KANSAS BAR ASSOCIATION

REPT News

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Section President's Message

Subcommittee looks at standardizing deeds forms

By Frederick B. Farmer
Lowe Farmer Bacon and Row, Olathe

In the last edition of the section's newsletter, I related that one of our goals is to keep our members informed regarding significant developments in our practice areas and to monitor and provide input to various pieces of legislation. In this issue, in addition to case reviews, Mark Andersen brings us legislative updates.

Also, for your information, there is a movement to formulate a statewide standard format for use by the register of deeds offices in accepting documents for recording. The recording offices are moving from hand stamping documents to electronic scanning and filing; therefore, technology imposes margins, color of ink, size and color of paper, among other things, to meet certain requirements. In addition to formatting requirements, the recorders are requesting that certain information should be included on the first page to assist in indexing the document. Failure to meet these requirements may cause the document to be rejected for recording.

As you are aware, there are times when land transaction documents cannot be re-executed and there are times when a delay in recording will effect the structure of the transaction, including priority. A rejection of a document for recording can have a disastrous effect.

The executive committee has formed a subcommittee to study this issue and is working with the Kansas Register of Deeds Association. We would welcome any input from members of the section. Please do not hesitate to contact me at frbf@yahoo.com.

The Plaza Lights seminar is scheduled for December 3 at the Country Club Mariott, Kansas City, Mo. I hope you have all marked your calendars and plan to attend for six valuable hours of CLE. ■

Real Estate Cases

By Mark A. Andersen
Barber Emerson L.C., Lawrence

Kansas Court of Appeals

CONCRETE ACCESSORIES CO., INC., V. MOSES, ET AL.
SEDGWICK DISTRICT COURT – AFFIRMED
NO. 90,805 – AUGUST 13, 2004
Commercial Lease; Option to Purchase

FACTS: Concrete Accessories (appellee) and Moses (appellant) entered into a written commercial lease for a three-year period with an increasing monthly rent payment every year. The lease required appellee to pay the property taxes at the 1995 assessment levels and the appellants would be responsible for any property taxes in excess of the 1995 assessment levels. The lease also provided for three additional three-year periods of contemplated possible renewal again with increasing monthly rent payment each additional year. The lease contained an option to purchase and a right of first refusal. Prior to the end of the initial three-year period, appellee sent appellants a letter explaining how appellee would pay the back taxes owed by the appellants and then prorate the amount out of their rent payment for a period extending past the end of the initial three-year period. Appellee gave no written formal notice it was extending the lease for the initial three-year extension period, and the initial three-year term expired without comment by any party. Appellee continued to pay the increased rent due under the first extension period and deducted the property taxes, and appellants accepted the rent checks for nearly two years and 11 months of the first three-year extension period. Approximately one month before the end of the first three-year extension period, the appellants sent the appellee a certified letter informing the appellee that the lease had expired at the end of the initial three-year period, because appellee failed to give written notice of any extension, and also that the lease would terminate at the end of the first three-year extension period. Appellee replied that all parties had acted in accordance with the lease agreement through the first three-year extension period and appellants could not now deny the existence of the terms of the lease. Appellee exercised its option to purchase prior to the end of the first three-year extension period. Appellee filed a declaratory judgment action, and the district court

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granted partial summary judgment to appellee finding a holdover tenant on a written lease continues under the terms of the original lease. In an additional hearing, the district court found appellee did not strictly comply with the option to renew, but that both parties ignored the terms of the lease and that appellants were estopped and waived their right to assert a breach two years and 11 months into the first three-year extension period. It also found that appellee had properly exercised their option to purchase.

ISSUES: (1) Is there substantial competent evidence to support the trial court's waiver and estoppel conclusions of law? (2) Is there substantial competent evidence to support the district court's decision that appellee properly exercised its option to purchase? (3) Does an option to purchase carry over to the renewal period under a written commercial lease?

HELD: Court affirmed the district court's holding that appellants waived their right to challenge appellee's failure to give proper notice. Court stated the lease contemplated extensions past the initial period, that prior to the end of the initial period appellee sent a letter explaining the property tax situation and a solution continuing into the first extension period, that the parties continued the lease in apparent extension of the lease, monthly rent increase was paid pursuant to the extension period, and appellants accepted 35 of 36 rent payments in the extension period without objection. Court stated that appellee was not a holdover tenant, but instead occupied the subject property pursuant to the first three-year extension period. Court held appellee properly exercised its option to purchase prior to the end of the first three-year extension period. Court stated that where an original lease or agreement to lease provides for an extension or renewal of the lease at the tenant's election, and where the tenant elects to renew the lease or extend its term, the time for exercising a purchase option contained in the lease and exercisable during the term of the lease is likewise extended.

STATUTES: K.S.A. 58-2502.

CONCURRING: Judge Greene concurred in the court's opinion stating the more direct and straightforward analysis is that when a tenant with consent continues to occupy leased premises after expiration of the term, tenant is deemed to be a tenant from year-to-year and that when a tenant holds over with the consent of the landlord, express or implied, the law implies a continuation of the original tenancy upon the same terms and conditions.

TRI-COUNTY CONCERNED CITIZENS V. BOARD OF CO. COM'RS OF HARPER CO., ET AL.

HARPER DISTRICT COURT – REVERSED AND REMANDED WITH DIRECTIONS

NO. 90,988 – AUGUST 20, 2004

Special Use Permits; Prejudgment

FACTS: Waste Connections of Kansas, Inc. (WCKI) began looking at Harper County as a potential landfill site. The Harper County Economic Development Council (EDC) first considered the issue and ultimately recommended to the Harper County Board of County Commissioners (Board) a proposed host agreement and to seek legal examination of the agreement. From January 2001 to May 15, 2001, Commissioner Burkholder contacted legal counsel for suggestions and later for applicability of open meetings, examination of the host agreement, and other issues. WCKI filed an application of special use permit on May 7, 2001, but the application was ultimately abandoned due to environmental concerns. On July 12, 2001, WCKI filed a special use permit for another landfill site and the Harper County Planning Commission conducted numerous public hearings, which were attended by all three commissioners, representatives of WCKI and the Kansas Department of Health and Environment (KDHE), and many county residents voicing their objections to the landfill. The Planning Commission recommended denial of a special use permit. The Board conducted further public hearings, reviewed all the Planning Commission proceedings, and granted a special use permit to WCKI. Tri-County Concerned Citizens (Concerned Citizens) filed an action challenging the Board's decision. The district court denied relief to the Concerned Citizens finding the Board maintained "an open mind and continued to listen to all the evidence presented before making the final decision." However, the district court reversed its order after Concerned Citizens presented new evidence of legal files of the attorneys contacted by Commissioner Burkholder, and the district court set aside the special use permit finding "the cart got a little ahead of the horse." District court also relied on testimony from Commissioner Williams that he would have been "breaking the law" had he voted against the WCKI application because of the agreements that had been made with WCKI.

ISSUES: (1) Did Concerned Citizens have standing to sue? (2) Did the district court err in finding that the prejudgment of the

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Newsletter

To be successful and informative, a section newsletter needs articles or ideas that reflect the needs of its membership. If you would like to contribute to the newsletter contact Cal Karlin.

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board members, specifically board Members Burkholder and Williams, on the merits of WCKI's application precluded a fair and impartial proceeding and rendered the resulting special use permit void?

HELD: Court held Concerned Citizens had standing to challenge the zoning decision. WCKI's application generated significant public interest because of major implications for the county. The individual members of Concerned Citizens lived within 1,000 feet of the landfill and would suffer a substantial grievance and loss of pecuniary interest. Concerned Citizens' purpose is to protect the environment consistent with the goals of the lawsuit, participation of individual members is not necessarily required. The court disagreed with the district court's conclusion that Burkholder's preapplication concern and interest in fully exploring the feasibility of a landfill for the County was fatal prejudgment. The court stated the nature of Burkholder's actions were consistent with his executive or legislative duties as a commissioner and should not be considered as evidence of prejudgment of the subsequent special use application. The court also found the timing of Burkholder's actions predated any site selection and filing of zoning application was prior to any required "shift" to a quasi-judicial rule and not necessarily material to any prejudgment of the subsequent application. Regarding the statements of Commissioner Williams, the court stated that decision making is an evolving process, and due consideration of appropriate evidence over the course of public hearings may properly enable the decision maker to form a reasonable decision prior to the moment of final vote. Court found the precise focus of a prejudgment inquiry must be the decision maker's state of mind as the evidence is presented, not when the evidence is subsequently discussed by the decision maker and considered by himself or herself in forming a decision.

STATUTES: K.S.A. 12-760.

DODSONS V. U-NEEDA SELF STORAGE

SEDGWICK DISTRICT COURT – AFFIRMED

NO. 90,527 – AUGUST 27, 2004

Consumer Protection

FACTS: District court granted judgment to Dodsons, finding U-Needa Self Storage had committed a deceptive act and an unconscionable act in violation of Kansas Consumer Protection Act (KCPA). District court imposed civil penalty of $1,000 for each act, and denied Dodsons' request for attorney fees. U-Needa appealed. Dodsons cross-appealed on amount of civil penalty and denial of attorney fees.

ISSUES: (1) Deceptive act, (2) unconscionable act, and (3) penalty and attorney fees

HELD: Under these facts, telling renters of a storage space that they had exclusive control of that space when the same space was already rented to someone else is a deceptive act according to KCPA. Case fits squarely within statutory example of an unconscionable act. U-Needa engaged in deceptive bargaining conduct, took advantage of unequal bargaining power, and denied Dodsons a material benefit of the consumer transaction. No abuse of discretion in penalty of only $2,000 against U-Needa or in the denial of attorney fees. District court granted U-Needa partial summary judgment, thus U-Needa prevailed on all of Dodsons' claims except the KCPA claims.

STATUTES: K.S.A. 2003 Supp. 50-626, –626(b)(1)(A), –627, –627(a), –627(b)(3), –636(a); K.S.A. 50-634 *et seq.*

JANKORD V. LIN

RILEY DISTRICT COURT – AFFIRMED

NO. 91,597 – SEPTEMBER 3, 2004

Mechanic's Lien

FACTS: District court granted summary judgment to Lin, finding Mead Building Center's mechanic's lien was invalid because the signature of Mead's manager on the lien did not identify his representative capacity. Although it was undisputed the signer was Mead's manager, his signature lacked a "for" or "by" preposition.

ISSUE: Validity of Mechanic's Lien

HELD: No error in granting summary judgment. Although mechanic's lien statutes are to be liberally construed once lien has attached, requirements for lien to come into existence must be strictly met. A corporation cannot sign a lien statement or verify one. Statement and verification must be signed and executed by individual acting for and on behalf of the corporation. Where there is nothing other than the name of the corporation appearing with an individual's signature, there is insufficient evidence to show representative capacity. Also, a slash mark between an individual's name and the name of the cor-

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KBA CLE Calendar

December

3 — **Plaza Lights Institute**
Marriott Country Club Plaza — Kansas City
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

8 — **Telephone Conference: Oil and Gas**
1.0 hour CLE credit

10 — **Family Law Supplement**
Capitol Plaza Hotel — Topeka
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

10 — **What You Need to Know About the Uniform Trust Code, but Were Afraid to Ask**
Online webcast
1.0 hour CLE credit

15 — **Telephone Conference: Medicaid Eligibility for Long-Term Care: What's New for 2005**
1.0 hour CLE credit

January

21 — **Government Law**
Capitol Plaza Hotel — Topeka
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

28 — **DUI**
Marriott — Wichita
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

February

11 — **Juvenile Law**
Hyatt Regency — Wichita
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

11 — **Family Law Institute**
Airport Hilton — Wichita
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

18 — **Estate Planning**
Capitol Plaza Hotel — Topeka
6.0 hours CLE credit, including 1.0 hour of professional responsibility credit

For more information, please contact the CLE Department at (785) 234-5696 or visit the KBA website at www.ksbar.org

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poration is insufficient to show that individual's representative capacity.

STATUTES: None. ■

Office of the Attorney General State of Kansas

OPINION NO. 2004-14

Cities and Municipalities – Buildings, Structures and Grounds; Development and Redevelopment of Areas In and Around Cities – Definitions: Redevelopment Project Costs; Site Preparation; Demolition of Existing Buildings; Capping Sewer Lines

SYNOPSIS: Site preparation may include demolition of buildings when the demolition is necessary to prepare the site for buildings and facilities proposed to be constructed in a redevelopment district. Relocation of sewer lines, including capping existing lines, is authorized as a site preparation under K.S.A. 2003 Supp. 72-1770a(q), as amended by L. 2004, Ch. 154, § 3. Under such circumstances, monies raised through bonds issued pursuant to K.S.A. 12-1770, *et seq.* may be used to pay the costs of these activities.

STATUTES: K.S.A. 10-1201; K.S.A. 2003 Supp. 12-6a01, as amended by L. 2004, Ch. 120; K.S.A. 12-1770; K.S.A. 2003 Supp. 12-1770a, as amended by L. 2004, Ch. 154, § 3; K.S.A. 12-1771; 12-1772; 12-1773, K.S.A. 2003 Supp. 12-1774, as amended by L. 2004, Ch. 154, § 6; 77-201.

OPINION NO. 2004-16

Waters and Watercourses – Groundwater Management Districts – District Powers; Acquisition of Land; General Improvement Bonds; Use of Monies

SYNOPSIS: A groundwater management district may acquire land and interest in land in excess of 1,000 acres by gift, exchange, or eminent domain. However, if the amount of land and interest in land so acquired exceeds 1,000 acres, the district must dispose of that excess in a reasonable and expeditious manner. The Kansas Legislature chose not to specify an exact time frame regarding what would be considered "reasonable and expeditious" because of the variability of factors involved in the sale of land. Consequently, it is not possible to establish a bright line time frame. Should the situation arise wherein a district needs to dispose of excess acreage, the district should act in good faith by taking necessary steps toward disposition as quickly as is feasible under the circumstances.

The purchase of a water right for the purpose of retiring the right is not a capital cost of works of improvement for which a groundwater management district established pursuant to K.S.A. 82a-1020 *et seq.* may expend monies raised through issuance of general improvement bonds authorized under K.S.A. 82a-1031.

STATUTES: K.S.A. 24-661; 24-1201a; 24-1206; 24-1209; 24-1228; 82a-701, as amended by 2004 S.B. 524, § 141; 82a-707; 82a-1020; 82a-1021, as amended by 2004 S.B. 524, § 148; 82a-1028; 82a-1031; 82a-1704. ■

KANSAS 2004 LEGISLATIVE HIGHLIGHTS

Title Insurance – Controlled Businesses: *SB 66.* Title insurers are prohibited from accepting orders for title insurance in connection with a transaction if the title insurer knows or has reason to believe the transaction will constitute controlled business for the title insurer and 70 percent or more of the closed title orders of the title insurer in the previous 12 calendar months is derived from controlled business. This amendment changes the proposed threshold level from 80 percent of gross operating revenue to 70 percent or more of closed title orders. The 70 percent requirement does not apply to transactions involving real estate located in a county that has a population of 10,000 or less.

Title insurers are also required to file a report with the Department of Insurance stating the percentage of closed title orders which originated from controlled business. The report is due within 90 days from the end of each business year. The legislation also requires a "producer" to disclose any financial interests the producer has in the title insurer or title agent. The producer must provide a disclosure to the person being referred. The disclosure must be in writing and must (1) state that the producer has a financial interest in the title insurer, (2) state the nature of the financial interest and a written estimate of the charge or range of charges generally made, (3) state that the consumer is not obligated to use the title insurer, (4) include the names and telephone numbers of no less than three other title insurers who operate in the county (or if less than three operate in the county, it must include all such title insurers), and (5) be signed by the consumer. No producer may require that the consumer purchase title insurance from the controlled title business. No title insurer may accept any title order if it knows or has reason to believe that the name of the title company was preprinted in the sales contract prior to the buyer or seller selecting that title company.

Wood Shingle Covenants (Not Enacted): *SB 292.* This bill would have declared neighborhood restrictive covenants that require residential dwellings to have wood shingles void and unenforceable. The basis for the declaration is that wood shingles constitute a fire hazard and requiring them is against public policy. This is not a new issue before the Kansas Legislature; it came up again this year and never made it out of the conference committee. The principle opposition to this bill has been and remains a belief by some members of the Legislature that this is a local subject that should not be dealt with by statewide legislation. Certain members of the Kansas Legislature are reluctant to act on what they believe is a local matter, which is best dealt with at the city or community level.

Execution Orders – Judge's Signature: *SB 316.* Currently, executions and orders of sale are issued by the clerk. This amendment requires executions and orders of sale to be issued by the clerk and signed by a judge.

Liens – Sewers: *SB 328.* Governing bodies have the authority to file liens against real estate for nonpayment of sewage and water costs. This amendment accepts water service and sewage disposal contracted for by a tenant, not by the landlord or owner of the property.

Forfeiture of Property – Notice: *SB 379.* The existing procedure for seizure of property (real and personal) by a law enforcement officer requires either the seizing agency or the plaintiff's attorney to provide notice of the seizure to a lienholder ("any interest holder of record"). The Kansas Bankers Association said this alternative responsibility created confusion as to who would serve the notice. Accordingly, the amendment deletes the ability of the plaintiff's attorney to give the notice and places the notice responsibility on the seizing agency. Moreover, notice must be provided to any interest holder of record within 30 days of seizing the property.

Brokers and Salespersons – Licensing: *SB 404.* The licensing laws for brokers and

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salespersons were amended as follows:

- The Real Estate Commission may consider the following factors in determining whether to grant or renew a license: conduct "which reflects on the applicant's honesty, trustworthiness, integrity or competence to transact the business of real estate."
- The Commission is given authority to discipline a licensee who has been sanctioned by suspension, probation or revocation in another state.
- Currently, a licensee can be subject to emergency proceedings if the licensee has entered a plea of "guilty." The amendment adds a plea of nolo contendere.
- K.S.A. 50-3062 contains a litany of prohibited acts of a licensee, whether acting as an agent or principal. The bill clarifies that these requirements also pertain to a licensee while acting as a transaction broker.
- Current law prohibits payment of a referral fee to a broker or salesperson in another jurisdiction if the licensee knows that the referral fee will result in payment of a [prohibited] rebate by the out-of-state licensee. The amendment extends this to referral fees paid to Kansas licensees.
- Removes the prohibition of offering or giving prizes, gifts or gratuities which are contingent upon an agency agreement or sale, and replaces it with a prohibition against paying a commission or compensation "to any person not licensed under this Act, for performing any activity for which a license is required under the Act."
- Requires salespersons and associate brokers to report to their appropriate supervisor that they are performing activity requiring a license.

Brokers and Salespersons – Foreign Licensees: *SB 534.* This new law says that Kansas brokers "may cooperate with and share commissions and other compensation" with foreign licensees in commercial real estate transactions if the real estate does not involve a single family residence and the brokers enter into a "broker cooperation agreement." The statute requires certain matters to be included in the agreement, some of which are:

- Foreign licensee agrees to comply with Kansas law, submit to jurisdiction, and consent to service of process, etc.
- All escrowed funds and earnest money deposits to be held in the trust account of the Kansas broker.
- Description of how compensation will be earned and shared.
- Foreign and Kansas licensees agree to keep each other informed on all showings and negotiations.
- Provide each other with copies of all documents which Kansas law requires licensees to retain.
- A copy of the broker cooperation agreement must be provided to the Kansas Real Estate Commission within five business days after execution.

Construction Contracts: *HB 2154.* Prohibits indemnification provisions in a "construction contract" (defined in the legislation) which require indemnifying the indemnitee for its own negligence as against public policy. Such provisions are void and unenforceable. Applies to all construction contracts for buildings and structures, both residential and commercial. Also applies to construction contracts for highways, roads, bridges, and other improvements to real property.

Historic Preservation Act: *HB 2531.* Amends the Historic Preservation Act to provide that land located within 500 feet of an historic property is deemed to be located within the environs of the historic property. It also provides that nothing in the legislation shall "prohibit, hinder or otherwise restrict" agricultural use of any land for "agricultural purposes" (defined in the legislation).

Nuisance – Extension of Time to Abate: *HB 2615.* Current law requires property owners to remove and abate a nuisance within 10 days after notice from the city. This amendment allows the city to grant extensions of the 10-day time period.

Taxes – Rebates: *Senate Substitute for Substitute for HB 2647.* The legislation allows the Kansas Department of Commerce to designate downtown redevelopment areas to qualify for real estate tax rebates. The local governing body must apply to the department for the designation. Thereafter, property owners must apply for the rebates. In order to qualify, the property owner must make improvements within 12 months, which are equal to or exceed 25 percent of the appraised value of the property, and the property must be in full compliance with city ordinances and county resolutions. A property tax increment will be refunded to the taxpayer at 100 percent for each year in years one through five, 80 percent in year six, 60 percent in year seven, 40 percent in year eight, and 20 percent in year nine. No rebate shall be paid on or after the 10th year. ■

By Dan C. Peare
Hinkle Elkouri Law Firm LLC, Wichita

1. IRS ANNOUNCES ADJUSTED AMOUNTS FOR TRANSFER TAX AND EXPATRIATION ITEMS.

For 2005, the following exclusions amounts and rules will apply:

The annual gift tax exclusion will remain at $11,000 per individual.

For individuals dying in 2005, the limit on the decrease in value that can result from an estate's use of special valuation rules will increase to $870,000 (up from $850,000).

For individuals dying in 2005, in determining the part of the estate tax that is deferred on a farm or closely-held business that is subject to interest at a two percent rate per year, the tentative tax will be computed on $1.17 million (up from $1.14 million), plus the applicable 2005 exclusion amount of $1.5 million.

The annual exclusion for gifts to noncitizen spouses will increase to $117,000 (up from $114,000).

It will be presumed that a tax avoidance motive exists for an expatriate if his or her average annual net income tax liability for the five tax years ending before the date he or she loses his citizenship or residency exceeds $127,000 (up from $124,000), or whose net worth on such date exceeds $636,000 (up from $622,000).

If a U.S. person (other than an exempt Code Section 501(c) organization) receives "foreign gifts" in the aggregate that exceed a threshold amount, the U.S. person must report each "foreign gift" to the IRS pursuant to Code Section 6039F(a). For gifts received from a nonresident alien individual or a foreign estate, such gifts must only be reported if the aggregate amount exceeds $100,000 during the tax year. For gifts from foreign corporations and foreign partnerships, the reporting threshold in 2005 will be $12,375 (up from $12,097).

2. BEQUEST TO MEMBER OF RELIGIOUS ORDER WHO HAS TAKEN VOW OF POVERTY FAILS TO QUALIFY FOR ESTATE TAX CHARITABLE DEDUCTION.

The decedent bequeathed his entire residuary estate to his sister ("beneficiary"), who prior to the date of the decedent's will, had taken a vow of poverty as a member of a religious order ("order"). Decedent's will provided that if the beneficiary predeceased him, his residuary estate was to be distributed to the order. As executrix of the decedent's estate, the beneficiary transferred the decedent's residuary estate to the order more than one year after the decedent's death.

The decedent's estate argued that the distribution to the order qualified for the estate tax charitable deduction under Code Section 2055 or, in the alternative, the beneficiary's vow of poverty constituted a qualified disclaimer under Code Section 2518.

The IRS found that the decedent's bequest did not qualify for the charitable deduction under Code Section 2055, because under the terms of the decedent's will, the residuary estate passed directly to the beneficiary and not to the order. The decedent's residuary estate then passed from the beneficiary to the order under the beneficiary's contractual vow of poverty.

The IRS also rejected the estate's argument that the beneficiary's written vow of poverty met the requirements of a qualified disclaimer under Code Section 2518(a) or, in the alternative, constituted a transfer that qualified as a disclaimer under Code Section 2518(c)(3), thus resulting in the disclaimed property being distributed to the order and qualifying for the charitable deduction. In rejecting the estate's argument, the IRS found that the beneficiary's vow of poverty did not meet the requirements of a qualified disclaimer, because (1) the vow did not meet the state law requirement that a qualified disclaimer be filed with the appropriate probate court, nor did it meet any of the state's other statutory procedural requirements for a qualified disclaimer; (2) the vow did not have the effect of treating the beneficiary as predeceasing the decedent so that for inheritance purposes the assets would not pass to the beneficiary; and (3) the vow did not describe or designate the particular property being disclaimed as required by Code Section 2518(b) and Treasury Regulation Section 25.2518-2(b)(1).

Similarly, the IRS rejected the estate's argument that the beneficiary made a transfer of the decedent's residuary estate that is treated as a qualified disclaimer under Code Section 2518(c)(3). Section 2518(c)(3) provides that a written transfer of the transferor's entire interest in property that meets the requirements of Code Section 2518(b)(2) and (3) and that results in the person receiving the property who would have received the property had the transferor made a qualified disclaimer, will be treated as a qualified disclaimer. In rejecting the estate's argument, the IRS relied on the legislative history of Code Section 2518(c)(3), which states such Section was only intended to apply when the disclaiming party could not effectively disclaim his or her interest under state law but could make a qualified disclaimer under federal law. In the instant case, the IRS found the beneficiary did not meet the requirements of Code Section 2518(c)(3), because the beneficiary transferred the subject assets to the order more than nine months after the decedent's death. Further, even if the beneficiary's vow of poverty could be viewed as a transfer, the vow did not describe or designate the particular property being disclaimed, nor did it purport to assign the decedent's assets to the order as required by Code Section 2518(c)(3). P.L.R. 200437032.

3. QTIP ELECTION NOT INVALIDATED BY STATE COURT ORDER DIVIDING MARITAL TRUST INTO TWO SEPARATE TRUSTS.

During the decedent's lifetime, the decedent and her husband created a joint revocable trust that owned each of their 50 percent interests in certain community property ("trust A"). Upon the death of the decedent, trust A terminated and the decedent's 50 percent interest in such trust passed to trust B, which the decedent created during her lifetime. The residue of the decedent's estate also passed to trust B under the decedent's will.

Under the terms of trust B, the trustee was instructed to distribute the residue to a marital trust. If the trustee elected to make only a partial qualified terminable interest property ("QTIP") election under Code Section 2056(b)(7), the trustee was to distribute the property not subject to the QTIP election to Trust C. Upon the death of the decedent's husband, after certain distributions to designated individuals and organizations, the balance of the marital trust property was to be distributed to a charitable organization.

The executor of the decedent's estate elected to treat the entire marital trust created under trust B as QTIP property. However, after the federal estate tax return for the decedent's estate was filed, pursuant to a petition filed by the decedent's spouse

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as trustee of the marital trust, pursuant to state law, a court order that the marital trust be divided into two trusts, marital trust one and marital trust two. The order further provided that if the decedent's husband assigns all of his interests in either marital trust one or marital trust two to the remainder beneficiary, then such marital trust would terminate and the property distributed to the remainder beneficiary.

The decedent's estate requested rulings from the IRS stating that (1) the court order dividing the marital trust into two separate trusts did not invalidate the marital trust's QTIP election; (2) the husband's assignment of his entire interest in marital trust two did not invalidate the marital trust's QTIP election; (3) the husband's gift of his entire interest in marital trust two will qualify for the gift tax charitable deduction under Code Sections 2511; (4) the husband will be treated under Code Section 2519 as making a gift of his remainder interest in marital trust two when he gifts his income interest in marital trust two to a charity, and the resulting gift of the remainder interest will qualify for the gift tax charitable deduction; (5) the husband's gift of his income interest in marital trust two does not result in any taxable gift for any portion of marital trust one; and (6) the husband's gift of his income interest in marital trust two qualifies for the income tax charitable deduction under Code Section 170.

The IRS found that the court order dividing the marital trust into two marital trusts did not invalidate the QTIP election made by the decedent's estate under Code Section 2056(b)(7) in regards to the marital trust, marital trust one and marital trust two. In addition, the IRS found that the husband's assignment of his entire interest in the marital trust two to a charity will not invalidate the QTIP election in regards to all three marital trusts.

The IRS further found that any assignment by the decedent's husband of his entire interest in marital trust two to a charity will be a charitable gift under Code Section 2511 of his qualifying income interest in such trust, and in accordance with Situation 2 of Rev. Rul. 86-60, such gift will qualify for the gift tax charitable deduction under Code Section 2522(a). Likewise, the IRS found that the husband's gift of his entire interest in marital trust two will not subject any portion of marital trust one to federal gift tax.

Lastly, the IRS agreed with the decedent's estate that the husband's gift of his entire interest in the marital trust two will qualify for the income tax charitable deduction under Code Section 170. The IRS found that because the decedent was the party responsible for dividing the husband's principal and income interest under the marital trust, and the husband would transfer his entire interest in marital trust two to the charity and not just a partial interest, Code Section 170(f)(3)(A) did not apply. Code Section 170(f)(3)(A) disallows a charitable deduction for a party's gift of a partial interest in property, unless the gift is of the party's entire interest in the property. P.L.R. 200438028.

4. SPLIT DOLLAR AGREEMENTS DID NOT CREATE SECOND CLASS OF STOCK FOR S CORPORATION.

An S corporation ("company") proposed to enter into split-dollar agreements with 19 different individuals, or trusts created for such individuals (a "recipient"). Under the terms of each split-dollar agreement, each recipient was obligated to pay the company a portion of the life insurance premium "equal to the lowest annual cost of insuring the joint lives of the insureds on the applicable policy," as determined in accordance with IRS Notice 2002-8 and final Treasury Regulation §1.61-22. Further, under each agreement, the company was required to pay the entire premium to the insurer, and if the recipient failed to reimburse the company for the recipient's portion of the premium, the company's payment to the insurer was treated as a loan by the company to the recipient. Upon the death of the last insured, the company was entitled to receive a portion of the policy's death benefit proceeds equal to any unpaid loans owed by the recipient to the company, plus the greater of the total amount of premiums paid by the company and the policy's cash surrender value. The company requested that the IRS rule that such split-dollar agreements will not cause the company to have more than one class of stock within the meaning of Code Section 1361(b)(1)(D).

Under Treasury Regulation Section 1.1361-(l)(1), an S corporation is viewed as having one class of stock if all of its outstanding shares of stock have identical rights to distribution and liquidation proceeds. Treasury Regulation Section 1.1361-1(l)(2)(i) provides that a company's corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to the distribution and liquidation proceeds will determine whether an S corporation confers identical rights to distribution and liquidation proceeds to all of its shares of outstanding stock. This regulation further provides that a "commercial contractual agreement, such as a lease, employment agreement, or loan agreement is not a binding agreement relating to a distribution and liquidation of proceeds" and will not be a governing provision, unless its principal purpose is to circumvent the one class of stock requirement.

The IRS found that the proposed split dollar agreements did not modify the stockholders' rights to distributions and liquidation proceeds, because under the terms of each agreement, a recipient must reimburse the company for the portion of the life insurance premium equal to the amount of the economic benefit received by the recipient. Thus, the IRS concluded that the split-dollar agreements were fringe benefits and not a vehicle to circumvent the one class of stock requirement. P.L.R. 200441023.

5. PAYMENTS RECEIVED BY ESTATE UNDER DECEDENT'S NONCOMPETE AGREEMENT ARE INCOME IN RESPECT OF DECEDENT.

Prior to his death, the taxpayer's father ("decedent") sold his veterinary clinic to another veterinarian. As part of the transaction, the decedent and the buyer entered into a 10-year noncompete agreement whereby the buyer agreed to pay the decedent 120 monthly payments of $1,000. The decedent died intestate. At the time of the decedent's death, the buyer owed 108 payments under the noncompete agreement, and such payments were included in the decedent's gross estate for federal estate tax purposes. For federal estate tax purposes, the unexpired portion of the noncompete agreement was valued at $81,000, which was 75 percent of the payments still owed under the agreement. The decedent's son ("petitioner") received a one-third interest in the unexpired portion of the noncompete agreement. During 1999, the petitioner received $3,666 under the noncompete agreement. However, the petitioner did not report any of the payments on his 1999 federal income tax return. The IRS determined there was a $398 deficiency in the petitioner's federal income tax return.

The petitioner argued that as of the date of the decedent's death, the basis in the unexpired portion of the noncompete agreement was "stepped-up" to 75 percent of its value, and thus only 25 percent of the payments received by the petitioner in 1999 should be included in his 1999 gross income. The IRS contended the full amount of the payments

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received by the petitioner should be included in the petitioner's 1999 gross income as income in respect of decedent ("IRD") under Code Section 691(a).

The tax court found that the payments received under the noncompete agreement were IRD under Code Section 691(a), because (1) pursuant to *Kinney v. Comm'r*, T. C. 1038 (1972), payments received under a covenant not to compete are includible in a taxpayer's gross income; (2) the decedent had a legally vested right to receive payments under the noncompete agreement for a 10-year period; (3) the value of the unexpired portion of the noncompete agreement was not included in the decedent's gross income prior to his death; and (4) the petitioner was a successor in interest to a one-third interest in the noncompete agreement. The tax court also found that the petitioner did not receive a step-up in basis of 75 percent of the noncompete payments under Code Section 1014(a), because under paragraph (c) of such Code Section, a taxpayer does not receive a step-up in basis if the payments received are IRD. *Coleman v. Comm'r.*, T.C. Memo 2004-126.

6. IRS GRANTS DECEDENT'S HEIRS AT LAW THE RIGHT TO INSPECT DECEDENT'S INCOME TAX RETURN TO DETERMINE DECEDENT'S ASSETS.

The decedent died intestate survived by two brothers and two sisters. Under state law, the four siblings were the decedent's heirs at law, and each was entitled to one-fourth of the decedent's estate. The siblings desired to inspect the decedent's income tax return for the year prior to his death to determine the assets owned by the decedent at the time of his death.

Under Code Section 6103(e)(3)(B), upon written request, a decedent's income tax return may be inspected or disclosed to any heir at law, next of kin, or beneficiary under the will of the decedent, or a donee of property, if the IRS finds that such party has a material interest that is affected by information contained in such tax return. The IRS has generally defined a "material interest" to mean an important interest that is financial in nature.

The IRS found that the decedent's income tax return filed for the year prior to his death may disclose assets or information materially affecting the distributions to be made to the decedent's heirs who take by intestacy within the meaning of Code Section 6103(e)(3)(B). Thus, the IRS granted the decedent's sibling access to his tax return for the prior year. This revenue ruling superseded Revenue Ruling 54-379, which according to the headnote of this revenue ruling, the IRS felt did not clearly address the application of the "material interest" standard when a decedent dies intestate.

This revenue ruling also outlines the information a requesting party must provide to the IRS to demonstrate that he or she has a material interest in reviewing a decedent's tax return. The requesting party must provide the IRS with (1) proof of the decedent's date of death, place of death, and the decedent's resident state to help the IRS determine which state's law is applicable; and (2) proof of the requesting party's relationship to the decedent, which may include a birth or baptismal certificate, school record, or an insurance designation. In addition, the IRS stated that a copy of a petition for probate or another comparable pleading required to institute an administration proceeding for the decedent's estate would be sufficient evidence, but not the only form of evidence, to establish a requesting party's material interest in a decedent's estate. Rev. Rul. 2004-68.

7. IRS DEFERS QUESTION OF WHETHER GRANTOR OF IRREVOCABLE TRUSTS COULD BE TREATED AS OWNER OF SUCH TRUSTS UNDER CODE SECTION 675(4)(C).

The grantor created an irrevocable trust number one where his father was the initial trustee. Under the terms of this irrevocable trust, the grantor's father and/or two of the grantor's brothers could at any time acquire any trust property by substituting property with an equivalent value without the approval of any person acting in a fiduciary or nonfiduciary capacity.

The grantor later created an irrevocable trust number two and had an unrelated party serve as the initial trustee. Under the terms of this irrevocable trust, the grantor had the power, acting solely in a nonfiduciary capacity and without any approval required of a person acting in a fiduciary capacity, to reacquire the trust principal by substituting property with an equivalent value.

Irrevocable trust number one proposed to transfer all of its assets to irrevocable trust number two in exchange for a promissory note with a principal amount equal to the value of the irrevocable trust number one assets, as determined by a qualified appraiser. The principal balance of the promissory note accrued interest equal to the long-term applicable federal rate for the month of the transfer.

Code Section 675(4)(c) provides that a grantor of a trust will be treated as the owner of any portion of the trust where a power of administration is exercised in a nonfiduciary capacity by any party without the consent or approval of any party acting in a fiduciary capacity. A "power of administration" includes the power to reacquire trust principal by substituting property with an equivalent value. Treasury Regulation Section 1.675-1(a) further provides that a grantor will be treated as the owner of any portion of a trust if under the trust agreement, or pursuant to the trust's operation, any administrative control is exercised primarily for the grantor's benefit, rather than for the benefit of the trust's beneficiaries.

The IRS concluded that it did not have sufficient facts to determine whether the power of administration under both irrevocable trusts was exercisable by the applicable individuals in a nonfiduciary capacity. The IRS stated it would make this determination when it reviewed the federal income tax returns of the involved parties. However, the IRS did state that if it finds the power of administration is exercisable in a nonfiduciary capacity, the grantor would be treated as the owner of both irrevocable trusts for income tax purposes, and the sale of the irrevocable trust No. 1 assets to the irrevocable trust No. 2 would be disregarded for income tax purposes. P.L.R. 200443012.

8. IRS GRANTS EXTENSIONS TO ALLOW TAXPAYERS TO MAKE PROPER GST EXEMPTION ALLOCATIONS.

Husband and wife each established an irrevocable trust for the benefit of their grandchildren and other skip persons (the "grandchildren's trusts"). Each irrevocable trust owned life insurance policies, and the husband and wife paid the premiums each year through annual split gifts under Code Section 2513. In years one through 12, the husband and wife each transferred cash to their respective irrevocable trust and filed federal gift tax returns. Husband and wife also elected to split each of these gifts for gift tax purposes. For years one through six, the husband and wife each made timely or late allocations of generation-skipping transfer ("GST") exemption for their gifts. Beginning in year seven, husband and wife did not have enough remaining GST exemption to allocate for the value of their gifts. Thus, the gift tax returns for years seven through 10 included the following statement, "Donor allocates to this trust the smallest amount of the Donor's GST exemp-

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tion necessary to produce an inclusion ratio (as defined in Internal Revenue Code Section 2642(a)) which is closest to or, if possible, equal to zero. This is a formula election which will change if values are changed on audit."

On a second date, the husband and wife each created three irrevocable trusts for the benefit of each of their three children and their descendants (the "children's trusts"). Husband and wife each gifted limited partnership interests to each of their children's trusts and filed gift tax returns splitting each of the gifts. The husband and wife made no other gifts to the children's trusts. In year five, the couple's estate planning attorney advised the couple's accountant in writing to allocate GST exemption to all of the children's trusts, but the accountant failed to do so. The accountant's firm later discovered the error, and husband and wife were advised to make late allocations of GST exemption to each of their children's trusts. In year six, the parties filed amended gift tax returns and allocated GST exemption to each of the children's trusts. After the amended returns were filed, the accounting firm discovered an error in the values of the gifts made to the children's trusts that were reported in the year five gift tax return.

The husband and wife each asked the IRS to grant extensions under Treasury Regulation §301.9100-3 to allow the husband and wife to file supplemental gift tax returns and properly allocate their remaining GST exemptions to the children's trusts and to the grandchildren's trusts. Under §301.9100-3, the IRS will grant relief when a taxpayer provides sufficient evidence satisfactory to the commissioner that the taxpayer acted reasonably and in good faith. Section 301.9100-3(b)(1)(v) states that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional and such professional failed to make, or failed to advise the taxpayer to make, the proper election. Based on the above facts, the IRS concluded the husband and wife each satisfied the requirements of §301.9100-3. P.L.R. 200440019 and P.L.R. 200440020.

9. PROCEEDS OF LIFE INSURANCE POLICY TRANSFERRED TO LLC INCLUDED IN DECEDENT'S GROSS ESTATE UNDER CODE SECTION 2035.

Decedent and his spouse created a limited liability company (the "LLC") where each initially owned a 50 percent membership interest. The decedent and his spouse each contributed cash and bonds to the LLC, and the decedent also contributed a life insurance policy on his life to the LLC. Although the decedent contributed a larger portion of assets to the LLC, one-half of its assets were credited to the spouse's capital account. Initially, the cash surrender value of the decedent's life insurance policy was allocated solely to the decedent's capital account. However, one-half of the policy's cash surrender value was subsequently transferred to the spouse's capital account. Later in the year, the decedent sent a letter to the insurer requesting that the insurer change the owner of the policy to the LLC and change the beneficiary from the decedent's spouse to the LLC.

Within a year of forming the LLC, the decedent transferred all of his membership interest to his three children in substantially equal shares. Simultaneously, the decedent's spouse also transferred a portion of her membership interest in equal amounts to the couple's three children. The transfers to the children were properly reflected in the LLC's capital accounts, on the partnership tax returns and the K-1. The decedent and his spouse also filed gift tax returns reflecting the transfers.

The decedent died approximately 16 months after he first transferred the life insurance policy to the LLC. The decedent's estate did not report any portion of the policy's proceeds in the decedent's gross estate when it filed the Form 706. The IRS contended that all of the policy's proceeds should have been included in the decedent's gross estate under Code Section 2035(a).

Code Section 2035(a) provides that when a decedent makes a transfer of any property interest during the three year period ending on the date of the decedent's death, and the value of such property would have been included in the decedent's gross estate under Code Sections 2036, 2037, 2038, or 2042, if the decedent had retained the transferred interest, the value of the decedent's gross estate will include the value of the transferred interest. However, under Code Section 2035(d), such rule does not apply for any bona fide sale for full and adequate consideration in money or money's worth.

In relying on the earlier case of *Shepherd v. Comm'r*, 115 T.C. 376 (2000) and Treasury Regulation §25.2511-1(h)(1), the IRS found that for transfer tax purposes the decedent made a constructive transfer of 50 percent of the policy to the decedent's spouse when such portion of the policy's value was reallocated from the decedent's capital account to the spouse's capital account. Because this transfer was made within three years of the decedent's death, the IRS held that the 50 percent policy interest transferred to the decedent's spouse would be included in the decedent's gross estate under Section 2035(a). Further, the exception under Code Section 2035(d) did not apply, because the decedent did not receive any consideration for the transfer made to his spouse.

Similarly, the IRS found that the 50 percent policy interest retained in the decedent's capital account would also be included in the decedent's gross estate under Section 2035(a), because the transfer occurred within three years of the decedent's death and such interest would have been included in the decedent's gross estate at his death under Code Section 2042 if the decedent had retained the interest. The IRS also held that under Code Section 2035(d), the decedent's transfer of the life insurance policy to the LLC did not meet the requirements of a bona fide sale, nor did the decedent receive full and adequate consideration in money or money's worth for the transfer of the policy to the LLC. In reaching this conclusion, the IRS found that the decedent's estate failed to produce any evidence that the LLC's formation was the result of an arms-length bargain between the decedent and the decedent's spouse and/or children. Rather, the decedent had signed all of the formation documents, contributed the majority of the assets to the LLC, and continued to pay the life insurance premiums even though the LLC had sufficient assets to pay the premiums. The IRS also rejected the estate's argument that the decedent received full and adequate consideration for the policy when he received an LLC membership interest. Instead, the IRS found the estate failed to show there was a valid business purpose for the transfer, and the purpose of the policy transfer was simply to remove the policy proceeds from the decedent's gross estate.

The decedent's estate also requested the IRS to rule on what portion of the policy proceeds would qualify for the marital deduction under Code Section 2056(a). The decedent's estate asserted that the estate was at least entitled to a marital deduction for the portion of the proceeds attributable to the one-half interest gifted by the decedent to his spouse on the grounds the decedent gifted an interest in the policy rather than an LLC interest. However, the IRS held that the estate was not entitled to any marital deduction, because the life insurance

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proceeds were payable to the LLC and not the spouse. T.A.M. 200432015

10. GIFT TAX AMOUNT PROPERLY EXCLUDED FROM DECEDENT'S GROSS ESTATE UNDER CODE SECTION 2035(b).

During year one, the decedent's spouse made gifts to various individuals, trusts and charities. Decedent and decedent's spouse elected to split such gifts under Code Section 2513 and each filed a federal gift tax return. The decedent's gift tax return reflected that the decedent owed gift tax and the decedent paid such amount. The decedent died exactly three years from the date that his spouse made gifts in year one. On the decedent's federal estate tax return, his estate excluded the gift tax paid for the gifts made on such a date on the grounds that the gifts were made one day beyond the three-year period, as defined in Code Section 2035(b). Code Section 2035(b) states that "the amount of the gross estate (determined without regard to this subsection) shall be increased by the amount of any tax paid under chapter 12 by the decedent or his estate on any gift made by the decedent or his spouse during the three-year period ending on the date of the decedent's death."

In concluding that the decedent's estate was correct, the IRS noted that under the Federal Rules of Civil Procedure and the Tax Court Rules, the general rule is that a period of limitations does not begin to run until the day after the triggering event, unless a statute specifically provides otherwise. However, the IRS found that Code Section 2035(b) is an exception to the general rule, because the statute specifically provides that the computation of the period of limitations is computed backwards from the date of the decedent's death and includes such date. T.A.M. 200432016

11. THIRD CIRCUIT HOLDS THAT FAMILY LIMITED PARTNERSHIP INTERESTS ARE INCLUDIBLE IN DECEDENT'S GROSS ESTATE UNDER 2036(a).

The decedent transferred $2.8 million in securities and other assets to two family limited partnerships in exchange for proportional partnership interests. The decedent formed the first limited partnership in 1993 with his daughter and son-in-law (the "Turner partnership"). The decedent contributed to this limited partnership securities worth $1,286,000 and notes receivable from his daughter's children totaling $125,000 in exchange for a 95.4 percent limited partnership interest. The decedent's son-in-law contributed $1,000 in cash and real property located in Vermont that was valued at $49,000 in exchange for a 3.54 percent limited partnership interest. The parties formed a corporation to own the remaining 1.06 percent general partnership interest. The corporation was owned 49 percent by decedent, 24.5 percent each by the decedent's daughter and son-in-law, and two percent by an unrelated tax-exempt organization.

Also in 1993, the decedent formed a second limited partnership with his son (the "Thompson partnership"). The decedent contributed $1,118,500 in securities and $293,000 of notes receivable to this limited partnership in exchange for a 62.27 percent limited partnership interest. The decedent's son contributed mutual funds worth $372,000 and Colorado ranch property valued at $460,000 in exchange for a 36.72 percent limited partnership interest. Similar to the Turner partnership, the parties formed a corporation to own the 1.01 percent general partnership interest. The decedent and the decedent's son each owned 49 percent of the corporation, and an unrelated third party owned the remaining two percent.

After the transfers to the two limited partnerships, the decedent only owned $153,000 of personal assets, and his annual income was only $14,000. The decedent's annual expenses were approximately $57,000 per year.

After the Turner partnership's formation, the decedent's daughter and son-in-law contributed additional real property to the limited partnership and their interests in a real estate partnership, even though the decedent's daughter and another family member retained title to the partnership's underlying assets. In addition, approximately one year after the parties formed the limited partnership, they amended the limited partnership agreement to provide that all gains and losses from, and gains and losses from distribution of, real property contributed by a partner would be allocated and distributed to the partner who contributed the real property. This amendment was made retroactive from the formation of the Turner partnership. Thus, the decedent's daughter and son-in-law received all of the income from, and the gains from the sale of, any real property contributed by them to the limited partnership.

The Turner partnership engaged in various business transactions, but none of them resulted in any economic gain for the limited partnership. Further, the Turner partnership made loans to members of the Turner family. However, many times the terms of the loans were not followed. The family members were either late in making their interest payments or failed to make such payments all together, and the limited partnership never sought to enforce the terms of the loans. In addition, the loans were frequently restructured.

After the formation of the Thompson partnership, there was very little trading of the limited partnership's securities and its only operational asset was the Colorado ranch contributed by the decedent's son. The decedent's son used the ranch as his primary residence, but only paid the limited partnership $12,000 per year in rent. In addition, the limited partnership paid the corporation acting as general partner a management fee of $23,625 in 1993, $45,000 in 1994, and $47,500 in 1995. The corporation in return paid decedent's son an annual salary of approximately $32,000 and his wife a monthly salary of $350. The corporation also carried life insurance on the decedent's son and his wife and paid for some of their other personal expenses.

In 1993, each limited partnership distributed $40,000 or more to the decedent to allow him to make holiday gifts to his family members. In 1995, each limited partnership made further cash distributions of approximately $45,000 to the decedent. The decedent also gifted certain limited partnership interests to family members, and in 1995 the Thompson partnership distributed $12,500 to the decedent to pay for certain personal expenses.

The decedent died in May 1995. On the decedent's federal estate tax return, his estate valued his 87.65 percent limited partnership interest in the Turner partnership at $875,811 and his 54.12 percent limited partnership interest in the Thompson partnership at $837,691. The estate valued the decedent's stock interests in the general partnership corporations at $5,190 and $7,888, respectively. Each value reflected a 40 percent discount for lack of control and marketability.

The IRS denied the estate's use of the 40 percent discount and issued a notice of deficiency for $707,054. In the commissioner's answer to the estate's amended petition for redetermination, the commissioner asserted that the limited partnerships and corporations should be disregarded, and the decedent's gross estate should include the undiscounted value of the decedent's pro-rata portion of such entities' underlying assets. Or alternatively, the full fair market value of the assets transferred by the decedent to the two limited partnerships should be included

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in the decedent's gross estate under Code Section 2036(a), because during the decedent's lifetime he retained control and enjoyment over the transferred assets.

Code Section 2036(a) provides that the value of the decedent's gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time transferred (except if the transfer is a bona fide sale for adequate and full consideration in money or money's worth) and where the decedent retained the possession, enjoyment, or right to the income to the transferred property, or where the decedent retained the right, either alone or with another party, to designate the persons who will possess or enjoy the transferred property or the income therefrom.

The tax court found that the two limited partnerships were properly formed and recognized for estate tax purposes. However, the tax court agreed with the IRS that the total fair market value of the partnerships' underlying assets should be included in the decedent's gross estate under Code Section 2036(a). In relying on *Thompson v. Comm'r.*, T.C. Memo 2004-246, the tax court found that there was an implied agreement among the decedent and his family members that the decedent would retain the enjoyment and the economic benefits of the assets transferred to the limited partnerships. The tax court made this conclusion based on the facts the decedent had transferred almost all of his assets to the limited partnerships, and the decedent's daughter and son-in-law sought assurances from financial advisors that the decedent would be allowed to make family gifts using assets withdrawn from the limited partnerships. The tax court also determined that the decedent's transfers to the limited partnerships were not bona fide sales for adequate and full consideration under Code Section 2036(a), because (1) neither limited partnership conducted a legitimate business, (2) the partners did not pool their assets in the limited partnerships, (3) the limited partnerships did not engage in any business transactions with nonfamily members, and (4) the loans to family members were testamentary in nature.

On appeal, the Third Circuit Court of Appeals upheld the tax court's finding that there was an implied agreement among the decedent and his family members that the decedent would remain the primary beneficiary of the assets transferred to the limited partnerships. The facts cited by the Third Circuit in reaching its conclusion included: (1) the decedent had transferred 95 percent of his assets to the limited partnerships when he was 95 years old; (2) the decedent did not retain sufficient assets to support himself; (3) the decedent's daughter and son-in-law sought assurances from financial advisors that the decedent would be able to use partnership assets to make gifts to family members; (4) the decedent's daughter obtained approval from the Turner partnership to distribute funds to pay for the decedent's personal expenses; and (5) with one exception, the limited partnerships did not engage in any business or loan transactions with unrelated third parties. In addition, the Third Circuit stated the fact that the decedent did not own a majority interest in the two corporations that served as general partners of the limited partnerships and did not defeat the inference of an implied agreement, because both the decedent's daughter and son testified that neither corporation would have refused the decedent's request to withdrawal funds from the limited partnerships. Accordingly, the Third Circuit concluded that the decedent's relationship with the transferred assets remained essentially the same both before and after the transfers to the limited partnerships.

The Third Circuit also agreed with the tax court's conclusion that the decedent's transfers of assets to the limited partnerships in exchange for limited partnership interests were not bona fide sales for full and adequate consideration under Code Section 2036(a). In both instances the tax court found that each limited partnership lacked a valid business purpose. In the case of the Thompson partnership, its only active business operation was the ranch that was contributed by the decedent's son, and the ranch did not generate any income for the partnership. In addition, even though the Thompson partnership had minimal operations, it still paid the corporation, acting as general partner, a management fee, and the corporation in turn paid the decedent's son a salary of approximately $32,000 per year.

In regards to the Turner partnership, the Third Circuit cited the following factors as evidence the limited partnership did not have a valid business purpose: (1) the interest payments on the loans made to the decedent's grandchildren were either late or never paid, and the limited partnership never took any enforcement actions against the grandchildren; (2) the partnership never made loans to unrelated third parties; and (3) the partners amended the limited partnership agreement retroactively to allocate all gains and losses from the real property owned by the limited partnership, and from the distribution of such real property, to the contributing partner only. The Third Circuit also took issue with the fact that the bulk of the assets owned by each limited partnership were untraded marketable securities. The Third Circuit stated, "[o]ther than favorable estate tax treatment resulting in the change in form, it is difficult to see what benefit can be derived from holding an untraded portfolio of securities in this family limited partnership with no ongoing business operations." *Turner v. Comm'r*, 94 AFTR 2d 2004-5764.

12. COURT REINSTATES JUDGMENT AGAINST CONSULTING COMPANY WHO WRONGLY ADVISED CLIENT REGARDING ESTATE TAX LIABILITY.

In 1987, the decedent executed a trust that divided his assets between a marital trust and a family trust. In 1994, the decedent entered into a contract with a consulting company to review his personal finances and to prepare a personal financial plan. The consulting company repeatedly requested a copy of the 1987 trust, but never received it. Nevertheless, the consulting company issued a report to the decedent and his spouse stating that under the current situation no federal estate tax would be due on the death of the first spouse. The decedent died in 1997, and contrary to the consulting company's report, his estate owed approximately $1.9 million in estate taxes.

The decedent's wife and children sued the consulting company for breach of contract and for violation of the Michigan Consumer Protection Act. A jury awarded the plaintiffs $761,927.90 in damages for the breach of contract claim and $2.2 million in damages for violation of the Michigan Consumer Protection Act. The district court granted the consulting company's motion for judgment as a matter of law. However, the Sixth Circuit Court of Appeals reinstated the jury's original verdict and remanded the case for further proceedings. *Karam v. Sagemark Consulting Inc.*, 6th Cir., No. 03-1763, 9/10/04.

13. OWNERSHIP OF S CORPORATION STOCK BY IRREVOCABLE TRUSTS, GRAT, PARTNERSHIP AND LLC WILL NOT TERMINATE COMPANY'S S ELECTION.

The subject company is an S corporation that is owned by individuals, including grantor. Under a series of transactions, the company's stock will be transferred to a

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partnership and trust one. The partnership is owned by grantor, trust two and an LLC. The LLC is owned by grantor and trust three. Grantor is the grantor of trust one, trust two, and trust three. Neither the partnership nor the LLC will elect to be taxed as a corporation for federal income tax purposes.

Trust one and trust three have almost identical terms, and grantor is the initial trustee of each trust. Under the terms of each trust, during grantor's lifetime, the trustee is instructed to distribute income and principal for the health, education, support, and maintenance of grantor's spouse and descendants. Upon grantor's death, the assets of each trust are to be distributed or held in trust for the benefit of grantor's spouse and issue as set out in each trust agreement.

Trust two provides that the trustee shall pay grantor or grantor's estate an annual annuity equal to 7.23 percent of the initial fair market value of the trust two assets for a period of 20 years from the date the trust is funded. At the end of the term, the assets are to be distributed or held in trust for the benefit of grantor's spouse and issue as set out in the trust agreement. The trustee has the power to add the spouse of any current beneficiary of trust two as an additional beneficiary.

The grantor requested a ruling from the IRS on whether any of the trusts, the partnership or LLC would be ineligible shareholders of S corporation stock under Code Section 1361. The IRS determined that trust 1, trust 2 and trust 3 are grantor trusts and would be treated as owned by the grantor under Code Section 671. In addition, it determined the partnership and LLC will be treated as owned by the grantor and will be considered disregarded entities for income tax purposes. Thus, the grantor will be treated as the owner of all of the company's stock and none of the trusts or entities will be ineligible shareholders for purposes of the company's S election. P.L.R. 200439027 ■

Probate and Trust Cases

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

In re Estate of Wolf

Kansas Court of Appeals,
September 3, 2004

In a 2-1 decision, the Kansas Court of Appeals refused to allow a creditor who prevailed on its claim to seek attorney fees (as provided in the underlying contract) due to failure to reference that contingent right in its original claim.

Marino and Wolf Inc. (M & W) filed a claim against the estate of Frank Wolf to force a sale of Mr. Wolf's 333 shares of stock for $625 per share to M & W pursuant to an option agreement. After much procedural wrangling that resolved the underlying claim in M & W's favor, Mrs. Wolf (as executor of her deceased husband's estate) then filed a petition for declaratory judgment in the Wyandotte County probate court seeking denial of M & W's attorney's fees, which they advised her they would assert following their success on the underlying claim to enforce the buy-out.

M and W claimed $143,659.41 in attorney fees and expenses. The probate court found the fees to be reasonable, but nevertheless reduced the amount by one percent.

Although M & W's original claim attached the option agreement that provided the prevailing party with the right to recover attorney fees, the demand itself did not make reference to the contingent right to recover any fees, if successful. A majority of the three judge Court of Appeals panel held that the more liberal pleading standards of Chapter 60 were not applicable to a probate proceeding and denied M & W its attorney fees. The majority noted that M & W could have amended its claim even after the expiration of the nonclaim statute and should have been aware of the need to do so when the executor filed a written defense to M & W's claim.

Judge Malone dissented. He indicated that Mrs. Wolf should not have been surprised by the attorney fee claim since it was clearly set forth in the contract being litigated. Judge Malone indicated that M & W should not be faulted for failing to make such a claim that was dependent upon it first becoming the "prevailing party in the final adjudication." He also surmised that had Mrs. Wolf prevailed she surely would have sought her fees, and it seems inequitable to deny M & W the same right to enforce the contract terms.

A petition for review has been filed with the Kansas Supreme Court, so stay tuned.

Stafford v. Crane

Tenth Circuit, 382 F.3d 1175
Sept. 3, 2004

In a rare case that involves both a habeas corpus petition and an irrevocable trust, the Tenth Circuit Court of Appeals affirmed an earlier decision by a Kansas Federal District Court. Mr. Stafford, who was a nearly 90-year-old resident of Oklahoma, executed a durable financial power of attorney, appointing his two sisters as his attorneys-in-fact. Six months later he executed a durable medical power of attorney naming one of the sisters as his agent for health care decisions. The following day that sister used the medical power of attorney to involuntarily admit Mr. Stafford to a geriatric hospital and psychiatric center in Elkhart, Kan. Two weeks later she transferred him to a locked-down Alzheimer's unit in Colorado. That same day she executed an irrevocable trust on his behalf. The initial trustee almost immediately ceased to serve and was succeeded by Carol Jane Crane.

Stafford filed a habeas corpus petition in Colorado; he was found competent and ordered release. He then filed suit in the federal district court in Kansas seeking a declaration that the trust was void ab initio and seeking return of nearly $4 million in property from the trust and reimbursement for funds appropriated by Crane.

The Tenth Circuit reviewed Oklahoma law regarding rights under a power of attorney (since it was executed there), and reviewed Kansas law regarding interpretation of rights under the trust (since it was executed in Kansas). Both the district court and appellate court noted, "neither Kansas law ... nor Oklahoma law ... specifically address[es] whether an attorney in fact may create an irrevocable trust without express language which grants such authority in the durable power of attorney itself." The court indicated that, "Without an explicit declaration of intent by Mr. Stafford to give Billie Jo Stafford the authority to create a trust on his behalf, the element of intent necessary to trust creation is missing." The Tenth Circuit concluded that "the Kansas and Oklahoma state courts would follow the general weight of authority, strictly construing the power of attorney and deeming the power to create trusts non-delegable in the absence of an express grant of authority." It was affirmed that the Kansas District Court's decision by Judge Vratil that the trust was avoid ab initio. The defendant trustee is therefore required to pay back the challenged disbursements, with interest. ■

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COURSE SCHEDULE

8:30 a.m. Registration

9:00 a.m. **Trust Design and Investment: Is Anything Better Than a Unitrust Invested in Index Funds?**

9:50 a.m. **Valuation Issues With Limited Partnerships and Limited Liability Companies – Recent Cases and What to do About Them.**

10:40 a.m. Break

10:55 a.m. **The Uniform Trust Code is Anything but Uniform – A Review of the Changes to the Code and Potential Problems Created by the Code.**

11:45 a.m. Lunch (on your own)

1:15 p.m. **Charitable Planning Developments – A Review of the Significant Changes Affecting Charitable Planning.**

2:05 p.m. **Changes to the Corporate Code – Keeping Current With a Review of Recent Statutory Changes to the Code.**

2:55 p.m. Break

3:10 p.m. **Professional Responsibility Issues – A Panel Discussion of Real Life Fact Patterns.**

4:05 p.m. Adjourn

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