



NORTH CAROLINA
BAR ASSOCIATION
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THE WILL & THE WAY

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The Chair's Comments

In the years that I have been participating in the activities of the Estate Planning & Fiduciary Law Section, I have been constantly impressed by the truly awesome amount of time and energy that the active members of this section spend in an effort to improve the practice of this area of law and the laws under which we practice. The effect is a great benefit to clients and the public, as well as to you, the members of this section.



E. William Kratt

In this spirit, North Carolina Bar Association President Janet Ward Black has challenged the sections and their members in a far-reaching program to promote and assist Legal Aid of North Carolina, Inc. in providing legal services to the poor across the state. This program, the 4ALL Campaign, is the focus of the NCBA for this fiscal year, and was previewed in this space by Past Chair Debbie Hildebran. The four prongs of 4ALL are: Educate, Legislate, Donate and Participate. A summary is viewable from the NCBA Web site's home page.

As professionals and attorneys, you are prominent and involved in your communi-

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Circular 230: A Roadmap to Prosecution?

BY W. Y. ALEX WEBB AND RICK E. GRAVES

Webb and Graves describe their personal experience with how the intersection between tax planning and criminal prosecution by the Justice Department has evolved in recent years.

Since early 2001 when Treasury issued the first wave of modifications to Circular 230, tax professionals everywhere have been forced to focus on what the changes mean to their particular practice. This article is one practitioner's journey through attempting to comply with what he believed were newly mandated rules while responding to a client's request for an asset protection and tax planning strategy. Who could have envisioned that the statements of an attorney assessing risk could lead to an indictment, in which the Department of Justice characterized statements in an opinion letter as being evidence of the criminal acts or criminal intentions of that attorney?

From the outset, you will quickly notice that this article is not a "scholarly" article as such is typically described. The reason for this is that most "scholarly" articles are presenting some well-researched opinion as to the potential and theoretical outcome of a particular set of facts or the impact of a particular recent court opinion. This article, however, is not supposition or theory. This article is a first-hand urgent dispatch from the battlefield, a report of what has happened, rather than what could happen. Pay attention—the battle that is causing the smoke you see over the hills is heading in your direction.

Since the spring and summer of 2002, tax professionals everywhere have been forced to focus on what the changes to Circular 230 mean to their particular practice. Like probably every other law firm and accounting firm, we started adding a boilerplate "Circular 230 disclaimer" to

every e-mail. You are familiar and probably have your own version, such as: "although this e-mail may look like tax advice upon which you can rely to avoid penalties, and although you are paying me for such tax advice, you are mistaken." However, we strongly suspect that in all the time that was spent by tax professionals debating correspondence disclaimers and the difference between principal purpose and significant purpose, never was it contemplated that what was being mandated by the Treasury Department could be used against tax professionals by the Justice Department.

Guess what? Like a sucker punch out of nowhere, the Justice Department (or at least the U.S. Attorney's office in the Western District of North Carolina) has asserted it believes that frank disclosure to clients by a tax professional about possible IRS attacks is evidence of the "criminal mind" of that tax professional and will use that "evidence" to prosecute the tax professional for conspiracy to commit tax fraud, among other crimes.

This is not theoretical. This amazing story, with a flavor of Kafka, is a sad part of recent federal criminal jurisprudence. The case was **United States of America v. Ricky Edward Graves** in the Western District of North Carolina. You will recognize the name of the defendant as that of one of the authors of this article, and it should be clarified at this point that this case went to trial on April 4, 2007, in Charlotte, and the result of that trial was a jury acquittal of Graves on both

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ties. You are aware that there are some in your community who cannot afford the services that attorneys provide, putting them at a disadvantage. The Preamble to the N.C. Rules of Professional Conduct provides, in part:

A lawyer should be mindful of deficiencies in the administration of justice and of the fact that the poor, and sometimes persons who are not poor, cannot afford adequate legal assistance. Therefore, all lawyers should devote professional time and resources and use civic influence to ensure equal access to our system of justice for all those who, because of economic or social barriers, cannot afford or secure adequate legal counsel.

...

A lawyer should render public interest legal service and provide civic leadership. A lawyer may discharge this responsibility by providing professional services at no fee or a reduced fee to persons of limited means or to public service or charitable groups or organizations, by service in activities for improving the law, society, the legal system or the legal profession, and by financial support for organizations that provide legal services to persons of limited means.

Legal Aid does important work that is deserving of the attention and support of this section. Its clients would otherwise have very limited access to legal assistance. Eighty percent of Legal Aid clients are working poor; 74 percent are women; the median income for a client household is \$9,000 and the maximum to be eligible is \$23,000. EIGHT cases with merit are turned down for each ONE that is accepted, mainly due to limited capacity.

Legal Aid does not have the funding or manpower to handle all the deserving cases and clients. In 2006, the private bar contributed over 19,000 hours to LANC clients. Yet it is estimated that eight of 10 lawyers do not contribute pro bono services. You can Participate and Donate your time by contacting your local Legal Aid office to join the rolls of those providing pro bono assistance. But what can you do if the needs of Legal Aid do not include estate planning or probate work?

I assure you that productive use will be made of any time that you are able to Donate directly. However, Legal Aid also needs funding in order to meet the needs of more of its target clients. One focus of the 4ALL campaign is to increase funding to the Legal Aid of NC Fund, established within the NCBA Foundation Endowment to provide additional funding to Legal Aid. A request to contribute to that Fund was included on this year's NCBA statement for Association and Section dues. An ambitious goal of \$1,000,000 in total contributions has been set.

As estate planning attorneys, we are in an ideal position to spread the word to our fellow attorneys about the limited opportunity to Donate tax-deferred amounts to the LANC Fund under the terms of the Pension Protection Act. The PPA permits up to \$100,000 in distributions of tax-deferred retirement funds to be excluded from taxable income if used for charitable purposes. Unless changed by Congress, the window on this opportunity will close on Dec. 31. Several of your colleagues have already taken that opening to Donate to the Fund—in at least one case, for the full \$100,000 amount. If you or an attorney you know might be interested in contributing to the LANC Fund, contact Norfleet Pruden or Tom Hull.

You each give back in your own way. Lawyers are involved in many good works, both individually and through groups, giving untold hours of benefit to your communities through the Association, the State Bar, religious and civic organizations, and elsewhere. However, the public often sees attorneys in a different light. An excellent chance to increase the visibility of the Bar's pro bono efforts will come as we approach April 4, 2008. That date, also known as "4/4 4ALL," has been designated as a statewide legal service day by the NCBA. Please look for more information on numerous events surrounding that date as it approaches.

Thank you for all the good that you do, and will do. I am honored by the opportunity to chair this section for the coming year. ■

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counts. Those counts were “Tax Conspiracy” (violation of 18 U.S.C. Sec. 371, also known as a “Klein conspiracy”) as Count One and “Obstruction of Due Administration of IRS” (violation of 26 U.S.C. Sec. 7212(a)) as Count Two.

Circular 230

As referred to in this article, Circular 230 is U.S. Treasury Department Circular 230 (Title 31, Code of Federal Regulations, Subtitle A, Part 10, revised as of June 20, 2005).

While there is debate about whether the recent changes to Circular 230 have successfully achieved some IRS purpose, there is little doubt about that IRS purpose. The IRS has directly attacked the legal tax opinion industry. Since taxpayers could avoid significant penalties if they were relying on a legal tax opinion, the production of these opinions was important to the marketers of certain tax plans and therefore very lucrative for the large law firms that produced these marketed legal tax opinions. The IRS evidently decided that a broadsword approach to a perceived crisis was preferred over a more measured solution addressed directly to actual abuses. Since the purpose of this article is not to point out the various practical absurdities of Circular 230 in its current form, we will leave the topic with that comment. Please note, while this article only addresses in detail the use of Circular 230 compliance as evidence of criminal conduct, attorney ethics rules also require similar disclosures to clients. See Ethics Exhibit, *infra*. So, every professional who has ethical requirements imposed by his or her profession should also have concerns after reading this article.

While Circular 230 in its creation and implementation by the Department of Treasury can easily be confusing, characterizing good faith efforts to comply as evidence in a criminal prosecution is nothing short of scary. The very idea that one agency of government would even attempt to prove criminal conduct by the actions of citizens when such actions were mandated by the pronouncement of another agency of government is the ultimate and most absurd “catch 22!” However, the Justice Department seems to have no problem implementing this particular absurdity.

Let us start with Circular 230 Section 10.34 and the standard required when a tax practitioner signs a tax return. Section 10.34 not only covers required disclosures to clients that are relevant to the main topic of this article, it also, when compared with the public hoopla about the strict

requirements for tax opinions, reminds us of the relatively low standard for positions actually taken on tax returns filed with the IRS. Section 10.34(b) states that, “A practitioner may not sign a tax return as a preparer if the practitioner determines that the tax return contains a position that does not have a realistic possibility of being sustained on its merits (the realistic possibility standard) unless the position is not frivolous and is adequately disclosed to the Internal Revenue Service.” This realistic possibility standard is defined in Section 10.34(d)(1) as follows: “[A] position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well informed analysis of the law and the facts by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately a one in three, or greater, likelihood of being sustained on its merits.” So, as a reminder to those practitioners who have only been focusing on the rules regarding tax opinions in Section 10.35(b), if a tax return position has only a 33.34 percent chance of being sustained, taking such a position is not only allowed by Circular 230, but also disclosure of the very fact that position is being taken is not required. This means that a tax practitioner violates no part of Circular 230 by signing a tax return even though the practitioner firmly believes the position has a 66.66 percent chance of going up in flames like a paper airplane in a California wildfire. We thought it important to point out this very manageable standard for actually filing a tax return before we delve into a summary of all of the bad things a practitioner must tell clients if the practitioner is going to also write an opinion about that tax return position that has a 66.66 percent chance of becoming a flaming specter in the sky.

Back on point, even if a practitioner believes there is a realistic possibility of success, Section 10.34(b) requires that “[A] practitioner advising a client to take a position on a tax return, or preparing or signing a tax return as a preparer, must inform the client of the penalties reasonably likely to apply to the client with respect to the position advised, prepared, or reported.”

Now we move to the famous Cir. Section 10.35 and its “Requirements for covered opinions.” Since it is not the purpose of this article to parse the words of Circular 230, indulge the following summarization of the definition of a covered opinion set out in Section 10.35(a)(2): A covered opinion is advice written in any form concerning Federal tax issues arising from (1) transactions similar to a “listed” transaction, (2) any tax plan the *principal purpose* of which is the

avoidance or evasion of any tax, or (3) any tax plan a *significant purpose* of which is the avoidance or evasion of any tax, *if* the written advice is a reliance opinion, a marketed opinion, is subject to conditions of confidentiality, or is subject to contractual protection.

Once again, to avoid extended discussion regarding the scope of “principal purpose” and “significant purpose,” for the purposes of this article we will make the wild assumption that the tax plans advised on, or implemented by, tax practitioners will have tax avoidance as either a principal or significant purpose. We will further assume that this type of covered opinion is a reliance opinion as described in Section 10.35(b)(4) because the tax practitioner has concluded in writing that the tax plan is more likely than not to have a greater than 50/50 chance of success in a fight with the IRS. These are the assumptions made here, not only because this is the position in which many tax practitioners likely find themselves on a regular basis, but also this is the probable determination of the Office of Professional Practice regarding the applicable sections of Circular 230 to the communications of Graves to the undercover IRS agent that he thought was his client.

That being the case, if a communication is a covered reliance opinion, then Section 10.35(c) requires that the opinion cover “factual matters” (Section 10.35(c)(1)), “relate law to facts” (Section 10.35(c)(2)), and consider all “significant Federal tax issues” (Section 10.35(c)(3)). In pertinent part Section 10.35(b)(3) states that “[F]or purposes of this subpart, a *Federal tax issue* is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.” Then, Section 10.35(c)(3)(ii) requires that “[T]he opinion must provide the practitioner’s conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion.”

One does not have to get all that technical or even join the philosophical debate about the fine points of Circular 230 to come to an unavoidable conclusion. That is, whatever Circular 230 does not mean, it most certainly does mean that advising clients of possible IRS challenges is required, so long as a tax professional wishes to continue to practice before the IRS. This is the case even if the

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tax practitioner believes such a challenge by the IRS would be unsuccessful. In other words, full and candid appraisal of success or failure in an IRS challenge is a required disclosure!

Circular 230 Compliance

To set the context, a short summary of the story is necessary. This summary is also intended to show that any practitioner can sometimes end up associated with the wrong people, even when precautions are taken and reasonable due diligence is done. The law firm of Webb & Graves is small tax and estate planning firm in southeastern North Carolina. As a law firm we would describe ourselves as tax generalists; that is, we are not specialists in a given area such as employee benefits, exempt entities, or mergers and acquisitions. We advise our clients on a wide variety of tax issues.

In the winter of 2001-02 our asset protection practice was starting to expand into possible “off-shore” asset protection, and with that we also started to see that there were legitimate international tax planning opportunities. We read what we could and started inquiring into international planning opportunities and looking for quality people who knew what they were doing. In the spring of 2002 we thought we had found what we were looking for when we met a man named Howell Woltz. Woltz came to us through a financial advisor with whom we had mutual clients. He was from a wealthy and well-respected western North Carolina family. Woltz owned a financial services company in the Bahamas and an international trust company. We met with Woltz a couple of times, and he presented the services he could provide our clients. Among these services were investments, asset protection, and tax planning through a dual trust structure. We paid to attend an educational seminar in Nassau where we were introduced to Samuel Currin. Currin had a long and distinguished resume and was well-connected in both the political and legal arenas. He had served as the U.S. Attorney in the Eastern District of North Carolina, a state judge in North Carolina, and the chair of the North Carolina Republican Party. At that time, fall of 2002, Currin was in private practice. Currin vouched for Woltz’s business practices and reputation. Currin also vouched for another attorney he introduced as an expert in the legal subject matter and a former personal attorney of President Ronald Reagan. Woltz described the gentleman as the “architect” of the dual trust strategy.

After this seminar we did some additional research, including inquiries to the presenter. The dual trust was a tax plan that relied to a large

extent on the willingness of a client to give up real ownership and control of an asset or income-producing opportunity. We realized this was a drastic step but determined that if the client would give up this ownership and control, then the dual trust strategy was defensible. Having come to this conclusion and having a client that was interested in pursuing this strategy, we drafted an extensive analysis letter for that client. This client pursued the dual trust strategy involving purchasing warranties in early 2003.

A couple of months later, in the summer of 2003, Graves was approached by an undercover IRS agent posing as a financial advisor named “Jack Smits” who was interested in learning about the dual trust structure. After several lengthy telephone conversations with “Smits,” Graves met with another IRS undercover agent posing as a client from Chicago named “John Stone.” In that meeting Graves presented several tax planning strategies (as ethically required, see Ethics Exhibit, *infra*), including the dual trust to “Stone.” “Stone” expressed interest in pursuing the dual trust strategy, so Graves sent him the analysis letter we had developed for the dual trust, customized for “Stone’s” particular facts. This letter provided a description of the planning strategy in detail, but for the sake of brevity we will only quote the portions of the letter that are most relevant to the central theme of this article. The letter concludes:

In simple language, under this arrangement (on its face) you are not the grantor of the distributing trust and do not have any of the ownership/control of the trust that owns the IBC as described in Internal Revenue Code (the Code) §671-§678 that would make the income taxable to you as from a grantor trust under Code §679.

If tax law were that simple, then everyone would be doing this. In this planning you are leaving the area of tax law that could be described as “specifically permitted” and are entering into the area of “not specifically prohibited.” As you might expect, the government has tried to cover this area of opportunity with various Code Sections, primarily §643. The group that I deal with seems to have skillfully maneuvered around the exact words of this Code Section and its regulations, but it is fairly clear that the intent of §643 is to prohibit exactly what you are contemplating. Once again, “not specifically prohibited” rather than

“specifically permitted.”

The letter to the undercover IRS agent then moved to the risks of the transaction. The first of these risks was a non-tax risk of the client actually not having ownership and control of assets. The second risk was the “IRS risk” and was described as follows:

The second risk is the IRS. Even if the letter of the law is followed, the IRS can always attack any transaction even if they are ultimately unsuccessful. With the current focus on foreign trust schemes this transaction would likely get more attention than usual if they ever find out about it. Given the current political climate the IRS is under a great deal of pressure to deal with “abusive” foreign trusts.

The first IRS risk is that the IRS will interpret the Code differently than we have. This is always a risk and can only be avoided by staying in the tax world of the “specifically permitted.”

The next IRS risk is that the IRS will use one of several broad-sweeping doctrines to collapse the transaction. These doctrines are very similar and are the step/sham transaction and “substance over form” doctrines. “Under the step transaction doctrine the tax consequences of an interrelated series of transactions are not to be determined by viewing each of them in isolation but by considering them together as component parts of an overall plan.” (See *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234, 1244 [51 AFTR2d 83-1183] (5th Cir., 1983 quoting *Crenshaw v. United States*, 450 F.2d 472, 475 [28 AFTR2d 71-5846] (5th Cir., 1971). The substance over form doctrine is similar. “In determining the incidence of taxation, we must look through form and search out the substance of a transaction ... [cases cited]. This basic concept of tax law is particularly pertinent to cases involving a series of transactions designed and executed as parts of a unitary plan to achieve an intended result. Such plans will be viewed as a whole regardless of whether the effect of so doing is imposition of or relief from taxation. The series of closely related steps in such a plan are merely the means by which to carry out the plan and will not be separated.” (*Kanawha Gas &*

Utilities Co. v. Commissioner, 5 Cir. 1954, 214 F.2d 685, 691 [45 AFTR 1805]).

This risk was further summarized in the next paragraph in the following manner: “[T]he risk is this—this transaction is so inter-dependent upon the order and timing of transaction[s] and the existence of the other trusts and companies in their intended form, if only one step is collapsed or disregarded in its form, then the whole transaction could collapse.” This letter did not predict a result if the facts were litigated and described this uncertainty with specificity:

I cannot hazard a guess as to what the result would be if the IRS attempted to apply these doctrines here. This offshore group has represented to me that this has never happened. In addition, I could not find a single case that applied the step transaction or substance over form doctrines to §643 and distributions from foreign trusts. Other than the broad-sweep doctrines described above, there simply is not case law that I could find that agrees or disagrees with the application of the law as I have explained it.

In addition, this letter covered the risk of the law changing and clearly prohibiting the dual trust plan, and warned that:

[P]ublicity has killed more than one legal transaction. Particularly in the tax field, if there is a “loophole” and too many people talk about it, then the law gets changed and the “loophole” gets closed. There is nothing more politically unattractive than a “rich” person not paying their “fair share.” Code §643 that currently does not specifically prohibit this transaction in its plain language could very easily prohibit this transaction by the end of the current session of Congress.

Then, in a final summary meant to leave the client with no illusions of certainty, the letter concluded that:

Assuming the worst case and this whole transaction is collapsed, what could happen? If the transaction is collapsed then all the profit of the IBC could be taxed to you. There would be failure to pay penalties (based on interest for the time it was not paid) and there could be some other penalties (including a 50 per-

cent civil fraud penalty). This letter and the legal opinion of the group’s counsel (which we are also relying on to some degree and which will be provided to you if you wish to move forward from here) should help you achieve the standard of a “more likely than not” chance of success. If that standard is met, then the taxpayer can avoid certain penalties if the IRS audits and decides that the transaction should be taxed differently. Also, it is theoretically possible that the IRS try to pursue this criminally. While I am not a criminal lawyer, tax fraud requires a certain degree of specific intent and I do not see where carrying out an arrangement that is not specifically prohibited can be a criminal act. However, if this concerns you, and since I cannot give a legal opinion as to the likelihood of criminal charges, then you may want to consult a criminal tax attorney.

Client “Stone” then dropped out of communication until the fall of 2004 when he reappeared and wished to travel to the Bahamas to meet Woltz and Currin. At that meeting, Graves began to suspect that “Stone” was not fully grasping the risks involved and sent a “risk refresher” to “Stone.” This letter quoted the ultimate conclusion of the initial letter that addressed the worst case scenario and further emphasized these risks:

These words were not empty “legalese” designed to disguise the facts. This was my legal analysis. That analysis was intended to fully inform you of the risks of undertaking planning that was based on the law but theoretical and untested. In theory, if you choose to make a bad business deal with an entity you do not own or legally control, then there should be no tax consequences. However, the counter-theory is that you would not make a bad business deal unless you had a reasonable expectation of making it up later. This second theory is the theory that would be argued to apply the “step transaction” or “substance over form” doctrines to collapse this transaction.

And yes, this letter is designed to scare you if you are inclined to being scared. You will recall that I proposed other planning possibilities that were more in the realm of “specifically permitted.” If you want to me refresh you with those options, then please do not hesitate to call me.

As you might suspect, Graves’ warnings of uncertainty, in writing and verbally, did not deter the undercover IRS agent, and the IRS agent went forward with the dual trust planning.

Circular 230 Compliance Equals Criminal Mind—Justice Department Absurdity (and Scary Reality)

Now, let us fast forward to April 18, 2006, when the IRS entered both our Wilmington and Aberdeen, N.C., offices with bulletproof vests, guns, and search warrants. Graves was arrested and taken in handcuffs to Raleigh. At the initial appearance where he was released on a signature bond, Graves was finally able to see the sealed indictment that had been handed down by a secret grand jury two weeks earlier. The complete filed documents of this entire case (beginning with the Indictment on April 4, 2006) can be viewed at www.pacer.psc.uscourts.gov. You will need to have an account with Pacer set up, but assuming you do have an account, or sign up for one, the Case Number is 3:06CR74. In our discussion of the documents constituting the case file, we will refer to them by their unique Pacer number (with further reference to paragraph or page numbers as needed for precision).

Looking at this indictment, it was immediately clear that the Department of Justice was characterizing the statements of an attorney assessing risk as being evidence of the criminal acts or criminal intentions of that attorney. Lest you suspect there is any exaggeration or that literary freedoms are being taken, let us go to the indictment. The Indictment (Pacer document #3), Para. 53, D, partially quotes the October 2003 letter by Graves to “Stone” stating that “it is fairly clear that the intent of Sec. 643 is to prohibit what you are contemplating.” This statement of an attorney in the letter explaining that Congress probably had attempted to prohibit certain planning but had left a loophole was now an “overt act” “...by which the conspiracy was carried out...” What was written as candid analysis for the client, the kind of candid analysis that Cir.230 mandates, was presented to a secret grand jury as evidence that Graves conspired to commit tax fraud. This quote about the intent of Section 643 would be a common theme throughout this case. This short statement, clearly intended to apprise the client of how close to the line this planning might be, was now a ready and oft-used quote for the prosecutor whenever he thought he needed “clear proof” that

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a crime had been committed.

Again looking to the indictment, Para. 53, U of the indictment identifies that Graves sent the “risk refresher” letter to the IRS undercover in October 2004. Once again, this letter, prepared by an attorney, advising a client about a “worst case scenario” had been presented to lay people in a secret grand jury as an overt act “in furtherance of the conspiracy, and to accomplish the objects thereof ...” This risk refresher letter would come up again at trial where it was presented to the jury as evidence of Graves’ criminal mind.

If this tortured use of an attorney’s written communication was, at best, surreal, it was only going to get worse. After being released, Graves immediately hired a defense attorney and traveled to Charlotte, to meet with Assistant U.S. Attorney who had brought the case to the secret grand jury. As still a newcomer to the federal criminal justice system, Graves still believed that if the AUSA saw that he was mistaken, then the charges would be dropped. Little did we know that the AUSA had already made his determination of guilt and was only interested in evidence that supported this conclusion. The initial meeting was a scary glimpse into the mind of a federal prosecutor with no grasp or appreciation (or interest in grasping or appreciating) (1) the difference between a disagreement regarding interpretation of the tax law between an attorney and the IRS and committing a crime or (2) between a civil and a criminal “violation” of the tax law. Once again, in case you are thinking that there is embellishment of any sort, for the following quotes from the AUSA, we are referring back to the notes Graves made immediately after the meeting on April 25, 2006—notes that were taken in detail because Graves wanted to have clear recollection of the some of the ridiculous statements made by the federal prosecutor, statements that would have been comical if they were not being spoken by a man with the power to cause us near economic ruin in defense of practicing tax law.

In particular (referring back to the statement in the analysis letter referring to Code Sec. 643), the AUSA stated, “If you had any question about whether it was legal, then you should have asked the IRS.” Yes, he said it! Read that again, and contemplate the potential consequences of a man tasked with deciding when crimes are committed actually believing that the IRS is the final arbiter of what is legal or illegal. The AUSA also stated in so many words that if Graves thought that a particular tax plan would be collapsed by the sham or step-transaction doctrines if challenged, and he told the client that, then that meant Graves knew

that if the client implemented the plan, it would be a crime. So much for only a 33.34 percent (i.e., Might succeed [one in three chance], but less than probable [a 51 percent chance]) chance of success that is acceptable under Circular 230 Section 10.34! The AUSA also told Graves that since he told the client in the letter that this was a “grey area,” he knew it was a crime. The same goes for an oral statement that the client was on “pretty thin ice.”

Needless to say, that first meeting did nothing to assure us that this prosecutor in the Western District of North Carolina was in any way interested in actual innocence or learning about the interpretation and application of tax law. Just for good measure, one of the best quotes of the day, although it really is not a Circular 230 point, came when Graves was attempting to explain that a big part of tax planning was changing how the facts occurred to avoid the application of certain tax laws and to achieve a particular tax result. Graves used an example of John Porter speaking at the Heckerling Institute in Miami in January 2006 on how to avoid the application of Code Section 2036 to FLPs while assisting your clients in maintaining control over assets that are not included in their taxable estates. In response, the AUSA Martens said that if this speaker was telling an audience how to avoid a certain code, then this seminar speaker committed a crime! I think Porter would be very surprised to learn that federal prosecutor Martens believes he is a felon and that many of his speaking engagements constitute criminal activity. It is this mixture of arrogance and ignorance that made it difficult to have rational communication with the U.S. Attorney’s office.

Through the various motions to dismiss and the government’s responses in August and September of 2006, the government focused primarily on oral statements of Graves, but the quotes in the indictment were repeated. Once again, in the interest of article size, we will not address the many instances where Graves’ spoken analysis to the undercover “client” was characterized as knowledge by Graves that the tax plan was illegal.

It was not until the prosecutor filed his trial brief (Pacer document #186), less than two weeks before trial, that it became clear that Graves’ trial was not going to be about tax law at all, but whether he knew about the criminal activity of Currin and Woltz, who had plead guilty since the indictment, nearly a year earlier. From the discovery that was received since the indictment, it was fairly clear that while Woltz and Currin may not

have planned from the beginning to operate the dual trust as a sham, probably by the fall of 2004, and certainly by early 2005, they were not operating the tax structure in the form it was explained to the participants at the seminar Graves attended in 2002 (nor as relied upon by us). While this was fairly clear, the problem with the government’s trial strategy was that evidence Graves knew of the illegal actions of Currin and Woltz was nearly non-existent, and the “evidence” that did exist was the result of twisting existing evidence to meet this new trial theory. For example, in the first analysis letter to “Stone,” Graves used an example of obvious illegal use of debit cards as a contrast to legal tax planning. Graves stated, “[T]here are many illegal tax schemes being peddled in the US. Most of these schemes involve moving money and business operations offshore and repatriating the asset with debit cards or simply not paying US income tax and counting on the fact the IRS will not find the asset.” As the AUSA was stretching and twisting everything that could be distorted for his purpose, on page 10 of the trial brief, he stated that in this quote the “Defendant discussed his own fraud even more clearly...” Incredulously, because he had no evidence that Graves knew of criminal activity, the AUSA was saying that Graves’ written example of criminal activity to his “client” was actually a confession that the planning described was tax fraud! No person with common sense and a loose grasp of the English language would have arrived at this absurd interpretation of Graves’ letter.

Unfortunately, this mis-characterization of Graves’ frank and candid communication (of the type encouraged and demanded by Circular 230 and attorney ethics rules) with an undercover IRS agent posing as a client only became worse at the trial.

It seemed the AUSA’s updated trial plan was to more or less forget about seriously arguing tax law and whether the structure was “legal” and instead focus primarily on whether Graves knew about the criminal activity of others, the government’s case mainly consisted of (1) playing recorded conversations Graves had with undercover agents, (2) highlighting the two letters Graves had written to undercover “Stone,” and (3) presenting evidence of the illegal activities of Graves’ alleged “co-conspirators,” Currin, Woltz, and others.

The government used Graves’ letters to his “client” in the government’s opening statement, referred to the letters in the testimony of the undercover agents “Smits” and “Stone,” and cross-examined Graves extensively with these letters. All of these uses of Graves’ letters by the pros-

ecutor was in the context of proving to the jury that Graves knew that the use of this tax plan was a crime. Once again, partly to provide context and partly to impress upon readers the very real danger that exists when prosecutors only see black and white in a tax world of gray, we wanted to give a couple specific instances from trial where the government's characterization or presentation of evidence was so shocking that our first thought was warning the tax planning community.

When undercover agent "Stone" was testifying, he stated that when he heard Graves say something was in the "gray area" that he knew there was "something criminal" going on. Of course, this is also the IRS agent, with 29 years of experience with the IRS (eight of those years in the criminal division), that testified that he did not know what an IRS Revenue Ruling was! No, we are not joking! When asked whether he could refer to any tax law at all related to this case, he said that he was not a lawyer. When asked why he did not consider one of the many other options that Graves presented to him, rather than the dual trust that he thought was illegal, he responded that "we were not looking for anything legal." When asked how in his years of criminal investigation he determined whether something was criminal, he said he looked at the facts and "wrote up a report."

The advisory and warning letters that have already been covered in this article were repeatedly used to show that when Graves (1) warned of legal uncertainty, (2) advised the client that Congress had probably tried to prohibit this planning, (3) showed that the IRS might attempt to apply certain legal doctrines, such as the step-transaction doctrine, and (4) advised that he did not think this was criminal but the client might want to consult a criminal tax attorney if concerned, Graves was intending to commit a crime. As this picture the prosecutor was painting emerged in the trial, the seeds of this article were born. In a very unmistakable manner, the type of advice, analysis, and warnings that Circular 230 mandates that tax practitioners provide with their written analysis was being systematically presented as proof that a tax practitioner knew that pursuing a particular tax planning strategy was a crime.

In what was probably the most egregious position taken by the prosecutor, the AUSA presented Graves' written and oral references to the potential applicability of the step-transaction doctrine as evidence that Graves knew of the criminality of the tax planning. Both in cross-examination and in the jury instructions, the government presented the step-transaction doctrine as a thing that the IRS could pull out of the hat at will in

order to kill a tax plan. The step-transaction doctrine was presented as a simple operation of ignoring the "paper" and looking at what "really happened." This doctrine was presented as a way of determining whether a tax plan was criminal or not, and the IRS or a prosecutor, in hindsight, are the ones who get to make this determination!

As a final example of the extent to which the government was willing to criminalize tax advice, in his closing, the AUSA turned to Shakespeare for a final argument of Graves' criminal mind. Throughout the analysis letter to the "client" and in verbal communication, Graves stated that our law firm did not get involved in anything that we thought was criminal. The prosecutor mocked Graves' words by repeating them in a high falsetto and saying "Me thinks he protests too much."

Conclusion

The government—at least in this one powerful instance with which we are frighteningly familiar—appears to have no qualms in attempting to criminalize ethically required behavior that is also mandated of tax practitioners by Circular 230. We hope this article has been a chilling introduction to the juncture of tax planning and crim-

inal prosecution by the Justice Department as it has evolved in recent years. We encourage you to be careful and circumspect while still trying to be zealous advocates (our first and highest duty to clients). It is the Justice Department's duty to enforce the law with the solemn exercise of its discretion to prosecute and, if successful, incarcerate the citizens of this country.

There are many inscriptions on the Justice Department building in Washington, D.C. Not one of these inscriptions encourages prosecutors to "win at all costs" or "indict first, investigate later." One of those inscriptions, attributed by most to Plato, says, "Justice in the life and conduct of the State is possible only as first it resides in the hearts and souls of the citizens." Federal prosecutors would do well to remember they are first citizens, though temporarily wielding the intoxicating, and often corrupting, power of the Department of Justice. When this is forgotten, what they do ceases to be justice.

Edmond Burke said, "[J]ustice is itself the great standing policy of civil society; and any eminent departure from it, under any circumstances, lies under the suspicion of being no policy at all." ■

Ethics

Among the specific ethics rules requiring Graves to act as he did are the NC Rules of Professional Conduct ("RPC"):

- RPC 1.0: TERMINOLOGY, Comment 6, "Informed Consent": "The lawyer must make reasonable efforts to ensure that the client ... possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client ... of the material advantages and disadvantages (emphasis added) of the proposed course of conduct and a discussion of the client's ... options and alternatives."
- RPC 1.1: COMPETENCE: "A lawyer shall not handle a legal matter that the lawyer knows or should know he or she is not competent to handle without associating with a lawyer who is competent to handle the matter."
- RPC 1.4: COMMUNICATION: (b): "A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."
- RPC 2.1: ADVISOR: "In representing a client, a lawyer shall exercise independent, professional judgment and render candid advice (emphasis added)."

Graves' assessment of the risk and the communication of that risk to his client is consistent with these Rules of Professional Conduct. While he was not opining specifically for the purpose of a tax return disclosure issue, Graves' conduct is also in conformity with long-standing ABA Formal Ethics Opinion 352 (1985) which states:

A lawyer may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will be no disclosure of the position in the return. However, the position to be asserted must be one which the lawyer in good faith believes in warranted in existing law or can be supported by a good faith argument for an extension, modification, or reversal of existing law. This requires that there is some 'realistic possibility' of success if the matter is litigated. In addition, in his role as advisor, the lawyer should refer to potential penalties and other legal consequences should the client take the position advised.

The essence of this "realistic possibility" standard for tax return positions is still embodied in the most recent revision of Cir. 230 §10.34 that is discussed in more detail in the body of the article.

Solving the 3-D Puzzle

Working with Retirement Benefits in Estate Planning

BY JEAN T. ADAMS

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The need to focus on income tax implications, as well as transfer tax issues and the client's personal and family considerations, creates new challenges for advisors in planning for individuals with substantial retirement benefits.

Dealing with retirement benefits¹ owned by an estate planning client is like solving a three-dimensional puzzle. Estate planners have been used to focusing on two dimensions: the client's personal and family considerations along one axis, and the transfer tax issues along another axis. When the intricate income tax implications of retirement plan distributions are thrown into the mix, the going gets very rough indeed. Trying to see through the confusion to a workable, realistic solution challenges the practitioner's skills—and sometimes the client's patience and pocketbook. This article is not intended to provide a thorough technical treatment of the rules relating to retirement plan distributions,² but instead, will focus on how the rules can best be applied in common planning situations.

In attacking the 3-D puzzle, the goal from the income tax side will generally be to keep assets inside the plan as long as possible, resulting in more net value in the hands of the participant and beneficiaries over the long run, even though the distributions will ultimately be fully subject to tax when received. In reaching this goal, however, there are several constraints:

Planning Constraints

MRD rules. The primary constraint is generally found in the minimum required distribution ("MRD") rules of Section 401(a)(9). During the participant's lifetime, distributions generally must begin no later than the required beginning date ("RBD"), defined as April 1 of the calendar year after

the year in which the participant attains age 70 1/2. After the RBD, minimum distributions are governed by the Uniform Lifetime Table, which is based on the assumption that the account must last throughout the lifetime of the participant and another (hypothetical) person 10 years younger than the participant. The Uniform Lifetime Table recalculates life expectancies annually, and so maintains a comfortable cushion against requiring that the entire account be paid out during the participant's lifetime. Nevertheless, as the participant ages, his account will obviously be depleted as ever-increasing proportions of the account must be withdrawn to comply with the MRD rules.

After the participant's death, distributions must be made in equal installments over the life expectancy of a designated beneficiary ("DB"), as determined on the date of the participant's death.³ In order to have a life expectancy at all, the DB must be an individual; an estate or a charity, for instance, can never be a DB. If a trust meets certain requirements,⁴ it is possible to "look through" a trust to its beneficiaries, treating them as the beneficiaries of the plan for purposes of determining the DB. Only beneficiaries that still have an interest in the plan account as of Sept. 30 of the year after the year in which the participant dies ("Designation Date") will "count" in determining the DB.

While it is not possible to add beneficiaries during the post-death period, it is possible to remove beneficiaries by making a complete distribution of their benefits or by disclaimer. If there is more than one individual beneficiary as of the Designation Date, the oldest will be the DB. If any one of the multiple beneficiaries is not an individual, there is no DB. Sometimes it is possible to treat the portions going to different beneficiaries as separate accounts under the plan.⁵ If separate accounts are established by the Designation Date, a separate DB for each separate account will be determined.

If a surviving spouse is the sole beneficiary of the plan, special MRD rules apply under which the spouse can defer MRDs until the

year in which the participant would have reached age 70-1/2⁶ and may recalculate her life expectancy annually.⁷ Unlike other beneficiaries, the spouse of a deceased participant may roll benefits she receives outright over to a new IRA (or treat the participant's IRA as her own). After a rollover, the spouse becomes the participant, will be subject to the lifetime MRD rules as described above, and will be in a position to name new beneficiaries.

If there is no DB, one of two rules will apply. If the participant's death occurred before his RBD, the account must be completely distributed within five years of his death. If the participant died after his RBD, the account must be distributed over the remaining single life expectancy of a person the same age as the participant as of his date of death. For a participant between ages 71 and 90, this is a more generous payout period than the five-year rule.

Other constraints. The terms of the qualified plan or IRA agreement may be more confining than required under the MRD rules. Many plans permit only distributions of a lump sum or other accelerated distribution options. A participant or a surviving spouse may roll the distribution into an IRA in his or her own name offering more extended payout options. Similarly, under the Pension Protection Act of 2006, non-spouse beneficiaries eligible to receive distributions from a decedent's retirement plan after 2006 may elect to have the funds transferred directly to an inherited IRA which allows MRDs under the rules described above.⁸ In either case, the benefit of the stretch payments must be balanced against certain benefits that may be available for qualifying lump-sum distributions ("LSDs").⁹

Under federal law, participants in many retirement plans must provide certain minimum benefits to the surviving spouse unless waived by the spouse. Even if the law would not require that 100% of the benefits pass to the spouse, many plan administrators opt to set such a requirement out of convenience. These requirements do not apply to IRAs or Roth IRAs.

Conflicting transfer tax and personal objectives

The strict requirements governing retirement plans often conflict with the client's personal need for more flexible distributions. Further, a retirement account is more unwieldy than a "normal" asset on the client's balance sheet. It is non-assignable by the participant, and often may not be accessed before retirement.

Because of its peculiar income tax characteristics, it may be seen as either more or less valuable to the participant and his beneficiaries than other assets. While offering the lure of compounding returns tax-free, it also bears the burden of a built-in tax cost when it is ultimately unwrapped and distributed, as well as the more subtle cost of complex rules that the participant and his family may not have the time, inclination, or ability to navigate properly. These considerations are difficult to evaluate, and even sophisticated financial planning software generally does an uncertain job of predicting the optimal outcome because of the many variables involved.

Scenario #1—Holdback trust

Pam, age 65, has a custodial IRA valued at \$1 million, marketable securities valued at \$500,000, and a home worth \$250,000. Pam has two adult children, Joe (age 38) and Freddy (age 25), whom she wants to benefit equally at her death. Freddy is going through tough times. After a divorce and a failed effort to start a business, he has creditors after him. He needs the protection of a trust until he is about 40 years old. How can Pam provide the protection Freddy needs without forfeiting the benefits of the extended payout she wants for her sons? Since their ages are so different, she wants each to be DB of his own share so that MRDs will not be affected by the other's life expectancy.

The first step will be to name a separate trust for Freddy (established under her will, her revocable trust, or as a free-standing document) directly on the IRA beneficiary form, so that Freddy's share will be treated as a separate account.¹⁰ Pam's preference is to provide for discretionary payments of income or principal to Freddy, with a mandatory termination at age 40. If he dies before age 40, she would like to give him a broad power of appointment, with default distributions to a trust for Freddy's infant son, or if he does not survive, then to a trust for Joe's three children, or if they do not survive, to Joe, or if he does not survive, to the church.

How would such a trust be analyzed under the MRD rules? In the normal course of events, Freddy would be expected to be the only beneficiary, since he will take the principal outright if living at age 40. However, because his interest is not unlimited—i.e., he is not the outright beneficiary—other beneficiaries must be taken into account. We have a number of contingent beneficiaries.

First, we have the potential takers under the power of appointment, which could include individuals both older and younger than Freddy, as well as charities. The first round of contingent default beneficiaries are all younger than Freddy (his issue), and the second round are also all younger than Freddy (Joe's issue), but their interests are also limited, so again we must look beyond them to the next takers. Only if these classes are wiped out do we get to an older contingent beneficiary (Joe), or if he is also dead, then to a non-qualifying beneficiary, the church. Which contingent beneficiaries "count" in determining the payout period for benefits payable to the trust?

The Regulations, unfortunately, are not clear on this point,¹¹ and the current IRS interpretation seems headed in the wrong direction. It is clear from examples in the Regulations that if distributions from the retirement plan might be held in the trust for eventual distribution to a remainder beneficiary, then the first line remainder beneficiary must be taken into account.¹² The effect of layers of contingent remainder beneficiaries is far less clear. A recent letter ruling indicates that the IRS is taking the position that you must peel back the layers until you find beneficiaries who would be eligible to take outright if the trust terminated. If the remainder would pass in further trust, the remainder beneficiaries of that successor trust must also be examined.¹³ On the other hand, if outright takers are living at the Designation Date, the contingency that they may die before the original trust terminates has been ignored.¹⁴ Since letter rulings may not be relied upon by other taxpayers, cautious practitioners will assume that all contingencies must be taken into account, at least if they are stated in the document.¹⁵

In the case of Freddy's trust, the foregoing analysis means that all the potentially older or disqualified takers under the power of appointment must be taken into account. Similarly, Joe will "count" as a beneficiary, and it is possible that we must consider the church as well. Therefore, the trust will not

qualify for installment payments over Freddy's life expectancy. To avoid this result, one option is to modify the language of the trust to (1) restrict the power of appointment to Freddy's issue,¹⁶ or to individuals who are no older than Freddy,¹⁷ and (2) remove Joe and the church as remote default beneficiaries, leaving only the grandchildren.¹⁸

Some clients, however, may insist on granting a broad power of appointment, or they may not have a deep bench of younger contingent beneficiaries to name, especially if their children do not yet have children of their own. Still other clients may need to include a general power of appointment in order to avoid potential generation-skipping transfer ("GST") taxes.¹⁹ A solution in that case may be to create a "conduit" trust. Such a trust includes a special provision requiring that any amounts distributed from the IRA to the trust *must* be distributed to the primary beneficiary. With a conduit trust, the remainder beneficiaries may be disregarded—they are treated as mere "successor" beneficiaries in the parlance of the Regulations.²⁰

The upside of a conduit trust is the freedom from restriction it buys the planner in setting out the remainder provisions. The downside is that it negates some of the trustee's discretion over the plan proceeds. Whether this cost is too high depends on the specific circumstances. Factors that must be considered include the age of the beneficiary (which affects the size of the expected payments), the risks of outright distribution, and the client's desire to preserve the principal for remainder beneficiaries. In a typical holdback trust for younger beneficiaries, the distribution amounts will be relatively small based on life expectancy, and may be applied directly to expenses for the beneficiary.

If you decide to include conduit provisions routinely in your holdback trusts, you must be careful that your drafting is not overbroad. If a retirement benefit passing to the trust is not eligible for installment MRDs based on the beneficiary's age—because the MRDs have already been locked in based on the life expectancy of a predecessor beneficiary, for example—a broad conduit distribution requirement would result in passing large amounts out of the trust to an immature beneficiary.

Sometimes the client's trust objectives simply cannot be reconciled with the MRD requirements, and the client will opt to use a trust even though it means that there will be

See 3-D PUZZLE page 10

3-D Puzzle *from page 9*

no DB for the retirement account, and that withdrawals must be made (and thus that tax must be paid) on a more accelerated basis. If Pam is of this mind, she can at least be consoled that Freddy's trust could take advantage of the five-year rule if she dies before her RBD, and could stretch payments out over Pam's remaining life expectancy if she dies after her RBD.

Scenario #2—Formula beneficiary designation

What if Pam wants to make an “off the top” gift to her church of 10% of the value of her estate? It makes sense to satisfy the gift out of the IRA at her death, because the church will not have to pay tax on the IRA proceeds, leaving more of the “normal” assets for her sons. This means that the church's interest in the retirement account must be defined in terms of the total estate, but structured to come directly out of the IRA, with the balance of the IRA passing to the sons in a manner eligible for installment treatment.

Putting the formula in Pam's will would require that the IRA be payable to the estate, which is not a DB. Putting the formula into a revocable trust is not much better; even if (1) the church's interest is satisfied by the Designation Date and (2) the document disallows use of the IRA for estate expenses, the use of a single flow-through trust means the IRS may not allow separate account treatment for the separate shares passing to the two sons.²¹

Ideally, the bequest should be set out on the IRA beneficiary designation form. That way, the church's interest will be paid to it directly, avoiding income tax, and the sons will take separately as well. However, it will be necessary to devise a way to define the charitable interest so that either (1) it will qualify for separate account treatment, or (2) it can be satisfied by the Designation Date. Using a fraction or percentage is best, allowing qualification for separate account treatment, since that approach buys a little bit more time for compliance following death.²²

Pam may be satisfied to pick a dollar amount or a percentage of the IRA that is approximately correct, and use that on the form. That approach is simple, though it requires frequent updates as values change.²³ For greater precision, she could use a formula such as the following:

To XYZ Church, for its general charitable purposes, that percentage of my IRA which is most nearly equal to ten percent (10%) of my adjusted gross estate as finally determined for federal estate tax purposes.

While such language may best achieve Pam's objective, it raises problems for the IRA custodian, and thus may be rejected. Terms of art must be fully defined; when, as here, they cannot be applied without knowledge of facts outside the IRA (the size of Pam's total estate, the amount of debts and expenses), they should be accompanied by provisions (1) stating that the percentage defined will be certified to the IRA provider by Pam's executor or trustee, (2) indemnifying the provider for relying on that certification, and (3) requiring the IRA custodian to provide information about the IRA to the executor or trustee upon request.²⁴ Further definitions and information can then be included in the will or trust agreement to help the fiduciary meet its responsibility to certify the percentage to the IRA custodian.

Scenario #3—Illiquidity

How would you advise Pam if the IRA were her only liquid asset—particularly if the illiquid assets are large enough to make her estate taxable? One option is to name Pam's estate as the beneficiary of that percentage of the IRA most nearly equal in value, as of the date of Pam's death, to the sum of (1) the federal and state death taxes due, and (2) the debts and costs of administration of her estate (including income taxes), all as certified to the IRA custodian by the personal representative. Such a formula should not be any more problematic than other formula clauses that may be affected by elections made and may depend, to some extent, on post-death facts.

If properly structured, the estate's share could be partitioned into a separate account or paid out prior to the Designation Date. Amounts received by the estate will be included in gross income for the estate. These amounts either will generate tax liability at the estate level, or will be passed out to Joe and Freddy (the residuary beneficiaries) as part of the estate's distributable net income (“DNI”) if distributions are made to them during the same fiscal year. In either case, the income in respect of a decedent (“IRD”)

deduction under Section 691(c) for estate taxes attributable to the estate's share of the IRA will be available to help offset the income tax liability.

The estate tax attributable to Pam's IRA may be at a higher rate than the income tax liability, particularly if the income tax liability is passed out to individual beneficiaries who enjoy lower tax rates than the estate itself. Therefore, it may be advantageous to trigger the income tax by making the necessary withdrawal prior to death, thus removing the income tax paid from the estate tax base. If Pam is given some warning that her death is imminent, such a withdrawal makes sense if a trial run of the tax computations indicates that there will be a savings. In normal circumstances, though, it would not make sense for a healthy 65-year-old participant to generate immediate income tax on her IRA just to mitigate future estate taxes.

Scenario #4—Credit shelter planning

Pete, age 60, is married to Sally, also age 60. Pete and Sally have two adult children, Jane and Kim, each of whom is married and each of whom has two minor children. Pete is an executive in a publicly traded company. He has a \$3 million interest in the company's qualified profit-sharing plan, and vested non-qualified deferred compensation awards totaling \$2 million, payable over a five-year period after his retirement.²⁵ Sally, a retired physician, has an IRA of \$2 million. The couple jointly owns a home, with an equity value of \$500,000 (\$1 million fair market value (“FMV”), subject to a \$500,000 mortgage), a brokerage account valued at \$800,000, and cash accounts of approximately \$200,000, and some cars and furnishings. Their goals are to provide for each other and their children and grandchildren in a tax-efficient manner, and to establish a scholarship fund at their university at the death of the survivor.

The couple has a problem in that most of their assets have an income tax price tag attached, and so must be carefully handled to avoid wasting about one-third of the estate tax exemption paying income tax. Upon Pete's death, the \$2 million in non-qualified deferred compensation will be immediately payable to his estate, and thus would be available to fund a credit shelter trust, but the trust will be required to bear its proportion-

ate share of the tax liability.²⁶ Similarly, Pete's profit-sharing account and Sally's IRA will be subjected to income tax when withdrawn under the MRD rules. Setting aside their home (which would be tricky to handle in a credit shelter trust in light of the mortgage),²⁷ the couple has only around \$1 million in other assets between them.

To make the most of their \$1 million in "clean" assets, Pete and Sally could consider using the technique employed by the taxpayers in Ltr. Rul. 200403094.²⁸ In the ruling, the husband owned assets in a revocable trust, which grants to his wife a testamentary general power of appointment over a portion of the trust assets (defined by a formula). The wife's will exercises her power to appoint sufficient assets from husband's trust to her own estate to fully fund her credit shelter trust if husband survives her.

The Service ruled that, if wife in fact dies before husband, the assets she appoints will be included in her gross estate. Husband will be deemed to have made a completed gift to wife, eligible for the marital deduction. Since he will not be deemed to have made a transfer directly to wife's credit shelter trust, he will not be charged with gifts to its beneficiaries, nor will the credit shelter trust come back into his estate by reason of his income interest and limited powers of appointment over that trust.

Pete and Sally could apply this same approach by having Sally hold the outside assets in a trust which grants Pete a testamentary general power of appointment over the trust assets if he dies before Sally, or vice versa. It may also be possible to split the assets and have the powers running both ways, but the possible application of the reciprocal trust doctrine makes this approach more risky.

Even if the first spouse to die is able to assign the full \$1 million in clean assets to the credit shelter trust, a significant amount of estate tax exemption remains. If Pete and Sally believe that the needs of the surviving spouse could be met through his or her own resources, each of them could name the children and/or trusts for the grandchildren as beneficiaries²⁹ of designated percentages of their qualified retirement accounts, allowing them to elect installment payments of the benefits over their life expectancies.³⁰ Of course, this approach makes sense only if Pete and Sally believe that the children and grandchildren would take appropriate advantage of the long-term tax deferral to allow these assets to grow significantly.³¹

If Pete and Sally are willing and able to send the exemption values straight to the children, the balance of the qualified retirement benefits will pass directly to the surviving spouse,³² as will the deferred compensation awards if Pete dies first. Alternatively, because the couple want to provide for the university at the second death, part of the deferred compensation proceeds may go into a charitable remainder trust for Sally, if it is possible to avoid immediate recognition of income to the estate.³³

If, on the other hand, Pete and Sally believe that the surviving spouse is likely to need access to the entire estate, they will need to consider naming a credit shelter trust³⁴ as beneficiary of a portion of the retirement benefit. From an income tax deferral standpoint, the effects are generally negative: loss of the rollover opportunity for the surviving spouse means that payments must be taken from the account more rapidly, thus defeating or significantly reducing the deferral benefit. Further, making taxable payments to the credit shelter trust diminishes the overall level of benefits passing under shelter of the estate tax exemption—the beneficiaries are forced to share the inheritance with Uncle Sam. Nevertheless, for a couple of Pete and Sally's overall wealth, the loss of income tax deferral may be a necessary trade-off in order to avoid significant transfer tax. In considering the possible outcomes, we will assume that the prior lessons regarding payments to trusts will be applied—i.e., the credit shelter trust's share will be set aside as a separate account, and will not be drawn upon for estate expenses or debts.

For a "normal" credit shelter trust for the benefit of spouse and issue, there are two possible outcomes under the MRD rules. Pete and Sally may be comfortable limiting the potential remainder beneficiaries of the trust to their own issue in all circumstances, foregoing contingent beneficiaries and powers of appointment (except among their issue). If so, the MRDs will be measured based on the life expectancy of the surviving spouse, taken from the single life table at date of death and reduced by one for each year thereafter. Because Pete and Sally are both age 60, the entire amount would be distributed to the trust, and tax paid, within 25 years if one of them died today.³⁵

Alternatively, they may insist on including charities or broad powers of appointment in the remainder provisions of the credit shelter trust. In that case, the entire amount must be

paid to the trust within five years after the decedent's death.³⁶ Amounts paid to the trust may be either distributed to the spouse or issue (who would then pay tax at their respective individual rates) or accumulated in the trust (after paying tax at the trust rate).

If the credit shelter trust includes conduit provisions for the benefit of the surviving spouse alone, the picture changes. The surviving spouse now qualifies as the "sole" beneficiary of the trust, and some special benefits are available in computing the MRDs. First, the distributions are not required to commence until the year the decedent would have attained age 70-1/2, leaving significantly more room for tax-deferred growth in the interim. Second, once distributions begin, the MRDs are computed based on the spouse's life expectancy *as recalculated annually*. This results in somewhat longer deferral.

For example, an 85-year-old still has a 7.6-year life expectancy, even though, at age 60, it was predicted that he would die by that age. Consequently, it is less likely that the entire benefit will be paid out during the spouse's lifetime than in the case of the normal credit shelter trust. These income tax benefits come at an estate tax price, though. The conduit trust, by its terms, passes all these benefits out to the spouse and into his or her estate, thus wasting the use of exemption to shelter the benefit from future estate tax. If you are going to do that, you might as well use an outright distribution and get the advantage of the rollover, unless there are non-tax reasons for wanting to control and limit the amount passing to the spouse in any one year.

Let's not forget that Pete and Sally want to benefit their university. Christopher Hoyt³⁷ has suggested an interesting way to fund the credit shelter share for a client whose balance sheet is top heavy with retirement benefits and deferred compensation—the credit shelter charitable remainder trust. The basic idea is to set up a charitable remainder unitrust ("CRUT") for the benefit of the surviving spouse and children and name it as the beneficiary of the credit shelter share of the retirement benefits. At the death of the last survivor of the beneficiaries, the assets pass to charity.

Because the CRUT is tax-exempt, it can receive and invest the proceeds without worrying about the MRD rules. The children will eventually step into a significant stream of payments for life. The CRUT itself may

See 3-D PUZZLE page 12

3-D Puzzle *from page 11*

include “flip” and/or “make-up” provisions, or may make use of a “spigot” investment such as an annuity contract or partnership to help control the amount and timing of distributions. Of course, such devices have strict limits. The main drawback³⁸ to this approach is its lack of flexibility in responding to the particular needs of the various beneficiaries, and it should not be relied upon as the sole or primary means of support of a surviving spouse. On the other hand, for a couple like Pete and Sally, who have significant outside resources, it may be an attractive alternative.³⁹

Given the uncertain planning environment, it makes sense to build in flexibility through a disclaimer plan, especially in a family like Pete and Sally’s, in which (1) both spouses are pursuing the same estate planning goals, and (2) their relative youth makes an optimal solution hard to predict. The disclaimer plan should start with the greatest benefit to the surviving spouse as the top layer or default plan. For Pete and Sally, that means leaving the entire plan to the surviving spouse as primary beneficiary.

Upon disclaimer, it might drop to a conduit trust, then upon further disclaimer to a “normal” trust, then upon further disclaimer to the children (who could further disclaim to their children if desired). This layered approach gives maximum flexibility. Not all the layers would be necessary or desirable in every case. The clients need to understand that their credit shelter trust cannot include powers of appointment (at least not with respect to retirement benefits that may fall into the trust by disclaimer). They have to sacrifice the “back end” flexibility afforded by powers of appointment and broad fiduciary powers that might otherwise be given to the spouse as trustee in favor of the “front end” flexibility afforded by the disclaimer plan.

It is important that the beneficiary form clearly state what will happen at each layer, and what needs to happen to move from one layer to the next. It is not a good idea to refer to a “qualified” disclaimer in the beneficiary designation, since the plan administrator or custodian will not have the ability to distinguish between qualified and non-qualified disclaimers.⁴⁰ In fact, to avoid problems in dealing with the plan administrator in a disclaimer situation, Natalie Choate suggests that the layers of the disclaimer be set forth in a separate trust agreement, such as the partic-

ipant’s revocable trust.⁴¹ But you do not want to forfeit separate account treatment for the children if the spouse chooses to disclaim a portion of the benefits absolutely, and that treatment will not be available unless the retirement account passes directly under the beneficiary designation. Therefore, you could use a combination approach, paraphrased as follows:

If my spouse survives me, then 100% of my account shall be payable to my revocable trust, to be administered as there provided. If my spouse does not survive me, or if my spouse disclaims absolutely any part or all of my spouse’s interest in the trust (as certified by the trustee of my revocable trust prior to the designation date), then 100% of my account (if my spouse does not survive me), or so much of my account as my spouse disclaims, shall be payable to my children in equal shares.

Estate planning strategies that turn on the effective use of disclaimers run the risk of failing in execution. Clients with this type of plan need to be sternly warned, in writing, of the need to avoid taking withdrawals from the account immediately after death, and the need to seek prompt legal and financial advice. A clear, easy-to-read memo should be placed with the client’s will to be sure that it will be seen by the survivors. It is critical that the spouse have a power of attorney in place that will authorize the attorney-in-fact to carry out an effective disclaimer, and will offer some guidance for doing so.

Scenario #5—Planning in second marriage situations

How do your recommendations change if Pete and Sally are in a second marriage? Assume that Jane is Pete’s daughter from his prior marriage, and Kim is Sally’s daughter from her prior marriage. Their assets are essentially the same as in the preceding example, except that they hold the home as tenants in common and hold separate brokerage accounts of \$500,000 each, with only a small joint household cash account. There is no premarital agreement, but Pete and Sally agree that their objectives are (1) to provide lifetime benefits for each other to maintain

their current lifestyle, and (2) to assure that all the remaining assets pass at the survivor’s death to the original owner’s child and grandchildren.

Pete and Sally may need to reinvent the way they are thinking about their benefits. Their natural instinct is to want to divide the benefits sequentially—first to spouse, then remainder to child. However, in working with retirement benefits, it is far more efficient to provide separate benefits for the decedent’s child, so that she can take advantage of her younger age and smaller MRDs. The credit shelter share for each spouse could be funded by making a portion of the retirement plan payable to the participant’s child or grandchildren directly as primary beneficiaries. Although this approach may conflict with the goal of providing for the support of the surviving spouse, it greatly improves the income tax efficiency of the estate plan. If necessary, insurance could be purchased in an irrevocable trust to help supplement the spouse’s income and ultimately pass to the insured’s child.⁴²

Each spouse’s share of the outside assets can be made payable to a standard QTIP trust, as can Pete’s deferred compensation awards. The question then is whether the balance of each spouse’s retirement account should also be made payable to the QTIP trust. The trust will need to include language requiring the trustee to withdraw the greater of the income earned on the account or the MRD for each year. The MRDs will be measured by the spouse’s life expectancy at the participant’s death, provided there are no ineligible or older remainder beneficiaries. Since, for a 60-year-old beneficiary, the MRD is approximately 4%, and will rise gradually each year, it is unlikely that the income will exceed this figure by very much.⁴³ As the beneficiary ages, the MRDs will likely exceed the income by a considerable amount; the trustee will distribute only the income portion to the spouse, and the remainder of each MRD after payment of tax will be added to trust principal.

Alternatively, the QTIP trust could be structured as a conduit trust, in which case all amounts withdrawn would be distributed directly to the spouse. This approach would make the surviving spouse the “sole beneficiary” of the plan, thus triggering special rules that defer all MRDs until the year the deceased participant would have had his

RBD, and permit some additional stretching of payments. But it does disturb the basic notion of a QTIP, in that it forces distribution of principal amounts to the spouse. Those amounts can be substantial as the spouse ages and the MRDs increase.

Scenario #6—Rollover by disabled spouse

Patty is 72, and her husband, Sam, is 74. Sam is in the early stages of Alzheimer's disease, but is still competent to execute documents and understands his condition. Patty has a \$1 million IRA, from which she is taking minimum withdrawals. In the context of the couple's other planning, it will probably be most beneficial if this IRA passes outright to Sam at Patty's death, to be rolled over and made payable at his death to the couple's grandchildren. However, their plan also includes provisions for establishment of a trust for Sam with any disclaimed portion of the IRA.⁴⁴ Again, the power of attorney must be customized to deal with the predicted rollover transaction and ongoing management of the IRA.

Specific language dealing with the power of disclaimer should be included and the document vetted with the IRA provider. If Sam (or his attorney-in-fact) does not get the rollover accomplished upon Patty's death, and then dies within nine months after her, Sam's executor may consider a disclaimer of both the outright and trust interests. This technique will accomplish the desired result if Patty's contingent beneficiary designation provides that the grandchildren will receive the benefits directly in case of such a disclaimer. However, if Sam's will names other residuary beneficiaries (such as the children), it is particularly important to include a provision in his will authorizing such a disclaimer by his personal representative, who may otherwise be constrained by fiduciary duties toward the residuary beneficiaries of Sam's estate to refrain from diverting the benefits.⁴⁵

Conclusion

The addition of a third dimension to planning for individuals with substantial retirement benefits on their balance sheets creates new challenges for estate planning professionals and their clients. Each situation must be evaluated with a fresh eye as we learn how to manipulate the puzzle pieces to make a pleasing picture when viewed from any angle. ■

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Endnotes

1. This article focuses on planning for qualified plans ("QPs") under Section 401(a), tax-sheltered annuities under Section 403(b), and individual retirement accounts ("IRAs") under Section 408.

2. To learn more, an extremely thorough and highly readable book on this topic is *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners*, by Natalie Choate (the 5th edition of which is cited herein as "Choate Handbook"), published by Ataxplan Publications, P.O. Box 1093-K, Boston, MA 12103. Many of the ideas incorporated in this article were inspired by or learned from that excellent resource. A 6th edition of the Handbook has been published since the preparation of this article. More information, as well as helpful articles and updates, can be found at www.ataxplan.com. An extensive listing and description of other resources is included in the appendix to the book. See also Wilsher, "Estate Planning Strategies for Retirement Benefits," 31 ETP 226 (May 2004).

3. This means that the DB's life expectancy is computed as of the date of death, and is not recalculated in future years. Instead, one year is subtracted from the initial computation for each year thereafter. Therefore, a DB who outlives his life expectancy as determined under the table will also outlive his benefit, even if he has taken only the MRD each year.

4. See Reg. 1.401(a)(9)-4, A-5.

5. Separate account treatment is available only if the beneficiary's interest is fractional as of the date of death. All post-death changes must be allocated proportionally until the accounts are segregated. To be controlling for purposes of determining the MRDs, the separate account must be established by the end of the calendar year after the year of death.

6. Reg. 1.401(a)(9)-3, A-3(b).

7. Reg. 1.401(a)(9)-5, A-5(c)(2) and A-6.

8. IRC Section 402(c)(11), added by section 829(a)(1) of the Pension Protection Act of 2006.

9. If the participant was born before 1936, a favorable method of taxation is available for a lump-sum distribution from the plan to an individual, estate, or trust. If a plan holds employer stock, special rules are available allowing continued deferral of tax on the gain inherent in the employer securities. If the securities are distributed as part of a qualifying lump-sum distribution as defined in Section 402(e), the participant may elect to pay immediate income tax only on the cost basis of the stock, which is taxed to the recipient as ordinary income. The net unrealized appreciation ("NUA") in the stock (i.e., the built-in gain at the date of distribution) is not taxed immediately. If applicable holding periods are met, the NUA will eventually be taxed as long-term capital gain when the stock is sold. The NUA retains its character

as such even at the participant's death, if he still owns the stock. Accordingly, under Section 1014, only the post-distribution gain, if any, is "stepped up." See Rev. Rul. 75-125, 1975-1 CB 254.

10. The IRS has taken the unfortunate position that it is not possible to leave retirement benefits to a single trust and rely on the post-death establishment of separate accounts for the trust beneficiaries, even if the trust document mandates the separate accounts. Instead, it is apparently necessary to make the beneficiary designation directly to separate trusts in a manner that will qualify them to set up separate accounts. See Ltr. Ruls. 200317041, 200317043, and 200317044. This position is a change from the position taken by the IRS under at least one letter ruling issued prior to the final Regulations under Section 401(a)(9). See Ltr. Rul. 200234074. Therefore, many practitioners have set up estate plans relying on the use of specialized language in a "funding" trust that will divide at the client's death. See Lee, "Guidelines for Naming a Trust as the Beneficiary of an IRA," 30 ETP 503 (Oct. 2003).

11. See Reg. 1.401(a)(9)-5, A-7(c).

12. A trust to pay income to one beneficiary for life, and remainder to a second beneficiary at the first beneficiary's death, has two beneficiaries for purposes of determining the applicable distribution period for any plan benefits payable to the trust. See Reg. 1.401(a)(9)-5, A-7(c).

13. See Ltr. Rul. 200228025. The trust was for the benefit of two minor children, each of whom would receive his share outright at age 30. If either died before age 30, his share would pass to the other minor beneficiary, but if both died before age 30, certain contingent beneficiaries were named, including a 67-year-old uncle. The Service ruled that the 67-year-old uncle was the oldest trust beneficiary for purposes of determining the applicable distribution period.

14. See Ltr. Rul. 200438044. The trust paid income to the participant's spouse for life, with remainder at her death to participant's then living descendants per stirpes, in trust to age 30. All the children were at least 30 at the participant's death. The IRS ruled that since the children's right to receive the remainder was "unrestricted" as of the death of the participant, the spouse and children were the only DB's—apparently ignoring the requirement that the children must survive the spouse in order to take. There is no mention of an ultimate disaster clause in the trust instrument.

15. Just as Ltr. Rul. 200438044, discussed in note 14, *supra*, ignores any ultimate beneficiaries beyond those stated, an example in the Regulations describes a trust to B for life, remainder to A's children, and states that the children are "the sole remainder beneficiaries . . . [and] no other person has a beneficial interest" in the trust. Reg. 1.401(a)(9)-5, A-7(c)(3), Example 1. That statement is, of course, inaccurate; if the children predeceased B, then either the trust agreement or state law would provide another taker. Perhaps we must leave out contingency clauses in our documents, trading bad drafting for good tax results.

16. It may also be necessary to include a definitional section limiting issue to those younger than the ancestor, to deal with the problem of adult adoption.

17. See Ltr. Rul. 200235038, in which the Service

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blesed a power of appointment exercisable only in favor of younger individuals. Such broad language apparently does not violate the rule that the trust beneficiaries must be ascertainable; presumably, it does not matter who the beneficiaries are so long as it is guaranteed that they are individuals who are younger than a designated person.

18. If you, as the drafter, are unwilling to leave a potential gap in the disposition, or if you are concerned that the IRS will require consideration of contingent takers supplied by state law, you could provide that Freddy will receive the trust assets outright at the earlier of his attainment of age 40 or the death of the last survivor of Pam's grandchildren. That covers the legal bases, and seems pretty safe under the circumstances.

19. You could argue that a general power of appointment or a remainder to the beneficiary's estate, should be disregarded, since the estate would hold any unspent payments the beneficiary actually received during his lifetime. However, any reference to an "estate" as a remainder beneficiary seems likely to raise IRS hackles and invite controversy. If a vested trust, payable to the beneficiary's estate at death, is intended, it may be less controversial to omit provisions for the remainder interest and instead state simply that the trust assets vest in the beneficiary.

20. See Reg. 1.401(a)(9)-5, A-7(c).

21. See note 10, *supra*.

22. Separate accounts must be established by the close of the calendar year after death, while the Designation Date is September 30 of that year. Pam could set up a separate IRA payable solely to charity, and two others payable to each of her sons. However, maintaining the appropriate values may be difficult, and keeping up with separate accounts may be an unwelcome burden, especially after Pam starts taking MRDs.

23. Consider customizing Pam's power of attorney to authorize changes in her beneficiary designation designed to maintain the charity's interest at approximately 10% of her net estate.

24. See Wasser, "17 Tips for Beneficiary Designation Forms," 141 Tr. & Est. 29 (Sept. 2002). Even when no formula is involved, it is a good idea to include language in any beneficiary designation requiring that the plan administrator or custodian provide the personal representative of the client's estate with any information reasonably requested in the performance of its duties. See Choate, "The 100 Best and Worst Planning Ideas for Your Client's Retirement Benefits," 38th *Ann. Southern Fed. Tax Inst.*, Outline Q at p. 33 (2003).

25. These awards are non-transferable, and will be fully taxed as ordinary income to Pete when received. If Pete dies before the awards are received, they are automatically payable to his estate, which can distribute the right to receive the payments to any beneficiary. The recipient of the payment will be taxable on the payments as ordinary income, and may be eligible for a deduction under Section 691(c) if any estate tax is attributable to the inclusion of these amounts in the estate.

26. See Reg. 1.663(c)-5, Example 6.

27. The home might become a viable addition to the credit shelter trust if one assumes that the surviv-

ing spouse would use his or her significant income and creditworthiness to buy the house from the deceased spouse's estate.

28. See Cason, "Maximum Funding of Credit Shelter Trust with Non-IRA Assets," 29 ETPL 282 (June 2002), and Cason, "IRS Ruling Approves 'Poorer Spouse Funding Technique,'" 31 ETPL 234 (May 2004).

29. Sally will be required to sign a waiver of her spousal rights in Pete's profit-sharing plan in order to make his beneficiary designation effective.

30. To assure that MRDs will be computed based on the grandchildren's life expectancies, their trusts will need to be structured as conduit trusts or otherwise restricted so that no contingent remainder beneficiary with a shorter life expectancy need be taken into account. The deferred compensation awards in Pete's estate are less attractive for funding the credit shelter share, because the income tax bite will be immediate.

31. If Pete's profit-sharing plan does not permit stretch payments, the beneficiaries would have to take advantage of the new non-spouse rollover provisions to make a direct transfer of their distributive shares of the plan to an inherited IRA. See note 8, *supra*, and the accompanying text.

32. Outright distribution to the spouse preserves his or her rollover option, and is consistent with the couple's plan.

33. However, this technique may not avoid income taxation unless it is possible for the executor to distribute the right to receive the deferred compensation benefit to the charitable trust rather than receiving it in the estate, since, at least arguably, the distribution of proceeds of the award out of the estate to the CRT will not be eligible for the DNI deduction under Section 663(a)(2). See, e.g., *Mott*, 30 AFTR 2d 72-5193, 199 Ct Cl 127, 462 F2d 512, 72-2 USTC 9557 (Ct.Cl., 1972), cert. den. (broadly reading Section 663(a)(2) to apply even if the Section 642(c) deduction is unavailable). But see TAM 8810006 (distinguishing *Mott*, and allowing a DNI deduction for a distribution from an estate to a charitable remainder annuity trust).

34. Unless the spouse is likely to be the primary beneficiary of the credit shelter trust, you are better off not using one at all, and leaving benefits directly to the younger generation, or combining the two approaches. Hence, if Pete and Sally are on the fence, the MRD rules will give them an incentive to let as much as possible go directly to the children, holding back in the credit shelter trust only what they believe is truly necessary for the welfare of the surviving spouse.

35. Contrast the effect of a rollover. In that case, no distributions are required until the survivor reaches his or her RBD. The distribution required under the Uniform Lifetime Table at age 85 (the same year when the entire amount must be paid if the benefit passes to a credit shelter trust for a 60-year-old spouse) is only about 6.7% of the remaining balance. Further, at the spouse's death, his or her beneficiaries can start all over, using their life expectancies. In the case of the credit shelter trust, on the other hand, any benefits not paid out prior to the spouse's death must be paid out according to the schedule that was locked

in at the participant's death. See Trytten, "To My Wife, I Leave My IRA," 141 Tr. & Est. 42 (Sept. 2002), for a comparative analysis of the effects of various distributive schemes.

36. The five-year-rule applies because Pete and Sally have not reached their RBDs. In counseling an older couple, it is important to keep in mind that the rule for distribution of an account that has no DB is that distributions must be made over the remaining fixed life expectancy of the decedent. Since Pete and Sally are the same age, there would be no advantage to structuring the trust to make use of the survivor's fixed life expectancy if the decedent had reached his or her RBD.

37. Hoyt, "Solution for Estates Overloaded with Retirement Plan Accounts: The Credit Shelter CRUT," 141 Tr. & Est. 23 (May 2002).

38. A second drawback is its incompatibility with GST tax rules.

39. Since Pete's deferred compensation would require immediate payout to his estate, it is the best candidate for this treatment if the payment can be directed into the CRT without income recognition. See note 33, *supra*.

40. See Wasser, *supra* note 24, at 36.

41. See Choate Handbook, *supra* note 2, 8.2.10, at pp. 361-62.

42. Because the assets held outside the retirement plan should gradually increase after retirement, as distributions are received, the mortgage is paid down, etc., the need for insurance may diminish, so a term policy could be considered for this purpose.

43. With a great deal more complexity, it is possible to structure a QTIP trust so that the excess income can stay inside the plan account, subject to a withdrawal right by the spouse. See Choate Handbook, *supra* note 2, 3.3.08-3.3.09, at pp. 161-64. However, it seems unnecessary to consider those options unless the plan investments produce unusually high income yields, or the spouse is relatively young.

44. Upon disclaimer, the disclaimed funds will pass to Patty's estate to be added to a discretionary testamentary trust that will not be taken into consideration for purposes of Sam's eligibility for government assistance. Although the IRA will not, in that case, have a DB, the continued withdrawal based on Patty's life expectancy as of the date of her death will actually be more beneficial than use of Sam's life expectancy, since Patty is the younger spouse.

45. It is generally *not* possible for the executor of the surviving spouse's estate to initiate a rollover of the predeceased spouse's IRA. See Choate Handbook, *supra* note 2, 3.2.07, at pp. 150-51.

Quiz Yourself on Traditional IRA Distributions

By JOHN R. CELLA JR.

Proper IRA distribution planning requires one to be familiar with the distribution rules in Internal Revenue Code Section 401(a)(9), the Treasury Regulations thereunder, and related guidance. Limited in scope to traditional IRAs, the short “pop quiz” that follows is designed to cover some of the basic distribution rules. Assume that the IRAs in the narratives below follow the life expectancy payout rules in the Code and Regulations.

1. Lou’s estate planning client, Irene (age 63 in 2007), owned a Fidelity traditional IRA with a balance of \$700,000. The scope of engagement included a review of Irene’s retirement plans and IRAs (and the possible income and estate tax consequences of any beneficiary designation thereof). Irene threw away her copy of the IRA account application—after all, she wanted to get rid of all the paper her late husband had left behind. Lou should rely on the following:

I. A voicemail from the Fidelity investment representative saying her account “looks fine”

II. A one-page printout that lists Irene’s contact information, account number, beneficiaries, most recent account balance, and investment allocation

III. A copy of the original IRA account application and most recent beneficiary designation on file

IV. The IRA custodian or trust agreement (assuming separate from III)

- (a) None of the above
- (b) II only
- (c) III only
- (d) III and IV

2. Irene couldn’t remember completing a beneficiary designation but seemed convinced that her IRA would pass to her two adult daughters because her will left everything to them. Lou requested from Fidelity a copy of the original IRA account application, the most recent beneficiary designation on file, and the custodian agreement. Lo and behold, Lou discovered that Irene never listed a beneficiary—the box was blank! The fine print in the custodian

agreement said that the IRA owner’s “estate” would be beneficiary if the owner had failed to name a beneficiary.

Suppose Irene died on Dec. 1, 2007 (at age 63) without completing the IRA beneficiary designation (i.e., leaving the blank beneficiary designation as is, with the estate as the default beneficiary). Which of the following would be true?

I. The IRA would pass through Irene’s probate estate, be included as a probate asset in accountings, and generate probate fees.

II. Irene’s death occurred before her “required beginning date” as defined in the Code.

III. Irene’s IRA would not have a “designated beneficiary” for purposes of the Code’s life expectancy payout rules, forcing payout of the entire IRA to her estate no later than Dec. 31, 2012 (and resulting in income tax paid by the estate beneficiaries to whom the estate assets are paid out).

IV. Even though Irene failed to complete the beneficiary designation form, Irene’s daughters can designate themselves as beneficiaries as long as they do so before Sept. 30, 2008 (and therefore can utilize the Code’s separate account rules and use their own life expectancies).

- (a) IV only
- (b) I, II, and III

3. Irene’s “estate” is the beneficiary of her IRA. Which of the following would be true if Irene were 74 as of the date of death (Dec. 1, 2007), her birthday were Dec. 10, 2007, and she had not yet taken her required minimum distribution from her IRA for 2007?

I. The IRA beneficiary, the estate, can wait until 2008 to take out the 2007 RMD, but it also would need to take out the 2008 RMD in that year.

II. The IRA beneficiary, the estate, must take out the 2007 required minimum distribution on or before Dec. 31, 2007; otherwise, the personal representative must file IRS Form 5329 and pay the IRS a penalty of 50% of the amount of the RMD not taken.

III. Distributions can continue over Irene’s remaining life expectancy determined using the Single Life Table and Irene’s age in the calendar year of death (74), subject to the

divisor’s reduction by one for each calendar year since the calendar year of death.

IV. Distributions can continue over Irene’s remaining life expectancy determined using the Single Life Table and Irene’s age in the calendar year of death (75), subject to the divisor’s reduction by one for each calendar year since the calendar year of death.

- (a) I only
- (b) II and IV
- (c) II and III
- (d) None of the above

Susan’s 70th birthday is coming up Aug. 1, 2008, and she’s still working full-time for her company. Susan is a participant in the company’s 401(k) plan, and she has a traditional IRA. Both the plan administrator and the IRA custodian have on file properly completed beneficiary designation forms that name Susan’s only son Simon as beneficiary.

4. Susan is alive. Which of the following are true with respect to her traditional IRA?

I. Her required beginning date is April 1, 2010.

II. Her required beginning date is April 1, 2009.

III. Her required beginning date is her retirement date.

IV. Her required beginning date is April 1, 2010, because she’s a 5%-owner.

- (a) III only
- (b) IV only
- (c) I only
- (d) II only

5. Susan is alive. Assume Susan’s required beginning date is April 1, 2010. Susan’s 72nd birthday is Aug. 1, 2010. Which of the following is true with respect to her traditional IRA?

I. Susan must take out her first lifetime required minimum distribution for 2009 either in 2009 or no later than April 1, 2010; she must take out her next required minimum distribution for 2010 no later than Dec. 31, 2010.

II. Susan’s lifetime required minimum distributions are calculated using the Uniform

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Lifetime Table.

III. Susan's lifetime required minimum distributions are calculated using the Single Life Table.

IV. Susan's life expectancy is recalculated annually for subsequent years' lifetime required minimum distributions.

- (a) I and III
- (b) I, II, and IV
- (c) III and IV
- (d) II and IV

6. Susan dies on Jan. 1, 2011, after her required beginning date. Which of the following is true with respect to her traditional IRA?

I. Simon is a "designated beneficiary", determined as of Sept. 30, 2012 for life expectancy payout purposes.

II. Simon can "roll over" Susan's IRA into his own IRA (i.e., titled in Simon's name alone) and not take distributions out until he is required to do so in several years.

III. Simon can set up an "inherited IRA" titled in Susan's name as deceased IRA owner for Simon's benefit (e.g., IRA Susan Smith (deceased) f/b/o Simon Smith, beneficiary)

IV. Distributions can be made to Simon over the greater of Susan's remaining life expectancy or Simon's life expectancy, using the Single Life Table.

- (a) IV only.
- (b) I and II only.
- (c) I, II, and III.
- (d) I, III, and IV.

Paul was 67 when he died on Dec. 1, 2007. Paul's 401(k) account value had grown considerably since his divorce in 1995. After the final divorce and entry of the qualified domestic relations order (QDRO) at that time, Paul prudently updated all his beneficiary designations, including that for his 401(k) plan. In accordance with the plan administrator's procedures, Paul named his daughter, Pat, as sole beneficiary of his 401(k) account.

As of Dec. 1, 2007, the 401(k) Plan ("Plan") had been amended to provide for the direct rollover of a death distribution to a non-spouse designated beneficiary. However, the plan's distribution terms were more restrictive than those in the Code. Specifically, the required beginning date for

all participants was April 1st of the year after the year in which a participant turns 70½. Furthermore, with respect to death distributions, the only permissible distribution options were (1) lump sum payout, or (2) full distribution no later than the end of the year containing the fifth anniversary of the participant's death (the "5-year rule"). The life expectancy payout was not available under the Plan.

7. Pat remembered reading about the Pension Protection Act "rollover" rule available for non-spouse beneficiaries of qualified plan death benefits. Which of the following are true?

I. Pat can roll over the 401(k) death benefit to her own IRA and wait to take out distributions until she is required to do so.

II. Pat can leave the account in the plan and take out distributions pursuant to the 5-year rule in the plan.

III. Pat can transfer by trustee-to-trustee transfer the plan death benefit directly to a newly-established inherited IRA in Paul's name (i.e., IRA Paul Smith (deceased) f/b/o Pat Smith) and take out distributions from the inherited IRA over her own life expectancy using the Single Life Table.

IV. Pat can transfer by trustee-to-trustee transfer the plan death benefit directly to a newly-established inherited IRA in Paul's name (i.e., IRA Paul Smith (deceased) f/b/o Pat Smith) and take out distributions from the inherited IRA over her own life expectancy, but only if Pat makes the direct transfer no later than Dec. 31, 2008, less the amount of the required minimum distribution for 2008; otherwise, the 5-year distribution period under the plan would apply to distributions from the inherited IRA.

- (a) I only.
- (b) III only.
- (c) II and IV.
- (d) II and III.

8. Assume the 401(k) Plan distribution options were the lump sum payout, 5-year payout, and the life expectancy payout. Which of the following would be true with respect to the inherited IRA?

(a) Pat can take out distributions from the inherited IRA over her own life expectancy using the Single Life Table because the Plan provides for the life expectancy payout method.

(b) Pat is limited to the five-year payout.

9. Which of the following is an excellent resource in understanding the requirements and application of the non-spouse rollover provision in the Pension Protection Act of 2006?

- (a) Code Sections 402(c)(11) & 408(d)(3)(C)
- (b) IRS Notice 2007-7 and subsequent administrative guidance
- (c) The qualified retirement plan document, as amended
- (d) All of the above

Mom had been sick for a long time, but she was determined to live into 2009 so that her estate could utilize the \$3.5 million federal estate tax exemption. Mom's IRA balance was \$1,000,000 when she died on Jan. 1, 2009, at age 85. Mom's three boys, Ed (age 65), Ned (age 55), and Ted (age 45), were properly designated as beneficiaries of Mom's IRA.

10. Which of the following is true?

I. Each of Ed, Ned, and Ted can roll over his respective share to his own IRA within 60 days after Mom's death.

II. If Ed decides to cash out his entire share a few weeks after Mom's death, then Mom's IRA can still have a designated beneficiary, determined for life expectancy payout purposes as of Sept. 30, 2010.

III. Assuming no one cashes out, Ed, Ned, and Ted can split Mom's IRA into three separate accounts at any time after Mom's death but no later than Dec. 31, 2010, and therefore each may use his own life expectancy using the Single Life Table to calculate required minimum distributions, beginning with the year after the year of death.

IV. If the separate accounts were established in 2010, the year after the year of death, then Ed, Ned, and Ted could wait until 2010 to take pro rata shares of Mom's required minimum distribution for 2009.

- (a) I only
- (b) III and IV
- (c) II only
- (d) II and III

11. Assume Ed, Ned, and Ted can't get separate accounts established by Dec. 31, 2010. What result?

I. Mom's IRA must be distributed pro rata no later than the end of the year that contains the fifth anniversary of Mom's date of death, i.e., Dec. 31, 2014.

II. The life expectancy of Ed, the oldest beneficiary (determined as of Sept. 30, 2010), is used to determine required minimum distributions.

III. The respective life expectancies of Ed, Ned, and Ted are averaged to determine the payout period.

IV. Ed, Ned, and Ted can still establish separate accounts after Dec. 31, 2010, but distributions must occur from each using Ed's life expectancy.

- (a) II and IV
- (b) I only
- (c) III only
- (d) II only

12. Assume Ed is the sole beneficiary of Mom's IRA but wants to disclaim. Which of the following could destroy a valid disclaimer under Code section 2518?

I. Ed didn't like Mom's conservative investment allocation, so shortly after her death he changed the investment allocation of the IRA assets.

II. Ed takes the minimum required distribution for 2009, the year Mom died.

III. The IRA is re-titled as "IRA Mom (deceased) f/b/o Ed" (no other action taken).

IV. Ed waits until September 2011 to disclaim the IRA.

- (a) All of the above
- (b) None of the above
- (c) I, III, and IV
- (d) I and IV

Michelle died on Dec. 1, 2007, before her required beginning date. Her IRA beneficiary designation directs her adult daughter Mary to receive 75% and Michelle's church, a charitable organization, to receive 25%.

13. Which of the following statements are true?

I. If Mary does nothing, then as of Sept. 30, 2008, Michelle's IRA will not have a designated beneficiary; therefore, distributions will be subject to the 5-year rule.

II. If Mary pays out the charity before Sept. 30, 2008, then Michelle's IRA will have a designated beneficiary (Mary). Determined using the Uniform Lifetime Table, Mary's life expectancy is used to determine the payout period.

III. If Mary pays out the charity before Sept. 30, 2008, then Michelle's IRA will have a designated beneficiary (Mary). Determined using the Single Life Table, Mary's life expectancy is used to determine the payout period.

IV. The charitable organization doesn't have a life expectancy, so the IRA must be paid out entirely no later than Dec. 31, 2008.

- (a) IV only
- (b) II only
- (c) I and III
- (d) I and II

Granddad's birthday was March 1, 1930. His second wife, Lula, was born exactly 20 years later, March 1, 1950. Granddad's IRA balance was \$1,000,000 when he died on July 1, 2007. Granddad's sole primary beneficiary was Lula and his contingent beneficiaries were his adult children, Lynn and Lois.

14. Which of the following statements is true with respect to Lula's options?

I. Lula must take the required minimum distribution that Granddad did not take in 2007, the year of his death, calculated by reference to the Uniform Lifetime Table.

II. Lula must take the required minimum distribution that Granddad did not take in 2007, the year of his death, calculated by reference to the Joint and Last Survivor Table for that year.

III. Lula can roll over Granddad's IRA into her own IRA and wait to take distributions until she is required to do so (April 1, 2021), using the Uniform Lifetime Table.

IV. After taking out the required minimum distribution for the year of death, Lula can elect to "re-designate" the account in Lula's name as IRA owner.

- (a) I, III, and IV
- (b) II, III, and IV
- (c) III only
- (d) IV only

Suppose Lula had executed a valid disclaimer, and the contingent beneficiary of Granddad's IRA was the trustee of a trust for the benefit of Lynn and Lois. Granddad, the settlor of the trust, named his brother Larry (age 72) as contingent beneficiary of the trust.

15. Which of the following statements are true, generally speaking?

I. The trust is a designated beneficiary of the IRA.

II. The trust is not a designated benefi-

ciary, but an individual trust beneficiary will be treated as a designated beneficiary as long as:

(i) the trust valid under state law,
(ii) the trust becomes irrevocable upon the IRA owner's death,

(iii) the trust beneficiaries are identifiable from the trust instrument, and

(iv) by Oct. 31, 2008, the trustee provides the IRA custodian with a list of all trust beneficiaries as of Sept. 30, 2008 (including a description of the conditions to their entitlement), certified as correct and complete, and agrees to provide a copy of the trust instrument to the IRA custodian upon demand.

III. If the trust is drafted as a conduit trust (i.e., distributions aren't accumulated in the trust but instead paid from the IRA to the trustee then immediately out to the beneficiaries), then only Lynn and Lois, the primary trust beneficiaries, are considered in determining the designated beneficiary whose life expectancy is used to determine the payout period.

IV. If the trust is drafted to accumulate IRA distributions made to the trustee (i.e., distributions go out to the trustee but are accumulated in the trust, not immediately distributed to the trust beneficiaries), then the contingent trust beneficiary (here, Larry) is considered in determining the designated beneficiary whose life expectancy is used to determine the payout period.

- (a) I only
- (b) II, III, and IV
- (c) None of the above
- (d) All of the above

16. Suppose Lynn is 25, Lois is 40, and the beneficiary designation form lists only trustee of the trust as beneficiary. Assume (i) the Regulations are satisfied with respect to the trust, and (ii) the trust contains conduit language. Which of the following is true?

I. The separate account rules for purposes of determining RMDs are not available to Lynn and Lois with respect to the trust's interest in the IRA.

II. The separate account rules for purposes of determining RMDs are available to Lynn and Lois with respect to the trust's interest in the IRA.

III. The life expectancy of Lois, the trust beneficiary with the shortest life expectancy, will be used to determine the payout period.

IV. Even if the IRA is split, Lois's life expectancy would still be used to determine

See QUIZ page 18

Quiz from page 17

the payout period.

- (a) II only
- (b) I only
- (c) I, III, and IV
- (d) I and III

ANSWERS:

1. (d) - If the scope of the estate planning engagement includes a review of the client's IRAs, then, at a minimum, it is prudent to obtain copies of the IRA account application, beneficiary designation on file, and custodian agreement. The custodian may bury the beneficiary designation in the account application, or the beneficiary designation could be a separate document. In any event, it's always a good idea to read the fine print to see what happens if the beneficiary designation is blank or defective.

2. (b) - Irene's IRA would be a probate asset because the estate is the beneficiary. Irene was 63, so she died before her required beginning date. An "estate" is not a designated beneficiary for purposes of the required minimum distribution rules. IRC Section 401(a)(9)(E). Treas. Reg. Section 1.409(a)(9)-4, Q&A 3. If the IRA owner dies before the required beginning date and there is no designated beneficiary, then payout is subject to the 5-year rule. 1.401(a)(9)-3, Q&A 4(a)(2).

3. (b) - If an IRA owner dies after the required beginning date, it is important to determine whether a required minimum distribution was made for the year of death. If no distribution was made for the year of death, then the beneficiary (here, Irene's estate) must take the year-of-death distribution to avoid triggering the 50% excise tax under Code section 4974. Treas. Reg. Section 1.401(a)(9)-5, Q&A 4(a). For years after the year of death, distributions can be made over Irene's remaining life expectancy using Irene's age in the calendar year of death (i.e., the age on her birthday in such year even if she died before her birthday) and the Single Life Table. See Treas. Reg. Section 1.401(a)(9)-5, Q&A 5(a)(2) & (c)(3).

4. (c) - Code section 408(a)(6) applies rules "similar to the rules of section 401(a)(9)" to distributions from IRAs. Susan's required beginning date is April 1st of

the year following the year in which she attained age 70½. Susan attained age 70½ on Feb. 1, 2009, so the required beginning date for her IRA is April 1, 2010. IRC Section 401(a)(9)(C)(i)(I) & (i)(II). Remember that required beginning dates under qualified retirement plans and IRAs are not necessarily the same. Plans are not required to use the Code's definition of required beginning date applicable to plans (i.e., April 1st of the year following the later of the year in which the participant attains age 70½ or the year in which the participant retires).

5. (b) - Susan's required beginning date is April 1, 2010. The payout period for lifetime distributions is determined using the Uniform Lifetime Table and it is recalculated each year using the IRA owner's age in such year. Treas. Reg. Sections 1.401(a)(9)-5, Q&A 4(a); 1.401(a)(9)-9.

6. (d) - Only a spouse can roll over an IRA into his or her own IRA, so the statement in II is incorrect. The opportunity to roll over an IRA into one's own IRA is not available to children or other non-spouse beneficiaries. Simon can set up an "inherited IRA" titled in the name of his mother and take out distributions in accordance with the rules that apply to death after the required beginning date. Treas. Reg. Section 1.401(a)(9)-5, Q&A 5(a)(1) & (c)(1).

7. (c) - See IRS Notice 2007-7, Section V, Q&As 11, 17(c)(2), 19; See also IRS Employee Plans News - Special Edition (Feb. 13, 2007). The new rule applies to death benefits under qualified retirement plans; therefore, to apply the distribution rules properly to the IRA created in the name of the deceased plan participant, one must review the plan document carefully and the special rule in Q&A 17(c)(2) of the above-referenced notice.

8. (a) - See IRS Notice 2007-7, Q&A 19.

9. (d).

10. (d) - See Treas. Reg. Sections 1.401(a)(9)-4, Q&A 4(a); 1.401(a)(9)-8, Q&A 2(a)(1) & (2).

11. (a) - See Treas. Reg. Section 1.401(a)(9)-8, Q&A 2(a)(1) & (2).

12. (d) - See Treas. Reg. Section 25.2518-2(a)(4) & (d)(1); IRS Rev. Rul. 2005-36 (June 27, 2005); Treas. Reg. Section 25.2518-2(c)(i).

13. (c) - IRC Section 401(a)(9)(C); Treas. Reg. Section 1.401(a)(9)-4, Q&As 3 & 4(a).

14. (b) - Treas. Reg. Sections 1.401(a)(9)-5, Q&A 4(a) & (b), 5(a) & (c); 1.408-8, Q&A 5(a) & (b).

15. (b) - Treas. Reg. Sections 1.401(a)(9)-4, Q&A 5(a)-(d); 1.401(a)(9)-5, Q&A 7(c)(3), Exs. 1 & 2; See also PLR 2002-28-025 (April 18, 2002), which although is not precedent gives an idea of what the IRS views as an accumulation trust with respect to which contingent beneficiaries would be considered in determining the designated beneficiary.

16. (c) - Treas. Reg. Section 1.401(a)(9)-4, Q&A 5(c). ■

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Committee Spotlights

Technology Committee

The Technology Committee continues to work with the North Carolina Bar Association to provide convenient and innovative ways for our members to access the resources of our section, to educate themselves in the areas of estate planning and fiduciary law, and to actively participate in the efforts of our section. Some of the projects we are pursuing for the 2007-08 fiscal year include revamping the section's Web page to make it more user-friendly, providing access to CLE materials online at no charge to section members, and creating a venue for effectively educating members of the section about current and upcoming legislation.

By Edward W. Griggs

Pro Bono Committee

Our committee continues to oversee the Hospice Pro Bono Project which provides volunteer attorneys to prepare basic estate planning documents for indigent Hospice patients throughout the state. This program is a long-standing, successful program of our section. However, there are still counties where there are no volunteer attorneys. If you are not currently participating in the Hospice Pro Bono Project and would like to join, please contact one of the co-chairs of the Pro Bono Committee, Tim Nordgren and Amy Kincaid.

Our Committee is focusing much of its attention on the Small Estate Administration Project this year. This project is designed to provide critical information about the estate administration process to executors and administrators of small estates who are unable to afford an attorney to assist them with their responsibilities. Our Committee created a PowerPoint presentation on small estate administration last year. This year, the committee is setting its sights on (1) creating a brochure explaining important aspects of the administration of small estates, which we hope will be handed out at Clerk's offices throughout the state; and (2) creating a DVD of the PowerPoint presentation to be viewed by executors and administrators who have come to the Clerk of Court to attempt to administer a small estate.

By Tim Nordgren and Amy Kincaid

Clerk of Court Initiative Committee

The purpose of the Clerk of Court Initiative is to update the AOC Manual and conform it with the NCBA Estate Administration Manual. The last update of the AOC Manual was completed in 2003. The intent was to update the Manual every six months but that has not occurred. Several provisions of the Manual do not conform with current law and are inconsistent with the Estate Administration Manual. During 2006, the Clerk of Court Initiative Committee attempted to review every chapter of the AOC manual in the areas of (1) legislative issues, (2) legal issues, and (3) Clerk's discretion issues. The Committee identified several issues that may need revision in various AOC Manual chapters including: (1) Probating copies of will; (2) Appearance of the Representative before the Clerk; (3) Qualification Fee; (4) Debt on Entireties Property; (5) Copies of Appraisals; (6) Date of Valuation; (7) When are annual accounts due; (8) Fees and Commissions; (9) Transfer of Vehicles; (10) Tie into Brokerage Account Values; (11) Uniform Trust Code and Transfers on Death Accounts; (12) Summary Administration.

In May of 2006, the co-chairs of the Committee met with Pam Best of the AOC to review the work of the Committee and discuss how to proceed. At that time, Ms. Best indicated that Joan Brannon at the School of Government had been assigned to the project of updating the AOC manual during the year 2007. After Ms. Brannon completes her work on the Manual, it is anticipated that the Committee will reconvene to review and discuss the updated version.

By Kimberly H. Stogner and John B. Dunn Jr.

Legislative Committee

For the upcoming year, the Legislative Committee has a number of significant projects underway. For the 2008 legislative session, the Committee is continuing to pursue the possibility of conforming North Carolina gift tax law to the federal law. The Revenue Laws Study Commission had actually independently proposed such an amendment to North Carolina's gift tax statutes, but the proposal was tabled in the General Assembly earlier this year as no data had been gathered as

to the revenue effect of such a change. In addition, the Legislative Committee had objected to some of the language of the Revenue Laws Study Commission's proposal. The Committee is currently working on an amended bill. Other issues being considered for the 2008 legislative session include technical corrections to the recently enacted changes to the health care power of attorney/living will statutes and amendments to the Official Comment and the North Carolina Comments for the Uniform Trust Code.

Earlier this year, the Legislative Committee formed a subcommittee to study and recommend changes to our elective share statutes (currently located at Article 1A of Chapter 30 of the General Statute). Two of the biggest issues the subcommittee is studying are (1) the determination of what assets should be included in calculating a spouse's elective share and (2) the procedure by which an elective share is awarded. It is anticipated that a bill proposing revisions to the elective share statutes will be submitted for consideration in the 2009 legislative session.

The Legislative Committee has also formed a subcommittee to work on drafting a set of rules and procedures that would govern how estate proceedings involving decedent's estate are handled before the clerk. With the passage of the Uniform Trust Code, a specific set of rules and procedures now govern how estate proceedings involving trusts before the clerk are handled. However, the rules governing how a clerk hears proceedings involving estates are still very unclear. For example, proceedings to remove an executor or to resolve any other adversarial claims raised in an estate administration are not governing by a uniform clear set of procedural rules. The goal of the subcommittee working on this project is to draft procedural rules for estate proceedings which rules would be similar to those governing trust proceedings (including specific references to when and how the Rules of Civil Procedure become applicable). As with the changes to the elective share statutes, the goal for the Legislative Committee is to submit a bill governing procedural rules applicable to estate proceedings for consideration in the 2009 legislative session.

See COMMITTEE page 20

Committee *from page 19*

The biggest and most significant project that the Legislative Committee is currently working to complete involves addressing an issue which has arisen regarding the constitutionality of recently enacted N.C.G.S. Section 41-23 which repeals the rule against perpetuities as it applies to private trusts in North Carolina (See N.C. Session Law 2007-230, eff. Aug. 19, 2007). Briefly, a summary of the issue is as follows:

Section 41-23 repeals former North Carolina law which prohibited remoteness of vesting of interests in a trust beyond 90 years or lives in being plus 21 years. Thus, under Section 41-23, there is no longer a limitation on when interests in trust must vest. As a result, dynasty trusts may now be created in North Carolina. However, the new statutory approach adopted in Section 41-23 does codify another North Carolina common law perpetuities prohibition—specifically, the prohibition against restraints on alienation. Under Section 41-23, a grantor of a trust cannot create a restraint on alienation of trust property that lasts beyond the permissible period described in the statute, which is defined under section (a) of the statute as lives in being at the creation of the trust plus 21 years. The effect of the new statutory approach is to permit North Carolina trusts to exist in perpetuity provided that the trustee (or some other person) has the absolute power to sell the trust's property (i.e., the power to either convey an absolute fee in possession in real property or convey full ownership of personal property).

Since the enactment of N.C.G.S. Section 41-23, a question has been raised as to the impact of a specific provision of the North Carolina Constitution on N.C.G.S. Section 41-23. Article I, Section 34 of the North Carolina Constitution provides, "Perpetuities and monopolies are against the genius of a free state and shall not be allowed." In *Mercer v. Mercer*, 230 N.C. 101, 103 (1949), the North Carolina Supreme Court referred to Article I, Section 34 of the North Carolina Constitution in holding that the rule against perpetuities applied to private trusts. This has raised the question among practitioners as to whether the repeal of the RAP as it applies to remoteness of vesting and the substitution instead of a prohibition against restraints on alienation of trust property which endure past the permissible period will satisfy the constitutional mandate of

Article I, Section 34 of the N.C. Constitution.

The Legislative Committee believes that Section 41-23 is constitutional and is currently looking into how to resolve any potential conflict between the N.C. Constitution and Section 41-23. The Committee is also reviewing a separate but related question which has been raised regarding the impact on any recently created North Carolina dynasty trusts should Section 41-23 be declared unconstitutional. The Uniform Statutory Rule Against Perpetuities (USRAP), when enacted in 1995, superseded the N.C. common law as it relates to perpetuities in private trusts. However, Section 41-23 states that USRAP no longer applies to trusts in North Carolina. Thus, if Section 41-23 were struck down as unconstitutional, it is unclear whether USRAP would automatically be revived so as to apply a 90-year wait and see perpetuities approach to recently created dynasty trusts whether the General Assembly would have to re-enact Section 41-15 in order to make it applicable. The Committee hopes to resolve both of these issues either judicially or legislatively in 2008.

By Elizabeth Arias and Lynn F. Chandler

CLE Committee

The CLE Committee has had a very active fall. Three seminars have been presented in September and October. The annual Advanced Planning seminar in Greensboro provided presentations on best practices for estate planning attorneys, planning for executive compensation, attorney-client privilege, gifting techniques and a report on the recent amendments to the North Carolina rule against perpetuities. Speakers included Lynn Chandler, Jim Hardin, Tim Herbst, Maria Lynch and Brett Sovine.

Joining with the Elder Law and Health Law Sections and the North Carolina Medical Society, an excellent seminar on End Of Life Planning was presented on Oct. 10 which addressed the new health care power of attorney and advanced directives statutes, including discussions of new forms. Presentations were made both by estate planners and physicians and many of their descriptions of the importance of this issue to their clients and patients were quite moving. Attendance at the End of Life Planning seminar far exceeded expectations. The CLE Committee appreciates the leadership and

efforts that Knox Proctor, Larry Rocamora, James Creamer, John Crill, and Melanie Phelps and their committee members provided in this important initiative.

On Oct. 17, 2007, a telephone seminar was presented by Graham Holding; Liz Arias and Brett Sovine presented an update on recent changes made to the North Carolina Uniform Trust Code.

The Committee will present the Estate Planning and Probate Survey Course on Nov. 1 and 2. For those estate planners considering sitting for the specialization exam as well as others desiring a broad review of estate planning and administration, this is an excellent resource. Also a basics course for estate planning and administration will be held on Jan. 31 and Feb. 1, 2008.

The CLE Committee welcomes suggestions for topics and speakers for the various seminars. Please contact Craig Dalton at craigdalton@poynerspruill.com with any ideas.

By Craig G. Dalton Jr.

Estate Administration Manual Committee Update

We are currently in the process of supplementing the current two-volume manual, Sixth Edition (2006). The Supplement will be released to coincide with the Basic Class in Estate Administration to be held in January of 2008. Please contact Sandy Clark, Clark@manningfulton.com, or Linda Johnson, ljohnson@ssjlaw.net, if you have any interest in becoming a Chapter Editor for the Seventh Edition of the Manual.

By Sandra Martin Clark and Linda Funke Johnson ■

Recent Developments

Federal Case

Law Developments

U.S. Supreme Court to Review Deductibility of Investment Advisor Management Fees. The U.S. Supreme Court recently agreed to determine whether an exception in the Internal Revenue Code allows a trustee to deduct the full amount of fees paid to an investment adviser. **Knight v. Commissioner of Internal Revenue**, U.S., No. 06-1286, cert. granted June 25, 2007. The federal courts of appeals are currently divided on the issue. In this particular case, Knight was serving as trustee and paid an investment adviser to manage the assets of a trust. When filing the trust income tax return, Knight deducted the full amount of the fees under I.R.C. Section 67(e)(1). In general, trust expenses are deductible only to the extent they exceed 2% of the trustee's adjusted gross income. Knight argued that the fees should fall under an exception to the general rule because they were paid in connection with administration of the trust, and because they would not have been paid unless the assets were held in trust. The IRS disagreed, arguing the fees were subject to the 2% floor rule. The U.S. Tax Court agreed with the IRS, as did the U.S. Court of Appeals for the Second Circuit. The decision by the Second Circuit is consistent with earlier decisions of the Fourth and Federal Circuits holding that the 2% floor applies and that a trust may deduct only the excess above that floor. The Sixth Circuit, however, has found that the expenses should be fully deductible. We will continue to follow this case in Recent Developments.

Ninth Circuit Affirms Tax Court's Use of Section 2036 to Include Transferred Family Limited Partnership Interests Inter Vivos in Decedent's Estate. In **Bigelow v. Commissioner**, No. 05-75957 (9th Cir. 9/14/07), the Ninth Circuit affirmed the Tax Court (T.C. Memo. 2005-65) in a Section 2036 family limited partnership case. In this case, after Ms. Bigelow's death the Estate filed a federal estate tax return applying a 37% discount for lack of control and marketability to Ms. Bigelow's remaining interest in a family limited partnership that held a residential property Ms. Bigelow had transferred before her death. The IRS filed a notice of deficiency and assessed an additional \$217,480.05 in

federal estate tax, claiming the residence's fair market value, rather than the value of the partnership shares subject to the discount, should be included in the gross estate. The Tax Court affirmed the deficiency determination, finding that Ms. Bigelow and the Bigelow children had an implied agreement that Ms. Bigelow would retain income and economic enjoyment from the transferred asset, and that the inter vivos transfer was not a bona fide sale for adequate and full consideration under I.R.C. Section 2036(a). The Ninth Circuit affirmed the Tax Court's decision.

Federal

Administrative Developments

IRS Proposed Rules on Grantor Retained Interest Trusts. The IRS recently proposed regulations, **REG 119097-05**, providing guidance on the portion of a trust properly includible in a grantor's gross estate under I.R.C. Sections 2036 and 2039 if the grantor has retained the use of property in a trust or the right to an annuity, unitrust, or other income payment from such trust for life, for any period not ascertainable without reference to the grantor's death, or for a period that does not in fact end before the grantor's death. The public hearing on these proposed regulations is currently scheduled for Sept. 26, 2007.

IRS Issues Sample CLAT Forms. Annotated sample declarations of trust and alternate provisions that meet the requirements for both an inter vivos and testamentary charitable lead annuity trusts (CLATs) providing for annuity payments payable to one or more charitable beneficiaries for the annuity period followed by the distribution of trust assets to one or more noncharitable remaindermen have been released. See **Revenue Procedures 2007-45 and 2007-46**.

Division of Trust into Two Trusts Will Not Result in Loss of GST Exempt Status. In PLR 200726003, the IRS ruled that a court-ordered modification to divide a trust pro rata into two trusts, one to benefit the issue of each of the two surviving income beneficiaries, will not cause the trust or the resulting trusts to lose their status as exempt from generation-skipping transfer tax. Further, the proposed division would not result in a transfer subject to gift tax by any of

the beneficiaries or in gain or loss recognition from a sale or other disposition of property.

Judicial Reformation of Trust to Limit Time for Withdrawal Right Will Not Result in Loss of Exempt Status for Purposes of GST tax. In PLR 200726008, the IRS ruled that a contemplated judicial reformation of a generation-skipping trust to require the life income beneficiary's right to demand the greater of \$5,000 or 5% of the principal during each calendar year be exercised in January, if it is exercised, will not result in the trust losing its GST exempt status. The Service found such proposed modification would not shift a beneficial interest in the trust to any beneficiary occupying a lower generation than the person or persons who held the beneficial interest prior to the modification. Further, the IRS said, the proposed modification would not extend the time for vesting of any beneficial interest.

Transfer of Private Foundation Assets Will Not Terminate Private Foundation Status. In PLR 200719012, the board of directors of a private operating foundation organized under I.R.C. Section 4642(j)(3) believed it would be in the best interest of the museums the foundation operated to be managed instead by a public charity. To that end, the foundation created the public charity and transferred the museum and museum related assets to it. The foundation agreed to pay the costs exceeding the revenue of the charity until the charity was fiscally sound. In addition, some of the foundation employees would work with the charity for a short time to ensure the museum was properly maintained until competent personnel could be hired by the charity. The foundation sought a ruling that the transfer of the assets to the charity would not result in the termination of the private foundation status and that the financial support given to the charity would still be considered in line with the foundation's exempt purpose. The IRS noted that because the foundation did not commit willful nor repeated acts that would give rise to an involuntary termination under I.R.C. Section 507(a)(2), nor had it given notice to the IRS of an intention to terminate voluntarily under I.R.C. Section 507(a)(1) of the Code, the transfer of assets would not result in a termination of the foundation's status.

See DEVELOPMENTS page 22

Developments *from page 21*

The IRS also stated that because the charity would provide reports to the foundation, the foundation would continue to comply with the expenditure responsibilities required under I.R.C. Section 4945(h). Further, because the expenditures would be used for a purpose connected with the foundation's exempt purpose, the expenditures would still be classified as "qualifying distributions" under I.R.C. Section 53.4942(b)-1(b).

Scholarships Are Not Taxable Expenditures. In PLR 200720020, a private foundation organized under I.R.C. Section 509(a) proposed to create a scholarship program. The intended beneficiaries of the scholarship program would be the children of a certain company's employees who had worked for the company for at least one year and maintained a 3.0 grade point average or higher at a college, university or a technical training school. The foundation proposed to hire an outside company to administer the scholarship program and a selection committee would be appointed with no members being officers, directors or employees of the company. In addition, relatives of any member of the selection committee would be ineligible for a scholarship. The foundation sought a ruling allowing the creation of the scholarship program without the inclusion of tax under I.R.C. Section 4945, which imposes a tax on all taxable expenditures of a private foundation. "Taxable expenditures" are defined as any amount paid or incurred by a private foundation as a grant for study, but there is an exemption under I.R.C. Section 4945(g) for a grant awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the IRS. Because the scholarship program would be implemented with procedures to ensure objectivity and prevent discrimination, the IRS ruled the scholarship program would qualify for the exception created by I.R.C. Section 4945(g).

Reorganization of Private Foundation Not Self-Dealing or Subject to Tax. In PLR 200715014, a private foundation was established for "religious and charitable, scientific or literary education purposes." When the directors began to disagree as to how to use the foundation's required expenditures and how to manage the foundation, the directors agreed to reorganize the foundation by transferring 75% of the foundation's assets to three new entities, each receiving 25% of the assets.

The initial foundation would retain the remaining 25%. The foundation would exercise expenditure responsibility under I.R.C. Section 4945(d) and (f) relating to the transfers. The IRS ruled that under I.R.C. Section 507(b)(2), a private foundation may transfer assets to another private foundation without terminating the transferor's private foundation status and that the transfer of assets to another foundation pursuant to a reorganization would not result in the transferee being treated as newly created under Treasury Regulation Section 1.507-1(b)(6). In addition, the IRS ruled that because the new entities have been recognized as tax-exempt entities and because the directors of all the foundations will serve without compensation, no self-dealing was present with regard to the transfer. Finally, the IRS ruled that when a foundation receives transferred funds subject to a reorganization in which it was created, the transferred funds will not count towards minimum distribution requirements pursuant to Treasury Regulation 1.507-3(a)(9)(i) and that the legal and accounting expenses incurred as a result of the reorganization would also not be considered taxable expenditures under I.R.C. Section 4945 given the complex nature of the transaction and the reasonableness of the fees.

Receipt of Royalties and Limited Partnership Interests Won't Give Rise to UBTI or Self-Dealing. In PLR 200715015, a charitable trust was classified as a private foundation under I.R.C. Section 509(a). The trustees of the trust are also owners of a corporation and members of a limited liability company. The LLC and Corporation both own interests in a limited partnership. The corporation contributed certain trademarks to the limited partnership and the limited partnership granted back to the corporation the exclusive right to use the trademarks in return for a percentage of net sales on products carrying the trademarks. The corporation proposed to contribute all of its interest in the limited partnership to a trust. As a result, the trust would become a partner with the LLC in the limited partnership. When the limited partnership received royalty payments from the corporation, the trust would receive distributions in proportion to its interest in the limited partnership. The trust requested a ruling that neither the interest in the limited partnership nor the receipt of royalties would result in unrelated business tax-

able income (UBTI). The IRS ruled that because the trust would only hold a limited partnership interest and would only be a passive investor in limited partnership with no management authority, the ownership of limited partnership interests will not give rise to the UBTI rules of I.R.C. Section 512(a)(1). Further, because I.R.C. Section 512 does not include royalties, the receipt of such royalties from limited partnership will not give rise to UBTI. The IRS also ruled that because the limited partnership would receive at least 95% of its income from passive activities (i.e. royalties), the ownership interest would not result in a violation of the excess business holdings rule of I.R.C. Section 4943. Finally, the IRS ruled that neither the receipt of limited partnership interests nor the receipt of royalty payments will have an adverse impact on the foundation's exempt status under I.R.C. Section 501(c)(3).

Termination of NIMCRUT Using Actuarial Values Allowable. In PLR 200725044, taxpayer created a NIMCRUT (net income plus make-up charitable remainder unitrust) to pay the lesser of the net trust earnings or 10% of the unitrust amount to himself for life. Taxpayer served as the trustee of NIMCRUT which named twelve charitable organizations as the remainder beneficiaries. Taxpayer and the charitable organizations later agreed to terminate the NIMCRUT and divide the trust pursuant to actuarial values with regard to their respective interests. Taxpayer sought a letter ruling from the IRS that such termination would not be an act of self-dealing under I.R.C. Section 4941(a) and that the termination would not give rise to termination tax under I.R.C. Section 507. The Service ruled that the termination would not be an act of self-dealing so long as the actuarial valuation method consistent with Treasury Regulation 1.7520-3(b)(1)(ii) was used. Essentially, because NIMCRUT pays out the lesser of the trust's net income or 10% of the trust value annually, the valuation method must use the lesser of the trust payout percent (in this case 10%) or the I.R.C. Section 7520 applicable federal rate. If this method is utilized then the self-dealing exception of Treasury Regulation 53.4947-1(c)(2)(i) applies. Finally, the Service noted that when the trust is terminated the income and remainder interests vest in the charitable beneficiaries. As such, the trust would no longer be a split-interest trust and the termi-

nation tax provisions of Sec. 507 would no longer apply.

Parcel of Subdivided Property Qualifies as Personal Residence under I.R.C. Section 2702. In PLR 200729004 a grantor sought to subdivide property used as a personal residence and transfer one parcel to a qualified personal residence trust (QPRT). The remaining parcel would be subject to a conservation easement. The IRS ruled that since the parcel that was proposed to be placed in the QPRT was comparable in size to properties used for residential purposes in its proximity and satisfies the primary use requirements of the regulations, it is a personal residence within the meaning of I.R.C. Section 2702.

Judicial Reformation of Trust to Reflect Grantor's Intent Will Not Cause the Assets to be Included in Grantor's Estate. In PLR 200730015, a settlor created an irrevocable inter vivos trust providing the trustee "shall" distribute for the benefit of her descendants so much of the income and principal the trustee deemed necessary for their education, health, maintenance, and support. Under a recent court opinion construing the relevant state law, this provision could be interpreted as requiring the trustee to make mandatory distributions. The settlor, her attorney, and the trustee by sworn affidavit indicated that her intent was to provide only for discretionary distributions. In addition, the settlor intended to grant a power of appointment over the trust principal to her youngest child but, due to a scrivener's error, this power was granted in the trust instrument to her youngest descendant, who is currently a minor. The trustee plans to petition a local court to revise the trust to provide distributions "may" be made in the trustee's discretion and to grant the power of appointment to the settlor's youngest child. The IRS ruled that judicial reformation will not result in the trust property being includible in the settlor's gross estate under I.R.C. Sections 2033, 2035, 2036, 2038, or 2041.

IRS Issues Guidance on Severance of Trusts For Generation-Skipping Transfer Tax Purpose. The Internal Revenue Service issued two sets of rules on the severance of trusts for generation-skipping transfer (GST) tax purposes on Aug. 1, 2007. In REG-128843-05, the proposed regulations under I.R.C. Section 2642 provide guidance regarding the generation-skipping transfer (GST) tax consequences of the severance of trusts in a manner that is effective under state law, but

that does not meet the requirements of a qualified severance under I.R.C. Section 2642(a)(3). The proposed regulations also provide guidance regarding the GST tax consequences of a qualified severance of a trust with an inclusion ratio between zero and one into more than two resulting trusts and special funding rules applicable to the non pro rata division of certain assets between or among resulting trusts. In T.D. 9348, the IRS issued final regulations under I.R.C. Section 2642 to provide guidance regarding the qualified severance of a trust for generation-skipping transfer (GST) tax purposes under I.R.C. Section 2642(a)(3).

North Carolina Legislative Developments

Health Care Power of Attorney and Living Wills. The N.C. Legislature has adopted changes to the forms of Health Care Power of Attorney and Living Wills. Please view these changes at: <http://www.ncga.state.nc.us/Sessions/2007/Bills/House/HTML/H634v4.html>

Caution with Court Filings Including Identifying Personal Information Should be Exercised. N.C.G.S. Section 132.10(d) says that no person preparing or filing "a document to be recorded or filed in the official records of the register of deeds ... or of the courts may include any person's social security, employer taxpayer identification, drivers license, state identification, passport, checking account, savings account, credit card, or debit card number, or personal identification (PIN) code or passwords in that document, unless otherwise expressly required by law or court order...." More importantly, any person who violates N.C.G.S. Section 132.10(d) "shall be guilty of an infraction, punishable by a fine not to exceed five hundred dollars (\$500.00) for each violation." Further, N.C.G.S. Section 132.10(f), which became effective July 1, 2007, allows a person to request a clerk of court to remove, from an image or copy of an official record placed on a court's Internet Website available to the general public the person's social security, employer taxpayer identification, drivers license, state identification, passport, checking account, savings account, credit card, or debit card number, or personal identification (PIN) code or passwords contained in that official record.

North Carolina Case Law Developments

Tenancy by the Entirety Property is Marital Property and Subject to Equitable Distribution. In *Nelson v. Nelson*, 361 N.C. 346, 643 S.E.2d 587 (May 4, 2007), the North Carolina Supreme Court affirmed the 2006 decision of the Court of Appeals in *Nelson v. Nelson*, 633 S.E.2d 124; 2006 N.C. App. (COA05-1267) (Aug. 15, 2006). In this case, Decedent and his wife purchased three properties during the marriage titling each as tenancy by the entirety. Before his death, Decedent filed an action for divorce and equitable distribution. While his claims were pending, Decedent died. The Superior Court found that the real property was the surviving spouse's separate property and therefore not subject to equitable distribution pursuant to N.C.G.S. Section 50-20(c). The appellate court reversed, holding the real property was marital property and that legal title alone was not controlling when determining whether property is marital or separate. Further, because N.C.G.S. Section 50-20 provides that "[a] pending action for equitable distribution shall not abate upon the death of a party," allowing property to pass to a survivor by operation of law would defeat the purpose of the statute.

The Rules of Civil Procedure Apply to Estate Proceedings. In *Estate of Rand*, 645 S.E.2d 174, COA 06-868 (June 5, 2007), decedent's wife qualified as personal representative of his estate. Five of his daughters challenged her handling of the estate. When the personal representative's final accounting was approved, the daughters filed a motion and notice of appeal requesting the court review the Clerk's order and conduct an accounting. In response, the personal representative filed a motion to dismiss the appeal and sought an order for sanctions and attorney's fees under Rule 11 of the North Carolina Rules of Civil Procedure. The trial court granted her request dismissing the appeal and issuing an order imposing sanctions and attorney's fees on the five sisters and their attorney. On appeal, the Court of Appeals held the Rules of Civil Procedure "govern the procedure...in all actions and proceedings of a civil nature except when a differing procedure is prescribed by statute." N.C.G.S. § 1A-1, Rule 1 (2005). In addition, the court found the phrase "all actions and proceedings of a civil nature" was inclusive, not exclusive, to civil

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actions. Further, the appellate court noted it was a Superior Court judge, not a probate clerk, who made the determination to impose Rule 11 sanctions and attorney's fees, and such decision was well within the Superior Court judge's authority and discretion. On Aug. 23, 2007, the North Carolina Supreme Court denied review of this case.

Reconciliation of Married Couple Will Cancel Waiver of Estate Rights in Previously Entered Separation Agreement. In *Estate of Archibald (Edwards)*, ___ N.C. App. ___, 644 S.E.2d 264 (May 15, 2007), Decedent and her surviving spouse executed a separation agreement containing a provision wherein they waived the right to inheritance rights from each others' estate. The separation agreement was recorded in the Register of Deeds office in Cumberland County. The couple later reconciled and continued to live together until Decedent's death in March 2004. Decedent died testate and her will, which was executed before the marriage, was admitted to probate. The surviving spouse applied for and was granted a year's spousal allowance pursuant to N.C.G.S. Section 30-15. The devisee under the Will filed a motion

requesting the Clerk set aside the assignment of a year's allowance and deny the surviving spouse an elective share. The Clerk denied the motion to set aside the assignment of a year's allowance on the grounds that the time for appeal had expired eight months earlier and denied the motion to deny the surviving spouse an elective shares on the grounds that the couple's reconciliation had canceled and rescinded the provisions of the separation agreement waiving interest in each other's estates. The Superior Court affirmed the Clerk's order. On appeal, the appellate court noted that pursuant to N.C.G.S. Section 30-23, an heir's deadline to file a notice of appeal of a finding of a clerk of court is limited to 10 days after the finding. Further, no notice is required under the statute for spousal elections. In addition, the appellate court held the surviving spouse had a right to claim an elective share because the waiver of estate rights in the separation agreement was cancelled by the parties' reconciliation. ■