree to a deemed asset sale if the purchase price is increased to compensate them for the additional taxes they incur compared to a straight stock

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[5] Treas. Reg. §1.338-6(b).

[6] §§197(a), 197(d)(1)(A) – (B); Treas. Reg. §1.338-6(b)(2)(vii).

[7] For example, if $1 million is allocated to acquired stock of a subsidiary corporation or an acquired interest in a partnership, then the $1 million will be capitalized as the tax basis of that acquired stock or partnership interest unless provisions of the Code treat the acquisition as a deemed acquisition of some or all of the underlying assets of the subsidiary corporation or partnership.

[8] §§336(e) (referencing the requirement that the stock sold in must meet the 80% vote or value test of §1502(a)(2)); 338(d)(3) (indicating that to be treated as a qualified stock purchase the stock sold must meet the 80% vote or value test of §1502(a)(2)).

[9] If the acquirer believes that it may be difficult to get consent from one or more minority shareholders of a target S corporation, then the parties could agree to structure the transaction as a forward cash merger of the target S corporation into the acquiring S corporation and still receive deemed asset sale treatment. *See, e.g.* Rev. Rul. 69-6, 1969-1 C.B. 104.

sale. Accordingly, an acquirer will want to carefully weigh the value of the step-up compared to any additional costs to the seller in arriving at a purchase price for the transaction.

b. *Disregarded entity.* If any of the assets being acquired are interests in an entity that is treated as "disregarded entity" for federal income tax purposes, the purchase of those interests will generally be treated as a purchase of the underlying assets owned by that entity. In that case, an acquiring S corporation will be treated for federal income tax purposes as having purchased the assets and will get a step-up in the tax basis of those assets.

However, some entities that look like they should be treated as a disregarded entity for federal income tax purposes, may not be. Accordingly, an acquirer will want to make sure that the entity is currently and will continue be treated as a disregarded entity for federal income tax purposes as of the closing date of the acquisition. This can be illustrated with two typical disregarded entities: (i) a qualified subchapter S subsidiary ("Q-Sub") and (ii) a single member limited liability company ("SMLLC"). In both cases, the purchasing S corporation will want to make sure that the Q-Sub or SMLLC has <u>not</u> made a check-the-box election to be treated as an association taxable as a corporation for federal income tax purposes.[10] In addition, if the disregarded entity is a SMLLC, then the acquiring S corporation will want to make sure that the SMLLC is a United States entity to avoid the default rules under the check-the-box regulations for foreign entities.[11]

The purchase of an interest in a SMLLC or a Q-Sub will generally be treated as a purchase of a proportionate interest in the underlying assets of the SMLLC or Q-Sub followed by a contribution of the purchased assets to a new entity. If the acquiring S corporation purchases 100% of the interests in a SMLLC, then the transaction will generally be treated as a purchase of all of the assets of the SMLLC followed by a drop down of the assets into a new single member LLC owned by the acquiring S corporation. If the acquiring S corporation purchases less than 100% of the SMLLC, then the transaction will generally be treated as acquisition of a proportionate part of the SMLLC's underlying assets followed by the tax-free contribution by both the current and the new member to a new LLC treated as a partnership for federal income tax purposes.[12]

The purchase of the interests in a Q-Sub is also generally treated as a purchase of a proportionate amount of assets of the underlying Q-Sub. If an S corporation purchaser acquires 100% of the interests in a Q-Sub from a selling S corporation, then the transaction will be treated as if: (i) the selling S corporation first sold all of the assets of the Q-Sub to the S corporation purchaser in exchange for the consideration paid for the Q-Sub stock and (ii) then contributed all of these assets to a newly formed subsidiary corporation of the S corporation purchaser. If the S corporation purchaser makes a new qualified subchapter S subsidiary election effective as of the date of the sale with respect to the new subsidiary, the assets will just continue to be treated as held by a disregarded entity of the S corporation purchaser.[13] Similarly, if an S corporation purchaser acquires less than 100% of the stock of a Q-Sub, the transaction will be treated as a

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[10] Treas. Reg. §301.7701-3(c).

[11] Treas. Reg. §301.7701-3(b)(2).

[12] Rev. Rul. 99-5, 1991-1 C.B. 434.

[13] Treas. Reg. §1.1361-5(b)(3), Ex. 9.

deemed purchase of only a proportionate part of the Q-Sub's assets (equal to the percentage of the Q-Sub's stock acquired), followed by a contribution of the newly acquired assets to a newly formed corporation in a transaction covered by Code Section 351.[14] However, the new subsidiary corporation will no longer meet the requirements to be treated as a Q-Sub and will become a C corporation subject to a corporate level tax.[15] Accordingly, an S corporation purchaser will generally want to acquire 100% of the stock of the Q-Sub in order to maintain flow-through treatment from the acquired subsidiary.

c. *Partnership*. If an S corporation acquires 100% of the interests in an entity currently treated as a partnership for federal income tax purposes, the acquisition of those interests will generally be treated as an acquisition of all of the assets owned by that entity and the S corporation will get a step-up in the tax basis of the assets of the entity.[16] The acquiring S corporation will want to confirm that the entity being acquired is currently treated as a partnership for federal income tax purposes and has not made a check-the-box election to be treated as an association taxable as a corporation. Alternatively, if the entity being acquired is currently a state law general or limited partnership, the acquiring S corporation may want to structure the acquisition through a SMLLC or Q-Sub of the acquiring S corporation to keep liabilities separate from the S corporation after the acquisition for non-income tax purposes.

If an S corporation acquires less than 100% of the interests in an entity treated as a partnership, the S corporation can still receive a step-up in the tax basis of its proportional interest in the assets of the entity if the entity has a Code Section 754 election in place.[17] In addition, an S corporation purchaser may need to take additional steps to make sure that it is only allocated income from its interest in the acquired entity for its period of ownership. In general, the income and loss from a partnership flows out to its partners as of the last day of the taxable year of the partnership. A sale of an interest in a partnership does not generally close the tax year unless the sale results in a technical termination of the partnership under Code Section 708(b)(1)(B) (i.e. a sale or exchange of 50% or more of the total interest in partnership capital and profits within the prior 12 month period). Accordingly, an S corporation purchaser may want to include language in the purchase agreement the requires the partnership to allocate income, gain, loss, deduction and credit for the sold partnership interests for the taxable year in which the S corporation's purchase takes place based on an interim closing of the books as of the closing date of the sale.[18]

2. <u>Anti-Churning Rules</u>. If the acquiring S corporation is treated as related to the seller, then the anti-churning rules of Code Section 197(f)(9) could eliminate the ability to amortize the step-up in tax basis of any "amortizable section 197 intangible" for federal income

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14 §1361(b)(3)(C)(ii). Prior to 2007, a sale of more than 20% of the stock of a Q-Sub could result in the parent S corporation recognizing 100% of the gain as part of a deemed contribution of the Q-Sub's assets to the newly formed corporation in exchange. Thankfully, this trap for the unwary has been largely eliminated for post-2006 transactions by new §1361(b)(3)(C).

15 *See, e.g.,* Treas. Reg. §1.1361-5(b)(3), Ex. 1.

16 Rev. Rul. 99-6, 1991-1 C.B. 432.

17 §754. If the entity does not have a Code Section 754 election in place, the acquirer may want to require that such an election be made as a condition of the purchase.

18 *See* §§ 706(c)(2), 708(b)(1)(B). *See also* Prop. Treas. Reg. §1.706-4 .

tax purposes.[19] The term “amortizable section 197 intangible” is defined as any section 197 intangible that was acquired after August 10, 1993 and is held in connection with the conduct of a trade or business or an activity described in Code Section 212 (i.e. an investment activity or other activity engaged in for profit).[20] The term section 197 intangible includes goodwill, going concern value, and other intangibles described in Code Section 197(d).[21] For purposes of these rules, a seller and an acquiring S corporation would generally be treated as related if the same owner or group of owners owned both more than 20% of the seller prior to the sale and also owned more than 20% of the acquiring S corporation as determined immediately before or after the acquisition. Due to this low ownership threshold and the fact that the relationship is tested both immediately before and after the transaction, seemingly benign transactions can run afoul of these rules. In addition, if these rules apply, they can deny amortization on the step-up of the entire section 197 intangible. For example, suppose a corporation that has been in existence since January 1, 1993 sold its business in a fully taxable asset sale to an acquiring S corporation and that the president and certain employees of the target S corporation acquired a 21% interest in the acquiring S corporation as part of the transaction. Even if the business only had a small amount of goodwill as of August 10, 1993 and the acquiring S corporation was controlled by another individual owning 79% of its outstanding stock, the anti-churning rules could still apply to the transaction. Although a full discussion of the anti-churning rules is beyond the scope of this article, acquiring S corporations would be well advised to fully review these rules whenever there was cross-ownership of the selling target and the acquiring S corporation.

<u>Successor Liability for Certain Taxes in an Actual Asset Purchase</u>

Another advantage of an asset purchase is that it can permit a purchaser to pick and choose which liabilities it agrees to assume or take subject to the acquired assets. With respect to tax liabilities, the structure of the transaction can greatly impact the tax liabilities that become the responsibility of the purchaser.

1. <u>Successor Liability for Taxes in an Actual Asset Purchase</u>. In an actual asset purchase transaction, taxes that are not assumed or taken subject to the acquired assets under the purchase agreement will generally remain with the seller.[22] However, there are exceptions to this general rule. For example, most states provide for successor liability with respect to unpaid sales and use taxes to taxpayers that acquire all or substantially all of the assets of a business.[23] Accordingly, a prudent acquirer will want to review the applicable tax law where the seller is doing business to determine where there is potential for successor liability for taxes.[24] If the acquirer discovers that there are unpaid sales and use taxes, the acquirer may want to withhold these taxes and pay them over to the appropriate governmental authority. In addition, an

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19 §197(f)(9)(A).

20 §197(c).

21 §197(d).

22 *See, e.g.*, Tex. Bus. Org. Code Ann. sec. 10.254(b) (2015) (indicating that a person acquiring property may not be responsible for a liability or obligation of the transferring domestic entity that is not expressly assumed by that person).

23 *See, e.g.*, Tex. Tax Code Ann. §111.020 (2015); Tax Admin. Code §3.7 (2015) (indicating that successor must withhold for unpaid sale or use tax, penalty and interest or become liable for such taxes).

24 In Texas, successor liability can also attach to a person who acquires a business or the assets of a business from a taxpayer through a fraudulent transfer or sham transaction. Tex. Tax Code Ann. §111.024(a).

acquirer may want to require the seller to provide as a closing condition a certificate from the applicable state or local governments indicating that there is no tax due.

2. Successor Liability for Taxes in a Deemed Asset Purchase. In many cases, the additional expenses and contractual approvals required by an actual transfer of assets will make it less efficient and more costly than a deemed asset purchase. As discussed, above, a purchase of interests can be treated for federal income tax purposes as a deemed asset purchase if the entity is treated as a disregarded entity for federal income tax purposes of the interests are stock in a corporation and the parties involved agree to make an election under Code Section 338(h)(10) or, if applicable Code Section 336(e). Although a deemed asset purchase will cut off the liability for federal income taxes of the acquired entity for taxable periods prior to the closing date of the acquisition, other unpaid tax liabilities will generally stay with the acquired entity. This will include unpaid federal and state payroll taxes, state and local property taxes, and other state taxes imposed on the entity (e.g. Texas franchise taxes). If the entity was formerly a taxable entity and subsequently became a pass-through entity (e.g. a C corporation that elected S corporation status), then any unpaid entity level federal income taxes would also continue to be a liability of that entity after the acquisition. Accordingly, even though the transaction is treated as a deemed asset purchase for federal income tax purposes, an acquiring S corporation will need to treat the acquisition of interests in and entity for other tax purposes. The S corporation will want to protect itself the same way it would in a stock acquisition with indemnification from the sellers for any pre-closing tax liabilities, successor and transferor liabilities, and receiving appropriate certificates from applicable state and local governments as to the current tax status of the selling entity.

Financing the Purchase -- Second Class of Stock Issues

In addition to receiving a step-up in the tax basis of acquired assets and the protection of successor liability for taxes, an S corporation must also take care that the acquisition doesn’t accidentally result in a termination of the acquirer’s S election. Accordingly, in financing an asset acquisition, an S corporation acquirer must not issue any debt in financing the transaction that could be treated as an impermissible second class of stock.[25] This is true for both third party financing as well as any seller financing.

Third party lenders often request additional compensation for loans in the form of warrants or other equity based compensation. S corporation acquirers should try to resist issuing these types of loan sweeteners to third party lenders where possible. In addition, some practitioners have noted that Code Section 163(l) could on its face apply to third party debt issued by an S corporation.[26] In general, Code Section 163(l) permanently disallows any interest deduction on corporate debt if a substantial amount of the principal or interest on the debt is paid in or by reference to the value of the equity of the issuing corporation. Although there are valid arguments that these rules do not and should not apply to an S corporation, Treasury has not confirmed this by issuing regulations or other guidance. Accordingly, an S corporation acquirer is well advised to enter into these waters only at the risk of great peril.

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[25] §1361(b)(1)(D) (permitting an S corporation to not have more than 1 class of stock).

[26] *See, e.g.*, Ginsburg, Levin and Rocap, Mergers, Acquisitions, and Buyouts, ¶1104.2 (Spring 2014).

These issues can also arise if the purchase of the assets is partially seller financed by the issuance of notes to the seller by the acquiring S corporation. If the note is simply straight debt of the S corporation, then it should be fine. However, if the note looks more like equity by providing continuing voting rights or contingent payments that could reasonably be interpreted as representing an continuing interest in the right to distributions or liquidation proceeds of the S corporation, then the S corporation could be putting its continuing status as an S corporation at risk. Again, these temptations should be resisted.

Conclusion

In conclusion, just remember the words from English fiction writer China Miéville who stated, “A trap is only a trap if you don’t know about it. If you know about it, it’s a challenge.”

Tax Considerations in Moving Technology to Texas

by Matt Hunsaker and Gordon Martens


Matt Hunsaker


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In the first installment of a new column called Silicon SALT, Hunsaker and Martens outline the tax considerations that tech companies considering relocation to Texas should factor into their decisions — including research and development credits, incentives, nexus, and sales and franchise tax issues.

From the "Silicon Hills" of Austin to the "Silicon Prairie" of North Texas, tech companies and entrepreneurs are flocking to the Lone Star State for its booming technology sector. And for good reason: Texas has a robust economy, no individual income tax, a modest cost of living, plentiful high-skilled workers, and an entrepreneurial spirit. For tech companies considering relocating some or all of their operations to Texas, there are tax considerations that should be factored into relocation decisions.

Research and Development Credit/Exemption

In 2013 the Texas Legislature instituted tax benefits for taxable entities conducting research and development activities in the state.[1] The primary benefit is a franchise tax credit for qualified research expenses or a sales and use tax exemption on the purchase, lease, rental, storage, or use of depreciable tangible personal property used in qualified research. In other words, taxpayers may take either a franchise tax credit — one of the few meaningful credits allowed against Texas's primary business activity tax — or a sales and use tax exemption, but not both. A franchise tax credit or sales tax exemption election is not permanent and may be changed at any time. The credit regime is due to expire on December 31, 2026, but unused credits may be carried forward for 20 years thereafter.

The franchise tax credit is equal to 5 percent of the amount by which qualified research expenses in Texas (QRET) exceed 50 percent of the average amount of all QRET incurred during the three preceding years.[2] That amount rises to 6.25 percent if the taxpayer performs any qualified research under a contract with public or private institutions of higher education in Texas.[3] If the taxpayer has no QRET in one or more preceding years, the credit equals 2.5 percent of the QRET for that year (3.125 percent with a contract with a higher education institution).[4]

Texas borrows the definition of qualified research from section 41(d) of the Internal Revenue Code (as in effect at the end of 2011) but requires that the research be conducted in Texas.[5] In other words, the research — conducted in Texas — must be undertaken for discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the entity undertaking the research. Substantially all of the research activities must be elements of a process of experimentation regarding a new or improved function, performance, reliability, or quality.

Qualified research expenses include in-house research expenses and contract research expenses. In-house research expenses include:

- wages paid to an employee for qualified services (services performed by a person engaged in qualified research, directly supervising qualified research, or directly supporting qualified research) performed by the employee;
- any amount paid or incurred for supplies used to conduct qualified research; and
- any amount paid or incurred to another person for the right to use computers to conduct qualified research.

[1] *See* HB 800, 83rd Leg., Reg. Sess. (Texas 2013).

[2] Tex. Tax Code Ann. section 171.654(a); 34 Tex. Admin. Code section 3.599(e)(1).

[3] Tex. Tax Code Ann. section 171.654(b); 34 Tex. Tax Code Ann. section 3.599(e)(3).

[4] Tex. Tax Code Ann. section 171.654(c)-(d); 34 Tex. Admin. Code section 3.599(e)(2) and (e)(4).

[5] Tex. Tax Code Ann. section 171.651(1) and (3); 34 Tex. Admin. Code section 3.599(b)(4).

Contract research expenses are generally defined as 65 percent of any expenses paid or incurred to any person — other than an employee of the taxpayer — for performing qualified research or services for the taxpayer that would constitute qualified services if performed by the taxpayer's employees.[6]

Qualified research does not include:

- research concerning style, taste, cosmetic, or seasonal design factors;
- research conducted after the beginning of commercial production of the business component;
- research adapting an existing product or process to a customer's need;
- duplication of an existing product or process;
- surveys or studies;
- research regarding some internal-use computer software;
- research conducted outside the United States, Puerto Rico, or a U.S. possession;
- research in the social sciences, arts, or humanities; or
- research funded by another person or governmental entity.

The sales tax exemption applies to the sale, storage, or use of depreciable tangible personal property directly used in qualified research. To register for the exemption, the taxpayer must be engaged in qualified research and must not claim the franchise tax credit or be in a combined group claiming the franchise tax credit.

For purposes of the exemption, depreciable tangible personal property has a useful life of more than one year and is subject to depreciation under generally accepted accounting principles or IRC section 167 or 168. The property, however, must be directly used in qualified research.

Taxpayers relocating research to Texas should compare estimated franchise tax credit savings to sales tax exemption savings. Taxpayers with significant R&D asset expenses early in the research cycle may benefit from claiming the sales tax exemption, while taxpayers with substantial Texas sales may benefit from claiming the franchise tax credit. Taxpayers should reevaluate the election annually to determine whether changing it will increase tax savings. After the election is made, it can be retroactively reversed for up to four years, but that may result in penalties and interest attributable to tax benefits previously claimed under the prior election.

Property Tax Incentives

All things are bigger in Texas, including property tax bills. Recognizing that barrier to entrance, the Legislature has enacted various property tax incentive programs to mitigate high property taxes for companies looking to invest in Texas, such as value limitation agreements for school district taxes and tax abatement agreements by other localities.

In Texas, school district property taxes comprise the lion's share of local property taxes. Chapter 313 of the Texas Tax Code allows school districts and taxpayers — with some oversight by the comptroller — to agree to limit the appraised value of property for 10 years for the school district maintenance and operations tax. In other words, school districts and investors can agree to an artificially low value for property for a decade to alleviate taxes that would otherwise be imposed on the high value of new investment.

Why would a school district do that? For the most part, school districts are guaranteed funding thresholds through complicated statutory formulas if their tax base proves inadequate. Also, those agreements often require taxpayers to make additional payments to compensate the school districts and to protect their funding. Entering into an agreement without understanding and modeling the interplay between the school finance formulas and those contract provisions can lead to surprising results.

To qualify for a value limitation agreement, a taxpayer must agree to build a project that will provide a specific number of qualifying jobs and involve a minimum amount of qualified investment within a specified time period — usually the remainder of the year when the application was approved plus the following two calendar years. The amounts and criteria for jobs and investment are set in statute and vary by school district. Minimum investment amounts range from $1 million for very small rural districts to $100 million for the largest metropolitan school districts. Minimum job creation is 25 jobs in urban districts and 10 jobs in rural districts, but the school district may waive the requirement if fewer jobs are reasonably necessary based on industry standards.

To qualify for value limitation, the property must be located in a reinvestment zone, which a school district may designate if the project is outside any existing zone. The project must be devoted to energy and manufacturing activities, R&D, and some computer centers used for the foregoing. The definitions of manufacturing and R&D activities are based on North American Industry Classification System sectors.[7] As a result, manufacturing encompasses most "mechanical, physical, or chemical transformation of materials, substances or components into new products," as well as supporting administrative operations, such as accounting, payroll, or management.[8] R&D embraces "research and experimental development in the physical, engineering, and life sciences" including biotechnology- and computer-related innovation.[9]

On its face, the Chapter 313 regime appears simple and mechanical. But navigating the interplay between the tax

[6]IRC section 41(b)(3); Tex. Tax Code Ann. section 171.651(3).

[7]Tex. Tax Code Ann. section 313.024(e)(1) and (e)(5).

[8]Office of Management and Budget, North American Industry Classification System, Sectors 31-33 (2007).

[9]Office of Management and Budget, North American Industry Classification System, Sector 541710 (2002).

code and school finance laws — as well as local politics — requires significant experience. Many taxpayers have found themselves in hot water after entering into a Chapter 313 agreement, only to find out that they cannot comply with the agreement or are subject to significant indemnity payments that could have been avoided.

Closely related to Chapter 313 are tax abatement agreements under Chapter 312 of the Texas Tax Code, which does not have the same rigid requirements as Chapter 313. Instead, it allows other units of local government (for example, counties, cities, and special purpose districts) to abate up to 100 percent of local property taxes for up to 10 years. Additional grant-based programs can allow an abatement to functionally continue past that 10-year window. Chapter 312 tax abatements are typically approved for manufacturing and high-tech projects.

As with all incentives, it is important that an applicant not publicly commit to a Texas location before exploring its options. The programs are incentives — not rewards — for investing capital and jobs in Texas. Once a company publicly commits to a relocation or investment, it loses all leverage in negotiating incentive packages.[10]

Texas's property tax regime has other features that make it appealing for technology investment. For example, state courts have determined that intangible assets such as computer software are not subject to Texas property tax.[11]

Sales Tax Considerations

Texas is not that unusual in its treatment of software for sales tax purposes. Software is treated as tangible personal property whether it is delivered by load and leave, download, or tangible medium. As a result, licensing or selling software is subject to sales and use tax.

Texas has not fully developed its sales tax policies regarding cloud computing transactions. In some circumstances, the state may treat a cloud service as a taxable service instead of as software. For example, Texas sometimes treats the sale of software as a service (SaaS) access as the provision of taxable information services or data processing services instead of as the sale of tangible personal property. SaaS access may be an information service for Web applications such as training modules in which the seller provides general or specialized current information.[12] Remote access may be a data processing service for Web applications such as customer relationship management or enterprise resource planning that process and manipulate data entered by the customer.[13] Information services and data processing services are given a 20 percent sales tax exemption. Because of the complexity and uncertainty surrounding cloud services, companies with cloud computing activities must exercise care to properly characterize transactions based on their peculiar facts.

One interesting nuance — most interesting to businesses producing software — is that Texas treats designing and writing code for a computer program as manufacturing for purposes of the sales and use tax exemption for manufacturing.[14] That exemption also applies to testing and demonstrating the software. That allows businesses engaged in software design and development to purchase tangible personal property used to create software tax-free.

Nexus Considerations of Using Texas Servers

In 2014 the Texas Comptroller affirmed an administrative court's decision that a software company had sufficient nexus with the state to require it to collect sales tax on its software licenses to Texas customers.[15] The administrative law judge concluded that the presence of the software company's software, though in the hands of licensees, constituted presence in Texas, a prerequisite to being required to collect sales tax. The ALJ also concluded that that presence was substantial enough to require collecting tax because of the magnitude of fees generated by the software located in Texas. The difficulty with that decision is that the amount of license fees was redacted, so it is unclear what level of sales is sufficient to create substantial nexus. That issue will likely see its way through the courts.

Perhaps a more pressing concern for those seeking to store code on servers in Texas is whether it creates nexus. In 2010 the comptroller amended an administrative rule regarding whether using in-state servers creates nexus,[16] suggesting that owning or using tangible personal property in Texas, including a computer server or software, means an out-of-state taxpayer has nexus.

In March 2011 the comptroller issued a letter ruling clarifying the amendment's intent. In that letter, the comptroller ruled that an out-of-state company does not have nexus if its only presence and business activity in Texas is a website on a third-party server in which the third party provides all of the website's functionality. In May 2011 the Legislature passed a law clarifying that nexus is not created solely by having a website hosted by an unrelated party on a

[10]Texas offers a variety of nontax incentives that are worthy of consideration but beyond the scope of this article (for example, the Texas Enterprise Fund).

[11]*Dallas Cent. Appraisal Dist. v. Tech Data Corp.*, 930 S.W.2d 119, 123-24 (Tex. App. 1996, *writ denied*).

[12]Texas Comptroller Policy Letter, STAR document 200812241L (Dec. 16, 2008).

[13]Texas Comptroller Policy Letter, STAR document 200805095L (May 28, 2008).

[14]Tex. Tax Code Ann. section 151.318(p); 34 Tex. Admin. Code section 3.300(a)(9).

[15]Texas Comptroller Hearing nos. 106,632 and 108,626; STAR document 201409970H (Sept. 19, 2014).

[16]34 Tex. Admin. Code section 3.286(a)(2)(E) (amendment effective July 11, 2010; current version at 34 Tex. Admin. Code section 3.286(a)(3)(E)).

Texas server.[17] Consistent with the new law, the comptroller amended the rule to provide that a taxpayer does not acquire nexus if it merely "uses the server or software as a purchaser of an Internet hosting service."[18]

There is some risk that in following that reasoning, Texas may treat storing digital products — such as music, photography, videos, and software — on third-party servers in the state as creating nexus. By analogy, the comptroller appears to be likening storing digital products and software on a computer to storing traditional tangible personal property in a physical warehouse in the state.

Franchise Tax Relocation Costs Deduction

While Texas's franchise tax rates are low compared with other states' corporate income and franchise taxes, few deductions are allowed. However, Texas allows a company to deduct relocation costs incurred in moving its main office or other principal place of business to Texas. Those costs include the cost of moving computers, peripherals, business supplies, furniture, and inventory, as well as any other costs regarding the relocation that are deductible for federal tax purposes.[19]

That potentially expansive deduction is subject to some limitations. The deduction is unavailable if the company or any affiliated group member in a unitary business has done business in Texas before relocating. The deduction may not reduce the apportioned margin below zero, and any unused deduction may not be carried over to another year. The relocation deduction must be claimed on the first franchise tax report.[20]

Franchise Tax Apportionment Advantages

Texas has a unique sourcing rule for gain from selling intangibles and licensing software. Those receipts are sourced to the location of the payer (that is, the buyer). That location is the buyer's legal domicile. For corporations and limited liability companies, that is the state of incorporation or formation; for partnerships it is the principal place of business — the place where the day-to-day operations are located and, in the event of a tie, the place where the partnership is directed.[21] That rule — coupled with Texas's single-sales-factor apportionment — offers significant tax planning opportunities for companies disposing of intangibles.

For example, assume a company in Texas decides to sell a patent. By ensuring that the buyer is domiciled outside Texas (for example, a Delaware corporation), all gain from the sale is sourced outside Texas and escapes its franchise tax. Not only does that produce an apportionment advantage, but it also avoids complexities and uncertainties of navigating the Uniform Division of Income for Tax Purposes Act and market-based sourcing rules for sales other than sales of tangible personal property.

The rule is not limited to sales of intangibles. The Texas Supreme Court has also held that it includes licensing transactions in which the asset being licensed does not constitute a patent, copyright, trademark, franchise, or license (in the sense of a sublicense). The court has held that those receipts must also be sourced to the payer's location. A fee from licensing the use of a patent is sourced to the location of use, which the comptroller defines to mean the location where a product is produced using the patent.

Conclusion

Texas presents many unique opportunities for businesses in the technology sector. As businesses explore those opportunities, they should be certain to carefully evaluate the state and local tax implications of relocating technology in Texas. ✰

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[17]HB 1841, 82nd Leg., Reg. Sess. (Tex. 2011), *codified at* Tex. Tax Code Ann. section 151.108(b).

[18]34 Tex. Admin. Code Ann. section 3.286(a)(3)(E), *amended by* 40 Tex. Reg. 3183.

[19]Tex. Tax Code Ann. section 171.109.

[20]*Id.* section 171.109(b)-(d).

[21]34 Tex. Admin. Code section 3.591(b)(2) and (b)(7).

THE NUTS AND BOLTS OF TAX COURT LITIGATION: POST-TRIAL PRACTICE*

Jaime Vasquez and Stuart H. Clements**

A. Post-Trial Briefs

- In general, parties shall file briefs after trial or submission of a case. *See* T.C. 151(a). If briefs are to be filed simultaneously, each party will file an Initial or Opening Brief, followed by an Answering or Reply Brief.

  - **Briefs.** A brief should comply with the requirements under T.C. Rule 23, Form and Style of Papers, as well as the specific requirements under T.C. Rule 151(e), which describes the form and content a brief shall contain. *See also* I.R.M. § 35.7.1.3.1.

    - Each brief must include a cover page, a table of contents, and a table of authorities. T.C. Rule 23 and 151(e)(1).

    - The brief should also include a summary statement of the nature of the case, which includes a description of the tax involved, and the issues to be decided. T.C. Rule 151(e)(2).

    - The opening brief must include proposed findings of fact in numbered paragraphs. Each paragraph must consist of a concise statement of essential facts, not a recital of testimony or a discussion or argument relating to the evidence or law. Each numbered paragraph must include a reference to the page of the transcript, exhibit, or other source relied upon. T.C. Rule 151(e)(3).

    - In an answering or reply brief, the parties should include objections to the proposed findings of the opposing party. The parties may also set forth alternative proposed findings of fact. *Id.*

    - The brief should contain a concise statement of the points on which the party relies. T.C. Rule 151(e)(4).

    - The brief must also include a persuasive argument, which sets forth and discusses in detail the points of law involved and any disputed questions of fact. T.C. Rule 151(e)(5).

    - The brief must be signed by either the party or its counsel. T.C. Rule 151(e)(6).

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* This outline, prepared by Jaime Vasquez and Stuart H. Clements, was originally presented at a CLE panel for a seminar sponsored by the ABA Section of Taxation (2016 Midyear Meeting).

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- **Other Submissions.** If the Court does not desire a formal brief, a Memorandum of Authorities may be filed with permission from the Court. The Memorandum should contain a brief recitation of the issues, the party's position, references to applicable statutory and case law, and incorporate facts established at trial. *See also* I.R.M. § 35.7.1.3.2.

- **Timing.** The Court may direct filing of briefs either simultaneously or seriatim. Unless otherwise directed by the presiding Judge, if directed to file simultaneously, opening briefs shall be filed and served within 75 days after the trial concludes and answered within 45 days thereafter. If directed to file seriatim, one party files and serves its opening brief within 75 days of the trial concludes, an answer is due 45 days thereafter, and a reply brief may be filed within 30 days after the answer due date. See T.C. Rule 151(b).

  - **Extensions of Time for Filing Briefs.** Upon motion, the Court may extend the time for filing post-trial briefs. The motion must be made prior to the due date and shall recite that the non-moving party has been advised and whether the non-moving party objects to the motion. See T.C. Rule 151(b). If the Court grants the motion to extend the deadline, it extends all deadlines for both parties whether briefs are to be submitted simultaneously or seriatim. See T.C. Rule 25(c).

  - **Motions to Supplement.** A motion to supplement a party's brief should be made if such party learns of new or missing case law relevant to the party's position. See "eFiling Instructions for Practitioners," which references the requirement to move for leave to supplement if an e-filed brief has already been accepted by the Court.

- **Other Briefing Issues.** Taking into account the preferences of the Judge in each case, the following drafting techniques are generally recommended in addition to the guidelines provided in T.C. Rules 151(e) and 23:

  - **Summary and Conclusion.** Always include a short summary and factual conclusion that informs the Court of the case in its most concise form;

  - **Record.** Clearly reference the record (see Tax Court docket sheet) in the brief;

  - **Size and Style.** Single side, 8.5 inches wide by 11 inches long (normal letter size) with 1 inch margins on the sides, 3/4 inch margins on top and bottom. 14-point font if proportional print font (e.g. Times New Roman), or 12-point font if nonproportional print font (e.g. Courier). Double spacing required and block quotes longer than five lines must be set of and indented. Text and footnotes must be in the same type font.

  - **Page Limits.** Strictly adhere to any page limits set by the Court. Be clear, concise, and to the point;

  - **Know your Judge.** Review prior opinions by the Judge assigned to the case. If available, review opinions relevant to the particular case matter. If possible, consult with colleagues and draw from past experience in front of the same Judge to understand and incorporate preferences into the brief;

  - **Facts.** Be fair and credible when presenting the pertinent facts of a case in the brief.

The Judge may utilize a particular party's recitation of the facts;

- o **Hyperlinks.** If applicable, utilize hyperlinking the brief electronically so the table of contents and/or table of authorities direct to the specific references.

- o **Harmless Error**. T.C. Rule 160. No error in either the admission or the exclusion of evidence, and no error or defect in any ruling or order or in anything done or omitted by the Court or by any of the parties, is ground for granting a new trial or for vacating, modifying, or otherwise disturbing a decision or order, unless refusal to take such action appears to the Court inconsistent with substantial justice. The Court at every stage of a case will disregard any error or defect that does not affect the substantial rights of the parties.

B. Tax Court Decisions and Opinions

- **In General.** In general, Tax Court decisions determine whether and to what extent a deficiency exists, whether an overpayment exists, or render a decision for other issues, such as interest abatement, collection due process, relief from joint and several liability, or partnership proceedings, as the case may be. Where jurisdiction exists, the Court will make a determination respecting each tax and penalty for each contested period. *See also* I.R.M. § 35.8.1.1(1).

- **Types of Opinions.** The Tax Court issues several types of opinions.

  - o **Division opinions.** A division opinion is a regular opinion of a single Judge. It is published in the official Tax Court reporter. A division opinion or a regular opinion is usually issued in cases of first impression or in cases that are selected to serve as a precedent.

  - o **Reviewed opinions.** A reviewed opinion is reviewed by the entire court sitting as a Court Conference. A reviewed opinion is generally issued in high profile cases or cases with legal sensitivities, such where the Tax Court has been reversed on this issue by a court of appeals, or where a decision would invalidate a regulation or overrule a prior opinion.

  - o **Memorandum opinion.** A memorandum opinion is not published in the official Tax Court reporter. However, it is published unofficially by various tax services. It is generally issued in fact-intensive cases and is not considered a binding precedent by the Tax Court. A memorandum opinion can gain importance, however, if it becomes the focus of appellate court review.

  - o **Summary opinion.** A summary opinion is an opinion in a case tried under the small case procedure. These opinions are generally not published and are not reviewable by any court of appeals. *See* Kafka and Cavanaugh, Litigation of Federal Civil Controversies, ¶ 2.06. *See also* Vasquez and Ziering, The Practical Tax Lawyer, 25, Fall 2012.

  - o **Bench Opinions.** The Judge may issue a Bench Opinion in a regular or S case during the trial session. In this situation, the Judge orally states the opinion in court during the trial session. The Tax Court will send you a copy of the transcript reflecting the Judge's opinion within a few weeks after the trial. A Bench Opinion cannot be relied on as precedent. All bench opinions delivered after March 1, 2008, are electronically viewable through the Tax Court's Docket Inquiry system. *See* "Taxpayer Information: After Trial," *Available at:* https://www.ustaxcourt.gov/taxpayer_info_after.htm

- **Golsen Rule.** If the court of appeals to which an appeal would be made has established precedent applicable to the case at bar, the Tax Court shall follow the decision in deciding the case. Therefore, the Tax Court could render different opinions to identical cases based on the geographic origin on the case. *See Golsen v. Comm'r*, 54 T.C. 742 (1970).

    - **CDP/Innocent Spouse.** Both of these types of cases are generally reviewed under an abuse of discretion standard. *See, e.g.*, *Dalton v. Comm'r*, 682 F.3d 149 (1st Cir. 2012) (applying reasonableness standard to determine whether reviewing conclusions were reasonable and if outcome was abuse of discretion); *Park v. Comm'r*, 25 F.3d 1289 (5th Cir. 1994) (reviewing decision of Tax Court in innocent spouse case using clear error standard). The Tax Court has determined that a *de novo* standard should be applied to innocent spouse cases during its review. *See e.g.*, *Porter v. Comm'r*, 132 T.C. 203 (2009). *See also Wilson v. Comm'r*, 705 F.3d 980 (9th Cir. 2013) (agreeing that the Tax Court should employ a *de novo* standard when reviewing innocent spouse cases).

- **Motion for Reconsideration of Opinion or Findings of Facts.** A motion to reconsider a finding of fact or opinion shall be filed within 30 days after the opinion or factual transcript is served, unless another time frame is permitted. *See* T.C. Rule 161.

- **Motion to Vacate or Revise Decision.** A motion to vacate or revise a decision shall be filed within 30 days after the decision is entered, unless the Court permits otherwise. *See* T.C. Rule 162.

C. Computations

- **In General.** A decision of the Tax Court in deficiency litigation must specify the dollar amount of deficiency, liability, or overpayment redetermined by the Tax Court. In cases where several cases are consolidated for the purposes of the trial, a decision is entered for each docket number.

- **Agreed Computations.** In general, the Court may withhold entry of its decision for the purpose of permitting the parties to submit computations upon which the parties may agree and shall file with the Court within 90 days of the service of opinion, the computation amount agreed upon by the parties indicating that there is no disagreement and are in accordance with the Court's findings and opinion. *See* T.C. Rule 155(a).

- **Unagreed Computations.** If the parties disagree as to the computation amount, then each party shall file with the Court within 90 days of the service of opinion the computation amount that party believes is in accordance with the Court's findings and opinion. *See* T.C. Rule 155(b)

- **Proceeding to Redetermine Interest.** A proceeding to redetermine interest on a deficiency or overpayment may be commenced by filing a motion with the Court. The proceeding must be commenced within one year after the Court's decision becomes final. *See* T.C. Rule 261(a).

- o **Content of Motion.** All motions shall contain petitioner's name and contact information, a statement setting forth petitioner's contentions regarding the correct amount of interest, and a report indicating whether petitioner has discussed the disputed amount with the Commissioner, and if not, why not. *See* T.C. Rule 261(b)(1).

- o **Redetermining Interest on Deficiency.** In addition, the motion must contain a statement that the petitioner has paid the deficiency including the interest claimed by the Commissioner and a schedule setting forth all payments, their amount, their dates, if applicable, the amounts of each payment allocated to interest, and a copy of the Court's decision redetermining the deficiency. *See* T.C. Rule 261(b)(2).

- o **Redetermining Interest on Overpayment.** In addition to the general information above, the motion shall contain a statement that the Court has determined petitioner made an overpayment and provide a schedule setting forth amounts of the overpayments, their dates, amounts of any credits, offsets, or refunds received from the Commissioner, and a copy of the Court's decision that determined the overpayment. *See* T.C. Rule 261(b)(3).

- o **Commissioner's Response.** Within 60 days, the Commissioner must respond and specifically address each contention made by the petitioner, attach a schedule detailing the computation of interest claimed to be owed or due from the Commissioner. If redetermining an overpayment, the Commissioner shall address the amount and date of each credit, offset, or refund allocated by the Commissioner to interest. If a hearing is required, then the response shall include the Commissioner's reasons why the motion cannot be disposed of without a hearing. If the hearing is opposed, then Commissioner must include a statement of reasons why. *See* T.C. Rule 261(c)

- o **Disposition.** Generally, motions to redetermine interest may be disposed of without an evidentiary or other hearing unless a bona fide factual dispute exists.

D. Appealing the Decision

- **Filing the Appeal.** I.R.C. § 7483 provides that a notice of appeal must be filed with the Tax Court within 90 days after the Court's decision. Upon the first party filing a notice of appeal, any other party shall have an additional 30 days to file any notices of appeal the other party or parties may want to pursue.

  - o **Venue.** All appeals are directed to a circuit of the Courts of Appeals in accordance with I.R.C. § 7482(b), which determines venue based on the legal residence of the petitioner unless the petitioner is a corporation, in which case venue is appropriate at the corporation's principal place of business or principal office. In the case of declaratory actions, similar rules are used to determine a corporation's venue for appeal. With respect to estates, the IRS contends that venue lies in the court of appeals for the circuit of the legal residence of the executor, executrix, or representative of the estate. *See* I.R.M. § 36.2.5.8(2). However, *see Estate of Clack v. Comm'r*, 106 T.C. 131 (1996) (Court divided on the issue of whether venue for appeal was determined by the residency of the executor at the time the petition was filed, or the residency of the decedent at the time of death).

- **Legislative Update.** Pursuant to the Consolidated Appropriations Act, 2016 (P.L. 114-113), I.R.C. § 7482(b)(1)(F), (G) have been amended to clarify that Tax Court decisions in cases involving innocent spouse relief under I.R.C. § 6015(e) and collection cases under I.R.C. §§ 6320 and 6330 (CDP lien and levy cases) are appealable to the U.S. Court of Appeals for the circuit in which an individual's legal residence is located or the principal place of business or principal office or agency, effective for Tax Court petitions filed after the date of enactment (12/18/15). Additionally, pursuant to the Bipartisan Budget Act of 2015 (P.L. 114-74), for partnership tax years after December 31, 2017, the venue for appeal is the U.S. Court of Appeals for the circuit in which principal place of business of the partnership is located.

- **Appeal Bonds.** I.R.C. § 7485 provides that the filing of a notice of appeal does not operate as a stay on assessment or collection of the deficiency determined by the Court unless the taxpayer also files a bond on or before filing the notice of appeal with the Tax Court. The bond must either be a surety bond not exceeding double the amount of the deficiency that is the subject of the appeal or a jeopardy bond filed under the income or estate tax laws. *See also* T.C. Rule 192.

  - **Paying the Deficiency.** Because I.R.C. § 7485 allows for bond to be posted in excess of the outstanding deficiency, it may be advisable for the taxpayer to pay the underlying deficiency and avoid filing a bond altogether. No bond is required if the tax is paid and the taxpayer also avoids the additional accrual of interest during the pendency of the appeal.

  - **Post-Bond Payments.** If a bond is posted and the taxpayer subsequently pays a portion of the deficiency, the bond shall be proportionately reduced if the taxpayer requests such. *See* I.R.C. § 7485(a)(flush language).

- **Standards of Review.** Whether the issues presented on appeal are questions of fact, law, or both, will determine how deferential the appellate court's review of the issues will be. Since *Dobson v. Commissioner*, 320 U.S. 489 (1943) the Courts of Appeals have become deferential to Tax Court rulings. I.R.C. § 7482(a) and (c) describe that Tax Court rulings should be evaluated as if the Tax Court were another district court. Under I.R.C. § 7482(c), the Courts of Appeals have the ability to modify or reverse a Tax Court decision if the Tax Court is not in accordance with law.

  - **Question of Fact.** When the issue on appeal from the Tax Court is a question of fact, then the reviewing court must determine if the factual findings were *clearly erroneous* to justify reversal. *See* I.R.M. § 36.1.1.3(1). Under this standard, the reviewing court must develop a "definite and firm conviction that a mistake has been committed" before modifying the decision below. *Concrete Pipe & Prod. Of Cal., Inc., v. Constr. Laborers Pension Tr. for S. Cal.*, 508 U.S. 602 (1993). *See also Taras* *v. Commissioner*, 187 F.3d 627 (3d Cir. 1999).

- **Question of Law.** Conversely, the appellate court standard of review is *de novo*, giving little deference to the lower court's decision. *See* I.R.M. § 36.1.1.3(2).

- **Mixed Question of Law and Fact.** Similarly, circuits generally apply the *de novo* standard when an issue on appeal is a mixed question of law and fact, and thus the trial court's findings may be set aside if it erred in applying the law. *See, e.g.*, *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013) (applying *de novo* standard to the extent the error is in the misunderstanding of a legal standard). In contrast, the Seventh Circuit applies a clearly erroneous standard when reviewing mixed questions of law and fact. *See, e.g.*, *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999).

- **Record on Appeal.** Tax Court Rule 191 states, "The Clerk will prepare the record on appeal and forward it to the Clerk of the Court of Appeals pursuant to the notice of appeal filed with the Court, in accordance with rules 10 and 11 of the Federal Rules of Appellate Procedure."

  - **Preserving the Argument.** In addition to the trial, include all applicable arguments as allowed under Tax Court Rule 152. If an argument does not appear in the trial transcript, pleadings, or in documents that either party requests to be included in the record on appeal, those arguments may not be adequately preserved for appellate consideration. *See generally* I.R.M. § 36.2.5.9(1)-(3).

  - **Building the Record.** Although the Tax Court Clerk will construct the record on appeal, the parties may influence its contents by requesting specific documentation be included. *See* FRAP, Rule 10(a)-(b). Further, under FRAP, rule 10(e), if any corrections or modifications need to be made to the record on appeal, the parties must work with the lower court to ensure that the record properly reflects the activities in the lower court. If anything is missing from the record, the lower court may forward to the Court of Appeals before or after the record has been forwarded. In accordance with the time limits set in FRAP, Rule 11(b) and the commentary to Rule 11(b), the Tax Court Clerk prefers to have all input from the parties by the 25th day after the notice of appeal is filed in order for the record on appeal to reach the Court of Appeals within 40 days after the notice of appeal is filed. *See* I.R.M. § 36.2.5.9.1(2).

Ethical Issues Facing Tax Departments Today

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Agenda

- Tax Department Role and Structure
- Applicable Rules, Guidance, and Legal Standards
- Hypothetical Ethical Dilemmas
- Questions

The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.

Tax Department Role and Structure

Tax Department Role and Structure

- Typically located within a corporation's finance function
- Focus on compliance, tax controversy, accounting, planning
- Risk mitigation a growing responsibility of Tax Departments
- Tax Departments include a variety of types of professionals:
  - CPAs
  - CFAs
  - Lawyers
  - Economists
  - Analysts

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Tax Department Role and Structure

- Tax Departments interact with a variety of intercompany and outside groups:
  - Company Management
  - Board of Directors
  - Outside Auditors
  - Outside Counsel
  - IRS
  - Government Regulators
  - SEC
  - PCAOB

Tax Department Role and Structure

- Tax Executives' responsibilities, obligations, and objectives typically differ depending on the groups with whom they are interacting. For example,
  - When addressing outside auditors, a Tax Executive is required to provide full and accurate information in a timely and deliberate manner;
  - During an IRS audit, a Tax Executive needs to be both responsive to IRS requests, while at the same time persuasively advocating the company's tax position; and
  - In conferring with outside counsel, a Tax Executive should clearly articulate company litigation/planning goals in light of defined management positions.

Applicable Rules, Guidance, and Legal Standards

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Applicable Rules, Guidance, and Legal Standards

- 5 U.S.C. § 500
- 31 U.S.C. § 330 & Circular 230
- AICPA Code of Professional Conduct
- AICPA Statements on Tax Services
- ABA Model Rules
- Substantive Tax and Penalty Sections in the IRC and Treas. Regs.
- Sarbanes-Oxley
- Civil Procedure/Evidentiary Rules and Case Law
- Company policies, rules, regulations, manuals, etc.

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5 U.S.C § 500
Administrative practice; general provisions

- Attorneys authorized to represent clients before all Federal agencies
  - An individual who is a member in good standing of the bar of the highest court of a State may represent a person before an agency on filing with the agency a written declaration that he is currently qualified as provided by this subsection and is authorized to represent the particular person in whose behalf he acts.
- CPAs authorized to practice before the IRS
  - An individual who is duly qualified to practice as a certified public accountant in a State may represent a person before the Internal Revenue Service of the Treasury Department on filing with that agency a written declaration that he is currently qualified as provided by this subsection and is authorized to represent the particular person in whose behalf he acts.

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31 U.S.C § 330
Practice Before the Department

- Treasury may:
  - Regulate the "practice before" the Department
  - Require that the representative demonstrate good character, good reputation, necessary qualifications, competencies, etc.
- After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice, or censure or impose monetary penalties on a representative who:
  - Is incompetent or disreputable
  - Violates regulations (Circular 230)
  - With intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented
- *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014) ("return preparers" not subject to Circular 230)
- *Ridgely v. Lew*, 55 F.Supp.3d 89 (D.D.C. 2014) (preparing "ordinary refund claims" is not "practice before the IRS")

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Circular 230 (31 CFR part 10)

- Circular 230 contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, registered tax return preparers, and other persons representing taxpayers before the Internal Revenue Service.
  - **Subpart A**: provides rules relating to the authority to practice before the Internal Revenue Service;
  - **Subpart B**: prescribes the duties and restrictions relating to such practice;
  - **Subpart C**: identifies the sanctions for violating the regulations;
  - **Subpart D**: contains the rules applicable to disciplinary proceedings; and
  - **Subpart E**: contains general provisions relating to the availability of official records.
- The Office of Professional Responsibility ("OPR") is responsible for matters related to practitioner conduct and is responsible for discipline, including disciplinary proceedings and sanctions.

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Circular 230 (Cont'd)

- New Changes in 2014
  - Elimination of Circular 230 disclaimer from written communications
  - Elimination of Covered Opinion Rules (Former § 10.35)
  - New General Requirements for Written Advice (§ 10.37)
  - General Standard of Competence (Current § 10.35)
  - Oversight responsibilities for those having "principal authority or responsibility for overseeing a firm's practice governed by [Circular 230]" (§ 10.36)

AICPA Code of Professional Conduct

- The AICPA membership adopted the Code of Professional Conduct to provide guidance and rules to all members in the performance of their professional responsibilities. The Code consists of principles and rules as well as interpretations and other guidance. The principles provide the framework for the rules that govern the performance of their professional responsibilities.
- **Principles**
  - Responsibility
  - The Public Interest
  - Integrity
  - Objectivity and Independence
  - Due Care
  - Scope and Nature of Services

AICPA Statements on Tax Services

- The AICPA's Statements on Standards for Tax Services (SSTS) are enforceable tax practice standards for members of the AICPA.
- There are 7 enumerated standards:
  - SSTS No. 1: Tax Return Positions
  - SSTS No. 2: Answers to Questions and Returns
  - SSTS No. 3: Certain Procedural Aspects of Preparing Returns
  - SSTS No. 4: Use of Estimates
  - SSTS No. 5: Departure From a Position Previously Concluded in an Administrative Proceeding or Court Decision
  - SSTS No. 6: Knowledge of Error: Return Preparation and Administrative Proceedings
  - SSTS No. 7: Form and Content of Advice to Taxpayers

ABA Model Rules

Preamble

- Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and to the lawyer's own interest in remaining an ethical person while earning a satisfactory living. The Rules of Professional Conduct often prescribe terms for resolving such conflicts. Within the framework of these Rules, however, many difficult issues of professional discretion can arise. Such issues must be resolved through the exercise of sensitive professional and moral judgment guided by the basic principles underlying the Rules. These principles include the lawyer's obligation zealously to protect and pursue a client's legitimate interests, within the bounds of the law, while maintaining a professional, courteous and civil attitude toward all persons involved in the legal system.
- *See also* Preamble 3 to the Model Rules:
  – There are Rules that apply to lawyers who are not active in the practice of law or to practicing lawyers even when they are acting in a nonprofessional capacity. For example, a lawyer who commits fraud in the conduct of a business is subject to discipline for engaging in conduct involving dishonesty, fraud, deceit or misrepresentation.

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ABA Model Rules

Relevant Rules

- **Client Lawyer Relationship**
  - Rule 1.2: Scope Of Representation And Allocation Of Authority Between Client And Lawyer
  - Rule 1.3: Diligence
  - Rule 1.6: Confidentiality Of Information
  - Rule 1.13: Organization As Client
- **Counselor**
  - Rule 2.1: Advisor
- **Advocate**
  - Rule 3.3: Candor Toward The Tribunal
  - Rule 3.4: Fairness To Opposing Party And Counsel
- **Transactions With Persons Other Than Client**
  - Rule 4.1: Truthfulness In Statements To Others
  - Rule 4.4: Respect for Rights of Third Persons
- **Maintaining The Integrity Of The Profession**
  - Rule 8.3: Reporting Professional Misconduct
  - Rule 8.4: Misconduct

ABA Model Rules

Standards of Tax Practice Committee

- The responsibilities of the ABA Standards of Tax Practice Committee include ethical standards and the requirements of Circular 230. The Committee takes an active interest in the standards of conduct imposed upon practitioners by various penalty provisions. The Committee is authorized to issue Statements of Standards of Tax Practice. *See, e.g.*:
  - Standard of Tax Practice Statement 1999-1
    - Issue of counsel's responsibilities upon discovering a computational error made by the Internal Revenue Service in the client's favor that is unrelated to any affirmative representation or omission of either the client or counsel.
  - Standard of Tax Practice Statement 2000-1
    - This standard addresses whether differences between the income tax return accuracy standards for taxpayers and the lawyers who advise them result in conflicts of interest between clients and their lawyers. Specifically, this standard explores whether the benefits of adequately disclosing return positions, which may affect taxpayers and advisers differently, generate conflicts of interest.

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Substantive Tax and Penalty Sections in the IRC and Treas. Regs.

- There are several rules and penalty provisions embedded within the IRC that should directly inform taxpayer/Tax Department behavior:
  - Criminal Penalty- Fraud and False Statements- IRC §7206
  - Civil Penalties- *See, e.g.*, IRC §6662
  - Return Preparer Penalty- IRC §6694
  - Whistleblower Provision- IRC §7623

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Sarbanes-Oxley Act of 2002

- The Act sets forth a number of reforms to enhance corporate responsibility, enhance financial disclosures, and combat corporate and accounting fraud.
- Tax Departments should take note of provisions regarding auditor independence and duties to prevent fraud.

Civil Procedure/Evidentiary Rules and Case Law

- Tax Executives should be aware of the elements of certain privileges and how Tax Department activity may affect privilege/work product protection in future litigation.
  - Attorney-Client Privilege: Protects: (1) communications; (2) made in confidence; (3) by a client to an attorney or an attorney to a client; (4) for the purpose of seeking, obtaining, or providing legal advice. *Hartz Mountain Indus. v. Comm'r*, 93 T.C. 521, 525 (1989).
    - The Federal Tax Practitioner Privilege, §7525, is an analog to the attorney-client privilege and may be invoked in noncriminal tax matters not involving tax shelters.
  - Work Product Doctrine: Protects analytical and factual materials prepared: (1) "by or for another party or by or for that other party's representative"; (2) "in anticipation of litigation or for trial." *See United States v. Nobles*, 422 U.S. 225, 238 (1975); *see also* Fed. R. Civ. P. 26(b)(3).
    - "**Textron Test**" (1^{st} Cir.)- documents must be created to ***assist in*** litigation
    - **"Because of Test"** (Majority Rule)- Documents must be created ***because of*** anticipated litigation that would not have been prepared in substantially similar form ***but for*** the prospect of litigation
    - **"Primary Motivation Test"** (Fifth Circuit)

Privilege Waiver
Disclosure to Third Parties

- Attorney-Client and Tax Practitioner Privileges:
  - Waived upon disclosure to any third party.
  - Waiver is generally subject-matter based, meaning once a privileged communication is disclosed, other communications on the same "subject matter" are no longer privileged.
- Work Product Protection:
  - **Waiver only for certain disclosures.**
    - Disclosure to an adversary
    - Disclosure to other third parties waives only if the disclosure increases the likelihood that an adversary will obtain the document

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Privilege Waiver

Disclosure to Third Parties- Scope of Waiver

- Attorney-Client Privilege & Work Product Protection (FED. R. EVID. 502):
  - **Intentional waivers** extend to undisclosed communications and information, if the disclosed and undisclosed materials:
    - Concern the same subject matter *and*
    - Ought in fairness be considered together.
  - **Inadvertent waivers** extend to undisclosed communications and information, unless the holder of the privilege:
    - Took reasonable steps to prevent disclosure *and*
    - Promptly took reasonable steps to rectify the error.
- Tax Practitioner Privilege:
  - Voluntary waiver likely extends to all communications on the same subject matter.

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Privilege Waiver
At Issue Waiver

- If a party affirmatively places privileged communications "at issue," it risks waiving all such communications
- Factors considered:
  - The assertion of the privilege was a result of some affirmative act, such as filing suit, by the asserting party;
  - Through the affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and
  - Application of the privilege would have denied the opposing party access to information vital to his defense.
- The Tax Court has held that alleging a reasonable cause and/or good faith penalty defense will waive privilege on certain confidential communications
  - *See AD Inv. 2000 Fund LLC v. Comm'r,* 142 T.C. No. 13 (2014); ORDER, *Eaton Corp. v. Comm'r*, Tax Court Dkt. No. 5576-12 (May 11, 2015).

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Company Policies, Rules, Regulations, Manuals, etc.

- Corporations typically craft procedures or standards that govern the conduct of Tax Department personnel.
- Whether Tax Department personnel follow these procedures may impact the availability of a reasonable cause and good faith penalty defense. *See* Treas. Reg. § 1.6664-4:
  - "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances."
  - "[R]eliance on erroneous information… inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors."

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Hypothetical Ethical Dilemmas

Hypothetical Dilemma #1

- A CPA in your tax department prepares your tax return for the year. The OPR begins an investigation of the CPA to determine whether he or she was acting fraudulently in preparing the return.   The CPA argues that the OPR has no authority to punish him/her.

- Is the CPA correct?

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Hypothetical Dilemma #1

Case Law

- Possibly
- *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014)
  - "To be sure, 'preparing and signing tax returns' could be considered a "practice" of sorts, particularly if the tax-return preparer is providing advice or making judgment calls about a taxpayer's liability. But Section 330 does not regulate the act of "practice" in the abstract. The statute instead addresses "practice . . . before the Department of the Treasury." Although the exact scope of "practice before" a court or agency varies depending on the context, to "practice before" a court or agency ordinarily refers to practice during an investigation, adversarial hearing, or other adjudicative proceeding. See, e.g., 35 U.S.C. § 32 (discussing "practice before the Patent and Trademark Office"); 26 U.S.C. § 7452 (practice before the tax court); 15 U.S.C. § 78d-3 ("Appearance and practice before" the SEC).

Hypothetical Dilemma #2

- An attorney/CPA wants to represent clients with adverse interests.

- **How should the attorney/CPA effect the representations?**

Hypothetical Dilemma #2

Most Restrictive Rule

- The Circular 230 Rules are more restrictive and should, therefore, govern the waiver process.
  - ABA Model Rules (§1.7(b))
    - A lawyer may represent a client with a concurrent conflict if:
      - (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.
  - Circular 230 (§10.29)
    - The practitioner may represent a client if:
      - (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client; (2) The representation is not prohibited by law; and (3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. **The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days. (c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to the IRS upon request.**

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Hypothetical Dilemma #3

- Your company is being examined by the IRS. You engage a former IRS lawyer, now working for a local law firm, because “she wrote the regs” addressing a tax issue that is significant to the company’s reporting position. You are hoping that the IRS will back off when the examining agents find out that the “expert” is on the case.

- **Is there any problem with hiring the former IRS lawyer?**

Hypothetical Dilemma #3

Circular 230

- There are specific rules in §10.25 regarding the practice of former government employees
  - Specifically §10.25(b)(4) restricts a former government employee, for one year after he leaves the government, from communicating with or appearing before any Treasury employee in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule in the development of which the employee participated, or for which the employee had official responsibility during his last year with the government
- IRS Pub 4814 provides the following illustrative example:
  - Employee Z drafted a new tax regulation. Employee Z then leaves the government. The proposed regulation is published in the Federal Register with a request for comments. Employee Z may not submit written comments or speak at a hearing on the rule for one year after he leaves the government. Employee Z may however represent Taxpayer Q before the Service regarding her 2008 return even though the matter involves the application of the rule Employee Z drafted, provided that certain conditions are satisfied.

Hypothetical Dilemma #3

ABA Model Rules

- There are specific rules in §1.11 regarding conflicts of interests for former government employees
  - (a) Except as law may otherwise expressly permit, a lawyer who has formerly served as a public officer or employee of the government… (2) shall not otherwise represent a client in connection with a matter in which the lawyer participated personally and substantially as a public officer or employee, unless the appropriate government agency gives its informed consent, confirmed in writing, to the representation.
  - (b) When a lawyer is disqualified from representation under paragraph (a), no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter unless:
    - (1) the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom; and
    - (2) written notice is promptly given to the appropriate government agency to enable it to ascertain compliance with the provisions of this rule.
  - (c) Except as law may otherwise expressly permit, a lawyer having information that the lawyer knows is confidential government information about a person acquired when the lawyer was a public officer or employee, may not represent a private client whose interests are adverse to that person in a matter in which the information could be used to the material disadvantage of that person… A firm with which that lawyer is associated may undertake or continue representation in the matter only if the disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom.

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Hypothetical Dilemma #4

- While preparing a company's current tax return you discover an error on a prior return that would result in $20 million in additional income. The IRS reviewed the prior return and did not catch the error.

Do you have an ethical obligation to notify the IRS of the error?

Hypothetical Dilemma #4

Treasury Regulations

- Treas. Reg. §1.451-1(a)
  - "If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom."
- Treas. Reg. §1.461-1(a)(3)
  - "If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due."

Hypothetical Dilemma #4

Case Law

- The Supreme Court has noted that the regulations referring to amended returns do not require the filing of such returns. *Badaracco v. Comm'r*, 464 U.S. 386 (1984).
- The Tax Court has held that a taxpayer was not obligated by statute to file an amended return, and was acting legally when it refused to do so, even though an amended return had been prepared by his accountant who discovered the error. *See Broadhead v. Comm'r*, T.C. Memo. 1955-328 *aff'd on other issues* 254 F.2d 169 (5th Cir. 1958).

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Hypothetical Dilemma #4

Circular 230 and AICPA Statement on Standards for Tax Services

- **Disclosure of Error to Client:**
  - **Circular 230, §10.21:** "A practitioner who…knows that the client has … made an error in or omission from any return … must advise the client promptly…."
  - **AICPA Statement on Standards for Tax Services, No. 6:** Accountants "should" inform the client of the existence of the error.

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Hypothetical Dilemma #4

Circular 230 and AICPA Statement on Standards for Tax Services

- **Amended Return:**
  - **Circular 230, § 10.21**: Does not provide that a professional should or must recommend the filing of an amended return to the client.
  - **AICPA Statement on Standards for Tax Services, No. 6**: Does not require that the accountant must recommend the filing of an amended return, although the Statement provides that a CPA "should" recommend "appropriate measures" to correct the error.

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Hypothetical Dilemma #4

ABA Model Rules and AICPA Statement on Standards for Tax Services

- **Disclosure of Error to Other Parties:**
  - **ABA Model Rule 1.6**: Lawyer may not disclose the error, absent the consent of the client.
  - **AICPA Statement on Standards for Tax Services, No. 6**: Accountants may not inform the IRS of the error "except where required by law."

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Hypothetical Dilemma #4

ABA Model Rules and AICPA Statement on Standards for Tax Services

- **Future Tax Filings:**
  - **ABA Model Rules 4.1(a) and 8.4**: Lawyer may not be involved or associated with the filing of a future tax return, or future filing of a tax document, that incorporates or continues the previous error.
  - **AICPA Statement on Standards for Tax Services, No. 6:** Accountants are required to take reasonable steps to assure that the error is not repeated in preparing tax returns in the future.

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Hypothetical Dilemma #4

Circular 230 and AICPA Statement on Standards for Tax Services

- **Future dealings with the IRS:**
  - **Circular 230 (§ 10.51(d)):** Prohibits giving false or misleading information to the IRS, as well as participating in any way in the giving of false or misleading information.
  - **AICPA Statement on Standards for Tax Services, No. 7:** A CPA representing a client before the IRS where the CPA is aware of an error in the return being audited, should consider withdrawing from representing the taxpayer if the client refuses to inform the IRS of the error. This language likely means that the CPA should withdraw unless the withdrawal itself might breach the client's confidentiality.

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Hypothetical Dilemma #5

- An accounting firm prepares ordinary refund claims for clients and charges a contingency fee in apparent violation of Circular 230's (§10.27)

- **Is this fee structure appropriate?**

Hypothetical Dilemma #5
Case Law

- Possibly
- *Ridgely v. Lew*, 55 F.Supp.3d 89 (D.D.C. 2014)
  - "CPAs preparing and filing such claims before possessing any power of attorney possesses no 'legal authority to act on behalf of taxpayers.' In *Loving*'s words, these individuals merely 'assist[ ]' the taxpayer. Thus, Section 330's use of the term 'representative' excludes refund claim preparers, just as it did tax-return preparers in *Loving."* (citations omitted).
  - The process of filing an Ordinary Refund Claim—again, before any back-and-forth with the IRS—is similar to the process of filing a tax return in that both take place prior to any type of adversarial assessment of the taxpayer's liability. If a 'tax-return preparer do[es] not practice *before the IRS* when [he] simply assist[s] in the preparation of someone else's tax return,' then a CPA hardly 'practices' before the IRS when he simply prepares and files a taxpayer's refund claim, before being designated as the taxpayer's representative and before the commencement of an audit or appeal. Following *Loving,* the Court therefore concludes that the plain text of Section 330 excludes preparers and filers of Ordinary Refund Claims from the ambit of the IRS's regulatory authority." (citations omitted).

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Hypothetical Dilemma #6

- An outside tax advisor agrees to counsel a client on a project without having any experience with the underlying legal issue.

- **What type of duties does the advisor owe?**

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Hypothetical Dilemma #6

Circular 230

- **Section 10.35**
  - A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

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Hypothetical Dilemma #6

AICPA Statement on Standards for Tax Services

- Statement on Standards for Tax Services No. 7, Form and Content of Advice to Taxpayers.
  - A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs.

Hypothetical Dilemma #6

ABA Model Rules

- **Rule 1.1: Competence**
  - A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation.
- **ABA Comment on Rule 1.1**
  - A lawyer need not necessarily have special training or prior experience to handle legal problems of a type with which the lawyer is unfamiliar. A newly admitted lawyer can be as competent as a practitioner with long experience. Some important legal skills, such as the analysis of precedent, the evaluation of evidence and legal drafting, are required in all legal problems. Perhaps the most fundamental legal skill consists of determining what kind of legal problems a situation may involve, a skill that necessarily transcends any particular specialized knowledge. A lawyer can provide adequate representation in a wholly novel field through necessary study. Competent representation can also be provided through the association of a lawyer of established competence in the field in question.
- **Rule 1.3: Diligence**
  - A lawyer shall act with reasonable diligence and promptness in representing a client.

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Hypothetical Dilemma #7

- An in-house tax practitioner finds himself with little time to review deduction schedules provided by other team members. Nonetheless, he relies on the schedule when preparing the return.

- **Does this satisfy his obligations?**

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Hypothetical Dilemma #7

Circular 230

- **Section 10.22- Diligence as to Accuracy**
  - (a) *In General*. A practitioner must exercise due diligence — (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters…
  - (b*) Reliance on others*. … [A] practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person

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Hypothetical Dilemma #7
Circular 230

- **Section 10.34- Standards with respect to tax returns and documents, affidavits and other papers**
  - (d) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

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Hypothetical Dilemma #7

AICPA Statement on Standards for Tax Services

- **Statement on Standards for Tax Services No. 1: Tax Return Positions**
  - A member should determine and comply with the standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position, or preparing or signing a tax return.
- **Statement on Standards for Tax Services No. 3, Certain Procedural Aspects of Preparing Returns**
  - In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. However, a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member.

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Hypothetical Dilemma #7

ABA Model Rules

- **Rule 1.3: Diligence**
  - A lawyer shall act with reasonable diligence and promptness in representing a client.
- **ABA Comment to Rule 1.3**
  - [A] A lawyer should pursue a matter on behalf of a client despite opposition, obstruction or personal inconvenience to the lawyer, and take whatever lawful and ethical measures are required to vindicate a client's cause or endeavor. A lawyer must also act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf. A lawyer is not bound, however, to press for every advantage that might be realized for a client. For example, a lawyer may have authority to exercise professional discretion in determining the means by which a matter should be pursued. The lawyer's duty to act with reasonable diligence does not require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.
  - [2] A lawyer's work load must be controlled so that each matter can be handled competently.

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Hypothetical Dilemma #8

- A client requests that tax counsel draft an opinion regarding a “listed transaction.”

- **Does the opinion need to include specialized disclosures?**

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Hypothetical Dilemma #8

Circular 230

- Former §10.35 provides that practitioners issuing "covered opinions" to make certain disclosures.
- Current rules eliminate the covered opinion rules in former § 10.35 and instead subject all written tax advice to one standard under § 10.37. Section 10.37 does not include the disclosure provisions.

Hypothetical Dilemma #9

- While you are structuring a transaction, you forward documents and have email conversations with tax counsel for the purpose of counsel preparing a tax opinion. The transaction is eventually implemented. The IRS later issues a statutory notice of deficiency, asserting an accuracy-related penalty on an understatement related to the transaction. You consider pleading a reasonable cause and good faith defense under § 6664(c).

- **What are the hazards?**

Hypothetical Dilemma #9
At Issue Waiver

- Its likely that by claiming a reasonable cause and good faith defense under § 6664(c), you may waive privilege on the documents forwarded to/communications with tax counsel.
  - The assertion of the privilege was a result of some affirmative act, such as filing suit, by the asserting party;
  - Through the affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and
  - Application of the privilege would have denied the opposing party access to information vital to his defense.
- This is true even if you don't assert reliance on the opinion.
  - *AD Inv. 2000 Fund LLC v. Comm'r,* 142 T.C. No. 13 (2014); ORDER, *Eaton Corp. v. Comm'r*, Tax Court Dkt. No. 5576-12 (May 11, 2015).

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Hypothetical Dilemma #10

- Your General Counsel comes into your office with a Purchase and Sale Agreement about to be signed. She wants to "backdate" the agreement to a date three months earlier because "this is when we had a deal". There may, or may not, be any tax advantages in so dating the agreement.
- **How should you respond to your General Counsel? What questions should you ask? Does it make any difference whether backdating the Agreement results in a tax advantage?**

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Hypothetical Dilemma #10

- It is acceptable to draft an agreement after-the-fact to memorialize a transaction
- Never backdate an agreement, but you can make an agreement effective “as of” a certain date
- Best to be within the same tax year as the transaction you are memorializing
- Use the “Whereas” clause to state your intentions

Hypothetical Dilemma #11

- At an IRS Appeals conference, an IRS Appeals Officer offers a settlement for 50% of the adjustments to your company's 2014 Form 1120. The company's counsel is confident that the company will be able to sustain the return positions if the case was tried in the U.S. Tax Court. Your annual bonus is based, in part, upon releases of tax reserves. Settlement of in IRS Appeals would allow the company to release 50% of its tax reserves on the financials and make you eligible for a bonus in 2016. The company will have to pay cash to settle.

How do you respond to the IRS offer to settle?

Hypothetical Dilemma #11
Circular 230 and ABA Model Rules

- **Circular 230 (§ 10.29)**
  - A practitioner shall not represent a client before the IRS if the representation involves a conflict of interest. A conflict of interest can exist where there is a significant risk that the representation will be limited by a personal interest of the practitioner.
- **ABA Model Rule 1.7: Conflict of Interest: Current Clients**
  - A lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest can exist where there is a significant risk that the representation of the client will be materially limited by a personal interest of the lawyer.

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Hypothetical Dilemma #12

- You discover that a company made an error in its favor on its return and now wants to file an amended return for an unrelated purpose.

Can you ignore the error and file the amended return?

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Hypothetical Dilemma #12
IRC Provisions

- "[A]ny return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that it is made under the penalties of perjury." IRC §6065(a).
- Failure to file complete and accurate return may result in civil tax penalties and even criminal prosecution if errors were made willfully. *See IRC* §7206.
- IRC § 6663(a) levies a penalty equal to 75% of any tax underpayment attributable to fraud, which the IRS must prove by clear and convincing evidence.

Hypothetical Dilemma #13

- During an on-going audit, you discover that a response provided to an IDR was not accurate.

Must you correct the mistake?

Hypothetical Dilemma #13

Circular 230

- **Circular 230 (§ 10.22)**
  - A practitioner must exercise due diligence in preparing or assisting the preparation or determining the correctness of an oral or written representation made to the IRS.
- **Circular 230 (§ 10.51)**
  - A practitioner may be punished for "giving false or misleading information to the IRS … in connection with any matter pending before the IRS."

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Hypothetical Dilemma #13
ABA Model Rules

- **ABA Model Rule 3.3(a): Candor Toward the Tribunal**
  – A lawyer shall not knowingly make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer

Hypothetical Dilemma #14

- You receive a poorly worded Information Document Request ("IDR") from the IRS. You can respond to the questions asked in a technically accurate manner without providing the information that you know the IRS is seeking. If the IRS had asked better questions, they would have uncovered a significant audit adjustment.

How do you respond to the IDR?

Hypothetical Dilemma #14
ABA Model Rules

- **ABA Model Rule 1.6: Confidentiality of Information**
  - Information relating to the representation is confidential.
  - Lawyer must receive informed consent to disclose.
  - The rule does not permit the lawyer to speculate whether particular information might be detrimental.

Hypothetical Dilemma #14
Zealous Representation

- There is no duty to help the opposition.
- Attorney has a duty to zealously advocate for the client.
- However, consider the practical consequences and ultimate best interests of the client.

Hypothetical Dilemma #15

- While challenging a Section 199 deduction before IRS Appeals, you file a Freedom of Information ("FOIA") request for any document addressing the IRS analysis of Section 199. The response to the FOIA request contains an unredacted memo from IRS counsel marked "privileged and confidential" that discusses an assessment of the IRS's hazards of litigation for Section 199. You are not able to settle the Section 199 dispute in IRS Appeals so you decide to litigate.

Can you use the document in the IRS Appeals proceeding and/or in the subsequent litigation?

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Hypothetical Dilemma #15

Federal Rules of Evidence

- **Limitations on Waiver:**
  - **FRE 502(b) Inadvertent Disclosure:** When made in a federal proceeding or to a federal office or agency, the disclosure does not operate as a waiver in a federal or state proceeding if:
    - **(1)** the disclosure is inadvertent;
    - **(2)** the holder of the privilege or protection took reasonable steps to prevent disclosure; and
    - **(3)** the holder promptly took reasonable steps to rectify the error.
  - *See Eden Isle Marina, Inc. v. U.S.*, 89 Fed. Cl. 480 (2009) (the court treated documents disclosed by the government through a FOIA request as if they were disclosed while the subsequent suit was pending)

Hypothetical Dilemma #15
ABA Model Rules

- **ABA Model Rule 4.4: Respect for Rights of Third Persons**
  - When lawyer receives inadvertently sent document, lawyer's duty is to promptly notify sender.
  - Rule does not specifically prohibit reading and using the document.
  - Comment [2] states that whether additional steps are required, such as returning the document, is a matter of law beyond the scope of the ethical rules, as is the question of whether privilege has been waived.

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Hypothetical Dilemma #15
Use of Privileged Information

- Courts have sought to limit parties from benefitting from inadvertent disclosures.
  - *See Edelen v. Campbell Soup Co.,* 265 F.R.D. 676, 698 (N.D. Ga. 2010) (finding that inadvertent disclosure did not waive privilege, and ordering receiving counsel to destroy the copies of disclosed documents, not to use any of the documents for any purpose, to destroy notes concerning the documents , and to certify compliance within seven days).
- Knowingly using opponent's privileged material may be a violation of ABA Model Rule 8.4 (c) (engaging in conduct that is deceptive or dishonest).
- Could result in disqualification.
- Could render evidence inadmissible.
- Practical consideration: Ask the Court for a ruling.

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Hypothetical Dilemma #16

- The factual records regarding a completed transaction are unavailable/lost.

May you prepare a tax return using estimates of the missing data?

Hypothetical Dilemma #16
AICPA Statement on Standards for Tax Services

- **Statement on Standards for Tax Services No. 4, Use of Estimates**
  - Unless prohibited by statute or by rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists.

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Hypothetical Dilemma #17

- Your 2013 tax year is audited by the IRS. You eventually settle a contested deductibility issue during IRS Appeals.

May you deviate from the settled tax position in subsequent years?

Hypothetical Dilemma #17

AICPA Statement on Standards for Tax Services

- **Statement on Standards for Tax Services No. 5: Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision**
  - A tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different tax position in a later year's return unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement.

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Hypothetical Dilemma #18

- In the course of reviewing tax records for a reasonably foreseeable, but not currently pending, Tax Court case, you find records that are potentially damaging to your tax position.

May you dispose of those records as part of normal document retention policies?

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Hypothetical Dilemma #18

Case Law

- **Document Retention Policies**
  - "Document retention policies, which are created in part to keep certain information from getting into the hands of others, including the Government, are common in business. . . . It is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances." *Arthur Anderson LLP v. U.S.*, 544 U.S. 696 (2005).
    - **Rev. Proc. 98-25**: The taxpayer must retain machine-sensible records so long as their contents may become material to the administration of the internal revenue laws under §1.6001-1(e). At a minimum, this materially continues until the expiration of the period of limitation for assessment, including extensions, for each tax year. In certain situations, records should be kept for a longer period of time. *See also* §§ 6001, 6111.
- **Spoliation**
  - "Spoliation is the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in *pending or reasonably foreseeable litigation." West v. Goodyear Tire & Rubber Co.,* 167 F.3d 776 (2nd Cir. 1999).

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Hypothetical Dilemma #18

Federal Rules of Civil Procedure/Tax Court Rules of Practice and Procedure

- **Spoliation** (Federal Rules of Civil Procedure 37 & Tax Court Rules of Practice and Procedure 104)
  - Courts can sanction companies and individuals for inadvertent or advertent destruction of seemingly immaterial information
  - Dismissal, fines, negative inferences
  - "A federal district court may impose sanctions under [Federal Rules of Civil Procedure 37] when a party spoliates evidence in violation of a court order. Even without a discovery order, a district court may impose sanctions for spoliation, exercising its inherent power to control litigation." *West v. Goodyear Tire & Rubber Co.,* 167 F.3d at 779 (citations omitted).

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Hypothetical Dilemma #19

- You produce privileged documents to the SEC as part of an administrative investigation.

Will a privilege claim be sustained if those documents are subsequently summoned by the IRS?

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Hypothetical Dilemma #19

Case Law

- As a general proposition, attorney-client privilege is waived upon disclosure to any third party.
- It is unsettled whether the submission of privileged materials to a Federal regulatory agency amounts to a waiver of the privilege in a subsequent civil trial.
  - *Westinghouse Elec. Corp. v. Republic of Philippines*, 951 F.2d 1414 (3d Cir. 1991) (voluntary disclosure of a report to the SEC and Department of Justice waives attorney-client and work product privileges as regards a third party who seeks those documents for purposes of a civil trial against the corporation).
  - *Diversified Industries v. Meredith*, 572 F.2d 596 (8^{th} Cir. 1978) (a corporation's voluntary disclosure of a report protected by attorney-client privilege to the SEC does not waive the privilege so as to allow discovery of the report in a civil trial against that corporation).

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Hypothetical Dilemma #20

- Your internal tax policies require compliance with the Internal Revenue Code, Treasury Regulations, and IRS informal guidance. During an IRS examination, an IRS agent discovers the Tax Department is not in full compliance. He/she asks you to explain/reconcile your noncompliance.

How should you respond to the IRS agent?

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Hypothetical Dilemma #20
Compliance Efforts

- Demonstrate that the company approached its compliance efforts with reasonable cause and in good faith. *See* Treas. Reg. § 1.6664-4.
- If possible, show your company's pattern of compliance.
  - Agents are more inclined to dismiss noncompliance issues where taxpayers can effectively show that the specific issue was an anomaly.
- **Best Practice**: Keep contemporaneous records documenting the steps taken to remain in full compliance.

Questions

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Ethical Issues Facing Tax Departments Today
Appendix

Circular 230, §10.21

- **Knowledge of a client's omission:**
  - A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

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Circular 230, §10.22

- **Diligence as to accuracy:**
  - (a) *In general*. A practitioner must exercise due diligence—
    - (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
    - (2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and
    - (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service
  - (b) *Reliance on others.* [Generally,] a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

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Circular 230, §10.29

- **Conflicting interests:**
  - (a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —
    - (1) The representation of one client will be directly adverse to another client; or
    - (2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.
  - (b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if —
    - (1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
    - (2) The representation is not prohibited by law; and
    - (3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

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Circular 230, §10.51

- **Incompetence and disreputable conduct:**
  - (a) *Incompetence and disreputable conduct.* Incompetence and disreputable conduct for which a practitioner may be sanctioned… includes, but is not limited to —
    - (1) Conviction of any criminal offense under the Federal tax laws.
    - (2) Conviction of any criminal offense involving dishonesty or breach of trust….
    - (4) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury… or to any tribunal authorized to pass upon Federal tax matters… knowing the information to be false or misleading….
    - (6) Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.
    - (7) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof….
    - (12) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false….

Statements on Standards for Tax Services No: 4

- **Use of Estimates**
  - **Statement**
    - (2) Unless prohibited by statute or by rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should be presented in a manner that does not imply greater accuracy than exists.
  - **Explanation**
    - (4) When the taxpayer's records do not accurately reflect information related to small expenditures, accuracy in recording some data may be difficult to achieve. Therefore, the use of estimates by a taxpayer in determining the amount to be deducted for such items may be appropriate.
    - (5) When records are missing or precise information about a transaction is not available at the time the return must be filed, a member may prepare a tax return using a taxpayer's estimates of the missing data.
    - (6) Estimated amounts should not be presented in a manner that provides a misleading impression about the degree of factual accuracy.
    - (7) Specific disclosure that an estimate is used for an item in the return is not generally required; however, such disclosure should be made in unusual circumstances where nondisclosure might mislead the taxing authority...

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Statements on Standards for Tax Services No: 5

- **Departure From a Position Previously Concluded in an Administrative Proceeding or Court Decision**
  - **Statement**
    - (4) The tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different tax position in a later year's return, unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement. Therefore, the member may recommend a tax return position or prepare or sign a tax return that departs from the treatment of an item as concluded in an administrative proceeding or court decision with respect to a prior return of the taxpayer…
  - **Explanation**
    - (5) If an administrative proceeding or court decision has resulted in a determination concerning a specific tax treatment of an item in a prior year's return, a member will usually recommend this same tax treatment in subsequent years. However, departures from consistent treatment may be justified under such circumstances as the following:
      - (a) Taxing authorities tend to act consistently in the disposition of an item that was the subject of a prior administrative proceeding but generally are not bound to do so. Similarly, a taxpayer is not bound to follow the tax treatment of an item as consented to in an earlier administrative proceeding….

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Statements on Standards for Tax Services No: 6

- **Knowledge of Error: Return Preparation and Administrative Proceedings**
  - **Statement**
    - (4) A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return, an error in a return that is the subject of an administrative proceeding, or a taxpayer's failure to file a required return. A member also should advise the taxpayer of the potential consequences of the error and recommend the corrective measures to be taken. Such advice and recommendation may be given orally. The member is not allowed to inform the taxing authority without the taxpayer's permission, except when required by law.
    - (5) If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer. If the member does prepare such current year's return, the member should take reasonable steps to ensure that the error is not repeated.
    - (6) If a member is representing a taxpayer in an administrative proceeding with respect to a return that contains an error of which the member is aware, the member should request the taxpayer's agreement to disclose the error to the taxing authority. Lacking such agreement, the member should consider whether to withdraw from representing the taxpayer in the administrative proceeding and whether to continue a professional or employment relationship with the taxpayer.

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Statements on Standards for Tax Services No: 7

- **Form and Content of Advice to Taxpayers**
  - **Statement**
    - (2) A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer's needs. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities' standards, if any, applicable to written tax advice. A member should use professional judgment about any need to document oral advice. A member is not required to follow a standard format when communicating or documenting oral advice.
    - (3) A member should assume that tax advice provided to a taxpayer will affect the manner in which the matters or transactions considered would be reported or disclosed on the taxpayer's tax returns. Therefore, for tax advice given to a taxpayer, a member should consider, when relevant (a) return reporting and disclosure standards applicable to the related tax return position and (b) the potential penalty consequences of the return position....
    - (4) A member has no obligation to communicate with a taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided or when a member undertakes this obligation by specific agreement.

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ABA Model Rule 1.6

- **Confidentiality of Information**
  - (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).
  - (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
    - (1) to prevent reasonably certain death or substantial bodily harm;
    - (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
    - (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
    - (4) to secure legal advice about the lawyer's compliance with these Rules;
    - (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
    - (6) to comply with other law or a court order; or
    - (7) to detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.

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ABA Model Rule 1.7

- **Conflict of Interest: Current Clients**
  - (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
    - (1) the representation of one client will be directly adverse to another client; or
    - (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
  - (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
    - (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
    - (2) the representation is not prohibited by law;
    - (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
    - (4) each affected client gives informed consent, confirmed in writing

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ABA Model Rule 3.3(a)

- **Candor Toward The Tribunal**
  - (a) A lawyer shall not knowingly:
    - (1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;
    - (2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or
    - (3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

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ABA Model Rule 4.1

- **Truthfulness in Statements to Others**
  - In the course of representing a client a lawyer shall not knowingly:
    - (a) make a false statement of material fact or law to a third person; or
    - (b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

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ABA Model Rule 4.4

- **Respect for Rights of Third Persons**
  - (a) In representing a client, a lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person, or use methods of obtaining evidence that violate the legal rights of such a person.
  - (b) A lawyer who receives a document or electronically stored information relating to the representation of the lawyer's client and knows or reasonably should know that the document or electronically stored information was inadvertently sent shall promptly notify the sender.

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ABA Model Rule 8.4

- **Misconduct**
  - It is professional misconduct for a lawyer to:
    - **(a)** violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another;
    - **(b)** commit a criminal act that reflects adversely on the lawyer's honesty, trustworthiness or fitness as a lawyer in other respects;
    - **(c)** engage in conduct involving dishonesty, fraud, deceit or misrepresentation;
    - **(d)** engage in conduct that is prejudicial to the administration of justice;
    - **(e)** state or imply an ability to influence improperly a government agency or official or to achieve results by means that violate the Rules of Professional Conduct or other law; or
    - **(f)** knowingly assist a judge or judicial officer in conduct that is a violation of applicable rules of judicial conduct or other law.

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TAX SECTION
State Bar of Texas

April 26, 2016

By First Class Mail

Internal Revenue Service
CC:PA:LPD:PR (Notice 2016-23)

Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments in Response to Notice 2016-23

Dear Sir/Madam:

On behalf of the Tax Section of the State Bar of Texas, we are pleased to submit the enclosed response to the request by the Treasury Department and the Internal Revenue Service in Notice 2016-23 for comments regarding implementation of the new partnership audit regime enacted as part of the Bipartisan Budget Act of 2015, as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We appreciate being extended the opportunity to assist in the development of the guidance to implement the new partnership audit regime.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

cc: Drita Tonuzi,
Associate Chief Counsel (Procedure and Administration),
Internal Revenue Service

Joy E. Gerdy Zogby, Attorney,
Office of Associate Chief Counsel (Procedure and Administration),
Internal Revenue Service

COMMENTS ON IMPLEMENTATION OF THE NEW PARTNERSHIP AUDIT REGIME ENACTED AS PART OF THE BIPARTISAN BUDGET ACT OF 2015

These comments ("Comments") on issues to be addressed in guidance to implement the new partnership audit regime (the "Partnership Audit Rules") enacted as part of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (the "BBA"), as corrected and clarified by the Protecting Americans from Tax Hikes Act of 2015, Pub. L. 114-113, div. Q (the "PATH Act"), are submitted on behalf of the Tax Section of the State Bar of Texas (the "Tax Section"). The principal drafters of these Comments were Chester W. Grudzinski, Jr., Stephen A. Beck, Brian S. Feiwell, Christopher J. Ohlgart, Hersh M. Verma, and Jacob Birnbaum. The Committee on Government Submissions (COGS) of the Tax Section has approved these Comments. Jeffry M. Blair, Vice Chair of COGS, reviewed these Comments. Mary McNulty also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 26, 2016

These Comments are provided in response to the request of the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") in Notice 2016-23 (the "Notice"), requesting comments regarding implementation of the Partnership Audit Rules. The BBA repeals the current rules governing partnership audits and replaces them, effective January 1, 2018, with the Partnership Audit Rules, which is a centralized audit regime that generally assesses and collects tax at the partnership level. The Tax Section thanks Treasury and the Service for the opportunity to provide input on the Partnership Audit Rules. We respectfully suggest that Treasury and the Service consider promulgating guidance to address the following issues.

I. THE ELECTION OUT FROM THE PARTNERSHIP AUDIT RULES.

A. Whether a Disregarded Entity is Taken into Account for Purposes of Election Out From the Partnership Audit Rules.

We believe guidance is needed for purposes of determining whether a partnership is eligible to elect out of the Partnership Audit Rules pursuant to Section 6221(b)[1] ("Election Out") if a partner holds its interest in such partnership through a business entity that is disregarded for federal income tax purposes (a "DRE"). Section 6221(b)(1) provides as follows:

> (b) ELECTION OUT FOR CERTAIN PARTNERSHIPS WITH 100 OR FEWER PARTNERS, ETC. – (1) IN GENERAL – This subchapter shall not apply with respect to any partnership for any taxable year if – (A) the partnership elects the application of this subsection for such taxable year, . . . (C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner . . . .

Additionally, the Election Out is only available for partnerships with 100 or fewer partners, and the 100 partner limit is determined by the number of statements under Section 6031(b) (*i.e.*, Schedule K-1s) a partnership furnishes to its partners.[2] The Partnership Audit Rules, however, do not specifically address whether a DRE owning an interest in a partnership would be: (i) treated as a separate entity, and, moreover, as an ineligible type of partner that would automatically cause the partnership to be ineligible for the Election Out; or (ii) separately counted as an additional partner for purposes of the Election Out's 100 partner limit. We

[1] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended (including amendments promulgated under the BBA and the PATH Act).

[2] Section 6221(b)(1)(B). In addition, Section 6221(b)(2)(A) provides a special rule for determining the 100 partner threshold when an S corporation is a partner of a partnership. In the case of a partner that is an S corporation, the partnership will only be treated as meeting the requirements of Section 6221(b) if such partnership includes a disclosure of the name and taxpayer identification number of each person with respect to whom such S corporation is required to furnish a statement under Section 6037(b) for the taxable year of the S corporation ending with or within the partnership taxable year of the Election Out, and the statements such S corporation is required to so furnish are treated as Schedule K-1s by the partnership for the 100 partner threshold under Section 6221(b)(1)(B).

therefore respectfully submit the following suggestions in connection with those two aforementioned issues.

First, with regard to the eligible types of partners, we respectfully suggest that it is appropriate to ignore a DRE's separate existence for purposes of determining whether the partnership in which it is a partner is eligible for the Election Out. This would be consistent with the general treatment of DREs for federal income tax purposes, under which a DRE's separate existence is generally ignored and the DRE is generally treated in the same manner as a sole proprietorship, branch, or division of its owner.[3] A partnership, by disregarding the separate existence of a DRE partner, would not be precluded from availing itself of the Election Out merely because it has one or more individual indirect partners who own an interest in the partnership through a DRE.

We respectfully submit that it is appropriate to disregard the separate existence of a DRE for purposes of the Election Out, notwithstanding that the Service previously ruled in Rev. Rul. 2004-88 that a DRE's separate existence is taken into account for purposes of determining whether a partnership is eligible for the small partnership exception from the partnership audit regime under the Tax Equity and Fiscal Responsibility Act ("TEFRA").[4] The Service's ruling in Rev. Rul. 2004-88 was based on the Treasury Regulations underlying TEFRA, which provide that a partnership is not eligible for the small partnership exception from TEFRA if that partnership has a "pass-thru partner," which includes an S corporation. In contrast, the Partnership Audit Rules provide more flexibility by explicitly: (i) allowing the Election Out by partnerships that have an S corporation as a partner;[5] and (ii) authorizing Treasury to prescribe Election Out Rules that would apply to partnerships with types of partners who are not currently designated as eligible partners under the Election Out's qualification requirements.[6] The additional flexibility provided under the Election Out provides further support for the position that it is appropriate to disregard the separate existence of a DRE partner in determining whether a partnership with a DRE partner is eligible for the Election Out.

In addition, the treatment of DREs under the Subchapter S eligibility requirements supports the position that it is appropriate to disregard the existence of a DRE for purposes of the Election Out. Similar to the Election Out, an entity seeking qualification as an S corporation can only have owners that are within certain qualifying types.[7] With regard to Subchapter S eligibility, the stock of an S corporation that is owned by a DRE is generally treated for federal income tax purposes as though such stock is owned directly by the owner of the DRE.[8] Accordingly, we

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[3] *See* Treas. Reg. § 301.7701-2(a).

[4] *See* Rev. Rul. 2004-88, 2004-2 C.B. 165.

[5] Section 6221(b)(1)(C).

[6] Section 6221(b)(2)(C).

[7] Section 1361(b)(1)(B) provides that, to qualify as an S corporation, all of the corporation's shareholders must be either individuals, estates, certain types of qualifying trusts, or certain tax exempt organizations.

[8] *See, e.g.*, Priv. Ltr. Rul. 201202003 (Jan. 13, 2012) (S corporation permitted to have as its shareholder a DRE wholly owned by an individual); Priv. Ltr. Rul. 201016025 (Apr. 23, 2010) (same).

respectfully submit that it is appropriate to disregard the separate existence of a DRE partner in determining the eligibility of a partnership for the Election Out.

Second, with regard to the 100 partner limit under the Election Out, we respectfully suggest that the separate existence of a DRE should be disregarded and only the owner of the DRE (and not the DRE itself) should be counted as a partner for purposes of the 100 partner limit. Disregarding the DRE for purposes of the 100 partner limit would be consistent with the general treatment of DREs under the federal income tax law. It would also be consistent with the treatment of a DRE under the Subchapter S eligibility requirements, which also impose a 100 owner limit.[9]

The Joint Committee on Taxation (the "JCT"), however, recently released the "General Explanation of Tax Legislation Enacted in 2015," which included an explanation on how the Service's future guidance may treat a partnership with a DRE partner in determining the availability of the Election Out.[10] The JCT explained that a DRE and the DRE's owner should each be taken into account as if each were a Section 6031(b) statement recipient in determining whether the 100 partner limit is met.[11] The JCT provided an example:

> [A]ssume that a partner of a partnership is a disregarded entity such as a State-law limited liability company ("LLC") with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole member, and each of them is taken into account as if each were a statement recipient in determining whether the 100 or fewer statements criterion is met.[12]

The JCT has taken the position that the number of partners is determined by applying both general look-through and regarded entity treatment to DREs because the owner of a DRE is considered a partner (*i.e.*, look-through treatment) and the DRE is considered a partner (*i.e.*, regarded treatment) for determining the number of partners for the 100 partner limit.

In contrast to the JCT's position, we respectfully suggest that the Service view the owner of a DRE partner as the only "partner" for purposes of the 100 partner limit. This is appropriate because the 100 partner limit is determined based on the number of Schedule K-1s (or its equivalent) issued by the partnership and its partners. There does not appear to be any federal

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[9] The maximum 100 shareholder limit is imposed under Section 1361(b)(1)(A). Of note, for purposes of this 100 shareholder limit, stock owned by members of a family is treated as owned by one shareholder and, for purposes of this rule, a DRE owned by a member of a family is itself treated as a member of the family. *See* Treas. Reg. § 1.1361-1(e)(3)(ii)(F).

[10] "General Explanation of Tax Legislation Enacted in 2015," The Staff of the Joint Committee on Taxation, 114th Congress, 2nd Session, JCS-1-16 (March 2016) (the "JCT Report").

[11] *See id.* at 60.

[12] *Id.* at 60.

income tax authority that would require a partnership with a DRE partner to issue separate Schedule K-1s to both the DRE partner and the owner of that DRE partner.[13] Indeed, the issuance of separate Schedule K-1s to the DRE and its owner reporting the same allocable share of partnership income would cause confusion because the separate Schedule K-1s would incorrectly suggest that both the DRE and its owner should report and pay tax on the same allocable share. Because only one Schedule K-1 is appropriately issued with respect to a DRE partner, we do not see any rationale that would support the treatment of both the DRE and its owner as separate partners of the partnership for purposes of the 100 partner limit.

We also respectfully suggest that the same proposals that we have made with respect to the treatment of DRE partners should also apply to partners that are grantor trusts for purposes of determining a partnership's eligibility for the Election Out. Similar to a DRE, a grantor trust is generally disregarded as separate from its grantor for federal income tax purposes under Sections 671 to 679. In addition, as with a DRE, a grantor trust is generally disregarded as a shareholder separate from its grantor for purposes of the Subchapter S eligibility requirements.[14]

B. Whether the Election Out is Available to Partnerships Owned by Partners Not Explicitly Listed in Section 6221(b)(1)(C).

As discussed above, Section 6221(b)(1)(C) provides that the Election Out is available only for partnerships that have partners consisting solely of: (i) individuals; (ii) C corporations; (iii) foreign entities that would be treated as a C corporation if they were domestic; (iv) S corporations; and (v) estates of deceased partners. Under the plain language in Section 6221(b)(1)(C), the Election Out is not available to partnerships with partners not included in the statutory list, such as trusts or partnerships. For example, under the plain language in Section 6221(b)(1)(C), a lower-tier partnership would be ineligible for the Election Out, even if the partners of that lower-tier partnership were comprised of one individual and a single upper-tier partnership, with that upper-tier partnership having only two individuals as its partners.

For purposes of the Election Out, S corporations are permitted partners only if certain disclosures are made to the Internal Revenue Service in accordance with Section 6221(b)(1)(C). Section 6221(b)(2)(C) authorizes Treasury to prescribe rules similar to those applying to S corporations for other types of partners that are not specifically listed in Section 6221(b)(1)(C) as permissible partners for purposes of the Election Out. This authorization by Congress gives Treasury the ability to expand the categories of permissible partners and provide more partnerships the ability to avail themselves of the Election Out. The JCT has also suggested that further guidance may

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[13] In the situation in which a person owns an interest in a partnership as nominee for another person who is the beneficial owner of that partnership interest, the Treasury Regulations provide that the partnership is obligated to issue a Schedule K-1 to either the nominee or the beneficial owner, but not both. *See* Temp. Treas. Reg. § 1.6031(b)-1T(a)(2).

[14] *See* Treas. Reg. § 1.1361-1(e)(1) ("if stock is held by a subpart E trust . . . the deemed owner of the trust is considered to be the shareholder."); Treas. Reg. § 1.1361-1(e)(3)(E) (grantor trust is treated as a family member if the deemed owner of that trust is a member of that family).

provide rules allowing for the Election Out by a partnership that has one or more partners that are also partnerships.[15]

Accordingly, we suggest that Treasury prescribe rules that would provide limited eligibility for the Election Out by partnerships with partners that are trusts or upper-tier partnerships in situations in which the Election Out would not impair the Service's ability to efficiently conduct audits. We suggest that the rules in Section 6221(b)(2)(A), which apply to partnerships with S corporation partners, could be modified to provide an acceptable methodology for allowing a limited Election Out by partnerships with partners that are trusts or upper-tier partnerships.

For example, Treasury could provide that a lower-tier partnership with an upper-tier partnership as its partner would be eligible for the Election Out, provided that the following three requirements are satisfied. First, the lower-tier partnership would be required to provide the Service with the name and taxpayer identification number of each of its direct and indirect owners. Second, the total number of Schedule K-1s (or its equivalent) required to be issued by the lower-tier partnership and its direct and indirect owners would be limited to no more than 100 (or some lesser number). Third, an upper-tier partnership that is a partner of the lower-tier partnership could not have any partners that are themselves partnerships (i.e., the lower-tier partnership would not be eligible for the Election Out if it was indirectly owned by any partnership).

In this manner, small tiers of partnerships could be eligible for the Election Out, without impairing the ability of the Service to perform its audit function. In addition, partnerships with different types of "flow-through" entities as partners would receive equivalent treatment under the Election Out.

C. Whether Spouses in a Community Property Jurisdiction Would be Counted Separately for Purposes of the 100 Partner Limit.

Under the community property laws recognized in many states, the property acquired during marriage by either spouse is generally treated as owned in equal shares by both spouses under state law.[16] As a result, if each spouse's community property ownership of an interest in a partnership is taken into account for purposes of the 100 partner limit, a partnership with one or more partners who are married individuals could be ineligible for the Election Out. This could result in differences in the treatment of partnerships organized in different states. A partnership with one or more partners who are married individuals not subject to community property law could be eligible for the Election Out, whereas another partnership with the same number of partners who are married individuals may not be eligible for the Election Out by reason of the 100 partner limit if those partners are subject to community property law.

[15] JCT Report at 60-61.

[16] *See, e.g.*, Tex. Fam. Code Ann. § 3.002 ("Community property consists of the property, other than separate property, acquired by either spouse during marriage").

To prevent this differing treatment, we respectfully request that Treasury promulgate rules to provide that a partnership interest owned by a married couple will be treated as owned by a single person for purposes of the 100 partner limit. This rule would be consistent with the treatment of a married couple as a single shareholder for purposes of the 100 shareholder limit for S corporation eligibility.[17]

II. APPLICATION OF THE PARTNERSHIP AUDIT RULES TO CONSTRUCTIVE PARTNERSHIPS.

The Notice requests comments on any issues relevant to the implementation of the Partnership Audit Rules, including issues not specifically identified in the Notice. In response to this request, we ask that the Service and Treasury address how the Partnership Audit Rules will apply to constructive tax partnerships that are not juridical entities for state law purposes. For instance, a joint operating agreement ("JOA") between co-owners of oil and gas properties usually creates a constructive tax partnership for federal income tax purposes, but there is no juridical entity for state law purposes, including a general partnership.[18]

Generally, the Partnership Audit Rules provide that any taxes resulting from adjustments "shall be assessed and collected . . . at the partnership level."[19] To be excluded from entity-level taxation, a partnership may make one of two elections. First, Section 6221(b) provides an Election Out of the entity-level taxation approach only if "the partnership elects the application of this subsection for such taxable year." In many cases, however, the parties to the JOA are partnerships, so an Election Out is not currently possible under the Partnership Audit Rules in that situation, as discussed above. Second, a partnership may make a timely election to push out adjustments to each partner (the "Alternative Method").[20] Consequently, unless a partnership voluntarily chooses to make either election, the Service can only impose taxation at the partnership level.[21] However, without a state law entity that holds assets, any tax assessed at the constructive partnership level is fruitless since there is no juridical entity with assets against which the Service could seek enforcement.

Accordingly, we request that Treasury promulgate rules to clarify how the Partnership Audit Rules will apply to constructive tax partnerships. With regard to a constructive tax partnership that is subject to Subchapter K of the Internal Revenue Code, we respectfully suggest that Treasury promulgate rules to require a constructive tax partnership to apply the Alternative Method. This would help to ensure that the federal income tax resulting from an audit adjustment with respect to a constructive tax partnership would be assessed upon and collected

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[17] *See* Section 1361(c)(1)(A)(i).

[18] *See* Sections 761(a) and 7701(a)(2).

[19] Section 6221(a).

[20] Section 6226.

[21] The election out of partnership treatment applies only for purposes of Subchapter K of the Internal Revenue Code. Treas. Reg. § 1.761-2. Therefore, a partnership electing out of partnership treatment could still be subject to the Partnership Audit Rules.

from the parties that own (for state law purposes) the assets from which the tax deficiency originated.

With regard to a constructive tax partnership that has elected out of the application of Subchapter K of the Internal Revenue Code pursuant to Section 761(a), we respectfully suggest that Treasury promulgate rules to clarify that such a constructive tax partnership would not be subject to the Partnership Audit Rules. This treatment would be consistent with the statute, which defines a "partnership" for purposes of the Partnership Audit Rules as "any partnership required to file a return under section 6031(a)."[22] A constructive tax partnership that has elected out of the application of Subchapter K generally would not be required to file a return under Section 6031(a)[23] and thus should be excluded from the application of the Partnership Audit Rules.

III. PARTNERSHIP REPRESENTATIVES

Under the Partnership Audit Rules, a partnership no longer designates a "tax matters partner" (a "TMP"). Instead, a partnership must designate a "partnership representative" (the "Partnership Representative") who handles tax matters with the Service.[24] The Partnership Representative is the only person who has authority to act on behalf of a partnership during a partnership audit.[25] Notably, the Partnership Representative's actions are binding on all former and current partners.[26] As such, the designation of the Partnership Representative is of higher significance than the designation of the TMP.

The Partnership Representative must be a "partner (or other person) with a substantial presence in the United States."[27] If a partnership has not designated a Partnership Representative, the Service has the authority to select *any person* as the Partnership Representative.[28] This rule is a departure from the partnership audit regime under TEFRA, under which only a partner can act as TMP.[29] Under TEFRA, when a partnership has not designated a TMP, the general partner with the largest profits interest is automatically designated as the TMP.[30] We suggest that Treasury adopt a similar principal under the Partnership Audit Rules and automatically designate the general partner or, if a partnership does not have a general partner, the partner with the largest profits interest that has a substantial presence in the United States as the Partnership Representative when the partnership has not designated a Partnership Representative.

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[22] Section 6241(1).
[23] *See* Treas. Reg. § 1.6031(a)-1(c)(1)(ii).
[24] Section 6223(a).
[25] *Id.*
[26] Section 6223(b).
[27] Section 6223(a).
[28] *Id.*
[29] Treas. Reg. §§ 301.6231(a)(7)-1(b)(1).
[30] Section 6231(a)(7)(B) (Pre-2018).

In addition, the Partnership Audit Rules are unclear about what happens when a partnership with no partner having a substantial presence in the United States fails to designate a Partnership Representative. In such case, the Service would designate a person with a substantial U.S. presence to act as the Partnership Representative, but it is uncertain whom the Service would designate.

As a result, we respectfully request that Treasury promulgate rules to clarify that a person with a substantial U.S. presence who is not a partner of a partnership may be selected to act as the Partnership Representative of that partnership in the situation in which the partnership does not designate its own Partnership Representative and none of its partners have a substantial U.S. presence. We respectfully suggest that Treasury would generally select the Partnership Representative from among the following persons, provided that the person selected has consented to serve as the Partnership Representative: (i) any person with a substantial U.S. presence who is authorized to sign the partnership's U.S. income tax return; (ii) a representative of the partnership who has a substantial U.S. presence and authority to conduct or oversee the partnership's activities giving rise to U.S. income taxation; (iii) a U.S. law firm or U.S. accounting firm engaged by the partnership; or (iv) the partnership's registered agent for service of process located within the U.S.

In addition, we respectfully suggest that any criteria involving the selection of a Partnership Representative should require the consent of the person so selected. A person's service as Partnership Representative may involve balancing various parties' interests (which interests may not be aligned) and may raise or involve a myriad of issues including indemnification, cost, and privilege. For these reasons, we respectfully suggest that Treasury promulgate rules to clarify that a person does not have to serve as Partnership Representative unless that person consents to do so.

The Partnership Audit Rules also do not provide guidance for who may act on behalf of an entity that is the Partnership Representative. We request that Treasury provide such guidance, specifically addressing the types of individuals who will be authorized to act in federal income tax matters on behalf of an entity that is the Partnership Representative. We suggest that the person so designated could be: (i) any person authorized to sign the entity's federal income tax return; or (ii) any person who has the authority under the entity's governing documents to conduct or manage the activities of the entity.

Moreover, the Partnership Audit Rules do not contain authority regarding replacement of the Partnership Representative when the Partnership Representative has either been designated by the partnership or by the Service. We suggest that Treasury clarify that a partnership can replace the Partnership Representative, regardless of whether the Partnership Representative is designated by the partnership or the Service. Additionally, we suggest that Treasury clarify whether the partners may replace the Partnership Representative at any time, including after the commencement of an audit.

IV. PARTNERSHIP LEVEL ASSESSMENT UNDER SECTION 6225.

A. What are the Tax Effects of the Partnership Level Adjustment to the Adjustment Year Partners?

The general rule under the Partnership Audit Rules is that a partnership is liable to pay "in the adjustment year" any imputed underpayment resulting from the adjustment made to the income of that partnership.[31] This general rule imposing and collecting the imputed underpayment at the partnership level is hereafter referred to as the "General Method."

Under the General Method, the partners of the partnership for the "adjustment year" (generally, the partnership taxable year in which the audit is finally resolved) bear the economic burden of the tax liability resulting from that adjustment, notwithstanding the possibility that a different set of partners[32] may have received one or more tax benefits for the partnership taxable year that was subject to review. The "adjustment year" as defined in Section 6225(d)(2) is hereinafter referred to as the "Adjustment Year," and the partners of the partnership for the Adjustment Year are the "Adjustment Year Partners." The partnership tax year that was subject to review is hereinafter referred to as the "Reviewed Year," and the partners of the partnership for the Reviewed Year are the "Reviewed Year Partners." The adjustment to the partnership's tax items, and the partnership's payment of tax, interest and penalties relating to those adjustments, presumably would have continuing income tax effects to the Adjustment Year Partners through their amounts of outside basis and capital accounts. The Partnership Audit Rules, however, do not elaborate on how those continuing income tax effects are determined.

We therefore respectfully request that Treasury promulgate rules and examples explaining and illustrating the manner in which the partnership level adjustment and payment of tax, interest and penalties will be taken into account in determining the future income tax effects for the Adjustment Year Partners. In addition, we have included in these Comments the following simplified fact pattern and suggested approach regarding the manner in which the partnership level adjustment and payment of tax, interest and penalties should impact the outside bases and capital accounts of the Adjustment Year Partners in a typical scenario. The following fact pattern is hereafter referred to as the "Example."

> Example: In 2018, two individuals, "A" and "B," each owns 50% of the capital and profits interests of a partnership. For the 2018 tax year, the partnership reports a deduction of $1 million, one-half of which is allocated to each of A and B.

[31] Section 6225(a)(1).

[32] Of note, a different set of partners can result from scenarios beyond transfers of partnership interests, including without limitation the admission of new partners or the withdrawal of existing partners. As a general consideration, forthcoming guidance from the Treasury under the Partnership Audit Rules should address these scenarios as well.

In 2019, A sells her interest to an individual, "C," for an amount in excess of her outside basis. A reports a taxable gain from this sale on her 2019 income tax return. C succeeds to A's capital account in the partnership.

In 2020, the Service makes an adjustment to the income of the partnership by disallowing the $1 million deduction that was claimed in 2018. This results in an imputed underpayment for 2020 in the amount of $396,000 (i.e., the $1 million positive adjustment, multiplied by an assumed maximum individual tax rate in 2018 of 39.6%).

Under the Partnership Audit Rules, the partnership is liable in 2020 for additional tax that would have resulted from a positive $1 million adjustment to the partnership's taxable income in 2018. Because the partnership is liable for that additional tax in the Adjustment Year, B and C are essentially sharing the economic burden of the increased tax burden attributable to that $1 million adjustment and should be entitled to take into account the effect of the $1 million adjustment and the partnership's payment of the imputed underpayment in their outside bases and capital accounts. Assuming that B and C have agreed to share the economic impact of all partnership items equally, they each presumably would be allocated one-half of the $1 million adjustment (or $500,000 each). Accordingly, each of B and C presumably would be entitled to increase the amount of her outside basis and capital account by $500,000.[33] In addition, if the partnership paid tax, interest and penalty in connection with the imputed underpayment in the total combined amount of $500,000, B and C would presumably reduce the amount of their outside basis and capital account by $250,000 each.[34]

As an additional consideration, under the General Rule, in certain instances, the proper treatment of an adjustment on the books of the partnership may be to create or restore one or more assets (in whole or in part). Additional guidance from the Treasury may be necessary to address subsequent allocations of items of income, gain, deduction, loss, and credit with respect to such assets. For example, the disallowance of a deduction would typically result in the addition of or to an asset and such additional amount may be subject to depreciation or amortization (e.g., start-up costs).

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[33] *See* Section 705(a)(1)(A); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*3*).

[34] *See* Section 705(a)(2)(B); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*6*). The suggested reduction of B's and C's outside bases to account for the partnership's payment of the imputed underpayment is similar to the effect of an S corporation's payment of the Section 1374 built-in gain tax on its shareholders. Under Section 1366(f)(2), the amount of Section 1374 built-in gain tax paid by an S corporation is treated as a loss sustained by that S corporation, which thereby generally results in a decrease in the shareholders' outside bases under Section 1367(a)(2).

B. What are the Tax Effects if a Reviewed Year Partner Files an Amended Return and Pays a Portion of the Tax Relating to the Imputed Underpayment?

One or more Reviewed Year Partners may file an amended return for the Reviewed Year to report and pay the tax resulting from their allocable share of the adjustments made to the partnership's tax items (the "Amended Return Exception").[35] Under the Amended Return Exception, the amount of the imputed underpayment imposed on the partnership is reduced to the extent the Reviewed Year Partners file amended returns for the Reviewed Year to report their allocable share of the adjustments and pay their income tax liability relating to those adjustments.[36]

We respectfully request that Treasury promulgate rules and examples to explain and illustrate the federal income tax effects to the parties where only some of the Reviewed Year Partners file amended returns reporting the adjustments and pay the related tax. The following is a suggested approach (elaborating on the Example).

> Assume the same facts as in the Example, except that A files an amended return for 2018 reporting her 50% share of the partnership adjustment (or $500,000) and paying the tax resulting from that adjustment. As a result of A's amended return, the partnership's imputed underpayment amount is reduced to take into account the $500,000 adjustment that was reported on A's amended return. Accordingly, the imputed underpayment would equal $198,000 (i.e., the remaining $500,000 adjustment, multiplied by an assumed 39.6% maximum individual tax rate in 2018).
>
> The manner in which the remaining $500,000 adjustment would be allocated among B and C generally depends on the manner in which they agree to allocate partnership items of income, gain, loss, deduction, and credit in their partnership agreement. Assuming that they have agreed to allocate all partnership items equally, then $250,000 (i.e., one-half of the $500,000 adjustment) would be allocated to each of them, increasing each of their outside basis and capital account by that amount.[37]
>
> In addition, if the partnership paid tax, interest and penalty in connection with the imputed underpayment in the total combined amount of $250,000, B and C would, in the absence of any permitted special allocations, reduce the amount of their outside basis and capital account by $125,000 each.[38]

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[35] Section 6225(c)(2).

[36] *See id.*

[37] *See* Section 705(a)(1)(A); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*3*).

[38] *See* Section 705(a)(2)(B); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*6*).

Furthermore, A's amended 2018 return reporting her allocable share of the partnership adjustment and the related tax payment potentially impacts her 2019 income tax liability. If A reports and pays tax on the $500,000 adjustment on her amended 2018 income tax return, A should increase the tax basis of her partnership interest, which she sold for a gain in 2019. If the statute of limitations for her 2019 tax year is still open under Section 6511, A can file an amended 2019 income tax return to claim a refund resulting from the increased basis in her partnership interest that was sold. If the statute of limitations for filing a refund claim has closed, however, A may be left without recourse for her 2019 tax year. As a result, we suggest that it would be equitable for Treasury to promulgate rules to provide a procedure through which A could receive the tax benefit from her increased basis in the partnership interest, even in situations in which the limitations period has expired, perhaps under the mitigation rules of Sections 1311 to 1314.

Under these facts, B's and C's capital account and outside basis would be reduced by the same amounts as a result of the partnership's payment of the $250,000 tax-related liability, even though C succeeded to A's capital account and A separately made a payment of tax. This appears to be an inequitable result because C essentially stepped into A's shoes as a partner in the partnership. This result could be addressed through a special allocation by the partnership of most of its (non-deductible) $250,000 loss resulting from its tax-related payment entirely to B. Due to potential circumstances similar to this one, we suggest that Treasury promulgate rules clarifying that, under the Amended Return Exception, certain special allocations by partnerships relating to certain tax-related payments made by partnerships should be treated as having economic effect.

Moreover, under the Amended Return Exception (as is the case under the General Rule), in certain instances, the proper treatment of an adjustment on the books of the partnership may be to create or restore one or more assets (in whole or in part). Additional guidance from the Treasury may be necessary to address subsequent allocations of items of income, gain, deduction, loss, and credit with respect to such assets.

C. Under the Amended Return Exception, Could the Section 6511 Statute of Limitations Prevent a Partner From Filing an Amended Return to Claim a Refund?

Under the Amended Return Exception, the language in Section 6225(c)(2) addressing the filing of amended returns by the Reviewed Year Partners explicitly states that those amended returns may be filed notwithstanding Section 6511. This indicates that a Reviewed Year Partner is eligible to file an amended return claiming a refund with respect to the partnership's Reviewed Year, even when the statute of limitations for claiming a refund with respect to the Reviewed Year would have expired. The BBA and Path Act, however, did not amend Section 6511 to provide an exception for a Reviewed Year Partner filing an amended return pursuant to the Amended Return Exception. As a result, we respectfully request that Treasury promulgate a rule (perhaps as an amendment to the regulations underlying Section 6511) to make clear that a partner filing an amended return pursuant to the Amended Return Exception is eligible to claim a refund on that return, even in situations in which the limitations period Section 6511 otherwise would have expired.

D. How are Penalties and Interest Calculated and Imposed Under the Amended Return Exception?

Section 6233 provides the general rule that interest and penalties relating to an imputed underpayment are imposed and collected at the partnership level. The Partnership Audit Rules, however, do not contain any language clearly resolving who is liable for the interest and any penalties resulting from a partnership adjustment if the Reviewed Year Partners file amended returns reporting their allocable shares of that adjustment and paying their related tax liabilities. This is in contrast to the rules under the Alternative Method, which explicitly provide that interest and penalties will be owed at the partner level.[39]

As a result, we respectfully request that Treasury promulgate rules to address the calculation of, and liability for, interest and penalties in the scenario in which the Reviewed Year Partners file amended returns to report and pay the tax in connection with their allocable shares of the partnership adjustment. We make the following recommendations: First, the amount of the interest and penalties would be determined at the partnership level in the same manner as though no amended partner returns were filed. Second, any Reviewed Year Partner filing an amended return could elect to pay her or its allocable share of the amount of interest and penalty determined at the partnership level. Third, any interest and/or penalties paid by a Reviewed Year Partner would be credited against the amount of interest and penalties owed by the partnership. Fourth, to the extent the interest and penalties resulting from the partnership adjustment are not paid by the Reviewed Year Partners, the interest and penalties would still be collectible against the partnership.

V. THE ALTERNATIVE METHOD UNDER SECTION 6226.

A. What are the Income Tax Effects of the Partner-Level Adjustments to the Reviewed Year Partners?

As with the General Method, it would be helpful for Treasury to promulgate rules and examples explaining and illustrating the income tax effects of the partner-level adjustments on the Reviewed Year Partners if the Alternative Method is elected under Section 6226. The following is our suggested approach (elaborating on the Example).

> Assume the same facts as in the Example, except that the partnership complies with the requirements for electing the Alternative Method. A and B agreed to share the economic impact of all partnership items equally. As a result, the $1 million adjustment relating to the disallowed deduction would be made in equal

[39] Section 6226(c).

shares of $500,000 to each of A and B.[40] Each of A's and B's income tax liability for their 2020 tax years would be increased by the amount by which their income tax liability for 2018 would have increased if the $500,000 adjustment was made in 2018.[41]

For B, who remained a partner in the partnership through 2020, the tax effects seem relatively clear. The positive $500,000 adjustment presumably would increase the amount of her outside basis and capital account balance in the partnership.[42]

The tax effects of the adjustment to A, however, are completely uncertain because Section 6226(b) contains language that leads to contradictory results. On the one hand, Section 6226(b)(3) provides that, in calculating the increase in the Reviewed Year Partner's tax liability for the Adjustment Year, the Reviewed Year Partner can take into account any "tax attribute" that would have been affected if the adjustments described in the notice of final partnership adjustment had been taken into account for the Reviewed Year. The meaning of the term "tax attribute" for purposes of Section 6226(b)(3) is unclear, but presumably the term would include a partner's outside basis in their partnership interest as determined under Section 705. Assuming that is the case, Section 6226(b)(3) suggests that, when A calculates the increase in her 2020 tax liability resulting from the $500,000 adjustment made to her 2018 tax year, she can take into account that her outside basis would have increased by $500,000 as a result of that adjustment, decreasing her taxable gain from the sale of the partnership interest in 2019 by $500,000.

On the other hand, Section 6226(b)(2) provides that a Reviewed Year Partner can only take into account the amount by which that partner's tax liability would "increase" for the Reviewed Year (i.e., 2018 under the Example) and any affected year (i.e., 2019 under the Example) in calculating the increase in the Reviewed Year Partner's tax liability for the Adjustment Year (i.e., 2020 under the Example). This suggests that A would not be able increase her outside basis in 2018 to reduce her tax liability in 2019 (resulting from her sale of her partnership interest in 2019), in determining the increase in her tax liability for 2020 resulting from the adjustment.

If A is required to increase her 2020 income tax liability by taking into account the $500,000 positive adjustment in her 2018 income, but receives no credit for that $500,000 adjustment in her outside basis to reduce her taxable gain from the sale in 2019, A is essentially taxed twice on the same $500,000 adjustment. To

[40] Section 6226(a).

[41] Section 6226(b).

[42] *See* Section 705(a)(1)(A); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*3*).

reach a conceptually correct result. A should be able to take into account both her increased outside basis and the resulting decrease in her 2019 tax liability in calculating the increase in her 2020 tax liability resulting under the Alternative Method.

We respectfully request that Treasury promulgate rules and examples to explain and illustrate the interplay between Sections 6226(b)(2) and (3) in a manner that reaches the conceptually correct result of preventing a Reviewed Year Partner from being taxed twice as a result of a single adjustment.

In addition, the aforementioned scenario illustrates a broader problem. The inability of a Reviewed Year Partner to take into account any decrease in that partner's tax liability for the Reviewed Year and any other affected year naturally leads to situations in which a Reviewed Year Partner is required to pay more tax than that partner otherwise would owe under the general application of the federal income tax laws. Moreover, a Reviewed Year Partner's artificially increased income tax liability is the result of an election to utilize the Alternative Method that is made by the partnership. The applicable Reviewed Year Partner may no longer be a partner in the partnership by the Adjustment Year and thus may have no input whatsoever regarding whether the partnership elects the Alternative Method.

As a result of these conceptual and fairness issues, we respectfully request that Treasury exercise its authority and discretion to promulgate rules that would enable Reviewed Year Partners, in calculating the amount of the increase in their tax liability for the Adjustment Year under Section 6226, to take into account any decrease in their tax liability for the Reviewed Year and any affected year that would result from the adjustments made in the notice of final partnership adjustment. Alternatively, we respectfully request that Treasury promulgate rules to make clear that a Reviewed Year Partner subjected to the Alternative Method may file a claim for refund for the Reviewed Year or any affected year, notwithstanding whether the limitations period under Section 6511 has expired.

Lastly, under the Alternative Method (as is the case under the General Rule and the Amended Return Exception), in certain instances, the proper treatment of an adjustment on the books of the partnership may require the creation or restoration of one or more assets (in whole or in part). Accordingly, we respectfully request that the Treasury consider issuing additional guidance as may be necessary to address subsequent allocations of items of income, gain, deduction, loss, and credit with respect to such assets.

B. How Would the Partner-Level Adjustment be Taken into Account by Indirect Partners?

We respectfully request that Treasury promulgate rules and examples to explain and illustrate the manner in which the Alternative Method would apply in a tiered partnership scenario. For example, assume the same facts as in the Example, except that B is a partnership with two individual partners, "D" and "E," who each have a 50% interest in the capital and profits of B. The Service makes an adjustment to the income of the lower-tier partnership in 2020 by disallowing the $1 million deduction that was claimed in 2018. The lower-tier partnership timely and effectively elects to use the Alternative Method. As a result, B presumably would be required to take into account its $500,000 allocable share of the adjustment made in the notice of final partnership adjustment ("FPA") issued to the lower-tier partnership.

Under the Alternative Method, the income tax liability of each partner who was a partner in the partnership for the Adjustment Year is increased by the amount by which their income tax liability for the Reviewed Year and any affected year would have increased if the partnership adjustment had been made in the Reviewed Year.[43] But B is a "flow-through" entity that generally is not required to pay federal income tax. As a result, the statutory language of the Alternative Method, as elected by a lower-tier partnership, may not apply to a partner that is itself a partnership. It is therefore unclear how the upper-tier partnership would be required to take into account the adjustment that was made to the lower-tier partnership that has elected the Alternative Method.

One possibility is that the upper-tier partnership could be required under the General Method to pay an imputed underpayment in the Adjustment Year in connection with that upper-tier partnership's allocable share of the adjustment made to the lower-tier partnership. In that scenario, B would be required in 2020 to pay an imputed underpayment equal to $198,000 (i.e., B's $500,000 allocable share of the adjustment made to the lower-tier partnership, multiplied by an assumed 39.6% maximum individual tax rate in 2018). D and E presumably would increase the amount of their outside basis and capital account in B by their $250,000 allocable share of the adjustment.[44] D and E would also presumably decrease the amount of their outside basis and capital account in B by their $99,000 allocable share of B's payment of tax resulting from the adjustment.[45]

It is unclear whether, in a tiered partnership scenario, an upper-tier partnership could elect the Alternative Method in connection with its allocable share of an adjustment that was made to a lower-tier partnership that elected the Alternative Method. The JCT Report, however, indicates that an upper-tier partnership may file an administrative adjustment request ("AAR") under Section 6227 with regard to its allocable share of an adjustment made to the lower-tier partnership.[46] The upper-tier partnership's filing of the AAR may enable the upper-tier partnership to achieve essentially the same result as the Alternative Method by causing the partners of the upper-tier partnership to take into account their allocable shares of the upper-tier partnership's allocable share of the adjustment that was made at the lower-tier partnership level.[47]

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[43] Section 6226(b).

[44] *See* Section 705(a)(1)(A); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*3*).

[45] *See* Section 705(a)(2)(B); Treas. Reg. § 1.704-1(b)(2)(iv)(*b*)(*6*).

[46] *See* Report at 71.

[47] *See* Section 6227(b)(2).

We respectfully suggest that Treasury promulgate rules to make clear that an upper-tier partnership may elect to apply the Alternative Method in connection with its allocable share of an adjustment made to a lower-tier partnership. We also suggest that those rules could provide that an upper-tier partnership may elect to apply the Alternative Method, without filing an AAR, by timely filing an election and providing its partners with the required information regarding their allocable shares of the adjustment, consistent with the requirements under Section 6226(a).

C. How Would Penalties be Determined Under the Alternative Method?

Section 6226(c)(1) provides that any penalties, additions to tax, or additional amount will be determined as provided under Section 6221, which in turn provides that the applicability of any penalty, addition to tax, or additional amount relating to a partnership adjustment will be determined at the partnership level. Nevertheless, Section 6226(c)(1) provides that the Reviewed Year Partners are liable for any such penalties, additions to tax or additional amounts.

We respectfully request that Treasury promulgate rules to explain how penalties and similar items are calculated and imposed under the Alternative Method. For example, if the applicability of the substantial understatement penalty under Section 6662(b)(2) is determined at the partnership level, we assume that determination would generally be made based on whether the amount of taxable income that was not reported on the partnership's Internal Revenue Service Form 1065 ("Form 1065") exceeds 10% of the taxable income required to be shown on that Form 1065.[48] In addition, although the applicability of a penalty is determined at the partnership level, we assume that the amount of the penalty imposed on the Reviewed Year Partner would be based on the amount of that Reviewed Year Partner's underpayment attributable to the substantial understatement. Clarification of these and other issues relating to the operation of the penalty rules under the Alternative Method would be helpful.

VI. PARTNERSHIP ADMINISTRATIVE ADJUSTMENT REQUESTS.

The Partnership Audit Rules are unclear regarding whether a partner can ever obtain a refund in connection with an AAR. Section 6227(a) provides: "A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year." Section 6227(b) provides that, if the adjustment relating to the AAR would not result in an imputed underpayment, then that adjustment is made under "rules similar to the rules of" the Alternative Method. Under the Alternative Method, however, the Adjustment Year Partners determine the amount of their adjustment only by taking into account the "increase" in their tax liability resulting from the adjustments.[49] The statutory language of the Alternative Method does not permit the Adjustment Year Partners to take into account any decrease in their tax liability. Thus, it is questionable under the Partnership Audit Rules whether a partner could ever claim a refund in connection with an AAR.

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[48] *See* Section 6662(d)(1).

[49] Section 6226(b)(2).

As a result, we respectfully request that Treasury promulgate rules to clarify that the partners may take into account adjustments that would decrease their tax liability for the Reviewed Year and any affected year in determining the amount of their tax liability for the Adjustment Year in connection with a AAR. This suggestion is consistent with aspects of the suggested approach set forth above in Section V.A. of these Comments.

VII. PARTNER NOTICE RIGHTS.

Section 6231 requires that Treasury mail to the "partnership and partnership representative" notice of any administrative proceeding initiated at the partnership level, notice of any proposed partnership adjustment, and notice of any final partnership adjustment. The Partnership Audit Rules, however, do not contain any statutory obligation on the part of any party to provide notice to the partners of the partnership or otherwise keep them informed of the partnership audit.

This is in contrast to the TEFRA rules, which provide that the Secretary generally must provide notice to each partner regarding the beginning of an administrative proceeding at the partnership level and the final partnership administrative adjustment resulting from that proceeding.[50] The TEFRA rules also provide that the Tax Matters Partner "shall keep each partner informed of all administrative and judicial proceedings" relating to the adjustment at the partnership level.[51]

The partners of the partnership, however, are in as much need of information relating to the partnership proceeding under the Partnership Audit Rules as they are under the TEFRA rules. This is because the Partnership Audit Rules provide that the Partnership Representative is the only person who has authority to act on behalf of a partnership during a partnership audit, and the Partnership Representative's actions are binding on all former and current partners.[52] In contrast, under the TEFRA rules, any partner has the right to participate in any administrative proceeding relating to an adjustment at the partnership level,[53] and the Tax Matters Partner has only limited ability to bind other parties during the administrative phase of a partnership proceeding.[54]

Due to the heightened need under the Partnership Audit Rules for the sharing of information with the partners, we respectfully request that Treasury promulgate rules that require the Partnership Representative to keep the Adjustment Year Partners informed regarding important steps of the proceeding to the same extent as is presently required under the TEFRA rules.

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[50] Section 6223(a) (Pre-2018).

[51] Section 6223(g) (Pre-2018).

[52] Section 6223.

[53] Section 6224(a) (Pre-2018).

[54] Section 6224(c)(3) (Pre-2018).

VIII. JUDICIAL REVIEW OF PARTNERSHIP ADJUSTMENTS.

Section 6234(a) provides that the partnership may file a petition for readjustment with the Tax Court, relevant U.S. District Court, or Court of Federal Claims, within 90 days after the date of mailing of the notice of final partnership adjustment. A partnership may file the petition for readjustment in U.S. District Court or the Court of Federal Claims, however, only if the partnership "deposits with the Secretary, on or before the date the petition is filed, the amount of the imputed underpayment (as of the date of the filing of the petition) if the partnership adjustment was made as provided by the notice of final partnership adjustment."[55]

We respectfully request that Treasury promulgate rules to explain the operation of the aforementioned deposit requirement under the Amended Return Exception when the Reviewed Year Partners have filed amended returns and paid at least a portion of the taxes due as a result of the partnership adjustments. The Reviewed Year Partners' tax payments are taken into account in determining the partnership's imputed underpayment amount.[56] Accordingly, the Reviewed Year Partners' payment should also reduce the amount of the partnership's required deposit in order to obtain review by the District Court or Court of Federal Claims. It would be helpful if Treasury would promulgate rules clarifying that the amount of the partnership's deposit requirement is reduced to take into account tax payments made by the Reviewed Year Partners under the Amended Return Exception.

IX. STATUTE OF LIMITATIONS FOR ADJUSTMENT

Section 6235(a) provides the limitations period within which the Service generally must make an adjustment under the Partnership Audit Rules. Section 6235(a) states as follows:

> (a) In General.—Except as otherwise provided in this section, no adjustment under this subpart for any partnership taxable year may be made after the later of—
>
> (1) the date which is 3 years after the latest of –
>
> (A) the date on which the partnership return for such taxable year was filed,
>
> (B) the return due date for the taxable year, or
>
> (C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227, or
>
> (2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (7) thereof) after the date on which everything required to be

55 Section 6234(b)(1).

56 Section 6225(c)(2).

submitted to the Secretary pursuant to such section is so submitted, or

(3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7) after the date of such notice.

Thus, the Partnership Audit Rules provide that the Service generally cannot make a partnership adjustment more than 330 days following the date of the notice of proposed partnership adjustment ("NOPPA"). The Partnership Audit Rules, however, do not explicitly establish any timeframe by which the Service must issue the NOPPA. We therefore respectfully request that Treasury promulgate rules to clarify the timeframe within which the NOPPA must be issued. We also respectfully suggest that Treasury promulgate rules to clarify that the issuance of a NOPPA will cause the extension of the statute of limitations for making an adjustment only with respect to the issues addressed in that NOPPA.

We appreciate being extended the opportunity to assist in the development of the guidance to implement the new partnership audit regime and thank you for your consideration with respect to the above suggestions and comments.

TAX SECTION
State Bar of Texas

April 27, 2016

Ms. Stephanie A. Servoss
Clerk of the Court
United States Tax Court
400 Second St., N.W., Room 111
Washington, D.C. 20217

RE: Comments on March 28, 2016 Proposed Amendments to United States Tax Court Rules of Practice and Procedure

Dear Ms. Servoss:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the United States Tax Court for comments regarding the proposed amendments to the Court's Rules of Practice and Procedure which were announced on March 28, 2016 (the "Proposed Amendments").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX

SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Court for the time and thought that has been put into preparing the Proposed Amendments, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

cc: The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

COMMENTS ON PROPOSED AMENDMENTS TO UNITED STATES TAX COURT'S RULES OF PRACTICE AND PROCEDURE ANNOUNCED MARCH 28, 2016

These comments on the Proposed Amendments ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Richard L. Hunn, who is Chair of the Tax Controversy Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Robert Probasco, Co-Chair of COGS, reviewed these Comments. Lawrence R. Jones, Jr. also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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1301 McKinney, Suite 5100
Houston, TX 77010-3095

Date: April 27, 2016

These Comments are provided in response to the Court's request for comments regarding the Proposed Amendments to its Rules of Practice and Procedure (the "Rules"). The Tax Section commends the Court for its efforts to amend its Rules in response to several recent enactments by Congress and thanks the Court for the opportunity to provide comments regarding the Proposed Amendments.

The Tax Section has only one subject for comment: proposed Form 2 for Appendix I to the Rules. Form 2 is the form that a petitioner may use to file a small tax case petition with the Court. Paragraph 1 of proposed Form 2 provides five categories of petition, and next to each a box may be checked to indicate the type of case that is being filed. Paragraph 1 of proposed Form 2 reads as follows:

1. Please check the appropriate box(es) to show which IRS NOTICE(s) you dispute:

[ ] Notice of Deficiency

[ ] Notice of Determination Concerning Collection Action

[ ] Notice of Final Determination Not to Abate Interest*

[ ] Determination of Worker Classification*

[ ] Notice of Determination Concerning Your Request for Relief From Joint and Several Liability*

*Please see the Court's Web site, www.ustaxcourt.gov, or information booklet for additional information if (1) you filed a claim for interest abatement or requested relief from joint and several liability, and the IRS has not made a determination, or (2) the petition involves a worker classification case.

We believe that most petitioners who will consider using this form to file a small tax case petition will be filing *pro se* and may be confused by paragraph 1 in the form that it is currently proposed, because it may not be entirely clear to them why there are asterisks next to three of the choices in paragraph 1. No such asterisks appear in the prior version of Form 2. Moreover, the note at the asterisk does not guide the petitioner to specific information about the topic.

With respect to two of the options—"Notice of Final Determination Not to Abate Interest" and "Notice of Determination Concerning Your Request for Relief From Joint and Several Liability"—the note indicates, but does not explicitly state, the reason for the asterisk. The note indicates that a person may be able to file a petition if the Commissioner fails to act upon a claim requesting an abatement of interest or fails to act upon a request for relief from joint and several liability. In those two instances, we believe it would be helpful to explicitly state that alternative in a parenthetical next to that option. Consequently, we suggest that the Court consider revising paragraph 1 in pertinent part to read as follows, with proposed additional language underlined:

1. Please check the appropriate box(es) to show which IRS NOTICE(s) you dispute:

[ ] Notice of Deficiency

[ ] Notice of Determination Concerning Collection Action

[ ] Notice of Final Determination Not to Abate Interest <u>(or Failure of IRS to Make a Final Determination Within 180 Days After Claim for Abatement)</u>*

[ ] Determination of Worker Classification*

[ ] Notice of Determination Concerning Your Request for Relief From Joint and Several Liability <u>(or Failure of IRS to Make a Determination Within 6 Months After Election or Request for Relief)</u>*

With respect to the option "Determination of Worker Classification," no substantive explanation for the asterisk is provided. With respect to all three of the options in question, we believe that the hyperlink to the Court's website that appears in the note may be confusing to petitioners, because the hyperlink redirects the petitioner only to the main page of the Court's website. We suggest that the Court consider revising the note to provide three specific hyperlinks to explanatory information with respect to each of the three topics.

We appreciate the opportunity to comment on the Proposed Amendments and to be a part of the Court's efforts to update and improve its Rules of Practice and Procedure.

TAX SECTION
State Bar of Texas

May 17, 2016

Via E-Mail to Elaine.H.Christophe@irs.gov

Elaine H. Christophe
Internal Revenue Service, Room 6517
1111 Constitution Avenue NW.
Washington, DC 20224

RE: Comments on Form 706-GS(D-1)

Dear Ms. Christophe:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury and the Internal Revenue Service in 81 Fed. Reg. 14937, concerning Form 706-GS(D-1).

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

COMMENTS ON FORM 706-GS(D-1)

These comments on Form 706-GS(D-1) (the "Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. Celeste Lawton, R. Glenn Davis, and Laurel Stephenson were the principal drafters of these Comments. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Robert Probasco, Co-Chair of COGS, reviewed these Comments. Eric Reis also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 17, 2016

The Department of Treasury and the Internal Revenue Service (the "IRS") have solicited comments concerning Form 706-GS(D-1). The intention of these Comments is to specifically address issues associated with the due date for filing Form 706-GS(D-1) and the filing requirement for trusts having an inclusion ratio of zero, in order to enhance the quality, utility, and clarity of the information to be collected and to minimize the burden of the collection of information on respondents.

1. Timing of Filing Form 706-GS(D-1)

We respectfully suggest that the IRS consider changing the due date for filing Form 706-GS(D-1) so that it does not coincide with the due date for filing Form 706-GS(D).

Generally, the trustee must file Form 706-GS(D-1) to report a taxable distribution by April 15th of the year following the year in which the taxable distribution was made. Similarly, by such date, a person who receives a taxable distribution from a trust (the "taxpayer") must file Form 706-GS(D). The trustee, thus, is not required to send the taxpayer a copy of Form 706-GS(D-1) prior to the due date for filing Form 706-GS(D). In order for the taxpayer to complete Form 706-GS(D), the taxpayer relies on information that he or she obtains from Form 706-GS(D-1). In some instances, a taxpayer may not realize that a trust distribution constitutes a taxable distribution that gives rise to the necessity of filing Form 706-GS(D) until the taxpayer receives the trustee's Form 706-GS(D-1).

Because the initial due date for both forms is the same, the taxpayer may not receive a copy of Form 706-GS(D-1) until after Form 706-GS(D) is due. As a result, if the taxpayer is relying solely on the information in Form 706-GS(D-1), it would be impossible for the taxpayer to timely file Form 706-GS(D). Furthermore, even if an extension of time to file is requested, without the information provided on Form 706-GS(D-1) it may be impossible for the taxpayer to timely pay any generation-skipping transfer (GST) tax that is due.

The taxpayer's difficulty in timely filing Form 706-GS(D) and paying any GST tax due would be exacerbated if a separate valuation were necessary. The Instructions for Form 706-GS(D) contemplate that there may be instances when the trustee has not completed column e of Form 706-GS(D-1) (regarding the value of property distributed from the trust) or that the taxpayer may disagree with the amounts that the trustee entered in column e of Form 706-GS(D-1). The burden of determining the appropriate value of the property received by the taxpayer in a taxable distribution ultimately lies with the taxpayer, given that he or she is the one who must pay the GST tax associated with the taxable distribution. In some instances, such as when the trustee fails to report the correct value of the distributed property, the taxpayer may need information from the trustee regarding the property or may need to engage a qualified appraiser in order to properly value the property. As shown in the Instructions, the definition of fair market value mirrors the definition for Federal estate tax purposes. In the Federal estate tax context, the fiduciary has nine months (or fifteen months, if the due date for Form 706 is extended) to fully value the property, unlike the taxpayer filing Form 706-GS(D), who has a fraction of that time if he or she begins the valuation process upon receipt of Form 706-GS(D-1) from the trustee.

Form 706-GS(D-1) is similar to a Form 1099 in that the form provides notice and information to a taxpayer to aid the taxpayer in properly paying tax. Form 1099, like other information returns, must be provided to taxpayers ("payees") by February 15th of the year following the year in which a payment is made. If the due date for Form 706-GS(D-1) were changed to a date such as March 15th of the year following the year in which a taxable distribution is made, the taxpayer's ability to timely file Form 706-GS(D) and pay any GST tax resulting from a taxable distribution may be improved.

Changing the due date of Form 706-GS(D-1) as suggested[1] would enhance the quality, utility, and clarity of the information to be collected both in that form and in Form 706-GS(D). We recognize that such a change could be more burdensome for the trustee, but it would better enable the taxpayer to timely and accurately file Form 706-GS(D) and pay any GST tax that may be due.

2. Addition of Cautionary Note to Instructions of Form 706-GS(D-1)

<u>We respectfully suggest that the IRS consider adding a cautionary note to the Instructions to Form 706-GS(D-1) regarding the timeliness of the trustee's filing Form 706-GS(D-1) and providing the taxpayer with information necessary for the taxpayer to timely file Form 706-GS(D).</u>

As mentioned previously, the taxpayer may not receive a copy of Form 706-GS(D-1) before the initial due date of the taxpayer's Form 706-GS(D) or may not otherwise have the information needed to file Form 706-GS(D) by its initial due date. We suggest that the IRS consider including in the Instructions to Form 706-GS(D-1) a cautionary note to inform or remind the trustee, if a distribution was made that results in GST tax being due, to file Form 706-GS(D-1) and provide a copy of such Form to the taxpayer in a timeframe sufficient to allow such taxpayer to challenge the valuation of any distributed asset and/or timely file Form 706-GS(D) and pay any GST tax due. We further suggest that such cautionary note inform or remind the trustee that failure to provide the Form 706-GS(D-1) to the taxpayer within a sufficient timeframe may risk a breach of fiduciary duty claim.

3. Eliminating Form 706-GS(D-1) Filing Requirement for Zero Inclusion Ratio Trusts

<u>We respectfully suggest that the IRS consider eliminating the Form 706-GS(D-1) filing requirement for trusts with an inclusion ratio of zero.</u>

Pursuant to the Instructions, the purpose of the Form 706-GS(D-1) is to "report certain distributions from a trust that are subject to the GST tax and to provide the skip person distributee with information needed to figure the tax due on the distribution." The Instructions suggest that a trustee of a trust having an inclusion ratio of zero would not have to file Form 706-GS(D-1), because such a trust is commonly understood as not subject to the GST tax. Nevertheless, the

[1] The due date for filing both Forms 706-GS(D) and 706-GS(D-1) is set forth in Treasury Regulation Section 26.2662-1. Our suggested change would require a revision of that regulation, which may be beyond the scope of the feedback requested.

Instructions make clear that the trustee must file Form 706-GS(D-1) for each skip person "even if the inclusion ratio applicable to the distribution is zero."

Form 706-GS(D-1) requires the trustee to include a detailed description of each distributed asset of the trust as well as the value of each such asset. This can be time consuming and expensive, particularly with respect to distributions of hard-to-value assets which would require appraisals to be obtained. When the trust has an inclusion ratio of zero, no GST tax is due regardless of the value of any distributed asset. Thus, it is seemingly a waste of time and resources to require the trustee of a trust having an inclusion ratio of zero to file the Form 706-GS(D-1), and it does not accomplish the Form's purpose. In fact, the beneficiary receiving a Form 706-GS(D-1) reporting an inclusion ratio of zero is not required to file Form 706-GS(D). Thus, eliminating the requirement that the trustee of a trust having an inclusion ratio of zero file a Form 706-GS(D-1) would be consistent with the relief previously granted to the beneficiaries with respect to the filing of a Form 706-GS(D).

In the alternative, if the trustee of a trust having an inclusion ratio of zero must file a Form 706-GS(D-1), we suggest that the trustee be required to file such return only in the first year in which a distribution is made from such trust. For any subsequent year in which a distribution is made from such trust, we suggest that the IRS consider eliminating the filing requirement if the inclusion ratio of the trust is still zero at the time such distribution was made.

TAX SECTION
State Bar of Texas

June 15, 2016

Via E-mail to Teresa.Bostick@cpa.texas.gov

Teresa G. Bostick
Director, Tax Policy Division
PO Box 13528
Austin, Texas 78711-3528

RE: **Comments on Proposed Amendments to 34 Tex. Admin. Code § 3.584, "Margin: Reports and Payments"**

Dear Ms. Bostick:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Texas Comptroller of Public Accounts for comments pertaining to Proposed Amendments to 34 Tex. Admin. Code § 3.584. The proposal appeared in the May 20, 2016, edition of the Texas Register.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT

SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Texas Comptroller of Public Accounts for the time and thought that has been put into preparing the Proposed Amendments to 34 Tex. Admin. Code § 3.584, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED AMENDMENTS TO 34 TEX. ADMIN. CODE § 3.584

These comments on Proposed Amendments to 34 Tex. Admin. Code § 3.584 ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Sam Megally and Charolette Noel, Co-Chairs of the State and Local Tax (SALT) Committee of the Tax Section of the State Bar of Texas, and Kirk Lyda, a member of the SALT Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Robert D. Probasco, Co-Chair of COGS, reviewed these Comments. Ira Lipstet, a member of the SALT Committee, also reviewed the comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 15, 2016

I. INTRODUCTION

These Comments are in response to the publication of Proposed Amendments to 34 Tex. Admin. Code § 3.584 (the "Proposed Rule"), by the Texas Comptroller of Public Accounts (the "Comptroller") in the May 20, 2016, edition of the Texas Register.

We recognize and appreciate the time and thoughtful work invested by the Comptroller's office in preparing the Proposed Rule. We also appreciate the efforts of the Comptroller to survey existing authority and update existing Rules, particularly as needed to reflect statutory changes. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Comptroller personnel in this endeavor.

II. COMMENTS REGARDING PROPOSED RULE

A. Taxable entities primarily engaged in retail or wholesale trade

Pursuant to Tex. Tax Code Ann. § 171.002 (West 2016),[1] the Texas franchise tax is imposed at a current rate of 0.75 percent on most taxable entities.[2] However, the tax is imposed at a rate of 0.375 percent on certain taxable entities "primarily engaged in retail or wholesale trade."[3] A taxable entity is primarily engaged in retail or wholesale trade (a "Qualifying Entity") only if it meets certain criteria set forth in Section 171.002. One such provision, subject to certain exceptions, requires that "less than 50 percent of the [taxable entity's] total revenue from activities in retail or wholesale trade comes from the sale of products it produces or products produced by an entity that is part of an affiliated group to which the taxable entity also belongs" (the "50% Test").[4]

Section 171.002 does not define the terms "products" or "produce." In 2007, soon after enactment of the current form of the franchise tax, the Comptroller promulgated 34 Tex. Admin. Code § 3.584, "Margin: Reports and Payments" (as in effect since adoption, "Rule 3.584"). Rule 3.584 addressed, among other issues, the application of the franchise tax to Qualifying Entities.[5] As initially promulgated, Rule 3.584 did not include any greater detail relating to the meaning of the terms "products" or "produce."[6] In 2009, the Comptroller proposed and adopted an amendment to Rule 3.584 to add clarifying language providing that "[a] product is not considered to be produced if modifications made to the acquired product do not increase its sales price by more than 10%" (the "10% Test").[7]

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[1] Unless otherwise provided, all references to the "Section" relate to Tex. Tax Code Ann. (West 2016) and all references to "Rule" refer to 34 Tex. Admin. Code.

[2] Tex. Tax Code Ann. § 171.002(a) (West 2016).

[3] Tex. Tax Code Ann. § 171.002(b) (West 2016).

[4] Tex. Tax Code Ann. § 171.002(c)(2) (West 2016).

[5] 34 Tex. Admin. Code § 3.584 (adopted to be effective January 1, 2008, 32 Tex. Reg. 10022).

[6] 34 Tex. Admin. Code § 3.584 (adopted to be effective January 1, 2008, 32 Tex. Reg. 10022).

[7] 34 Tex. Admin. Code § 3.584 (amended to be effective December 31, 2009, 34 Tex. Reg. 9469).

With respect to the 50% Test, the Proposed Rule would introduce into Rule 3.584 language providing that:

> (i) A taxable entity produces the product that it sells if the taxable entity acquires the product and makes modifications to the product that increase the sales price of the product by more than 10%.
>
> (ii) A taxable entity produces the product that it sells if the taxable entity manufactures, develops, or creates tangible personal property that is incorporated into, installed in, or becomes a component part of the product that it sells. For example:
>
> I. A taxable entity produces an electronic device that it sells when the taxable entity produces a computer program, such as an application or operating system, that is installed in the device, even if the device is manufactured by an unrelated party.
>
> II. A taxable entity produces a drug that it sells when the taxable entity produces the active ingredient in the drug, even if the drug is manufactured by an unrelated party.
>
> (iii) A taxable entity does not produce a product that it sells if the product is manufactured by an unrelated party to the taxable entity's specifications.[8]

The preamble to the Proposed Rule acknowledges that the cited language makes "changes" from the current version of Rule 3.584.[9] The preamble also provides that cited subsections (ii) and (iii) "are added to memorialize comptroller policy from STAR Accession No. 201508350L."[10]

STAR Accession No. 201508350L is a memorandum from the Comptroller's Tax Policy Division to the Comptroller's Audit Division (the "Memorandum").[11] The Memorandum relates to the 50% Test and the underlying 10% Test.[12] The Memorandum correctly cites the language of the 10% Test as set forth in the current version of Rule 3.584: "[a] product is not considered to be

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8 34 Tex. Admin. Code § 3.584(b)(2)(C) (proposed May 20, 2016, 41 Tex. Reg. 3620).

9 41 Tex. Reg. 3618.

10 41 Tex. Reg. 3618.

11 STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html.

12 STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html.

produced if modifications made to the acquired product do not increase its sales price by more than 10%."[13]

However, some of the language relating to the revised 10% Test that the Proposed Rule would introduce into Rule 3.584 (quoted above) appears to be based on a portion of the Memorandum that provides:

> A taxable entity *will be considered the producer of the products it sells* if the taxable entity performs any part of the manufacturing or assembly of the product, produces a component part of the product, or *makes modifications to an acquired product that increases the sales price by more than 10%*.[14]

This description in the Memorandum of the 10% Test, as a threshold inquiry underlying the 50% Test, represents a substantive difference from the language of the 10% Test set forth in current Rule 3.584. We respectfully suggest that the Comptroller should maintain the current nature of the 10% Test, which has for six years been a *de minimis* safe harbor that excludes, rather than a bright-line test that positively includes, certain products as "produced" by taxpayers. We also note that the Proposed Rule appears to distinguish between taxpayers making modifications to products and taxpayers supplying components or ingredients that are ultimately incorporated into a finished product. Under the current language of the Proposed Rule, the revised 10% Test apparently would apply to the former but not to the latter.[15] If that is indeed the intent of the Proposed Rule, we respectfully suggest that the distinction appears to be arbitrary.

Since its amendment in the 2006 legislative session as part of the legislature's adoption of the current form of the Texas franchise tax, Section 171.002 has been amended numerous times. However, the "production" criterion appearing in subsection (c)(2) has remained unchanged since the initial adoption of that statutory provision.[16] We are not aware of any legislative history either during the initial adoption of Section 171.002 or in the legislative sessions during which it has been amended indicating that the legislature has ever accepted the formulation of the 10% Test set forth in the Memorandum or in the Proposed Amendments.[17]

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[13] STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html (*citing* 34 Tex. Admin. Code § 3.584 (amended to be effective December 31, 2009, 34 Tex. Reg. 9469)).

[14] STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html (emphases added).

[15] Compare 34 Tex. Admin. Code § 3.584(b)(2)(C)(i), (ii) (proposed May 20, 2016, 41 Tex. Reg. 3620).

[16] *See* Tex. Tax Code Ann. § 171.002 (*amended by:* Acts 2007, 80th Leg., R.S., Ch. 1282 (H.B. 3928), Sec. 7, eff. January 1, 2008; Acts 2009, 81st Leg., R.S., Ch. 286 (H.B. 4765), Sec. 1(a), eff. January 1, 2010; Acts 2009, 81st Leg., R.S., Ch. 286 (H.B. 4765), Sec. 2(a), eff. January 1, 2012; Acts 2013, 83rd Leg., R.S., Ch. 1232 (H.B. 500), Sec. 17, eff. January 1, 2014; *and* Acts 2015, 84th Leg., R.S., Ch. 449 (H.B. 32), Sec. 2, eff. January 1, 2016).

[17] Indeed, we are aware of no legislative history indicating that the legislature intended any form of the 10% Test, but for purposes of this discussion, we assume that the legislature has been aware of and acquiesced to the form of the 10% Test currently appearing in Rule 3.584.

The current language of Rule 3.584 appears to operate as a *de minimis* safe harbor, clarifying that taxpayers will not be considered producers of products they sell in instances described by the provision.

If adopted, however, the Proposed Amendments would convert the operative language of the current version of Rule 3.584 from a protective measure to a bright-line determination that a taxpayer is automatically a "producer" of any products for which the taxpayer's modifications increase the sales price by more than 10%. This could cause the taxpayer to fail the 50% Test and therefore not be a Qualifying Entity. Accordingly, we respectfully suggest that the best course of action would be for the Comptroller to retain the current formulation of the 10% Test. If the Comptroller decides to adopt the formulation of the 10% Test in the Proposed Rule, however, we respectfully suggest that the revised 10% Test should apply equally to taxpayers making modifications and taxpayers supplying components or ingredients.

As currently drafted, the Proposed Rule arguably makes taxpayers supplying components or ingredients unable to rely on the provisions of the 10% Test with any degree of certainty. If that is the intent of the Proposed Rule, it may be viewed as inconsistent with and ultimately be considered to exceed statutory authority. Indeed, the distinction between taxpayers making modifications to products and taxpayers supplying components or ingredients to other entities is apparently also inconsistent with certain language in the Memorandum, which provides that:

> Further, the taxable entity's eligibility for the reduced tax rate *is not affected by factors such as supplying materials* or detailed specifications, retaining project oversight during manufacturing, holding the product patent(s) or copyrights; or using a manufacturing NAICS or SIC code on its federal tax return or SEC filings.[18]

If the Comptroller nevertheless believes that such changes are warranted, we respectfully suggest that it would be more appropriate for the legislature to consider and enact such changes as opposed to the Comptroller doing so through the rule-making process.

From a practical perspective, the changes to the 10% Test articulated in the Proposed Amendments create a significant evidentiary burden for taxpayers. It may be possible to show on audit the price for which a product was purchased for resale and the ultimate price of such resale to a consumer. However, it is not clear whether "modifications to the product [or components or ingredients] . . . increase its sales price" by the entire difference between those two prices. Some portion of the increase could, for instance, merely represent taxpayer profit. This may be particularly unclear when the final product is not assembled or manufactured by the taxpayer. This is an inherent ambiguity even with the current 10% Test, but it becomes much more significant if the 10% Test changes from a *de minimis* safe harbor that excludes, rather than a bright-line test that positively includes, certain products as "produced" by taxpayers.

[18] STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html (emphasis added).

We respectfully note further that the examples set forth in subsection (b)(2)(C)(ii) are overly broad and could potentially undercut the ability of any taxpayer producing a software application ("App"), operating system ("OS") or active drug ingredient to be a Qualifying Entity, even if such a taxpayer otherwise should be considered a retailer / wholesaler rather than a producer of goods.

Vast and increasing numbers of taxpayers currently develop proprietary Apps for installation on devices otherwise produced entirely by unrelated parties. Similarly, taxpayers in the pharmaceutical space may develop active ingredients and, separately, market to consumers drugs that were otherwise produced entirely by an unrelated party. Mandating that any App or OS producer or developer of active ingredients is deemed to be the producer of all products into which its App, OS or active ingredient is incorporated, "even if [the device or the drug] is manufactured by an unrelated party," appears to be in direct conflict with the language of Section 171.002(c)(2). We suggest that Section 171.002(c)(2) requires a reasoned determination of whether each taxpayer in the chain of development and production is a "producer" for purposes of the 50% Test. Respectfully, we note that the formulation of the 10% Test articulated in the Proposed Rule could be read to contravene that apparent statutory requirement.

Finally, we respectfully note that it is not clear that the plain language of Section 171.002 would allow for a determination that there may be more than one "producer" with respect to any "product" for purposes of the 50% Test, though the 10% Test articulated in the Proposed Amendments could clearly yield such a result. We are aware of no legislative history supporting the position that the legislature intended a given product to have more than one producer in this context. To the contrary, the language of the 50% Test in the statute could reasonably be read to indicate the legislature anticipated that a product would have only one producer.[19] Even certain language in the Memorandum seems to suggest that a product would typically have only one producer:

> A taxable entity will be considered *the* producer of the products it sells if the taxable entity performs any part of the manufacturing or assembly of the product, produces a component part of the product, or makes modifications to an acquired product that increases the sales price by more than 10%.[20]

As currently drafted, the Proposed Rule could lead to a determination that multiple entities are "producers" of any given "product" if the product's value was increased as a result of such taxpayers' efforts. Indeed, it is possible that the current language of the Proposed Rule could yield audit determinations that each and every taxpayer that touches a product -- or that supplies a component or ingredient -- from the raw material phase to the final packaging phase is a "producer" of the final "product." Such a result would appear to contravene the plain language of the statute, as well as the common-sense understanding of the terms "retailer" and "wholesaler." It could

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[19] Tex. Tax Code Ann. § 171.002(c)(2) (West 2016) ("...less than 50 percent of the total revenue from activities in retail or wholesale trade comes from the sale of *products it produces or products produced by an entity* that is part of an affiliated group to which the taxable entity also belongs...") (emphasis added).

[20] STAR Accession No. 201508350L, *available at* http://aixtcp.cpa.state.tx.us/opendocs/open32/201508350l.html.

thereby unfairly and inappropriately restrict taxpayers' ability to be Qualifying Entities under the 50% Test.

B. Taxable entities providing retail or wholesale electric utilities

Section 171.002(c)(3) provides that a taxable entity is primarily engaged in retail or wholesale trade -- and therefore qualifies for the retail / wholesale franchise tax rate -- only if the taxable entity "does not provide retail or wholesale utilities."[21] House Bill 500, adopted during the 2013 regular legislative session, amended Section 171.1014 (Combined Reporting; Affiliated Group Engaged in Unitary Business) by adding new subsection (j), which provides:

> Notwithstanding any other provision of this section, a taxable entity that provides retail or wholesale electric utilities may not be included as a member of a combined group that includes one or more taxable entities that do not provide retail or wholesale electric utilities if that combined group in the absence of this subsection:
> (1) would not meet the requirements of Section 171.002(c) solely because one or more members of the combined group provide retail or wholesale electric utilities; and
> (2) would have less than five percent of the combined group's total revenue derived from providing retail or wholesale electric utilities.[22]

Although this provision is contained within the statutory section pertaining to combined reporting, it impacts the determination of whether certain taxable entities will qualify for the retail / wholesale franchise tax rate. If the Comptroller already intends to update Rule 3.590 to incorporate the language of Section 171.1014(j), we would certainly encourage such an amendment. We would also suggest that adding within Rule 3.584 a cross-reference to Rule 3.590 would provide a valuable road map for taxable entities whose affiliates may provide retail or wholesale electric utilities. To the extent the Comptroller does not plan to make such a change to Rule 3.590, we respectfully suggest introducing to Rule 3.584 language tracking Section 171.1014(j) so that taxpayers that may potentially be affected by the operation of that provision will have adequate notice of its language.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these Comments provide relevant analysis for your review. Thank you for your consideration.

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[21] Tex. Tax Code Ann. § 171.002(c)(3) (West 2016).

[22] Tex. Tax Code Ann. § 171.1014(j) (West 2016) (*amended by* Acts 2013, 83rd Leg., R.S., Ch. 1232 (H.B. 500), Sec. 11, eff. January 1, 2014).

TAX SECTION
State Bar of Texas

June 17, 2016

Via Federal eRulemaking Portal at www.regulations.gov

CC:PA:LPD:PR (REG-127923-15)
Internal Revenue Service
Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: **Comments on Proposed Regulations Regarding Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent**

Dear Ladies and Gentlemen:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice of Proposed Rulemaking (REG-127923-15) issued on March 4, 2016 (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding the requirement that a recipient's basis in certain property acquired from a decedent be consistent with the value of the property as finally determined for Federal estate tax purposes.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

COMMENTS ON PROPOSED REGULATIONS REGARDING CONSISTENT BASIS REPORTING BETWEEN ESTATE AND PERSON ACQUIRING PROPERTY FROM DECEDENT

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these Comments were Lora G. Davis, a Council Member, and Celeste C. Lawton, Chair of the Estate and Gift Tax Committee, of the Tax Section of the State Bar of Texas. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Robert D. Probasco, Co-Chair of COGS, reviewed these Comments. Laurel Stephenson, Vice-Chair of the Estate and Gift Tax Committee, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Persons:

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Date: June 17, 2016

I. INTRODUCTION

These Comments are in response to the Proposed Regulations regarding the requirement that a recipient's basis in certain property acquired from a decedent be consistent with the value of the property as finally determined for Federal estate tax purposes, which were issued by Treasury and the IRS on March 2, 2016.

We recognize and appreciate the time and thoughtful work invested by Treasury and the IRS in preparing the Proposed Regulations and the accompanying explanatory preamble to the Proposed Regulations. These efforts are extremely useful to taxpayers and practitioners. It is our intent to present items for consideration that may help and support Treasury and the IRS in this endeavor.

II. COMMENTS REGARDING PROPOSED REGULATIONS UNDER SECTION 6035

A. Alternate Method for Reporting Assets not yet Acquired by a Beneficiary by the Due Date of Schedule A of Form 8971

Section 6035(a)(1) requires an executor of an estate that is required to file an estate tax return to provide the IRS and each beneficiary "acquiring any interest" in the property included on the estate tax return a statement, on Schedule A to Form 8971, identifying the value of the "interest in such property." The due date for providing this information is generally 30 days after the due date of the estate tax return.

The nature of assets in the larger estates that will be subject to this filing requirement are often complicated in nature and the distribution of assets, or even the decisions regarding the division of those assets among multiple beneficiaries of an estate, is not often accomplished prior to the deadline for Schedule A. A beneficiary cannot have a basis consistency reporting requirement with respect to assets he or she has not yet received from an estate. The IRS has acknowledged that determining which assets to report on Schedule A by the due date may be challenging. Accordingly, Proposed Regulation § 1.6035-1(c)(3) provides that if an executor has not determined which assets a beneficiary will receive by the due date, the executor must list on the beneficiary's Schedule A all items of property "that the executor could use to satisfy that beneficiary's interest."

We commend the IRS on their creative approach to finding a solution that will both meet the statutory requirements and accomplish the goal of providing information relating to the value of property of the estate to the beneficiaries of the estate. However, we do not believe this would be the most effective approach in many cases. Accordingly, we respectfully suggest that the IRS consider allowing an alternate method. Under this alternate method, to the extent that assets have not yet been distributed to a beneficiary by the filing due date, the executor would file Schedule A when due, reporting only a dollar amount equal to the value of the beneficiary's share of estate assets not yet distributed, but without identification of specific assets. When the distributions of assets from the estate are later made, the executor would then file a supplemental Schedule A to report any assets that were actually distributed to each beneficiary that are subject to the basis consistency rules. In complex estates, this approach would reduce the compliance burden on the executor, reduce potential fiduciary risk to the executor, and reduce or eliminate confusion for beneficiaries who would otherwise receive information that is not needed or relevant at the time. The supplemental Schedule A later filed by the executor will result in the accurate information being provided to both the IRS and the beneficiary at a time when it will be needed, without creating unnecessary confusion.

We understand that some executors may be able to easily comply with the rule in the Proposed Regulations. Under that rule, no supplemental Schedule A would need to be prepared, as long as the initial Schedule A included the value information on each asset the beneficiary later received. For those estates that can easily comply with this requirement, this alternative should reduce the compliance burden on the executor and the beneficiaries, while providing the necessary information to the IRS in an efficient manner. Accordingly, we respectfully request that the IRS offer both alternatives – the reporting method in the Proposed Regulations and the alternate method suggested above – as options for reporting on Schedule A.

B. Extension of Time to File Form 8971 and Furnish Schedule(s) A

Proposed Regulation § 1.6035-1(d) generally requires that the executor file Form 8971 and Schedule(s) A with the IRS and furnish Schedule A to each beneficiary of the estate within 30 days after the estate tax return is due. Pursuant to section 6081, the IRS has authority to grant a reasonable extension of time for filing any return, statement or other document required under the Code or regulations thereunder. We respectfully suggest that the IRS consider permitting the executor to request an automatic extension of time to file with the IRS and furnish the Schedule(s) A to the beneficiaries of an estate. An automatic extension of six months would, for most estates, allow the executor sufficient time to accurately determine the assets that will be required to be reported on the return and the schedules. This would, in turn, reduce the overall burden on executors and the beneficiaries of the estate by reducing the need for supplemental filings to correct errors and would result in lower processing costs and increased efficiency for the IRS.

C. Excepted Property to Include Cash Equivalents

Proposed Regulation § 1.6035-1(b) provides exceptions with respect to property that is subject to the reporting requirements under Section 6035. Specifically, pursuant to Proposed Regulations § 1.6035-1(b)(1)(i), cash does not have to be reported on Form 8971 and Schedule(s) A. We respectfully suggest that Proposed Regulation § 1.6035-1(b)(1)(i) be expanded to include cash equivalents, including, but not limited to, money market funds and certificates of deposit.

III. CONCLUSION

We greatly appreciate the opportunity to work with your office on these significant tax issues and hope these comments provide relevant analysis for your review. Thank you for your consideration.

TAX SECTION
OF
THE STATE BAR OF TEXAS

2015 – 2016 CALENDAR

June 2015	
10 - 12	**Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
18	**2015 – 2016 Tax Section Council Planning Retreat** Grand Hyatt San Antonio San Antonio, TX 1:00pm – 4:00pm
18	**2015 Tax Section Annual Meting Speaker's Dinner** Biga on the Banks San Antonio, TX
19	**2015 Tax Section Annual Meeting Program** Henry B. Gonzales Convention Center San Antonio, TX 8:00 am – 4:40 pm
22	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
23	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
July 2015	
16 - 18	**Texas Bar College** Summer School Galveston, TX
24 - 25	**SBOT Bar Leaders Conference** Westin Galleria Houston, TX
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL
August 2015	
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL

7	**SBOT Chair and Treasurer Training** Texas Law Center Austin, TX 10:30am – 2:30pm
17	**Tax Section Officer Planning Retreat** Houston, TX 11:45am – 3:45pm
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
September 2015	
11	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Hosted by Meadows, Collier, Reed, Cousins, Crouch & Ungerman 901 Main Street, Suite 3700 Dallas, TX 75202 214-744-3700 10:30am – 12:30pm Dial-in information will be distributed via email
17	**Deadline for Appointment of Tax Section Nominating Committee** Per Bylaws, posted to Tax Section website in June 2015
17 - 19	**ABA Tax Section Fall Meeting** Sheraton Chicago Hotel & Towers Chicago, IL
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court El Paso, TX
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
25	**UT CLE Texas Margin Tax Conference** AT&T Conference Center Austin, TX
28	**Outreach to Law Schools** Texas Tech University School of Law Lubbock, TX

28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court San Antonio, TX
28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Lubbock, TX
October 2015	
5	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
5	**State and Local Tax Committee Annual Comptroller Briefing** **Co-Sponsored with TSCPA and TEI** Austin, TX
12	**Submission Deadline - Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
15	**Outreach to Law Schools** Southern Methodist University Dedman School of Law Dallas, TX
19	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
23	**Council of Chairs Meeting** Texas Law Center Austin TX
26	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
29 - 30	**Advanced Tax Law Course** **Co-Sponsored with TexasBarCLE** Crowne Center Houston – River Oaks Houston, TX
November 2015	
12	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA** Cityplace Conference Center Dallas, TX

13	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA and Houston CPA Society** Houston CPA Society Houston, TX
13	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney Street, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm Dial-in information will be distributed via email
16	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
30	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
December 2015	
7	**Pro Bono Committee Calendar Call Assistance** United States Tax Court Houston, TX
15	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
January 2016	
8	**Nomination Period Opens for 2016 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2016 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Stephanie Schroepfer (stephanie.schroepfer@nortonrosefulbright.com)
15	**Application Deadline – Tax Section Leadership Academy**
18	**Application Period Opens For Law Student Scholarship Program**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am

22	**Meeting of Council, Committee Chairs, and Committee Vice Chairs Meeting** Hosted by Jones Day 2727 North Harwood Street Dallas, TX 75201 214-220-3939 10:30am – 12:30pm Dial-in information will be distributed via email
28 – 30	**ABA Tax Section Midyear Meeting** JW Marriott LA Live Los Angeles, CA
February 2016	
5	**Submission Deadline - Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
3 – 9	**ABA Midyear Meeting** San Diego, California
11	**Tax Law in a Day CLE** Houston, TX
16	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
26	**Council of Chairs Meeting** Texas Law Center Austin, TX
March 2016	
1	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
7	**Pro Bono Calendar Call-Dallas**
21	**Pro Bono Calendar Call-Houston** **Pro Bono Calendar Call-San Antonio**
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
24 - 25	**Leadership Academy Program (1st of 4 programs)** San Antonio, TX
April 2016	
1	**Nominating Committee's Report Due to Council** (Per Bylaws, deadline is at least 10 days before April 15, 2016 Council meeting)

8	**Law Student Scholarship Application Deadline**
15	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm
15	**Council Vote and Selection of Recipient of 2016 Outstanding Texas Tax Lawyer Award**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
22	**Submission Deadline - Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
TBD	**Property Tax Conference** Thompson Conference Center Austin TX
May 2016	
2	**Pro Bono Calendar Call-Houston**
5 – 7	**ABA Tax Section May Meeting** Grand Hyatt Washington, DC
16	**Pro Bono Calendar Call-San Antonio** **Pro Bono Calendar Call-Houston**
23	**Pro Bono Calendar Call-Dallas**
24	**Government Submissions Call (COGS)** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
June 2016	
6	**Pro Bono Calendar Call-Houston**
8 – 10	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
15 - 17	**Leadership Academy Program (2nd of 4 programs)** Fort Worth, TX
16	**2016 Tax Section Annual Meeting Speaker's Dinner** TBD
16	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner

17	**2016 Tax Section Annual Meeting Program** For Worth Omni and Convention Center Fort Worth, TX
17	**Presentation of 2016 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
TBD	**2016 – 2017 Tax Section Council Planning Retreat**
July & Aug 2016	
July 30 – Aug. 4	**ABA Annual Meeting** San Francisco CA
Sept 2016	
22 - 23	**Leadership Academy (3rd of 4 programs)** Houston, TX
TBD	**Annual Texas Comptroller's Meeting**
Oct 2016	
28-29	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting-San Francisco, CA**
Jan. 2017	
18	**Leadership Academy (4th of 4 programs)** Austin, TX

TAX SECTION
THE STATE BAR OF TEXAS

LEADERSHIP ROSTER

2015 - 2016

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