THE REPORTER

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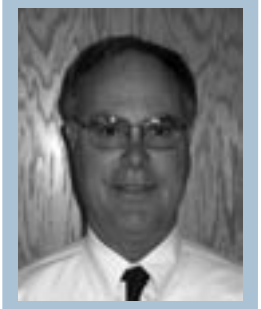
President's Message

HOW SAFE IS YOUR HOMESTEAD?

The homestead law has been in the Kansas Constitution since the beginning of statehood.

Early on it was determined not to violate the federal constitution as impairing the obligation of contracts as it pertains to the remedy and not the obligation.

Section President



Frederick B. Farmer
Lowe Farmer Bacon and Roe, Olathe

As we learned in law school, the Kansas homestead is protected from claims of creditors and from alienation by the action of one spouse acting alone. Provided the requirements of ownership, occupancy, residency, and location are met, the debtor and/or his family may assert the exemption.

Quoting our Supreme Court:

> "Kansas has zealously protected the family rights in homestead property by liberally construing the homestead provision in order to safeguard its humanitarian and soundly social and economic purposes." *State ex rel. v. Mitchell*, 194 Kan. 463, 466.

The unlimited dollar value of the homestead exemption has made Kansas a debtor friendly state. Studies support the *Mitchell* Court's observation showing that in states such as Kansas with higher homestead exemptions, homeowners are more likely to be in business for themselves. Additionally, ownership of unincorporated firms, which carries unlimited liability, may be linked to the higher exemption.

Two recent and separate happenings (one by the judiciary and one by Congress) may have put safety of the Kansas homestead and the entrepreneurial spirit at issue.

The U.S. Supreme Court, in *Kelo v. City of New London*, (put in plain English) ruled that the U.S. Constitution allows the government to take property from one private party in order to give it to another private party because the new owner might produce more profit and more taxes for the city from the land, regardless of the degree of care given to the property by the owner. This may be good for economic purposes, but bad for humanitarian and social purposes. Although the Kansas Supreme Court in *State ex rel. v. Unified Gov't of Wyandotte County*, 265 Kan. 779, ruled there is no precise definition of what constitutes a valid public purpose, the *Kelo* decision may further expand Kansas' use of eminent domain to the endangerment of the homestead.

On April 20, 2005, President Bush signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Act). In passing the Act, Congress intended to tighten the country's generous bankruptcy provisions. In doing so, it imposes restrictions on the Kansas homestead right and caps the exemption at $125,000, contrary to the Kansas Constitution.

However, all may not be lost. In the first published opinion interpreting the Act, the court in *In re McNabb*, 2005 WL 1525101 (Bankr. D. Ariz. June 23, 2005), ruled that the new federal exemption does not apply to an Arizona debtor.

The Act reads such as to allow the debtor to elect to exempt property pursuant to either the federal bankruptcy exemptions or the state exemptions and federal nonbankruptcy exemptions.

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In This Issue ...

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Estate Tax Notes

TAX CASES AND RULINGS AFFECTING THE ESTATE AND BUSINESS SUCCESSION PLANNER

1. Individual Retirement Accounts Qualify for Federal Bankruptcy Exemption

The owners of an individual retirement account (IRA) filed for bankruptcy under Chapter 7 of the U.S. Bankruptcy Code. They claimed the IRA assets were exempt from the bankruptcy estate under 11 U.S.C. § 522(d)(10)(E), which generally exempts payments under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of age. The 8th Circuit held the IRA did not qualify for the exemption because there was no right to receive payment on account of age. Rather, the 8th Circuit held the IRA was a savings account readily accessible at any time for any purpose.

The U.S. Supreme Court reversed the 8th Circuit and held the IRA was exempt from the bankruptcy estate because it confers a right to receive payment on account of age and is similar to the plans and contracts enumerated in 11 U.S.C. § 522(d)(10)(E). The Court found Jacoway (the bankruptcy trustee) was mistaken in arguing there was no causal connection between the right to receive payment and age because the IRAs provide a right to payment on demand. It stated the right to receive payment was restricted by a substantial 10 percent tax penalty on any withdrawal made prior to attaining age 59½, preventing access to the 10 percent the owners would forfeit should they withdraw the money early. Therefore, the penalty effectively prevents access to the entire balance and limits the right to "payment" of the balance. Because the condition is removed when the owner attains the age of 59½, the right to the balance of the IRA is a right to payment on account of age. The Court further held the IRA is similar to the enumerated plans in the statute because it provides income that substitutes for wages earned as salary or hourly compensation, which is demonstrated by the facts that (i) Treasury Regulations require distribution to begin no later than the calendar year after the year the owner attains age 70½; (ii) taxation of IRA money is deferred until the year in which it is distributed; (iii) withdrawals made prior to attaining age 59½ are subject to the 10 percent penalty; and (iv) failure to take the requisite minimum distributions results in a 50 percent tax penalty on funds improperly remaining in the account. Because the IRA meets both requirements of the statute, it is exempt from the owner's bankruptcy estate. *Rousey v. Jacoway*, 95 AFTR 2d 2005-1716 (S. Ct.).

2. Surviving Spouse's Right of Election May Disqualify Charitable Remainder Trust Without Valid Waiver

With respect to a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT), Code Sections 664(d)(1)(B) and (d)(2)(B) provide that no amount other than the annuity payments or unitrust payments, respectively, may be paid to or for the use of any person other than an organization described in Code Section 170(c). Generally, if the assets of a CRAT or a CRUT may be used to satisfy the elective share of a surviving spouse, whether the right of election is exercised, the CRAT or CRUT will fail to qualify under Code Section 664(d). Thus, the IRS has provided a safe harbor procedure that will cause a surviving spouse's right of election to be disregarded for purposes of determining whether a CRAT or CRUT meets the requirements of Code Section 664(d) continuously from the date the trust is created.

In states that provide a surviving spouse with a right of election to receive an elective share of the deceased spouse's estate, the safe harbor procedure requires that the surviving spouse irrevocably waive the right of election with respect to the assets of the CRAT or CRUT to ensure that no part of the trust will be used to satisfy the elective share. The failure of a surviving spouse to waive the right of election with respect to the assets of a CRAT or CRUT created on or after June 28, 2005, will result in the CRAT or CRUT failing to qualify under Code Section 664(d) continuously since its creation, whether the surviving spouse exercises the right of election. For CRATs or CRUTs created prior to June 28, 2005, the failure of the surviving spouse to waive the right of election, coupled with the surviving spouse's exercise of that right of election, will cause the CRAT or CRUT to so qualify. The surviving spouse's waiver does not have to include a waiver of the right to receive the annuity or unitrust payment from the CRAT or CRUT.

For trusts created on or after June 28, 2005, a valid waiver must be made on or before the date that is six months after the due date of Form 5227, Split-Interest Trust Information Return, for the year in which the later of the following four events occurs: (i) the creation of the trust;

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(ii) the date of the grantor's marriage to the spouse; (iii) the date that the grantor first becomes domiciled or resident in a jurisdiction whose law provides a right of election that could be satisfied from assets of the trust; or (iv) the effective date of applicable state law creating a right of election. A copy of the signed waiver must be provided to the trustee of the CRAT or CRUT and must be retained in the official records of the trust. Rev. Proc. 2005-24, 2005-16 I.R.B.

3. New Deferred Compensation Legislation

Congress enacted, as part of the American Jobs Creation Act of 2004, new Code Section 409A, which provides, in part, for the imposition of a 20 percent penalty tax on taxpayers covered by arrangements that do not comply with the new rules, even where the arrangement presents no abuse potential. Code Section 409A generally applies to amounts deferred after Dec. 31, 2004. Amounts deferred on or before that date are grandfathered unless the plan providing for the deferrals is materially modified after Oct. 3, 2004. The IRS has indicated that adding or enhancing participant benefits and rights under a plan will result in a material modification, but that narrowing or eliminating participant benefits and rights will not.

Under Code Section 409A, an election to defer compensation generally must be made no later than the end of the taxable year prior to the year before the compensation is earned. A plan may not pay out deferred compensation to participants other than on separation from service, disability, death, a change of control, an unforeseeable emergency, or at a specified time or under a fixed schedule set out under the plan. An election by a participant to defer a distribution generally must be made at least 12 months prior to the distribution and in most cases must delay the distribution by at least five years. Subject to certain exceptions, a plan may not accelerate or allow for the acceleration of any payment of deferred compensation. The legislative history contemplates that the IRS will create exceptions for accelerated distributions that result from circumstances beyond the participant's control.

Intending to prohibit offshore rabbi trusts, the new rules specify that a company cannot secure its deferred compensation obligations by holding assets offshore in a trust or other arrangement designated by the Treasury and IRS. The legislative history indicates that the Treasury and IRS should identify arrangements that effectively shield assets from the claims of general creditors of the employer and result in inappropriate tax deferral. The Treasury and IRS can exempt arrangements that do not have this effect.

A deferred compensation plan that fails any of the new rules will trigger significant tax consequences for the affected participant. The participant will be required to pay tax on all of his or her vested deferred compensation, including any accrued earnings. Additionally, the participant will have to pay an interest charge at 1 percent over the tax deficiency rate on the hypothetical underpayments resulting from any amounts that are deferred and vested in one year but includible in a later year. The participant will also have to pay the 20 percent penalty tax, which applies whether or not there has actually been any tax deferral, proper or improper. I.R.C. § 409A; P.L. 108-357.

4. New Rules Make S Corporation Status More Widely Available

Under the new rules governing subchapter S corporations, the number of persons that may be shareholders of an S corporation was increased from 75 to 100, effective for taxable years beginning after Dec. 31, 2004. Coinciding with the increase in the number of permitted shareholders was an amendment permitting an extended family to elect to be treated as one shareholder. A member of the family includes the common ancestor, lineal descendants of the common ancestor, and the spouses or former spouses of such lineal descendants or common ancestors. A common ancestor cannot be an individual who is more than six generations removed from the youngest generation of shareholders who would be members of the family as of the later of the effective date of this provision or the time an election to be an S corporation is made. The definition of family also includes adopted children and foster children.

In the case of an electing small business trust (ESBT), each potential current beneficiary is treated as a shareholder during the period in which such person may receive a distribution from the trust. With respect to powers of appointment, formerly, any person to whom property could potentially be appointed pursuant to the present exercise of a power of appointment was to be treated as a potential current beneficiary. The new rules provide that unexercised powers of appointment are disregarded in determining whether a person is a potential current beneficiary. The new rules also extend the period of time (from 60 days to one year) during which an ESBT may dispose of S corporation stock when an ineligible shareholder becomes a potential current beneficiary. The American Jobs Creation Act of 2004, P.L. 108-357.

5. IRS Issues Final Amendments to Circular 230

The IRS issued final regulations amending Treasury Department Circular 230, which applies to attorneys, accountants, and other tax professionals who practice before the IRS. The revisions provide standards of practice for written advice that reflect current best practices, including mandatory requirements for written advice that presents a greater potential for concern, and minimum standards for other advice. Under the mandatory requirements for advice that presents a greater potential for concern, practitioners are prohibited from providing advice that relies on incorrect factual assumptions or representations, does not consider all relevant facts, or fails to analyze important legal issues. The IRS also issued proposed regulations regarding written advice concerning tax-exempt bonds that are similar to the standards for written advice in the final regulations. A practitioner may be censured, suspended, or disbarred from practice before the IRS for willfully violating Circular 230 or recklessly or through gross incompetence violating the covered opinion requirements, the other writing requirements, or the compliance provisions. In addition, the American Jobs Creation Act of 2004 authorizes the IRS to impose penalties against practitioners who violate any provision in Circular 230 and authorizes injunctions to prevent violations of Circular 230. Circular 230, 31 C.F.R. part 10.

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Newsletter

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

6. Portion of Death Benefit Received Under Deferred Annuity Contract Income in Respect of a Decedent

The decedent died prior to the annuity starting date for a deferred annuity contract he purchased during his lifetime. The decedent had the option during his lifetime to surrender the contract for its account value, as determined by the formula in the contract. The contract provided for a death benefit to be paid to a beneficiary equal to the account value, as determined by a formula in the contract, if the decedent died prior to the annuity starting date. The beneficiary could elect to receive a lump sum or periodic payments. The death benefit to be paid to the beneficiary exceeded the decedent's investment in the contract. The IRS held the amount paid in excess of the decedent's investment in the contract would be includible in the beneficiary's gross income as income in respect of a decedent (IRD) under Code Section 691. The IRS reasoned that had the decedent surrendered the contract and received the amounts at issue, those amounts would have been income to the decedent under Code Section 72(e) to the extent they exceeded his investment in the contract. Accordingly, amounts received by the beneficiary in excess of the decedent's investment in the contract are IRD under Code Section 691(a). Rev. Rul. 2005-30.

7. Loan Interest not Deductible as Estate Administration Expense

Approximately five years before his death, the decedent and his spouse created a limited partnership. The decedent contributed 90 percent of his assets to the partnership in exchange for a 2 percent general partnership interest and a 97 percent limited partnership interest. The decedent's spouse contributed cash in exchange for a 1 percent general partnership interest. The decedent transferred a 1 percent general partnership interest to one of his children (Child A). The decedent and his spouse were subsequently divorced, at which time the partnership purchased the spouse's 1 percent general partnership interest.

The decedent's estate residue consisted primarily of the decedent's 99 percent interest in the partnership. At his death, approximately 57.6 percent of the partnership assets consisted of publicly traded stocks, bonds, and cash. The remaining partnership assets consisted primarily of real property (17.5 percent) and personal notes (24.7 percent) that had been issued to the partnership on the sale of real property previously owned by the partnership. Under the decedent's will, the estate residue was to be held in equal trust shares for the decedent's two children. All taxes were to be paid from the estate residue. Child A and an accountant were appointed as executors of the estate, and the accountant was the trustee of the two trusts created for the decedent's children.

Following the decedent's death, the executors and Child A, as general partner of the limited partnership, executed a promissory note naming the estate as borrower and the partnership as lender. The note was an advancing line of credit and matured 10 years from the date of execution. Principal advanced under the note and all accrued interest was to be paid in a lump sum on the maturity date, and prepayment of principal or interest was prohibited. The estate's 99 percent partnership interest was pledged as security pursuant to a separate security agreement. On the decedent's federal estate tax return, the executors claimed a deduction under Code Section 2053(a) for the interest that was to be paid on the due date of the note.

The IRS stated that, in general, the courts and the IRS have concluded interest expense incurred by an estate on funds borrowed by the estate can be a deductible administration expense provided the loan was reasonably and necessarily incurred in the administration of the estate. The IRS further stated a deduction may be allowed under Code Section 2053 for estimated interest payments that have not yet accrued, provided the estimated amount must be ascertainable with reasonable certainty and certain to be paid.

The IRS held in the present situation, the loan by the estate from the partnership cannot be viewed as necessary to the administration of the estate because it was not necessary for payment of the estate tax liability in order to avoid selling estate assets. The partnership held liquid assets comprising approximately 57.6 percent of the partnership assets, and the partnership was not engaged in any active business that would necessitate the retention of liquid assets. The IRS further held the interest deduction cannot be the justification for an otherwise unnecessary loan.

The IRS stated the same parties (closely related family members whose proportionate interests in the estate were virtually identical to their proportionate interests in the partnership)

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stood on all sides of the transaction, and it was questionable whether the estate would actually make the payments required under the note. If the estate did in fact make the required payments, the IRS determined it would have no economic impact on the parties involved because its only purpose was to generate an up-front estate tax deduction. The IRS, thus, held a deduction was not allowed under Code Section 2053(a)(2) for the interest amount on the loan. T.A.M. 200513028.

8. Division of Charitable Remainder Trust Pursuant to Divorce Approved

During their marriage, a husband and wife created a charitable remainder unitrust, reserving to themselves consecutive unitrust interests, first to the husband for his life, and thereafter to the wife for her life. The husband reserved the power to revoke the wife's interest exercisable in his last will and testament. The husband and wife subsequently divorced, and their property settlement agreement contained an irrevocable renouncement of the husband's power to revoke the wife's unitrust interest, and it provided the trust would be divided into two separate charitable remainder trusts. One trust would pay a unitrust interest to the husband, and the other trust would pay a unitrust interest to the wife.

The IRS ruled the division of the charitable remainder unitrust into two separate unitrusts would not cause either trust to fail to qualify under Code Section 664. The IRS further held pursuant to Code Section 1041, no gain or loss would be recognized by the husband on his transfer of one-half of the unitrust interest to the wife. The wife receives the interest as a gift with a carry-over basis from the husband pursuant to Code Section 1041(b). In addition, the pro rata division of the unitrust into two separate trusts would not result in the recognition of gain or loss to either of the trusts for purposes of Code Section 1001. P.L.R. 200502037.

9. Amounts Paid to Taxpayer by Employer Were Bonuses and not Gifts

The taxpayer, Williams, worked as a radiation therapist at Deland & Noell (Corporation) and received bonuses from the Corporation in addition to her salary for tax years 1989 to 1995. With respect to the bonuses Williams received through 1992, she treated the bonuses as part of her gross income and included them in her personal income. However, she did not include the bonuses she received for 1993 to 1995 in her income. The original W-2 forms issued by the Corporation did not include the bonuses, but the Corporation issued corrected W-2s in 1997 showing the bonuses as additional compensation. Williams did not file amended tax returns for the years in question. Williams claimed the bonuses she received in the years in question qualified as gifts from her employer and were excludable from her gross income pursuant to Code Section 102(a). The IRS determined the amounts were not gifts, but performance bonuses, and issued notices of deficiency and assessed penalties. The Tax Court subsequently approved the deficiencies and penalties.

On appeal to the 10th Circuit, the court rejected Williams' argument that the payments were gifts properly excludable from gross income, citing Code Section 102(c)(1), which provides that gross income shall not exclude any amount transferred by or for an employer to, or for, the benefit of, an employee. The court held the fact that Williams and Dr. Deland (president and shareholder of the Corporation) were close personal friends did not change the result. It was still a payment made by an employer to an employee, and Dr. Deland filed no gift tax returns for the amounts here in issue ($25,000, $35,000, and $35,000, respectively, for the years in question). Thus, the IRS properly included the amounts in Williams' gross income for the years in question.

Williams also argued the Tax Court erred in assessing penalties for her failure to include the amounts in gross income because she relied on the W-2s issued by her employer and was, therefore, not negligent. However, the Tax Court had concluded that Williams was negligent in that she failed to do what a reasonable and ordinarily prudent person would do under the circumstances, amounting to a disregard of the rules and regulations. The 10th Circuit upheld the penalties. *Williams v. Comm.*, 95 AFTR 2d 2005-764 (10th Cir.).

10. Series of Proposed Disclaimers Qualified

The grantor created an irrevocable trust for the benefit of his spouse and descendants. Under the terms of the trust, an Initial Trust is created whereby the principal was to be held in trust for the benefit of the spouse. The spouse was to receive all income from the Initial Trust, and the trustee had the absolute discretion to distribute principal to the spouse. The trust agreement contemplated a series of disclaimers as follows: (i) if the spouse disclaimed any of her interest in the Initial Trust, the disclaimed portion would be held in Trust 2; (ii) if the spouse disclaimed any of her interest in Trust 2, the disclaimed portion would be held in Trust 3; (iii) if the spouse disclaimed any of her interest in Trust 3, the disclaimed portion would be held in Trust 4; and (iv) if the spouse disclaimed any of her interest in Trust 4, the disclaimed portion would be held in Trust 5. Trusts 2 and 3 provided for income to the spouse during her lifetime and principal payable to her in the trustee's discretion. Both trusts terminated on the spouse's death, and any remaining principal was to divide into separate shares for the grantor's then living issue, per stirpes. Trusts 4 and 5 provided for income and principal to the spouse and to grantor's issue at the trustee's discretion. Both trusts, if not terminated sooner, were to terminate on the spouse's death, and any remaining principal was to divide into separate shares for the grantor's then living issue, per stirpes.

The spouse intended to execute the following series of disclaimers within nine months of the creation of the irrevocable trust: (i) all of her interest in the Initial Trust, (ii) her interest in $x of Trust 2, (iii) her interest in $y of Trust 3, and (iv) her interest in $z of Trust 4. The IRS reviewed the rules for a qualified disclaimer, which are as follows: (i) the disclaimer is in writing, (ii) the disclaimer is made no later than nine months after the transfer creating the interest is made,(iii) the person disclaiming the interest has not accepted the interest or any of its benefits, and (iv) the disclaimed interest passes without any discretion by the person making the disclaimer and passes either to the spouse of the decedent or to a person other than the person making the disclaimer. The IRS recognized that in the present situation, the disclaimed assets would pass to a series of trusts for the benefit of the spouse and grantor's issue without any direction on the part of the spouse. The IRS held, assuming the other requirements

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of a qualified disclaimer were met, the spouse's proposed disclaimers would be qualified under Code Section 2518, and the property would be treated as passing directly from the grantor pursuant to the terms of the trust. P.L.R. 200442027.

11. Post-Valuation Date Sale Used to Determine Value of Closely Held Stock

The decedent died in September 1996, owning 116 shares of stock, representing an 11.6 percent interest, in a local bank. At the time of the decedent's death, the bank had only one class of stock outstanding, consisting of 1,000 nonpublicly traded shares. The value of the stock as reported on the estate tax return equaled its 1996 book value less a 45 percent minority interest discount, resulting in a reported fair market value of $903,988. When the decedent died, Glenwood Bancorporation (Glenwood) owned the remaining 88.4 percent interest in the bank. The shares of Glenwood were owned by three shareholders, all unrelated to the decedent. One of the three shareholders sought to purchase the decedent's shares following his death and obtained a written appraisal of the fair market value of the shares as of Dec. 31, 1996. The appraisal concluded the fair market value of the shares was $878,004, which value included a 29 percent minority interest discount and a 35 percent lack of marketability discount. The estate declined to sell the shares and ultimately sold them to Glenwood in October 1997 for $1.1 million. In July 2001, the IRS issued a notice of deficiency asserting the value of the shares was $1.1 million, rather than the $903,988 reported on the estate tax return.

The IRS' expert at trial testified the value of the shares was $1.1 million, which value he arrived at after considering four valuation methods and applying a 15 percent minority interest discount and a 30 percent lack of marketability discount. The estate's expert at trial testified the value of the shares was $841,000, which value was derived from considering five valuation methods and applying a 43 percent lack of marketability discount to the marketable minority interest value.

The Tax Court stated the fair market value of nonpublicly traded stock is best ascertained through arm's-length sales near the valuation date of reasonable amounts of that stock, as long as both the buyer and the seller were willing and informed and the sales did not include a compulsion to buy or to sell. The Tax Court recognized the applicable valuation date in this case was the date of the decedent's death, near which there were three sales of the bank shares. The first two sales involved 10 shares and seven shares, respectively, and the buyer was Glenwood. The third sale was the decedent's 116 shares to Glenwood. The decedent's estate argued sales may be indicative of fair market value only if they occur within a reasonable time before the valuation date. However, the Tax Court rejected the argument that only sales that predate the valuation date may be considered in determining the fair market value of stock as of the valuation date. The Tax Court held subsequent sales may be considered so long as the sale occurred within a reasonable time and no intervening events drastically changed the value of the stock. The estate argued, however, that Glenwood was a strategic buyer and paid a premium for the shares in order to be the sole shareholder of the bank. The Tax Court rejected this argument and held that the sale occurred between unrelated parties and was prima facie at arm's length.

In using the subsequent sale to value the stock as of an earlier date, the Tax Court noted adjustments should be made to the sale price to account for the passage of time, as well as to reflect any change in the setting from the date of valuation to the date of the sale. Such factors to consider include inflation, changes in the relevant industry and the expectations for that industry, changes in business component results, changes in technology, macroeconomics, or tax law and the occurrence or nonoccurrence of any event that a hypothetical reasonable buyer or hypothetical reasonable seller would conclude would affect the selling price of the property subject to valuation. The Tax Court held in the present case, the only adjustment to be made was for inflation and held the fair market value of the decedent's 116 shares in the bank was $1,067,000, after application of a 3 percent inflation rate. *Estate of Noble v. Comm.*, T.C. Memo 2005-2.

12. IRS Issues Final Grantor Retained Annuity Trust (GRAT) and Grantor Retained Unitrust (GRUT)

In 2004, the IRS issued proposed Treasury Regulations conforming to the *Walton* and *Schott* decisions. See *Walton v. Comm.*, 115 T.C. 589 (2000); *Schott v. Comm.*, 319 F.3d 1203 (9th Cir. 2003). The IRS has now issued those proposed regulations in final form, after receiving written and telephone comments. The final regulations revise Examples 5 and 6 of Treasury Regulation 25.2702-3(e) to conform to the *Walton* decision. Under the examples, as revised, a unitrust amount payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies before the expiration of the term, is a qualified interest for the specified term.

In the *Schott* case, the 9th U.S. Circuit Court of Appeals held a two-life annuity retained by spouses who had created Grantor Retained Annuity Trust was a qualified interest under Code Section 2702 (Code), and the value of the two-life annuity could be subtracted in arriving at the value of the gift of the remainder. The 9th Circuit stressed a two-life annuity table made the value of the gift ascertainable, and the value of the grantor's power to revoke the spouse's interest was the retention of a qualified interest. The IRS had argued the spouses had contingent interests, making them unqualified interests. The 9th Circuit stated neither the Code nor the regulations excluded contingent interests as such. The final regulations clarify that the revocable spousal interest exception applies only if the spouse's annuity or unitrust interest, standing alone, constitutes a qualified interest, but for the grantor spouse's revocation power. The final regulations also add the requirements that payment of a qualified interest cannot be subject to any contingency other than the holder's survival, or the grantor spouse's right to revoke the spouse's interest. The final regulations remove Examples 6 and 7 from Regulation Section 25.2702-2(d)(1) and add two new examples illustrating how the revocable spousal interest applies. In the first Example, the spouse's interest is qualified because the term of the spouse's interest is fixed and ascertainable upon creation of the trust, and the spouse's right to receive the annuity is contingent only on her survival and her spouse's power to revoke. In the second Example, the spouse's interest is not qualified because the spouse's annuity is a contingent interest payable only if the grantor dies before the end of the term of the trust. T.D. 9181 (02/24/2005); Treas. Reg. §§ 25.2702-2, 25.2702-3, 25.2702-7.

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Real Estate Cases

Kansas Supreme Court

DATA TREE LLC V. BILL MEEK, SEDGWICK COUNTY REGISTER OF DEEDS
SEDGWICK DISTRICT COURT – AFFIRMED
NO. 92,596 – APRIL 22, 2005
Kansas Open Records Act and Register of Deeds

ATTORNEYS: Michael W. Merriam, Topeka, for appellant. Ed L. Randels, assistant county counselor, for appellee.

FACTS: Data Tree is in the business of collecting and providing real estate information and, in the course of such business, gathers and disseminates facts obtained from public records to its clients. First American attempted to gather the public records from the Sedgwick County Register of Deeds for sale to Data Tree and was required to sign an affidavit prohibiting the selling or offering for sale any lists of names and addresses derived from public records. First American signed an affidavit under objection in order to receive the public records. The Register of Deeds informed First American they would be required to pay the cost of redacting confidential information out of the microfilm of the public records. Data Tree sued the Register of Deeds seeking declaratory judgment that: (1) the Register of Deed's actions were contrary to law and the duties of its office; (2) the requested documents were public records, which must be disclosed and copied at a reasonable charge; and (3) alternatively, the Register of Deeds must bear the costs of deleting the personal information. The district court granted summary judgment in favor of the Register of Deeds finding the Kansas Open Records Act (KORA) applied, but sensitive information may be redacted before distribution to the public and all costs of redaction were to be borne by Data Tree.

ISSUES: (1) Does the Register of Deeds have authority to redact recorded information? (2) Do the privacy protections of K.S.A. 2004 Supp. 45-221(a)(30) apply to the Register of Deeds, and are they a basis for denial of access to copies of public records? (3) If redaction is required, is the cost borne by the Register of Deeds? (4) Is Data Tree entitled to attorney fees for denial of access?

HELD: Court affirmed summary judgment in favor of the Register of Deeds. (1) Court held that it is beyond dispute that the Register of Deed's office is a public agency and that the documents filed for record in that office are public records. (2) In considering the privacy concerns of K.S.A. 2004 Supp. 45-221(a)(30), the Court held that social security numbers are considered information of a personal nature. Court stated there was no reason mothers' maiden names and dates of birth do not fall within this privacy realm as well. Court found the information sought by Data Tree is not being sought for its public notice properties, but for commercial purposes, and the public interest to be served by releasing unredacted documents is insignificant. Court held that where balancing the privacy interests of the individual with the public's need to know or where disclosure of the personal or private information fails to significantly serve the principal purpose of the KORA, nondisclosure is favored if nondisclosure complies with other requirements of KORA. Court held that the Register of Deeds did not abuse his discretion in determining that public disclosure of the personal information within the documents requested constituted a clearly unwarranted invasion of privacy. (3) Court found KORA is silent on who bears the costs of redaction. Court held KORA makes clear the legislative intent that actual costs of furnishing copies of public records may be recovered by the agency and that the person seeking the records should bear the actual expense. Court held the district court did not err in ruling the costs of producing records, including the costs of redaction, are to be borne by Data Tree. (4) Court agreed with the district court that the change in policy of the Register of Deeds from nonredaction to redaction of social security numbers, mothers' maiden names, and dates of birth from recorded instruments was not made in bad faith and was taken during the ordinary course of his duties. Court held the district court did not err in not awarding attorneys fees to Data Tree because there was a "reasonable basis in fact or law" for the actions of the Register of Deeds.

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Author

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STATUTES: K.S.A. 8-240(b)(1); K.S.A. 19-1204(a); K.S.A. 20-3018(c); K.S.A. 21-3914; K.S.A. 2004 Supp. 25-2320(b); K.S.A. 2004 Supp. 44-550b(a)(4); K.S.A. 45-201 *et seq*.; K.S.A. 45-215 *et seq*., - 215(a)(30), -217(f)(1), -216, -218(a), -219(c), -221(a), (26), (30), -222(c); K.S.A. 2004 Supp. 45-221(a)(30), (d), -222(c), -230; K.S.A. 2003 Supp. 45-221(a)(30), -230

Kansas Court of Appeals

IN RE EQUALIZATION PROCEEDING OF AMOCO PRODUCTION COMPANY
KANSAS BOARD OF TAX APPEALS AFFIRMED IN PART, REVERSED IN PART, AND REMANDED WITH DIRECTIONS
NO. 91,253 – DECEMBER 17, 2004
Tax Appeal, Valuation, Oil and Gas

ATTORNEYS: Michael Lennen, Morris, Laing, Evans, Brock & Kennedy Chtd., Wichita, for appellant. Douglas P. Campbell, county attorney, for appellee.

FACTS: Amoco appeals the ad valorem tax valuation for the Jayhawk Natural Gas Processing Plant in Grant County for the tax years 2000 and 2001. The plant is a cryogenic gas processing facility where natural gas is processed in order to "condition" it for sale and to recover valuable constituents contained within the gas stream. Amoco estimated the plant's value was $50 million in 2000 and $38.5 million in 2001. Grant County assessed its value to be the same as its 1999 value, $70,733,660, for both years 2000 and 2001. The Kansas Board of Tax Appeals (BOTA) approved the values assessed by the county and that decision was affirmed by the district court.

ISSUES: Did the county meet its burden of supporting its value determination by a preponderance of the evidence? Did the county's valuation witness qualify as an expert witness? Did the county's witness meet the generally accepted appraisal standards found in the USPAP? Did the county's valuation follow the definition of fair market value? Was there evidence presented of the future availability of natural gas supplies? Did BOTA act unreasonable and arbitrary in rejecting Amoco's opinion of the plant's value?

HELD: Court held there was substantial competent evidence that supports all three valuation conclusions for the year 2000, the county's appraised value, BOTA's order, and the district court's subsequent affirmation. The court held the county's witness was properly accepted as an expert witness, that he followed the USPAP, that the cost approach provided credible evidence in support of the plant's valuation, that BOTA's finding of future gas supply was supported by substantial competent evidence, and that BOTA considered all the evidence in establishing its valuation. The court affirmed the district court's order determining the year 2000 value. However, because the county merely adopted the same 2000 year value for the 2001 tax year and failed to take any steps to appraise the plant for 2001, the record is devoid of any evidence to support the 2001 value determination. Consequently, the court reversed the district court and BOTA's findings for 2001 and remanded the case back to the Grant County appraiser with directions to begin the appraisal process anew for that year.

STATUTES: K.S.A. 60-456(b); K.S.A. 74-2426(c)(4), -2438; K.S.A. 75-5105a(d); K.S.A. 77-621(a)(1), (c)(8); K.S.A. 79-503a, -506, -1455, -1609

SCHLUP V. BOURDON
DOUGLAS DISTRICT COURT – REVERSED AND REMANDED WITH DIRECTIONS
NO. 92,450 – FEBRUARY 11, 2005
Real Estate Contracts, Covenants, Notice, Merger, Oil and Gas

ATTORNEYS: John C. Chappell, Lawrence, for appellants. Price T. Banks, Lawrence, for appellee.

FACTS: Smith owned 40 acres of land. In 1986, he leased 10 acres to Midland Enterprises for drilling a gas well. The well was not commercially productive and Midland abandoned it to Smith for personal use. In 1988, Smith sold 7.2 acres to Schlup with a provision in the contract that Schlup had free natural gas so long as the gas well on Smith's property supplied sufficient gas for both houses. The contract also had a provision that the covenant/agreement would extend to and be obligatory on future parties to the property. The contract for deed was not recorded at that time. Instead, an affidavit of equitable interest was recorded in 1988 that gave notice of the Schlups' interest in the property they were acquiring but not their interest in free gas from the well. There was a recorded easement over Smith's property in 1997, but again the document made no mention of the gas well interest. After the Schlups completed payments on the contract, the deed again made no mention of the gas well interest. In 2000, the Bourdon's purchased Smith's property and there was no visible notice of the Smith's gas well interest and they were not informed of the gas well interest, nor did a title search reveal any encumbrances concerning the gas well. In 2002, the Bourdons saw the Schlups near the gas well and learned for the first time about the Schlups' gas well interest. The Bourdons told the Schlups they would terminate the gas supply on Dec. 31, 2002. In January 2003, the Schlups filed the old 1988 contract for deed. After settlement was unsuccessful, the Schlups were eventually awarded a permanent injunction.

ISSUES: Did the Schlups put the world on notice of their gas well interest? Does the notice statute apply to covenants running with the land? Did the trial court err in determining that the contract for deed did not merge with the deed?

HELD: Court reversed and remanded with directions to vacate the permanent injunction. Court stated the late filing of the Schlups' contract for deed had no retroactive application and the world received notice of the contract for deed on the date of filing, January 2003. Court stated the covenant for free gas in Schlup's contract for deed was a covenant that runs with the surface estate. However, the court held that a covenant running with the land is not binding upon successors in interest who have no notice of the covenant. Court also held that merger did not apply. The deed did not contain the free gas provision that was contained in the contract for deed. Thus, the presumption is that the free gas provision was waived and superseded by the deed. However, the district court held that the parties intended the free gas provision to continue in effect after the deed was executed. Court held that while the evidence supported the district court's opinion

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that the parties intended the covenant to continue and it survived the deed, since the deed imparted no notice to the world of their interest in gas from the well, it was not binding upon and enforceable against the Bourdons who later purchased the Smith property.

STATUTES: K.S.A. 58-2221, -2222, -2223

FIDELITY BANK V. KING ET AL.
SEDGWICK DISTRICT COURT – AFFIRMED
NO. 92,410 – APRIL 1, 2005
Mortgage Foreclosure, Redemption Rights

ATTORNEYS: Bradley S. Anderson, South & Associates P.C., Kansas City, Mo., for appellant. Karl R. Swartz and Kelly S. Herzik, Morris, Laing, Evans, Brock & Kennedy Chtd., Wichita, for appellee.

FACTS: James and Carol King assumed the debt and obligations for real estate in Wichita for which Fidelity Bank was the mortgage holder. The Kings executed a second mortgage for $32,000 with U.S. Bank. Fidelity petitioned for foreclosure after the Kings defaulted. U.S. Bank was a named defendant and served with summons and petition. U.S. Bank failed to answer or otherwise plead in the action. The trial court foreclosed the mortgage and ordered the property sold at a sheriff's sale. The journal entry did not recognize any interest in U.S. Bank and stated all defendants were barred from interest in the property. The property sold at the sheriff's sale for $93,000; $73,092.71 was paid to satisfy Fidelity's foreclosure judgment; and the remaining $20,407.29 was held by the court. River City filed a motion for distribution of sale proceeds, claiming they had acquired all right, title, and interest of the King's prior to the sheriff's sale. U.S. Bank objected and requested the proceeds as well. The trial court held that by failing to respond to the petition and assert its lien rights in the property, U.S. Bank waived its redemption rights as junior lien holder; had no rights in and to the subject property, including redemption rights; and had no claim to the excess sale proceeds.

ISSUES: Did the trial court err in holding that River City, as owner, was entitled to the surplus proceeds from the foreclosure sale of the King's property and not U.S. Bank as a junior lien holder?

HELD: Court affirmed. Court stated that a junior lien holder who has responded in a foreclosure action, and whose lien is adjudicated by the trial court, has three rights: (1) the right to offset bid its judgment at sheriff's sale to protect the value of its lien; (2) the right to redeem the property from sale should the owner fail to redeem during the exclusive period; and (3) the right to share in surplus proceeds after payment of the senior mortgage judgment. Court held U.S. Bank's failure to participate in the foreclosure proceedings results in its position of being a holder of a $30,000 note not now secured by the property. Court found both in law and equity that River City as holder of the owner's rights of redemption and right to excess proceeds is entitled to the surplus proceeds as compared to U.S. Bank and its note against the Kings.

STATUTES: K.S.A. 60-2414(b)

MAIN LINE INC. V. BOARD OF RENO COUNTY COMMISSIONERS
RENO DISTRICT COURT – AFFIRMED
NO. 91,569 – OCTOBER 1, 2004
PUBLISHED VERSION FILED MAY 3, 2005
Property Tax Appeal, Tax Exempt Entity

ATTORNEYS: Robert J. O'Connor and Geron J. Bird, Stinson Morrison Hecker LLP, Wichita, for appellant. Richard A. Benjes, Hutchinson, for appellee.

FACTS: Main Line was a for-profit corporation with property valued in excess of $10 million. Health Care Inc., a nonprofit corporation, purchased a 100 percent interest in Main Line and converted it into a tax-exempt organization. Main Line's application for tax-exempt status was dated Nov. 27, 1998. The IRS issued a letter ruling determining Main Line to be exempt from federal income tax as a 501(c)(3) organization. Main Line owns medical equipment, land, and buildings, all of which are leased to Hutchinson Clinic, a Kansas corporation. Main Line's only source of operating revenue is the rental income from the clinic. The lease is a triple-net lease, requiring the clinic to pay the insurance, taxes, and repairs. Main Line challenged the ad valorem taxes for 1999, 2000, and 2001. Main Line's challenges to the Board of Tax Appeals (BOTA) were either dismissed on jurisdiction claims or denied on the merits. The district court sustained BOTA's findings.

ISSUES: Whether Main Line "operated" the land, as required by K.S.A. 79-1439(b)(1)(D), in order to receive a favorable 12 percent tax rate or should be taxed at the normal 25 percent of value for commercial property under K.S.A. 79-1439(b)(1)(F).

HELD: Court affirmed. Court stated that Main Line is clearly a 501(c)(3) in the eyes of the IRS. However, court stated that under Kansas statutes, the property must be operated by the qualifying not-for-profit, tax-exempt organization in order to receive favorable tax treatment. Court held that a 501(c)(3) tax-exempt entity does not "operate" real property by entering into a passive, triple-net commercial lease with a non-tax-exempt entity, which exclusively occupies and uses the property to conduct activities for profit.

STATUTES: K.S.A. 79-201a; K.S.A. 79-201 *Ninth*; K.S.A. 79-1439(b)(1)(D), (F); K.S.A. 79-1439a; K.S.A. 2003 Supp. 79-213

Office of the Attorney General
State of Kansas

OPINION NO. 2005-14
Cities and Municipalities –
Buildings, Structures and Grounds – Definitions;
Permissible Use of STAR Bonds; Lease-Back Arrangement

SYNOPSIS: K.S.A. 2004 Supp. 12-1773(a) specifically allows cities to acquire land as part of a redevelopment project. Subsection (b) of that statute allows cities to sell or lease such land to developers and to use proceeds from bonds issued under the Tax Increment Financing (TIF) Act to pay redevelopment project costs. K.S.A. 2004 Supp. 12-

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1770a(q) defines redevelopment project costs to include acquisition of property within the redevelopment project area. The statutes do not preclude resale of such property by the developer, for a profit, to other developers in accordance with the project plan. Further, these statutes are written to only restrict the first use of the bond proceeds, not any subsequent generation of dollars from the land, implements, or structures built with those proceeds. Because the purpose of the TIF Act is to promote and stimulate development by assisting cities to help finance redevelopment projects, and because the Act does not specifically preclude the dedication of revenues from buildings and structures that have been constructed using Sales Tax and Revenue (STAR) bond moneys to provide incentives to developers, we do not believe that the Unified Government's lease, lease-back agreements that are the subject of Legislative Post Audit's February 2005 Performance Audit Report violate K.S.A. 2004 Supp. 12-1773(b) and 12-1770a(q).

STATUTES: K.S.A. 12-1757; 12-1880; K.S.A. 2004 Supp. 12-1770a; 12-1771; 12-1772; 12-1773; 12-1774; L. 1980, Ch. 68, §; L. Ch. 78, § 4; L. 1996, Ch. 52, §4(b); L. 1997, Ch. 93, § 1; L. 1997, Ch. 162, § 2; L. 1998, Ch. 17, § 5; L. 2001, Ch. 103, § 2; L. 2004, Ch. 183, § 4; 1976 HB 2666, § 4

U.S. Supreme Court

KELO ET AL. V. CITY OF NEW LONDON ET AL.
SUPREME COURT OF CONNECTICUT – AFFIRMED
CASE NO. 04-108 – JUNE 23, 2005
Eminent Domain, Economic Development, Public Purposes

FACTS: New London, Conn., used its eminent domain authority to seize private property to sell to private developers. The city said developing the land would create jobs and increase tax revenues. Property owners whose property was seized sued the city of New London. The property owners argued, among other things, that the city violated the Fifth Amendment's takings clause, which guarantees that the government shall not take private property for public use without just compensation. The property owners argued that taking private property to sell to private developers was not a legitimate public use. The Connecticut Supreme Court ruled for New London.

ISSUE: Whether a city violates the Fifth Amendment's takings clause if the city takes private property and sells it for private development, believing that the resulting economic development might stimulate new jobs and increase tax revenues.

HELD: In a 5-4 opinion, the Court ruled that New London's condemnation of private property for economic development qualifies as a public use and is, therefore, not an unconstitutional taking. The claim that the condemnation was an abuse of public power for private gain was rejected by the Court. The Court determined that the city had established a development plan, which was carefully considered, and not adopted for the purpose of benefitting a particular class of identifiable individuals. The disposition of this case turned on the question whether the city's development plan serves a "public purpose." The city's development plan for the area included a variety of proposed land uses, including commercial, residential, and recreational uses, which were intended to provide public benefits, including new jobs and increased tax revenues. The takings for economic development qualified as "public use," even though the property was not going to be used by the public. According to the majority, the Fifth Amendment does not require literal "public use," but instead requires merely use for a "public purpose."

DISSENT: In her dissent, Justice O'Connor wrote: "*To reason, as the Court does, that the incidental public benefits resulting from the subsequent ordinary use of private property render economic development takings 'for public use' is to wash out any distinction between private and public use of property and thereby effectively to delete the words 'for public use' from the Takings Clause of the Fifth Amendment*." O'Connor argued that the majority's references to the *Berman* and *Midkiff* cases were inappropriate. In each of those cases, the condemned property inflicted some harm on society (i.e., the property had a detrimental impact on the public good, and the Court decided that removal of the harm caused a direct public benefit). In *Kelo*, the land in question caused no immediate harm to society, and the economic and aesthetic environment merely had a chance of improving if the land was condemned.

U.S. Court of Appeals 10th Circuit

JENKINS V. HODES
NO. 03-3309 – MARCH 25, 2005
Homestead Exemption, Builder Deposit, Equitable Conversion

ATTORNEYS: Mark S. Carder and Michael L. Kahn, Stinson Morrison Hecker LLP, Kansas City, Mo., for appellants Lawrence S. Jenkins and Roger W. Hood, M.D.; and Eric C. Rajala, Law Office of Eric C. Rajala, Overland Park, for appellant Eric C. Rajala, Trustee. Cynthia F. Grimes, Grimes and Rebein L.C., Lenexa, for appellees.

FACTS: On Nov. 17, 1997, Lawrence Jenkins and Roger Hood became judgment creditors of Phillip and Barbara Hodes (Debtors), for $4 million. On Dec. 7, 1997, Debtors entered into a contract with a builder for a 1,056 square-foot addition to their 3,700 square-foot home in Leawood to cost no more than $225,000. Pursuant to the contract, they paid the builder a cash deposit of $225,000 up front. On Jan. 6, 1998, before the builder had commenced construction, Jenkins and Hood filed involuntary Chapter 7 bankruptcy petitions against Debtors. In the bankruptcy proceedings, the Bankruptcy Judge upheld Debtors' claim that the deposit placed with the builder was exempt under Kansas' homestead exemption. Jenkins and Hood appealed.

ISSUE: Whether, and to what extent, the Kansas homestead exemption extends to a deposit paid pursuant to a contractually binding contract with a builder for improvements to an already existing homestead.

HELD: The court held that a Kansas debtor who enters into a valid contract with a builder prior to the filing of an involuntary bankruptcy petition against the debtor, secured by a deposit with the builder placed before the petition is filed, may claim under the Kansas homestead exemption any amount of the deposit actually spent on improvements to the homestead. The court reached this holding under a theory of equitable conversion. Under the doctrine of equitable conversion, money is converted into real property at the

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moment a sales contract for real property is entered into. In Kansas, buildings, fixtures, and improvements upon land are considered to be real property. Therefore, the court reasoned, the Debtors' deposit became equitably converted into real property at the moment they entered into the contract with the builder, prior to the filing of the bankruptcy petition. As Kansas law also protects an incomplete structure as a homestead, so long as it was purchased with a view to occupancy followed by occupancy within a reasonable time, the planned addition clearly fell within the scope of the homestead exemption. Therefore, the court ruled that Debtors' deposit was exempt.

STATUTES: Kan. Const. Art. 15, § 9; K.S.A. 60-2301

U.S. Bankruptcy Court District of Kansas

IN RE DAY-BY-DAY ENTERPRISES INC.
NO. 04-11794 – FEBRUARY 11, 2005
ADVERSARY NO. 04-5246
Avoiding Unrecorded Mortgage as Preference, Constructive Notice of Mortgage

ATTORNEYS: Susan G. Saidian, Redmond & Nazar LLP, Wichita, for debtor. Michelle M. Masoner, Bryan Cave LLP, Kansas City, Mo., for defendants.

FACTS: Day-by-Day Enterprises Inc. (Debtor) operates seven Burger King restaurants in Kansas, under franchises granted by the Burger King Corp. (BKC), including store No. 1669 located in Hutchinson. BKC owns the land and building used for that store. Beginning in 1994, BKC leased the premises to Debtor in a series of documents, none of which has ever been recorded with the Register of Deeds for Reno County, where the store is located. In 1997, the Franchise Mortgage Acceptance Co., along with successors and transferees (Lender), loaned $1 million to Debtor, secured by a mortgage on the Debtor's leasehold interest in store 1669, and a security interest in all personal property the Debtor had or used at or in connection with the store. In 1997, Lender properly perfected its security interest in the personal property by filing the appropriate forms with the Kansas Secretary of State. Lender also filed a fixture filing with the Reno County Register of Deeds. Lender did not record its mortgage on Debtor's leasehold interest until Jan. 12, 2004. On March 2, Lender began proceedings to foreclose on its mortgage. On April 8, 2004, Debtor filed a Chapter 11 bankruptcy petition, less than 90 days after Lender's mortgage on the leasehold was recorded. Debtor commenced this proceeding against Lender seeking to avoid its mortgage on the leasehold as a preference under 11 U.S.C.A. § 547(b).

ISSUE: Whether a debtor can avoid a mortgage on its leasehold interest as a preference, when the mortgagee did not record its mortgage until a time within 90 days of the time the debtor filed for bankruptcy protection, but the mortgagee had recorded a fixture filing much earlier.

HELD: The court held that Debtor could avoid the mortgage as a preference made within 90 days of the filing of the bankruptcy petition. Under the Bankruptcy Code, if a mortgagee does not perfect its mortgage within 10 days, the mortgage is not deemed to be made until the time at which it is perfected. The court noted that a mortgage in a leasehold interest is perfected, under the Bankruptcy Code, when a bona fide purchaser of the leasehold from the debtor cannot acquire an interest that is superior to the interest of the mortgagee. The court rejected Lender's argument that its fixture filing provides constructive notice of its mortgage in the leasehold interest. Although Kansas law holds that unrecorded instruments are valid as to those who know of the instrument or when the circumstances are such that one purchasing the interest should have discovered the unrecorded instrument, a buyer interested only in the leasehold interest and not fixtures or personal property (the hypothetical buyer contemplated by the Bankruptcy Code's provisions defining perfection) would not have constructive notice of Lender's interest in the leasehold. Further, the court held that Lender could not rely on its foreclosure suit to establish notice, and thus perfection, at any time prior to the date it was filed. Because Lender did not perfect its mortgage more than 90 days prior to Debtor filing its bankruptcy petition, Debtor was able to avoid the mortgage as a preference.

STATUTES: K.S.A. 58-2221B2223; K.S.A 60-2201(a), 2202(a); K.S.A. 84-9-102(41), 334(a)

IN RE ALAN D. SAGER AND TONYA G. SAGER
NO. 03-13626-DLS – FEBRUARY 25, 2005
BANKWEST OF KANSAS V. SAGER –
ADVERSARY NO. 03-5308
Homestead Exemption, "Peculiar Equity" Limitation

ATTORNEYS: William B. Sorensen Jr., Morris, Laing, Evans, Brock & Kennedy Chtd., Wichita, for plaintiff. Sarah L. Newell, Klenda, Mitchell, Austerman & Zuercher LLC, Wichita, for defendants.

FACTS: Bankwest of Kansas (Bank) sought an order denying in part the Sager's (Debtors) homestead exemption. Bank is an undersecured creditor. It seeks to recover a portion of its unsecured claim by challenging the Debtors' prepetition use of proceeds from the sale of collateral to reduce their obligation on the note secured by their homestead. Because of this, Bank contends that it has a "peculiar equity" in Debtors' homestead such that it can circumvent the normal homestead exemption. Bank had a security interest in all of Debtors' equipment, including a perfected security interest in a Jet Grain Trailer. The Jet Grain Trailer was wrecked, and Debtors' insurance company declared it totaled, issuing a check to Debtors. Several months later, Debtors used these proceeds to purchase a second grain trailer. Bank did not record its security interest on the new trailer's certificate of title, and thus did not have a perfected security interest in the new trailer. After purchasing the new trailer, the Debtors purchased a homestead, and mortgaged it to a lender other than Bank. Later, Debtors sold the new trailer and used the proceeds to pay down the note on their homestead.

ISSUE: Whether a creditor can avoid a debtor's homestead exemption because of a "peculiar equity," when the debtor has converted into the homestead proceeds of collateral in which creditor had an unperfected security interest.

HELD: The court denied Bank's motion for summary judgment. The court stated that a debtor is permitted to convert nonexempt property into exempt property before filing a bankruptcy petition, that such practice is not automatically fraudulent as to creditors, and that such

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practice permits the debtor to make full use of the exemptions to which the debtor is entitled to under the law. The court stated that although the Bankruptcy Code generally permits conversion of assets prepetition, it also includes vehicles to prevent abuse; a conversion of nonexempt assets may be set aside because made with intent to hinder, delay, or defraud creditors sufficient to render the transfer voidable. The court also stated that the homestead exemption is liberally construed in Kansas to safeguard its humanitarian, social, and economic purposes. The court construed the Kansas "peculiar equity" exception to require a showing of fraudulent intent and the tracing of nonexempt assets in which an objecting creditor held an interest to the exempt property; therefore, the creditor's interest in the funds used to acquire the homestead must be shown in addition to the usual requirements of fraudulent transfer. The court held that Bank was not entitled to the benefits of the Kansas "peculiar equity" exception to the permissible conversion of nonexempt assets to exempt assets. The absence of facts supporting a finding of actual fraud required the Court to deny Bank's motion for summary judgment seeking the remedy of a partial denial of the homestead.

STATUTES: Kan. Const. Art. 15, § 9; K.S.A. 60-2301; K.S.A. 84-9-311; K.S.A. 84-9-315

IN RE KERRY LEEBURNES McCAMBRY AND TINA MARIE McCAMBRY
NO. 04-20520 – JULY 1, 2005
Homestead Exemption

ATTORNEYS: William H. Griffin, on his own behalf, for plaintiff. William D. Peters, Kansas City, Kan., for debtors.

FACTS: The McCambrys own a side-by-side duplex located on less than one acre of land. The McCambrys occupy half of the duplex and rent out the other half to a tenant under a month-to-month lease. At any time the tenant may be required to surrender the leased premises with only one month's notice. The entire property is encumbered by a single note and mortgage. The McCambrys maintain the exterior and interior of the entire duplex. The McCambrys also maintain and have access to personal property located inside and outside of the rented portion of the duplex. The McCambrys maintain exclusive rights to the land surrounding the entire duplex limited only by the tenant's right to enter and exit the building. Mrs. McCambry is disabled and unable to work full time. The McCambry's primary purpose for purchasing the property was to secure a home and create a mechanism to pay for the home. The McCambrys, subsequently, filed for Chapter 13 bankruptcy and claimed the entire duplex as a homestead exemption. The Chapter 13 trustee objected to the McCambrys' homestead exemption of the entire duplex.

ISSUE: Whether the entire duplex is covered by the homestead exemption despite the fact that one side is rented to and occupied by a tenant.

HELD: The court stated that a homestead is a constitutional right, and a resident is entitled to the full value of such property. To be considered as a homestead, the property must not be used for business purposes unless such purposes are incidental to the property's nature as a place of residence. The court stated that the McCambrys maintain considerable control over the entire duplex consistent with their homestead interest because the duplex stands on less than one acre of land, the McCambrys maintain complete control over the land limited only by the tenant's right to exit and enter the building, and the tenant of the leased portion may be required to leave with only one month's notice. The court held that the McCambrys were entitled to exempt the entire duplex under the homestead exemption because "[t]he McCambrys' limited business use of the portion of the duplex structure currently occupied by a tenant is, under the facts and circumstances of this matter, incidental to their homestead interests in the entire duplex structure and surrounding land."

STATUTES: K.S.A. § 60-2301; Kan. Const. Art. 15, § 9

2005 Kansas Legislative Highlights

SB 33 — *Kansas Fairness in Private Construction Act*. Prohibits waiver of certain terms regarding timing of payments, interest for late payments, limits on retainage, suspension of work on account of late payments, and delays in performing the contract. Does not apply to single family residential housing, multifamily residential housing of four units or less, or public works projects. Kansas 2005 Session Laws, Ch. 156.

SB 112 — *Materialman's Lien*. This amendment creates a materialman's lien for labor and materials furnished at the building site, even though not visible. Also, relation back to earliest lien is eliminated if the earliest lien is discharged. This amendment states that "*[i]f an earlier unsatisfied lien is paid in full or otherwise discharged, the commencement date for all claimants shall be the date of the next earliest unsatisfied lien*." Current law requires subcontractors and suppliers on new residential property to give a notice of intent to perform. This amendment extends this requirement to all persons contracting directly with an owner, in addition to subcontractors and suppliers. Kansas 2005 Session Laws, Ch. 95.

SB 126 — *Property Taxation*. Authorizes county appraisers to amend the current year's property tax appraisal rolls up to Oct. 31 when a final determination on property valuation appeals has been made for the prior tax year (previous deadline was June 15). Permits property owners to protest taxes prior to Jan. 31 when an escrow agent pays first half of taxes. Prior law required the escrow agent to pay all of the taxes to allow an owner to protest the tax. Kansas 2005 Session Laws, Ch. 161.

SB 178 — *Home Service Contracts*. This Act pertains to the regulation of home service contracts, as opposed to home inspection contracts. A "*service contract*" includes a contract for any specified duration to service, repair, replace, or maintain all or any part of any structural component, appliance, or utility system of any residential property, consumer good, or other property, and also includes any nonconsumer commercial service contract. Under this Act, a service contract: (i) is not deemed an insurance product for purposes of regulation, (ii) shall not contain a provision for consequential damages unless caused by failure to render the services under the contract, and (iii) shall not contain provisions covered by a property or liability insurance contract. Kansas 2005 Session Laws, Ch. 140.

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SB 215 — *Commercial Real Estate Broker Liens*. This Act establishes the procedure for recording a real estate broker's lien on commercial real estate. To be entitled to a lien, the broker must have a written agreement for payment. The notice of lien must be filed with the register of deeds in the county where the real estate is located and must specify the name of the broker, property owner, legal description, amount claimed, and the real estate license number of the broker. The broker must sign the lien notice and attest that the information contained therein is true and accurate as to the broker's knowledge and belief. The broker must mail a copy of the lien to the property owner within 10 days, unless the notice is recorded within 10 days prior to closing. If payment is sought from a seller, the broker must record the lien prior to conveyance of the property. If payment is sought from a buyer, the broker must record the lien within 90 days after conveyance of the property. The lien for services performed for a seller or buyer must be foreclosed within two years after recordation. This Act also amends the anti-kickback provisions of the real estate broker's and salesperson's license act, in order to allow a licensee to receive compensation from an affiliated business arrangement with a title insurance agency permitted by K.S.A. 40-2404(14)(e)-(j). Kansas 2005 Session Laws, Ch. 179.

House Sub. for SB 24 — *Annexation*. Amends the city annexation law dealing with the unilateral annexation to expand the scope of review that a court may make of these decisions and to require cities to consider 16 different factors when annexing land unilaterally. This amendment also gives any city whose boundary line is located within one-half mile of the land being annexed and any owner of land annexed to the city (the latter provision is current law) the ability to challenge the annexation in district court. When a unilateral annexation is challenged, the court must determine whether the annexation is reasonable and the service plan adequate and the effect the annexation would have on future growth of any city challenging the annexation. Kansas 2005 Session Laws, Ch. 155.

HB 2125 — *Satisfaction of Mortgages*. This Act relating to mortgages on real property allows a mortgagee to charge a mortgagor a fee for releasing a mortgage. However, nonpayment of the fee by the mortgagor does not relieve the mortgagee of the obligation to record satisfaction of the mortgage. Kansas 2005 Session Laws, Ch. 52. ■

President's Message

Continued from Page 1

In Arizona, a debtor has no right to "elect" state exemptions, because the Arizona Legislature elected to opt out of the federal exemptions and the state exemptions are the only exemptions available to the debtor. After applying the principles of statutory interpretation, the Court found that the new statutory cap did not apply and allowed the debtor to take Arizona's more liberal homestead exemption.

It will be interesting to see if the actions of the judiciary and Congress will, in fact, erode the protection afforded by the Kansas homestead exemption.

On to something else.

In this issue of the *Reporter* we recognize our section members involved in the cases digested for their good work in creating/interpreting the law in Kansas.

Although you may not have a reported case, each of you can become involved with our section in helping create or modify legislation or just suggesting items that you would like to see addressed. We are always looking for CLE presenters. We would also be interested in hearing suggestions from the practitioner as to what forms could be posted on the Web site for downloading. You may e-mail me at frbf@yahoo.com. ■

Author

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Probate and Trust Cases

IN THE MATTER OF THE ESTATE OF FRANCIS J. WOLF JR., DECEASED
112 P.3d 94
JUNE 3, 2005

ATTORNEYS: John M. McFarland, Kutak Rock LLP, Kansas City, Mo.; and David L. Higgins, Higgins Lysaught Tomasic & Lynch, Kansas City, Kan., for appellant/executrix. Jeffrey B. Rosen and Kevin J. Breer, Polsinelli, Shalton & Welte P.C., Overland Park, for appellee/creditor.

The Kansas Supreme Court held that a probate claim for attorney fees was not properly or timely made by merely attaching a copy of a contract containing an attorney fee's clause to a creditor's petition. The Supreme Court upheld the Court of Appeals and reversed the district court.

The dispute was over $143,659.41 in attorney fees and expenses on a several year dispute over an option agreement. The district court reduced the fees by 1 percent but otherwise allowed recovery of the full fees and expenses. Although the attorney fee claim was recognized by the Kansas Supreme Court to be contingent upon the outcome of the underlying litigation, it held that K.S.A. 59-2239 is all-inclusive in requiring "all demands" to be filed, and consequently required such a contingent claim to be pled in the probate petition for allowance of its demand.

The creditor argued that K.S.A. 60-209(h) and 60-210(c) authorize notice pleading and incorporation of exhibits, but the Supreme Court held that these concepts from the code of civil procedure are inapplicable to a probate case that has its own pleading statute (K.S.A. 59-2202) and nonclaim statute (K.S.A. 59-2239) with a more specific requirement that contingent claims must be set forth in the creditor's petition.

MCGINLEY V. BANK OF AMERICA N.A.
109 P. 3d 1146
APRIL 22, 2005

ATTORNEYS: Phillip L. Turner and Dan E. Turner, Turner & Turner, Topeka; and Don Hoffman and Jason Hoffman, of Hoffman & Hoffman, Topeka, for appellant/plaintiff. Steven E. Mauer, Rebecca S. Jelinek, Robert J. Hoffman, and Jennifer A. Donnelli, Bryan Cave LLP, Kansas City, Mo., for appellee/defendant.

Marie McGinley directed her trustee to retain the Enron stock held in trust and then sued the trustee when the value dropped from $789,687 to $4,800. She lost.

McGinley created a revocable trust in 1990. Seven months later she signed a letter (prepared by her own legal counsel) directing Bank of America, as trustee, to retain the Enron stock and agreeing to exonerate the trustee for any loss. The district court granted the trustee summary judgment and the Kansas Supreme Court transferred the case from the Court of Appeals on its own motion.

The Court noted that McGinley, as grantor, reserved the right to revoke or amend the trust and the exclusive power to control all purchases and sales. She was at all relevant times capable of managing her own affairs. She asserted the following causes of action against the trustee: (1) breach of fiduciary duty, (2) negligent failure to supervise bank employees, (3) breach of loyalty, (4) tortious conduct of bank employees, (5) violations of the Kansas Consumer Protection Act, and (6) fraud and misrepresentation by failing to disclose an alleged conflict of interest. The Court rejected all of these with the observation that a trustee must follow the trust terms (which indicated that the grantor would control the investments and she did nothing to change her direction to retain the Enron stock).

The Court rejected expert witness opinions on the legal validity of the exculpatory provisions in the letter and held that the validity of the letter could be determined by the Court as a matter of law.

The Court provides an extensive historical analysis of the Kansas statutes governing trustee powers and prudent investors.

IN THE MATTER OF VICTOR W. MILLER
112 P.3d 169
JUNE 3, 2005

ATTORNEYS: Judith Davis, deputy disciplinary administrator, Topeka; Gregory A. Lee, Cooper & Lee LLC, Topeka, for respondent (who also argued *pro se*).

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This is an ethics case involving the late filing of a probate inventory and delay in filing a petition for final settlement. Public censure was ordered by the Kansas Supreme Court in accordance with the uncontested unanimous recommendation of the Kansas Board of Discipline's hearing panel.

The will of Howard Moses was admitted to probate, and Miller was appointed executor on Dec. 6, 2001. Pursuant to K.S.A. 59-1201, an Inventory and Valuation is due within 30 days from the personal representative's appointment unless a longer time is granted by the court. On the 31st day, the Shawnee County Court Clerk issued a Notice and Order for Inventory to Miller. The decedent's mother hired Craig McKinney as her attorney to pursue answers to questions the mother had addressed to Miller to which she had received no response. When Miller also failed to respond to McKinney, he filed a petition on Nov. 12, 2002, to compel an inventory and accounting. On Dec. 1, 2002, the court clerk issued a notice that final settlement was due. On Dec. 5, 2002, Miller failed to appear at a hearing on the petition to require an inventory and was ordered to file it forthwith. He did not do so.

A petition was filed to recover the mother's attorney's fees and Miller failed to appear at that hearing on Feb. 24, 2003. The mother was awarded $1,031.25 in fees.

On April 9, 2003, McKinney filed a complaint with the disciplinary administrator. On June 18, 2003, the Court issued an Order to Appear and Show Cause threatening an arrest warrant for failure to appear. Miller appeared on July 16, 2003, and was ordered to file the necessary pleadings by July 25, 2003. He continued to fail to do so. On Aug. 18, 2003, an additional $2,520.07 in attorney fees was awarded to the mother.

An Inventory was finally filed, more than 19 months after it was due, on Aug. 23, 2003. On Oct. 9, 2003, Miller was ordered to transfer the estate assets in his possession ($6,587.37) to the court clerk.

On March 1, 2004, the court clerk issued a second Notice of Final Settlement Due. On April 10, 2004, the court clerk issued a Notice of Delinquency. On May 10, 2004, the court clerk issued a second delinquency notice. On Aug. 13, 2004, a Petition for Final Settlement was filed by another attorney who was assisting Miller. On Sept. 13, 2004, a Journal Entry of Final Settlement was entered. On Sept. 29, 2004, the Journal Entry of Final Discharge was entered. This was seven days prior to the disciplinary panel's hearing.

Miller stipulated to a violation of the Kansas Rules of Professional Conduct (KRPC) 1.3 (reasonable diligence and promptness) for failing to prepare and file the Inventory and the Petition for Final Settlement. Miller also admitted to violating KRPC 1.1 (competent representation) and the hearing panel concluded that this was also indicated by his failing to prepare and file the Inventory and Petition For Final Settlement. Miller stipulated to violating the duty of KRPC 1.4 to keep a client "reasonably informed" and this was also due to his failure to communicate with the mother regarding the status of her deceased son's estate. He also stipulated to violation of KRPC 3.2 (expedite litigation). The hearing panel also concluded, and the Court agreed, that he violated KRPC 8.4(d) (engage in conduct that is prejudicial to the administration of justice) by failing to comply with or even respond to court orders and failing to complete a small estate for two and a half years.

It is presumed that the filing of an inventory one day after the 30-day deadline would not by itself constitute an ethical violation any more than would a late response to Interrogatories or a Request for Production of Documents in a civil case (to which KRPC 3.4(d) might also apply). These may also involve situations where the attorney does not necessarily control the ability to make a timely filing or response if the client does not provide adequate and timely information. Presumably it was Miller's pattern of delay and refusal to comply despite numerous requests, orders, etc., that caused not only the ethics complaint but also the finding of a violation. Kansas Disciplinary Administrator Stan Hazlett has indicated that he does not think the late filing of an inventory (or late response to Interrogatories or Request for Production of Documents) is an automatic ethics violation without more factors, such as those in the Miller case.

MAENHOUDT V. STANLEY BANK
115 P.3d 157
JULY 15, 2005

ATTORNEYS: Phillip H. Schuley, Overland Park, for appellant, Tammy M. Somogye, Lathrop & Gage L.C., Overland Park, for appellee.

A summary of facts in this case would not do it justice. The bank indicated that it did not accept powers of attorney. The Court of Appeals states in its own Syllabus 3 that, "[a] financial institution is not required to honor every durable power of attorney." In Syllabus 4, however, the court states that, "[a] bank or other financial institution may rely on a power of attorney as long as there are no circumstances that would indicate a potential of misappropriation of the principal's funds. An unqualified refusal to honor a power of attorney is contrary to Kansas law." Given this latter sentence it would appear that the permissive "may" in K.S.A. 58-658's reference to the third party reliance on a power of attorney is being interpreted as "shall" unless there are circumstances that would indicate a potential misappropriation of the principal's funds. The court does indicate that incapacity of the principal at the time a durable power of attorney is presented is not a factor that a bank may consider.

The next syllabus paragraph states that, "[w]hen presented with a durable power of attorney or trust agreement, a bank or financial institution has a duty to: (1) compare the signature on the power of attorney with the customer's signature on file; (2) obtain proper identification from the person seeking withdrawal as the person designated as attorney in fact; and (3) determine whether the requested transaction was within the scope of the durable power of attorney." The court does not go on to say in the syllabus or the text itself what the bank is to do with this information. Presumably any problem would be a basis for rejecting use of the power of attorney. If everything checks out, is the bank obligated to accept the power of attorney so long as there are no circumstances that would indicate a potential misappropriation? Presumably so, but the opinion's text adds that K.S.A. 58-658(d) "allows the Bank to require indemnification from the fiduciary."

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Probate and Trust Cases

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It will be interesting to see how this case is resolved on remand and how banks implement their interpretation of the court's opinion.

2005 Kansas Legislation

SB 50 conforms references in Kansas statutes to the federal change in the name of the "Soldiers and Sailors Civil Relief Act" to the "Servicemembers Civil Relief Act." This will affect the references used by attorneys representing those on active duty and in affidavits of nonmilitary service.

SB 258 eliminates various statutory forms. The probate forms eliminated are the small estate affidavit (K.S.A. 59-1507b), those for adoptions (K.S.A. 59-2124, 59-2129 and 59-2143), and the notice for probate hearings (K.S.A. 59-2210). Instead, the statutes now make reference to the forms provided by the Kansas Judicial Council. The Judicial Council forms can be found at www.kscourts.org/council/statutoryforms.htm.

A Web site that allows you to check whether someone is in the military is now available at https://www.dmdc.osd.mil/scra/owa/home. ■

Estate Tax Notes

Continued from Page 6

13. Stock Redemption Qualifies for Capital Gain Treatment Despite Cross-Default and Cross-Collaterization Provisions

Hurst was the sole owner of Hurst Mechanical Inc. (Corporation), which started as a C corporation but elected S status in 1989. Hurst and his wife owned the Corporation's headquarters building and leased it to the Corporation. The Corporation had three key employees, one of which was Hurst's son, who offered to buy the business from Hurst in 1997 for $2.5 million payable with interest in installments over 15 years. The deal occurred as follows: (i) the Corporation purchased Hurst's shares for a $2 million note; (ii) Hurst sold his remaining shares to the three key employees for a $250,000 note; (iii) the Corporation purchased RHI, another business owned by Hurst, for a $250,000 note. All notes bore interest at a rate of 8 percent and were payable in 60 quarterly installments. The Hursts signed a new 15-year lease with the Corporation and gave the Corporation an option to purchase the building. The Corporation signed a 10-year employment contract with Hurst's wife that gave her a small salary plus fringe benefits that included employee health insurance and use of the truck that Hurst had driven while he owned the Corporation. Hurst received health insurance coverage as his wife's spouse. To reduce the risks associated with the sales, the parties agreed to a complicated series of cross-default and cross-collateralization provisions, the net result of which was that a default on any one of the notes, the lease, or the employment contract would constitute a default on them all. Since the notes were secured by the Corporation and RHI stock that the Hursts had sold, a default on any one of the obligations would have allowed Hurst to seize the Corporation stock to satisfy any unpaid debt. The Hursts reported the dispositions of the stock on their 1997 tax return as installment sales of long-term capital assets. The IRS disagreed and recharacterized the dispositions as producing more than $400,000 in dividends and more than $1.8 million in immediately recognized capital gains, leading to a deficiency of more than $530,000 and a penalty of more than $100,000.

At trial, the Hursts argued the sale qualified for capital gain treatment because it was a complete redemption under Code Section 302(b)(3). They further argued the family attribution rule did not apply to prevent a complete redemption because immediately after the redemption he had no personal financial interest in the Corporation other than as a creditor and would not acquire any prohibited interest or position within 10 years after the redemption. The IRS argued the Corporation stock sale was not a complete redemption because the total number of related obligations resulting from the transaction gave Hurst a prohibited interest by giving him a financial stake in the Corporation's continued success.

The Tax Court ruled in favor of the Hursts with respect to the sale of the Corporation. It held the number of legal connections between Hurst and the buyers that continued after the deal was signed did not change their character as permissible security interests. The cross-default clauses were necessary to protect Hurst's interests since he sold the stock for a note. Further, the lease contained terms that would be reasonable if negotiated between unrelated parties. The Tax Court held the facts did not show a continuing proprietary stake or control of corporation management. Thus, the sale qualified as an installment sale of long-term capital assets. *Hurst v. Comm.*, 124 T.C. 16 (2005).

14. Sale of Property Acquired by Split-Purchase not Subject to Chapter 14

In two different years prior to Oct. 8, 1990, the taxpayer, his spouse, and five of their six children purchased property for its fair market value from an unrelated party. The taxpayer acquired a life interest; the spouse acquired a life interest effective upon the death of the taxpayer; Child One acquired a one-third common undivided interest in the remainder; and Children Two through Five each acquired a one-sixth common undivided interest in the remainder. Child Six did not participate in the purchase because he was a minor. The taxpayer, spouse, and their five children each paid the actuarial value of their respective interest from their own resources, and none of the children used funds acquired from their parents to acquire their interests. The purchasers entered into an agreement in connection with the purchase of the property that provided for their respective rights, duties, and obligations in the acquisition, ownership, and disposition of the property. Pursuant to the agreement, upon the youngest child's subsequent attainment of the age of majority, he received his one-sixth interest in the property by conveyance by Child One. Under the agreement, if the property is disposed of prior to the expiration of the taxpayer's and spouse's life tenancies, the proceeds are to be held in trust with the taxpayer and spouse as trustees. The trust will pay all income at least annually to the taxpayer and spouse. Upon both of

Continued on Page 17

their deaths, the trust will terminate, and the remaining assets will be immediately paid to the children in accordance with their respective interests. Any sale of the property requires the consent of the taxpayer, spouse, and remaindermen. An addendum to the agreement provides any subsequent acquisition of real property by the taxpayer, spouse, and their children will be subject to the same terms and conditions as contained in the agreement. The parties subsequently acquired additional properties prior to Oct. 8, 1990. They now propose to sell their original property for fair market value to an unrelated party and have stated that a sale of their other properties could be made in the future.

The IRS ruled the proceeds of a sale or other conveyance of their properties, and the principal proceeds of any investments or reinvestments that are held in trust pursuant to the agreement will be treated as a transfer or transfers occurring prior to Oct. 8, 1990, for purposes of applying the provision of Chapter 14 of the Code. The IRS further held after the sale of the original property, the other properties would continue to be treated as property acquired pursuant to a transfer occurring prior to Oct. 8, 1990. In so ruling, the IRS relied on the facts all properties were in fact acquired prior to Oct. 8, 1990, the agreement and addendum were executed prior to Oct. 8, 1990, and neither the sale or other disposition of the properties nor the deposit of the proceeds in trust would involve any transfer of value among the family members. They would all have substantially identical interests before and after the proposed transaction. P.L.R.s 200502008, 200502009, 200502035.

15. FLP Asset Includible in Decedent's Gross Estate

In 1991, the decedent created a trust and transferred her residence to it. In 1992, the decedent suffered a stroke and was hospitalized. Six weeks after she was released from the hospital, she moved into an assisted-living facility. In 1993, the trust and the decedent's children exchanged the residence for other real property (the two daughters each owned less than 0.8 percent, and the son owned a 1/175 interest in the residence). The following year, the decedent's trust and the decedent's children formed a family limited partnership (FLP), to which the real property was transferred. The loan and line of credit totaling $450,000 that were secured by the real property were not transferred to the FLP. The trust was the general partner and a limited partner. The three children were all limited partners. At the time of the decedent's death, the trust owned a 1 percent general partnership interest and a 45 percent limited partnership interest. The decedent's estate tax return showed the value of the trust's limited partnership interest at $135,080, derived from taking a 37 percent discount for lack of marketability. The general partnership interest was reported at $19,912, computed by taking 1 percent of the value of the real property and applying a 35 percent control premium. The IRS determined the real property transferred to the FLP was includible in the decedent's gross estate, resulting in a deficiency of $217,480.

The Tax Court held for the IRS stating the decedent retained the economic benefit of ownership of the property. After the initial transfer of assets to the FLP, the decedent was left with an insufficient amount of income to meet her living expenses or to satisfy her liability for the indebtedness. The Tax Court found the decedent's expenses exceeded her income by $2,700. The Tax Court observed the FLP made the $2,000 monthly payments on the loan and the decedent's son transferred partnership funds to the decedent's trust to support her. No other distributions were made to any other partner prior to the decedent's death. The Tax Court determined there was an implied agreement between the decedent and her children that she would retain for her life the present economic benefit of the property transferred to the partnership. Further, the property transferred continued to secure the decedent's loan and line of credit. The Tax Court held the transfer of the property by the trust for an interest in the FLP was not a bona fide sale for adequate and full consideration. The Tax Court also determined the corporate formalities were not respected, the partnership did not maintain proper records of partners' capital accounts, and the family did not comply with all of the terms in the partnership agreement. Therefore, the Tax Court concluded the value of the real property was includible in the decedent's gross estate. *Estate of Bigelow v. Comm.*, T.C. Memo 2005-65.

16. Merger of Trusts to Qualify for ESBT Election Will Not Subject Trusts to GST Tax

The settlor created three trusts, named for each of his three sons. The terms of the three trusts are identical except for the identity of the initial beneficiary. Each trust provides its trustee with discretionary power to accumulate income or pay any part of it for charitable purposes (limited to 20 percent of the annual income). Any remaining net income is required to be distributed to the son/beneficiary. After a son dies, the trustee has the discretion to pay any remaining net income of the trust to the settlor's grandchildren. The trusts will terminate 21 years after the last survivor of the settler and the three sons. At the time of the ruling request, only one of the sons was still living. On termination, the trust assets will be distributed to the settlor's grandchildren, in equal shares, per capita, but the living issue of a deceased grandchild will take the share of the deceased grandchild, per stirpes.

The primary asset of each trust is stock in a subchapter C corporation. The shareholders of the corporation want it to elect S corporation status. Thus, the trustees of the trusts want to make an electing small business trust (ESBT) election for each trust under Code Section 1361(a) in order to be eligible to hold S corporation stock. The trusts are not presently eligible because the discretionary power of the trustee to pay up to 20 percent of a trust's net annual income to one or more charities does not limit the number of charities that can receive income distributions and because the trusts do not limit permissible charitable beneficiaries to those described in Code Section 170.

The trustees propose to create three new trusts that provide them with discretionary power to pay up to 20 percent of the annual net income to either or both of two charities, as determined by the trustees, provided that no payments may be made or set aside for a charity not described in Code Section 170(c)(2). Any payment to one of the charities must be made to a donor advised fund, for which the trustees are the advisors. After the new trusts are created, the old trusts will merge into the new trusts. Three grandchildren and five great-grandchildren of the settlor are the current beneficiaries of two of the trusts and are the contingent beneficiaries of the third trust following the surviving son's death.

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The IRS determined the original trusts meet the requirements for the exception to the generation-skipping transfer tax provided for in Section 1433(b)(2)(A) of the Tax Reform Act of 1986 and Regulation Section 26.2601-1(b)(1)(i). The IRS held the proposed mergers are substantially similar to Example 6 in Regulation Section 26.2601-1(b)(4)(i)(E), and concluded each merger will not subject the assets of the merged trust to the Code Section 2601 tax by reason of a change in the effective date of the trust. The IRS additionally held the proposed mergers would not result in a transfer by a beneficiary that is subject to the gift tax. Because the interests of the beneficiaries in the old trusts would not differ materially from their interests in the new trusts, the IRS ruled the proposed mergers would not be treated as a sale or disposition that would require any trust or beneficiary to recognize gain or loss under Code Section 1001. Finally, the IRS held the new trusts would qualify as ESBTs, provided the trustees make the proper elections. P.L.R.s 200513003-200513005.

17. IRS Issues Final Regulations Explaining Tax Character of Distributions From CRTs

Code Section 664(b) provides for the following ordering of distributions from a charitable remainder trust (CRT): (i) ordinary income, to the extent of the trust's ordinary income for that year and undistributed ordinary income for earlier years; (ii) capital gain, to the extent of capital gain for that year and undistributed capital gain (determined on a cumulative net basis) for earlier years; (iii) other income, to the extent of that income for that year and undistributed amounts for earlier years; and (iv) trust corpus. The final regulations take into account differences in the income tax rates that apply to the items of income assigned to the same category under these ordering rules. For example, a trust with category (ii) capital gain income may include short-term and long-term capital gains and losses. The regulations treat a CRT distribution as being made from the categories in the following order within each category: income is treated as distributed from the classes of income in that category beginning with the class subject to the highest income tax rate and ending with the class subject to the lowest income tax rate. The tax rate to be used in computing the recipient's tax on the distribution are those that apply in the year in which the distribution is required to be made to the classes of income deemed to make up that distribution, not the tax rates that apply to those classes of income in the year the income is received by the trust. The final regulations also provide rules for netting different classes of capital gains and losses. T.D. 9190 (March 15, 2005); Treas. Reg. § 1.664-1. ■

CLE Docket 2005

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