

CONNECTICUT BAR ASSOCIATION

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VIEW FROM THE CHAIR
BY PETER T. MOTT

It is with great pleasure that I write this introduction to the latest issue of the Estates and Probate newsletter. We are pleased to have another issue after a hiatus and I am grateful for the good work of our subcommittee led by Jim Funnell and George Smith. The newsletter dates back to 1981 (prior issues can be found on the CBA website). This is our first issue since July 2006. This is also the first time with a new format where the newsletter is not mailed by hard copy to members of the Section but is available on the CBA website, allowing for more expeditious publication. It is our hope to publish two newsletters each year. As in the past, we welcome submissions of articles by any and all members of the Section. These are not meant to be law review comments or case notes but rather relatively short articles, which often are based on a subject matter you are dealing with in your practice.

This is certainly an interesting time for our Section. We have seen a significant consolidation and reform of the probate courts in Connecticut with the likelihood of additional measures to come. The Connecticut succession tax, the

subject of several past newsletter articles, is a thing of the past as we now grapple with changes to Connecticut estate tax and the uncertainty of the federal estate tax. Of course, we all face the challenges of practicing in the aftermath of one of the most significant financial crises in history of the country. The executive committee of the Section will continue to make every effort to provide excellent continuing legal education (whether with presentations by our own practitioners or from nationwide experts). We also will work toward advancing legislative measures so that Connecticut keeps pace with other states in offering an intelligent and comprehensive framework of laws for the trusts and estates practice.

We welcome your comments on the newsletter and hope you will consider submitting an article.

2009 CONNECTICUT TAX, PENDING FEDERAL TAX LEGISLATION BY FRANK S. BERALL

Connecticut

Although the current economic situation has put Connecticut and most other states into a major fiscal crisis, neither a tax bill nor a budget was passed during the legislature's regular session. One passed in the special session was vetoed. Throughout the summer, blocked out negotiations between Governor Rell and Democratic legislative leaders finally resulted in tax and budget bill, No. 6802, with a last-minute amendment by House "C" (LCO 9659), on August 31, 2009. Effective September 6, 2009, without Governor Rell's signature, it has many retroactive tax changes. not paid, for ... taxes due on or after July 1, 2009, within such six months."

Attorneys' Occupational Tax and Filing Fees Raised

While no sales tax on legal or professional services was imposed, the Attorneys' Occupational Tax is being increased from \$450 to \$565. This is consistent with other similarly situated professional license fees (i.e. health care professionals, Certified Public Accountants, real estate brokers, etc.). Besides court filing fee increases retroactive to July 1, 2009, several other fees have also been raised .

Estate and Gift Taxes

For deaths occurring and gifts made on or after January 1, 2010, § 116 of the bill amends C.G.S. § 2-391(g),¹ to raise the tax threshold from \$2,000,000 to \$3,500,000, reduce marginal rates on estates and gifts valued in excess of \$3,500,000 and eliminate the tax cliff, which has never affected large estates. Currently the cliff exists when a taxable estate or gift, valued between \$2,000,000 and \$2,100,000 increases by even \$1. A 5.085% tax then goes from \$0 up to \$101,700. Thus, once an estate's or gift's taxable value exceeds \$2,000,000, the tax applies to its entire value; not merely the excess over that amount.

Thus, section 116(g)(2), reduces all marginal rates in excess of \$3.5 million by 25%. It imposes a 7.2% rate on the excess of a taxable estate over \$3,500,000. Increases of six-tenth's percent occur at various taxable amounts, up to taxable estates exceeding \$10,100,000. The tax on \$10,100,000 will be \$640,200 (instead of \$1,082,800), plus 12% of that excess.

Section 118(a)(2) imposes gift tax on taxable gifts in 2010 and thereafter at 7.2% on the excess of gifts over \$3,500,000 (with no tax on taxable gifts below that amount) to \$640,200

plus 12% of the excess of taxable gifts over \$10,100,000, thereby reducing the present 16% rate to 12%. Thus, the estate and gift tax rates remain the same at comparable levels.

Section 117 amends § 12-392(a) to require that estate taxes due at the date of the taxable transfer are payable nine months from a death prior to July 1, 2009 and six months from deaths, thereafter, if due on or after July 1, 2009. Thus, the filing deadline for an estate tax return is decreased from nine to six months from date of death, applicable to taxes payable on or after July 1, 2009.

This apparently ambiguously worded provision distinguishes between the "due" date (date of death) and the date taxes are "payable" (six or nine months later, depending on the date of death). For deaths before July 1, 2009, the tax will be payable nine months after death, while the period is six months for taxes due July 1, 2009 and thereafter. There is a late payment penalty of the greater of \$50 or 10% of the amount due.

The Office of Legislative Research Report clarifies this situation, saying the new six-month rule applies to deaths on and after July 1, 2009.

A September 1, 2009 email to the CBA Estates & Probate Section from Professor Jeffrey A. Cooper of the Quinnipiac Law School gives an example of a decedent who died January 2, 2009. Taxes on that estate should be due October 2, 2009. But since the taxes are payable on or after July 1, 2009, amended § 12-392(a) applies. Since the latter has no reference to the date of death and that date is now "on or after July 1, 2009," the tax on this January estate appears to be overdue, because six months after death was July 2, 2009. Furthermore, the penalty provision seemingly is triggered since the "amount of tax reported to be due on the return is not paid, for ... taxes due on or after July 1, 2009, within such six months."

Thus, Professor Cooper perceives an error in the effective date language. This provides that "the change in the estate tax filing deadline takes effect July 1, 2009 and applies to taxes payable on or after that date." It is inconsistent with that in the prior section and would retroactively make a number of tax returns overdue.

In summary, Professor Cooper says "the statute is poorly-worded and creates an ambiguity where none should exist . . . [T]he legislature [probably] intended the new rule to apply

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to those dying after July 1, 2009 . . . [and there is no] clear reference to date of death in the statute or the effective date provisions . . . [T]he statute as drafted could [be argued to apply] retroactively [but that is probably not] what the legislature had in mind . . . [and the Office of Legislative Research] Report takes the position that the statute only applies to deaths after 7/1/09. [Unfortunately, the statute] can reasonably be construed to achieve a different result [and this still could be] a problem.”

The problem in section 117 of the bill is that it uses “due date of such tax” as the date on which interest becomes payable. The phrase “date such tax becomes payable” would have been more precise. The D.R.S. should issue something on this subject soon. While Attorney John Ivimey, of Reid & Reige, is trying to obtain a “technical correction” to clarify the ambiguity, a copy of this article has been emailed to D.R.S. Commissioner Richard Nicholson to alert him to the problem and request that the Department accept the Office of Legislative Research’s interpretation.

Whether the due date is six or nine months after death, the taxes due after July 1, 2009, presumably were not paid within six months. Unless an argument is made that the word “such” creates an ambiguity, the penalty provision appears to have been triggered.

This new § 12-392(a)(1) should be effective “for decedents dying on or after July 1” or else it should include the words “for decedents dying” twice in its first sentence. But it does neither.

But, since § 117, in amending § 12-392(a) distinguishes between the “due” date (date of death) and the date that taxes are “payable” (six or nine months thereafter, depending on that date), while not clear, seems to be saying that for deaths before July 1, 2009, the tax would be payable nine months after death.

Nevertheless, § 12-392(a)(1) says “Subject to the provisions of section 12-3a [which requires the Penalty Review Committee] to approve any waiver of penalty . . . in excess of five hundred dollars . . . the commissioner may waive all or part of the penalties . . . when it is proven to his satisfaction that the failure to pay . . . was due to reasonable cause and was not intentional or due to neglect.” The Commissioner should be satisfied that failure to pay under the above circumstances was due to reasonable cause, not intentional or due to neglect, thus testing the D.R.S.’s attitude to poorly drafted legislation. Furthermore, while the first sentence in subsection (a)(1) is not well written, its ambiguity is resolved in the

penalty provision, which references the quote “due” date as the date of the taxable transfer; namely date of death.

July 1, 2009 is the dividing line between six and nine months, so relief may come from the Commissioner using his powers under the statute to waive penalties (and one hopes interest), because unlucky estates get euchred by terrible drafting; thus reasonable cause exists.

The Revival of Creeping Palm Tree Disease²

Rep. Cameron Saples, Finance Committee Co-Chair, claimed that “[w]e’ve never seen any evidence that our estate tax has any impact on people’s [sic] decision where to live.”³ But he was obviously unaware of the Connecticut estate tax “study [which] found that an increasing number of households [have caught creeping palm tree disease and] are leaving Connecticut in favor of states with no estate tax or a less burdensome one. According to data from the Internal Revenue Service, the overwhelming majority of households leaving Connecticut during calendar years 2002-2006 relocated to Florida, which has neither estate nor income taxes. Connecticut tax practitioners who were (surveyed in September 2007) reported that almost 53% of their clients changed their Connecticut domicile primarily because of the state’s estate tax. According to the report, the average gross estate of households leaving Connecticut was \$7.5 million, equating to a potential loss of over \$700,000 in estate and gift taxes for each emigrating household.”⁴

Thus, while the estate tax has been reduced and the cliff (which does not affect really wealthy taxpayers) eliminated, retention of even the reduced estate and gift taxes, coupled with very ill-advised increase in income tax rates (discussed below) will clearly increase the incidence of creeping palm tree disease among Connecticut’s more affluent citizens. While they may not attempt to change their domicile to avoid the estate tax, since that requires far more extensive changes in the way they live, many of them will increase their time spent outside Connecticut to more than 183 days per year so as to avoid the income tax.

This will result in their purchases of less taxable goods and services and reduced travel in Connecticut, thus reducing state sales and gasoline tax revenues. Many will give up their Connecticut leadership positions, spend less time in civil, charitable, social and religious affairs, reduce their contributions to Connecticut charitable and religious organizations and no longer vote in Connecticut (even though voting here would not impair their nonresident status).

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Flat income tax rate on trusts and estates is to be increased from 5% to 6.5% of their Connecticut taxable income.

Section 120 amends § 12-701(10), also starting in 2009, to include in the Connecticut Fiduciary Adjustment the deduction allowable as qualified domestic production activities income (pursuant to section 199 of the Internal Revenue Code), to the extent these are deductible in determining federal taxable income prior to distribution deductions.

Section 121(x) amends § 12-701(a)(20)(A) by adding the deduction for qualified domestic production activities under § 199 of the federal Internal Revenue Code, to the extent deductible in determining federal adjusted gross income.

Section 122 amends §§ 12-702(a)(1)(G), (H) and (I) to change the credits against the tax while § 124 amends § 12-704(c) to make other changes.

Use Tax Information Will Now Appear on Income Tax Returns

Section 115 requires revision of the personal income tax return to include a statement of the use tax rate and a table listing its amount corresponding to the amount spent. For 2008 and prior years, only a line requesting the amount of use tax due appeared on the return.

Corporate Income Tax Surcharge

Sections 94 and 102 impose a 10% corporation tax surcharge for 2009, 2010 and 2011, inapplicable to companies with less than \$100 million in annual gross revenues for any of those years or whose tax liability does not exceed the \$250 minimum tax. Companies filing combined or unitary returns for the income year are ineligible for this gross revenue exemption.

Section 96 gives a credit against the corporate tax for donations or discounted sales of open space or interests in land to the state, a political subdivision or a nonprofit land conservation organization, when the land will be permanently preserved as open space. The credit is 50% of the donated land's market value at its highest and best use or the value of the discounted sales price of the land or its interest, with a carry forward period for unused credits extended from 15 to 25 years, for credits allowed in tax years on or after 2000, applicable to income years from 2009 and thereafter. A number of other technical changes are made to taxes in certain industries, including a section 103 corporation combined reporting preference tax.

Sales Tax Reduction and Miscellaneous Other Tax Changes

Sections 108 through 113 reduce the sales and use tax from 6% to 5.5%, effective January 1, 2010. Section 114 of the act increases the real estate conveyance tax on foreclosures.

Sections 95, 120 and 121 bar companies and individuals from using the federal tax deduction for income from qualified domestic production activities to determine taxable income for corporate and individual income taxes.

Sections 104 through 106 increase the cigarette tax from \$2 to \$3 per pack of 20, starting October 1, 2009. Other changes are made to this tax and the tobacco products tax is raised from 20% to 27.5% of the wholesale price. The tax on snuff tobacco is increased from 40 to 55 cents per ounce starting October 1, 2009.

Unenacted Proposals from the Regular Session

The Office of Legislative Research summarized the income tax provisions⁵ of unenacted Substitute Senate Bill #932 (File #693), *An Act Concerning Various Revenue Measures*. This died when the legislature adjourned on June 3, 2009, was resurrected, passed in the special session and then vetoed. It would have increased the income tax by adding four higher brackets for joint filers with taxable income over \$250,000, \$132,500 for single filers, \$200,000 for heads of household and \$125,000 for married people filing separately. Rates on them were to be raised from 5% to between 6% and 7.5%. A flat 7.95% tax was to be imposed on trusts and estates. The compromise income tax increases in the enacted legislation effective September 6, 2009, was not quite as draconian.

Income eligibility for phasing out the property tax credit against the income tax was to be lowered by 25% (27% for single filers) for 2009 and 75% (76% for single filers) for 2010. The phase out steps were made smaller, thus phasing out this credit faster and making fewer taxpayers eligible for it, while reducing the maximum amounts taxpayers received if their incomes exceed the lower phase out thresholds.

The previously scheduled (i) income tax reductions for single filers, (ii) increases in adjusted gross income exempt from tax and (iii) income thresholds for reducing personal exemption credits were to be delayed by three years. The \$13,000 personal exemption was retained for three more years (through 2011) and personal credits were also to be delayed by three years.

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Taxpayers were to be prohibited from using the federal domestic production activity deduction when calculating state income tax.⁶

Proposed provisions affecting the corporate income tax, also effective in 2009, were in sections 1 through 7,⁷ while sections 8, 9 and 10 proposed increases in the cigarette excise tax to 125 mills per cigarette, effective for sales after 2009.⁸

Proposed provisions affecting the corporate income tax, also effective in 2009, were in sections 1 through 7,⁹ while sections 8, 9 and 10 proposed increases in the cigarette excise tax to 125 mills per cigarette, effective for sales after 2009.

Section 11 was to be effective July 1, 2009, but applicable to estates of decedents dying in 2009, 2010 and 2011. It would have imposed a 30% tax surcharge on the section 12-391 estate tax and on taxable gifts that exceed \$2 million.

Section 12 would have amended section 12-407(HH) applicable on and after July 1, 2010 to make tax preparation and other services subject to the state sales tax.¹⁰ Except for this provision, many of the above are at least partially in the enacted legislation.

Tax Consequences Of Same-Sex Marriages

The Federal Defense of Marriage Act¹¹ precludes any federal tax recognition of same-sex marriages. Thus, same-sex couples may not file joint federal income tax returns and are ineligible for the federal gift and estate tax marital deductions, Connecticut has held same-sex marriages valid.¹²

Its Attorney General's opinion states that same-sex couples should receive essentially the same treatment as parties to other marriages.¹³ The Department of Revenue Services "revised the Federal-State Electronic Filing Handbook, instructing that the correct filing status for individuals parties to a civil union recognized under Connecticut law or who are in a marriage recognized under *Kerrigan* should [either file jointly for Connecticut only or separately for Connecticut only, indicating] that such returns should be electronically transmitted under the 'state only' process.¹⁴ Other forms and instructions are to be revised accordingly."¹⁵ Connecticut's gift and estate tax marital deductions are available for same-sex couples.

Kerrigan's result was codified.¹⁶ All prior marriage laws were replaced with genderless terms, making all references to mar-

riage gender neutral. While civil unions will no longer be allowed after October 1, 2010, those previously entered into will remain valid and may be upgraded to marriages. Same-sex marriages, civil unions and broad domestic partnerships from other jurisdictions will be recognized as marriages in Connecticut.

Federal Tax Legislation

As of the September 8, 2009 publication deadline for this article, no 2009 federal tax legislation had been passed, other than tax provisions in the *State Children's Health Insurance Program (SCHIP)* and *The American Recovery and Reinvestment Act*;¹⁷ both enacted in February, 2009.

A refundable Making Work Pay (MWP) credit is the latter's principal personal income tax provision. Others included a § 36(h)¹⁸ expansion of the first-time home buyer credit for 2009 purchases. More families will get the § 24(d) \$1,000 refundable child tax credit, even non-income taxpayers. There is a § 55 one year increase in the alternative minimum tax floor to \$70,950 for joint filers and a § 25A \$2,500 expanded Hope Scholarship tax credit for college tuition and related expenses for 2009 and 2010, phased out for couples making more than \$160,000. For first-time home buyers, there is an \$8,000 refundable credit for all homes bought in 2009, with repayment provisions repealed for purchases in that year and held more than three years. There is also a new 2009 § 85(c) exclusion of the first \$2,400 of unemployment compensation benefits, a § 32(b)(3)(B) expanded earned income tax credit for low income workers with families of at least three children, an expansion of the § 25C home energy credit to homeowners who make their homes more energy-efficient in 2009 and 2010 (to recoup 30% of the cost, up to \$1,500, for numerous projects) and a § 164 deduction for sales taxes on cars, phased out for purchasers whose incomes exceed \$250,000.

Business tax relief provisions to allow companies to use current losses to offset profits of the previous five instead of two years, making them eligible for tax refunds and credits for renewable energy production are extended to 2014. A law that would have taken effect in 2012 requiring government agencies to withhold 3% of payments to contractors to help ensure they paid their tax bills is repealed. There is an extension of bonus depreciation and firms buying money losing banks may use more of the latter's losses as tax credits to offset the profits of the merged banks.

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Estate, Gift and Generation Skipping Taxes (Hereafter GST)

The present estate, gift and GST laws, enacted by the 2001 *Economic Growth and Tax Relief Reconciliation Act of 2001*¹⁹ (hereafter referred to as EGTRRA), provide a \$3.5 million applicable exclusion and a 45% flat rate on the excess for 2009 deaths. There is a gift tax \$1 million lifetime exemption and repeal of the federal credit for state death taxes. For 2010 deaths, EGTRRA eliminated the estate tax, but "sunsets" in 2011, with the tax returning to its former (pre-2002) 55% top rate (with a 60% "bubble"), a state death tax credit, a \$1 million estate tax exemption and \$1,130,000 inflation adjusted GST exemption.

The Obama Administration's Tax Program

Apparently neither President Obama's threatened soak the rich income tax proposals nor any other bills have been introduced since enactment of *The State Children's Health Insurance Program* and *The American Recovery and Reinvestment Act of 2009*. Due to the uncertain status of bills dealing with major revisions to health care containing income tax increases, comments on them are premature and not of help to the practitioner. But EGTRRA's reduced dividend and capital gains tax rates expire December 31, 2010.

During his election campaign, President Obama favored making the estate tax permanent, with a \$3.5 million exemption and a 45% top rate. Thus, not surprisingly, the May 11, 2009, *General Explanations Of The Administration's Fiscal Year 2010 Revenue Proposals* (the Treasury's Green book) assumes extension of the transfer taxes at the 45% top rate for 2009 with a \$3.5 million exemption, consistent values for transfer and income tax purposes, a modification of valuation discount rules and a ten-year minimum term required for grantor retained annuity trusts (GRATs).

"The Administration's primary policy proposals reflect changes from a tax baseline that modifies current law by 'patching' the alternative minimum tax, freezing the estate tax, and making permanent a number of the tax cuts enacted in 2001 and 2003 [except for repeal of the estate and gift taxes]."

A condensed version of the Treasury's Green Book table of contents disclosed that upper-income tax provisions, dedicated to deficit reduction, would reinstate the 39.6% rate, the 36% rate for taxpayers with income over \$250,000

(married filing jointly) and \$200,000 (single), the limitation on itemized deductions for taxpayers with income over \$250,000 (married filing jointly) and \$200,000 (single), the personal exemption phase-out for taxpayers with income over \$250,000 (married filing jointly) and \$200,000 (single), impose a 20% rate on dividends and capital gains for taxpayers with income over \$250,000 (married filing jointly) and \$200,000 (single) and limit the tax rate at which itemized deductions reduce tax liability to 28%.

The MWP credit would be made permanent, the beginning of its phase-out range indexed for inflation and its phase-out rate reduced to 1.6%, effective for tax years beginning after December 31, 2010.

Information reporting would be expanded, with increased information return penalties and tax administration strengthened by allowing assessment of criminal restitution as tax. Offer-in-compromise rules would be revised, repeated willful failure to file a tax return made a felony and required electronic filing by tax return preparers expanded, among other matters. Penalties would be expanded, such as by clarifying that the bad check penalty applies to electronic checks and other payment forms and failure to comply with electronic filing requirements would be penalized. Reforms to close tax loopholes will be made and deductions denied for punitive claims.

Estate and gift tax valuation discounts would be modified, consistency in value for transfer and income tax purposes will be required along, with minimum terms for grantor retained annuity trusts (GRATs).

Effective dates would either be those of enactment or retroactive to the date of introduction.

Since any tax bill will probably give the Treasury broad regulatory authority, uncertainty may arise on a number of issues for an extended period, because Treasury Regulations often take a very long time to complete.

Status Of Federal Tax Proposals As Of September 8, 2009

No tax bills nor budget resolutions dealing with transfer taxes have been enacted by even one chamber, but three bills and Budget Resolutions with estate and gift tax provisions are pending. If legislation combining their various features, or at least some transfer tax legislation is not enacted before the end of 2009, there will be no federal estate tax for 2010 deaths. However, there will be an incredibly

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complex, difficult to comply with and administer, carryover basis regime in 2010.

Both unenacted Senate Bill 722 and the administration's income tax proposals also address the individual AMT, the regular and capital gains tax rates for lower and middle-income taxpayers, the child tax credit, marriage penalty relief, the dependent care credit, the adoption credit and adoption assistance programs, as well as the earned income tax credit. The likelihood of their eventual passage seems fairly high, now that the recently confirmed election of Minnesota Senator Franken gives the Democrats an apparent filibuster-proof majority, if the late Massachusetts Senator Kennedy's seat is filled by an appointee until the January 19 special election to replace him.

These income tax provisions, supported by Finance Committee Chairman Senator Baucus, are also co-sponsored by two other Senate Finance Committee Democrats, Rockefeller of West Virginia and Schumer of New York. Thus, they are serious legislative proposals. Inclusion of AMT relief, a priority for Ways and Means Committee Chairman Rangel, will make them attractive to his committee.

Any tax decreases (which are doubtful) will be phased in over many years. Thereafter, exemptions and brackets may be indexed for inflation. The GST exemption and rates will probably remain tied to that of the estate tax, while the gift tax exemption and rates may be recoupled with the estate tax and GST exemption and rates.

Tax Planning Suggestions

Neither possible tax changes affecting individuals, estates and trusts nor conformity of the gift and estate taxes should be counted on. But early planning is required, *before* enactment or even introduction of any new tax legislation. The use of leveraged gift strategies, such as GRATs, sales to grantor trusts and charitable lead trusts are advisable. If a gap exists between the gift tax and GST exemptions, lifetime GST tax planning may be expensive. Therefore, practitioners should be alert for opportunities to create, update, merge, divide or extend GST trusts.

There should be a reexamination of whether a trust should distribute all income, as well as a reconsideration of the traditional notions of income and principal, to accommodate the larger tax exempt amounts and the passage of more significant wealth. Since restoration of the credit for state death taxes is unlikely, planning for mobility among states and

property ownership in several states will continue to be important.

The portability between spouses of the exemption/unified credit is likely and transferability of a predeceased spouse's exemption to the survivor should simplify some married couples' estate planning. However, there will be a loss of the opportunity to shelter intervening growth in value and accumulated income from the estate tax and loss of the potential for reconsidering previous valuations. This, together with other complexities, may still make it wise to use the first spouse's exemption, probably in a trust, especially where there are illiquid assets, such as a family business.

However, for many assets, income tax basis will be a much more important factor. Techniques such as the use of joint and survivorship property, previously frowned on by many Connecticut practitioners, may become more important, as well as the use of joint trusts.²⁰ Carryover basis, enacted initially in 1976 and unwisely resurrected in the 2001 EG-TRRA, after its retroactive repeal in 1980, will and should again be permanently killed.²¹

Conclusion

Connecticut's budget and tax increases, except the estate and gift tax reductions (delayed until 2010), were enacted effective September 6, 2009. While no significant federal tax legislation has been enacted, eventually some of the above described proposals will be passed. While federal estate and gift tax revision should occur in 2009, it could be delayed until just before the 2010 Congressional elections and then made retroactive to the beginning of that year.

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- 1 All three digit section Numbers are those of the bill. All others are those of the Connecticut General Statutes.
 - 2 The Creeping Palm Tree Disease was initially diagnosed some years ago by Attorney Stuyvesant K. Bearns of Shipman & Goodwin's Lakeville office. He observed wealthy Connecticut residents were fleeing to Florida to establish their domicile and residence there to avoid the Connecticut estate (then an inheritance), gift and income taxes.
 - 3 Hartford Courant, August 30, 2009, p. A6.

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- 4 From Shaughnessy and Sebastian, *2008 Connecticut Tax Law Developments*, 83 Conn. B. J. 35, 40-41 (March, 2009), quoting the Commissioner of Revenue of Services and the Secretary of the Office of Policy and Management's study mandated by P.A. 07-1 of the June Special Session. Connecticut Department of Revenue Services, Connecticut Estate Tax Study—2008 (February 1, 2008).
- 5 This analysis is based on an Office of Fiscal Analysis Fiscal Note and Office of Legislative Research Bill analysis, as of May 27, 2009.
- 6 Section 16 of the Bill amended C.G.S. §12-700(a), effective July 1, 2009, applicable to taxable years commencing in 2009. Sections 7(A), (B), (C), and (D) increase the individual income tax rates, while § 7(E) sets the rate on trusts and estates at 7.95% of Connecticut taxable income.
- Section 17 of the Bill amended C.G.S. § 12-701(20)(A), dealing with the income tax on state and local bonds, other than those of Connecticut.
- Section 18 of the Bill amended C.G.S. §12-702(a), applicable to taxable years commencing in 2009, reduces the personal exemptions for taxpayers whose Connecticut adjusted gross income exceeds \$27,000 by \$1,000 for each \$1,000 or fraction thereof of the excess, but the reduction shall not exceed 100% of the exemption. In subsequent years (through 2015), other exemption reductions are also made.
- Section 19 of the Bill amended C.G.S. §12-703(a), effective for taxable years commencing in 2009 to reduce the credits against adjusted gross income, but is not applicable to a trust or estate.
- None of these increases were enacted in the law effective September 6, 2009.
- 7 This would have increased business taxes by imposing a 30% corporate tax surcharge for 2009, 2010 and 2011, reduced the maximum amount by which companies can use tax credits to reduce their corporation or insurance premium tax liability from 70% to 65% for 2009 and 50% for 2010 and thereafter. It barred companies from using the federal domestic production activity deduction to reduce corporation tax liability and eliminates corporation tax exemptions for domestic international service corporations (DISCs) and income other companies receive from such companies.
- 8 The cigarette tax was to be raised from \$2.00 to \$2.50 per pack as of July 1, 2010.
- 9 The sales tax free week was to be suspended for 2009 and 2010 and, as of July 1, 2010, many sales tax exemptions were to be eliminated.
- 10 1 U.S.C.A. §§ 1,7 and 28 U.S.C.A. § 1738C, et seq; 110 Stat. 2419, P.L. 104-199 (1996), and P.L. 104-99 (H.R. 3396), § 3.
- 11 *Kerrigan v. Commissioner of Public Health*, 289 Conn. 135, 957 A.2d 407 (2008).
- 12 Op. Atty. Gen. 2008-18.
- 13 Informational Publication I.P. 2008 (25.1) (November 1, 2008).
- 14 Partially condensed and partially quoted from Shaughnessy and Sebastian, *2008 Connecticut Tax Law Developments*, 83 Conn.B.J. 35 (March, 2009).
- 15 *An Act Implementing the Guarantee of Equal Protection Under the Constitution of the United States for Same-Sex Couples*, Public Act 09-13, Substitute Senate Bill No. 899, was signed by Governor Rell on April 23, 2009.
- 16 P.L. 111-3 enacted February 13, 2009 and P.L. 111-5, enacted February 17, 2009 are summarized from their descriptions in CCH 2009 Tax Legislation and in Wikipedia, the free encyclopedia (last modified May 28, 2009).
- 17 All references to section numbers, unless otherwise stated, are to the 1986 Internal Revenue Code.
- 18 P.L. 107-16.
- 19 The above observations concerning the status of proposed estate and gift tax legislation have been condensed and paraphrased (with permission) from a paper by Ronald D. Aucutt, *Estate Tax Changes in the Obama Administration*, pages 32 -38.
- 20 For an analysis of the unfortunately revived carryover basis provisions in the 2000 EGTRRA, see Berall, Blattmachr, Detzel and Harrison, *Planning for Carry-*

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over Basis That Can Be/Should Be/Must Be Done Now, 29 Estate Planning #3, p. 99 (March 2002).

ABOUT THE AUTHOR

Frank S. Berall, principal of Copp & Berall, LLP and senior tax consultant to Andros, Floyd & Miller, PC, both of Hartford, has an LLM in Taxation, is a former Chair of both the

Connecticut Bar Association's Tax and its Estates and Probate Sections, a Senior Editor of the Connecticut Bar Journal, an Editor of Estate Planning, on the Connecticut Lawyer's Advisory Committee, a Vice President of the International Academy of Estate and Trust Law, a former Regent of the American College of Trust and Estate Counsel, a Co-chair of the Notre Dame Estate and Tax Planning Institute and a member of the American College of Tax Counsel.

CONSERVATION EASEMENT WHAT IS IT, HOW DO I GET IT, AND WHAT DOES IT DO FOR ME? BY TAMMY A. MOHLER-AVERY

Conservation easements can be an effective tool to provide income, estate and gift tax savings, while at the same time preserving our natural environment for generations to come. The use of conservation easements has been supported by statute for the last thirty years, with numerous recent evolutions over the last ten years. Many people create conservation easements to ensure that the property they have lovingly nourished will not see development once they are gone. A conservation easement is a prime example of the "dead hand control" we all heard about in our law school Trusts and Estates classes and have seen our clients try to assert in numerous ways throughout our careers. However, unlike other more insidious types of dead hand control, conservation easements have abundant benefits both for the landowner, for the landowner's beneficiaries, and for our planet. In a time when more and more people are becoming conscious of the rapid changes to our environment and the long-term negative impact which overdevelopment can have on our planet, a conservation easement can be one way for our clients to leave a positive legacy consisting of more than just money.

What is a Conservation Easement?

Officially described as a Qualified Conservation Contribution under the Internal Revenue Code, a conservation easement is comprised three elements: a qualified real property interest, given to a qualified organization, exclusively for conservation

purposes. For this purpose, a qualified real property interest is property that is set aside exclusively and perpetually for conservation purposes. A qualified organization includes certain governmental units, a traditional public charity, or a private charitable organization that receives substantial public support from gifts and grants. The qualified organization must be committed to enforcing the conservation purposes of the easement and have adequate financing and resources to back-up that commitment.

The final element, exclusively for conservation purposes, includes the preservation of land for outdoor recreation by the public, protection of an ecosystem or natural habitat, preservation of open space for scenic purposes or other purposes allowed by government entities that will provide a significant public benefit, and preservation of an historically important land area or structure. Also, for these purposes, exclusivity requires that the property donated be protected in perpetuity and prohibits any use, including surface mining, which would conflict with the purposes of the easement.

Additionally, the Internal Revenue Code and Treasury Regulations provide that the conservation easement must be enforced in perpetuity. This requires the following four components: the rights retained by donor to use the property must be subject to restrictions to prevent use inconsistent with the conservation purposes; any mortgage on the

CONSERVATION EASEMENT

property must be subordinate to the easement; the donor retaining rights agrees to certain oversight by the qualified organization; and if circumstance happen that make the qualified property unable to be used for conservation purposes, and that property is sold, a portion of the sales proceeds must go to the charitable organization and be used in a manner consistent with the purposes of the conservation easement. Also, the creation of the conservation easement may not obstruct a conservation purpose already in effect.

How do I Create a Conservation Easement?

In order to create a conservation easement, the owner of the property must first choose the property to be conserved; and second, select the governmental unit or charitable organization to accept the easement. Many organizations have been created with the primary purpose of holding conservation easements. In addition, some federal, state, and local entities accept conservation easements when they meet some specific public purpose. The actual conveyance is accomplished by a deed filed with the appropriate recording office.

If the donor wants a financial benefit for the creation and donation of the easement, proper valuation is required. Determining the fair market value of the easement can be complicated. Due to the nature of the transaction, a typical valuation, based on an arms length transaction, will not work. The appraiser chosen by the donor to value the easement should have a proven track record appraising conservation easements. An appraisal too high or too low can result in penalties being assessed by the IRS.

A qualified appraiser may look to similar transactions to determine value if there is a clear record of sales of comparable easements. Where a comparison is not possible, the determination of the fair market value of the underlying property both before and after the creation of the easement is required. The difference between these two values determines the value of the easement.

What Does a Conservation Easement Do for Me?

Property Tax Benefits – Since the value of the underlying property has been reduced by the creation of the conservation easement, the local taxing authority may reduce the value of the property for real estate tax purposes.

Income Tax Benefits – The donor of a conservation easement may be able to take a federal income tax deduction of up to fifty percent of his adjusted gross income in any given year, with an overage carried forward for up to fifteen successive

years. Like any other charitable donation in excess of \$5,000, the donor must include with his income tax return a copy of the qualified appraisal and an appraisal summary. In addition, the donor's basis in the underlying property is reduced proportionately and any gain or loss on the sale of the underlying property subject to the easement would be based on the sales price less the adjusted basis.

Gift Tax Benefits – The value of property subject to the conservation easement is reduced, so any gift of that property would be computed at the lower value. Portions of the property at the lower value may be gifted using applicable annual exclusion amounts or the lifetime gift tax exclusion.

Estate Tax Savings, Part I – The value of the conservation easement is not included in the donor's gross estate for estate tax purposes. Also, the executor of the estate may be able to elect to exclude from the gross estate up to forty percent of the value of the land subject to the conservation easement, to a maximum of \$500,000, if the property meets certain criteria. These criteria include ownership by the decedent or a member of his family during the three-year period prior to the decedent's death, requirements concerning the location of the property and a requirement that the conservation easement must have been created by the taxpayer or a member of his family. To receive the maximum benefit, the easement must reduce the value of the property by at least thirty percent. Any reduction less than thirty percent will reduce the forty percent maximum exclusion. A reduction in value of less than ten percent will result in no allowable exclusion. For purposes of determining the exclusion percentage, the values at the date of the creation of the easement are used. This exclusion also reduces the step-up in basis at death. Note that this additional exclusion does not apply to a conservation easement made to preserve historic land or structures. The exclusion election must be made prior to the final due date of the estate tax return and is reported on Schedule U.

Estate Tax Savings, Part II – If a qualified conservation easement was not created by the decedent prior to his death, the executor of the estate may create such an easement. Under this scenario, the full value of the underlying property is included in the decedent's gross estate and a charitable deduction is taken on Schedule O of the estate tax return for the appraised value of the easement. This port-mortem easement creation also allows for the forty percent exclusion described above. Post-mortem easements are not allowed for property encumbered by debt. Both the creation

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of the easement and the exclusion election must be made prior to the final due date of the return. If the charitable deduction is taken on the estate tax return, an additional income tax deduction may not be taken by the estate or any individual.

Final Items to Remember

If the creation of the conservation easement does not effect the value of the underlying property, or it increases its value, then the easement has no immediate financial benefit. Also if the easement increases the value of other property owned by the donor, there is again no immediate financial benefit. This is why the selection of the property to be conserved is so important and why a qualified appraiser should be brought into the transaction at an early stage. Also, if the easement is disallowed by the IRS after audit, the easement cannot be undone, and any financial benefits will be lost which can lead to unexpected taxes, interest and penalties. This is why the donor should consult both legal and tax professionals knowledgeable in conservation easements from the beginning as well.

A conservation easement can provide significant income, gift and estate tax savings, but only if established in strict accordance with all applicable laws and regulations. In 2004, the IRS issued a notice that they would begin scrutinizing conservation easements as many abuses had come to light. With anticipated changes to estate and gift tax laws, as well as the need to generate revenue, it's unclear where the future of the conservation easement lies. Until the Congress or the IRS says otherwise, conservation easements are still a great way to save some money and leave a lasting legacy for years to come.

A NEW PLANNING OPPORTUNITY FOR UTMA ACCOUNTS BY CHRISTOPHER S. DREW

Background

The Connecticut Uniform Transfers to Minors Act ("UTMA") creates a convenient structure for parents and grandparents to give money to minors to help the minor accumulate some wealth without giving the minor immediate access to the money. Prior to October 1, 2007 the UTMA required the custodian to deliver the custodial property to the minor when he or she reached the age of twenty-one. In the vast majority of cases, either the minor reaching the age of twenty-one is prepared for the responsibility of receiving the custodial property or the amount of the custodial property is not enough to cause the custodian concern about distributing the custodial property to the minor when he or she reaches age twenty-one. In some cases, however, either because the custodial property has appreciated significantly or because of the minor's behavior, the custodian is concerned that transferring custodial assets to the minor at age twenty-one would not be in the long-term best interests of the minor.

New Legislation

In 2007 the Connecticut legislature passed Public Act 07-169 which amended Section 45a-558k of the Connecticut statutes to permit a custodian to distribute custodial property to a trust, including a trust created by the custodian, as an alternative to delivering the custodial property to the minor. Probate Court approval is not required to transfer the custodial property to a trust and once the property is transferred the custodianship is terminated. In order for the custodian to distribute custodial property to a trust, all of the following conditions must be met:

- (1) The custodian has a good faith belief that such distribution of all or part of the custodial property to a trust is in the best interest of the minor.
- (2) The minor is the sole beneficiary of the trust during the minor's lifetime.
- (3) The trust satisfies the requirements of Section 2503(c) of the Internal Revenue Code ("Code") which states:

A NEW PLANNING OPPORTUNITY FOR UTMA ACCOUNTS

No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom (1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and (2) will to the extent not so expended (A) pass to the donee on his attaining the age of 21 years, and (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514 (c).

receive an outright distribution of the custodial property by permitting the transfer of custodial property into a trust. Planners should make it very clear to the custodian, however, that there is a risk that the beneficiary could negate the plan by withdrawing the trust property either at age twenty-one or at age twenty-five. If the assets are not withdrawn from the trust, the trustee would have broad discretion to distribute income and principal to or for the benefit of the beneficiary for many years after the beneficiary reaches age twenty-one.

- (4) If the terms of the trust grant to the minor a right to withdraw the trust assets when the minor reaches age twenty-one, which would be required by Section 2503 (c) of the Code, then the trust should include language to meet all of the following requirements:

(A) The terms of the trust shall also grant to the minor a right to withdraw any remaining trust assets when the minor reaches age twenty-five.

(B) The trustee shall notify the minor in writing, by certified mail or similar means of delivery, of such right to withdraw (i) on or before the minor reaches age twenty-one, and (ii) if there are any remaining trust assets thereafter, on or before the minor reaches age twenty-five.

(C) The time period during which such withdrawal may be made shall not be less than thirty days from the date the minor attains the applicable age specified in subparagraph (B) of this subdivision or the date the minor receives the applicable notification required by said subparagraph, whichever date is later. Any such right to withdraw shall not lapse if the applicable notification required by subparagraph (B) of subdivision (4) of this subsection is not received by the minor.

Conclusion

This legislation potentially addresses the concerns of custodians who feel that age twenty-one is too young for a person to

UNIFORM LAW COMMISSION REPORT

BY SUZANNE BROWN WALSH

At its 118th Annual Meeting in Santa Fe, New Mexico, this July, the Uniform Law Commission (ULC) approved five new acts and a portion of another. The approved acts not relevant to our section are: The Uniform Collateral Consequences of Conviction Act, The Uniform Collaborative Law Act, and a portion of the Uniform Business Organizations Act (UBOA). An act of interest that was debated, but is not final because of insurance industry opposition, is the Uniform Insurable Interests in Trusts Act. This is intended to be a *Chawla*-antidote act and it should be final by next year's meeting.

The Acts that were approved in 2009 and are relevant to trusts and estates attorneys are:

1. The Uniform Real Property Transfer on Death Act, which provides a mechanism for the non-probate transfer of land. The Act allows an owner of real property to pass the property simply and directly to a beneficiary on the owner's death without probate. The property passes by means of a recorded transfer on a death (TOD) deed. During the owner's lifetime, the beneficiary of a TOD deed has no interest in the property and the owner retains full power to transfer or encumber the property or to revoke the deed. In other parts of the country, these types of deeds have been successfully used without incident for years, we were told.
- 2.. The Uniform Law Enforcement Access to Entity Information Act is designed to be a substitute for the Incorporation Transparency and Law Enforcement Assistance Act (S.569), currently pending in Congress (co-sponsored by Senators Levin, Grassley, and McCaskill, and supported by then Senator Obama when it was first introduced). S.569 would require virtually all corporations and limited liability companies to file "beneficial ownership" information with the Secretary of State. The Uniform Act, a joint project with the ULC and the American Bar Association Committee on Corporate Laws, and supported by the National Association of Secretaries of State, would preserve the traditional confidentiality of entity ownership and would instead require the filing of the name of an individual (a records-contact) who would be responsible for obtaining, maintaining, and verifying record ownership information.

NOTE: this anti money-laundering act applies to charities organized as corporations.

The Uniform Statutory Trust Entity Act governs the use of

statutory trusts as a mode of business organization. A statutory trust provides a flexible business entity that can be used as an alternative to the partnership, limited partnership, limited liability company, and corporate forms of organization. Statutory trusts are commonly used in the mutual fund and securitization industries, and it is also used in certain tax-advantaged real estate transactions. The Uniform Act modernizes the existing, but outdated, laws governing these types of entities.

The current drafts of all of these acts can be found at the ULC's website at www.nccusl.org. All of the prior drafts and background memos and material are on the website, under the applicable drafting committee, where you will also find the final, approved text of each act.

The Uniform Law Commission, now in its 118th year, comprises more than 350 practicing lawyers, governmental lawyers, judges, law professors, and lawyer-legislators from every state, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Its mission is to draft and promote enactment of uniform laws that are designed to solve problems common to all the states.

After receiving the ULC's seal of approval, a uniform act is officially promulgated for consideration by the states, and legislatures are urged to adopt it. To my knowledge, none of the above, 2009 acts will be introduced in Connecticut this year.

The Estates and Probate Section does plan to ask that the 2008 (technical) amendments to the Uniform Principal and Income Act (Senate Bill 1083, enacted in 16 other states to date) be introduced again, and I believe that the 2006 Revised Uniform Anatomical Gift Act, which was introduced last session as House Bill 6677, will also be introduced again, but not by our section. The updated Anatomical Gifts Act was approved by NCCUSL in 2006 and has been enacted in 35 states in just 2 years, which is warp speed in legislative time. Connecticut was one of 9 or 10 states to introduce it this year. In a nutshell, this is an important update to an act that was originally drafted in 1967, then updated in 1987 by amendments which were not uniformly enacted by the states. The 2006 updates include, but are not limited to, prioritizing "health care agents" as donation makers consistent with the agents' priority as decision makers in other health related choices, clarifying the consent process, harmonizing Connecticut's Anatomical Gift Act with federal law, current technology and medical practice, and advance medical directives,

UNIFORM LAW COMMISSION REPORT

providing for a uniformity of practice across states and regions (important because organ procurement organizations operate and serve other states), recognizing the donation forms commonly used on driver's licenses, recognizing an individual's right to refuse donation, and preventing others from overriding a donation decision made by the donor.

Both acts died for technical reasons, but were unopposed. Finally, the Section plans to reintroduce a consensus version of the Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act, which was introduced last year as Senate Bill 576.

BENEFICIARY DESIGNATIONS: A SUPREME DECISION

BY

LEONARD LEADER AND MICHAEL CLEAR

Retirement benefits often make up a significant portion of our client's net worth. As a non-probate asset, retirement benefits pass at death pursuant to the owner's beneficiary designations on record with the plan administrator. Although we educate and advise our clients on beneficiary designations that complement their estate plan, not all clients implement this advice after they have updated their estate plan. This term the U.S. Supreme Court ruled on the validity of beneficiary designations and provided plan administrators with additional guidance for interpreting and accepting beneficiary designations.

In *Kennedy v. Plan Administrator for DuPont Savings and Investment Plan (07-636)*, the U.S. Supreme Court addressed whether or not a divorce decree could trump the deceased's beneficiary designation on record.

In 1974 William Kennedy designated his wife, Liv Kennedy, as the beneficiary of his savings and investment plan (SIP) at E.I. DuPont de Nemours & Company. The SIP was an ERISA "employee pension benefit plan." In 1994 William and Liv divorced. In the divorce decree Liv agreed to divest herself of all claims related to William's employment related retirement plans. William failed to revise his beneficiary designation for the SIP plan before he died in 2001. William Kennedy's daughter, Kari Kennedy, was appointed as executrix of his estate and requested that DuPont distribute the SIP funds to the estate. DuPont relied upon William's beneficiary designation and paid the \$400,000 balance to Liv. The Estate sued the plan administrator, alleging that it had misdirected the plan benefits because Liv surrendered her rights under the divorce decree, and the plan administrator sued Liv to recover the funds, only to discover Liv already spent the money.

The Employee Retirement Income Security Act of 1974 (ERISA) obligates plan administrators to manage ERISA plans in accordance with the plan governing documents. 29 U. S. C. §1104(a)(1)(D). ERISA also requires plan administrators to manage their plan in accordance with the documents and instruments governing the plan. §1056(d)(1). Finally, ERISA permits the assignment of benefits by a qualified domestic relations order (QDRO). §1056(d)(3). Simply, a QDRO is a domestic relations order is a court order that creates or recognizes the existence of an alternate payee's right to receive, or assigns to an alternate payee the right to receive, all or a portion of the benefits payable with respect to a participant under a retirement plan.

The District Court entered summary judgment for the Estate, ordering DuPont to pay the benefits to the Estate.

The Fifth Circuit Court reversed, holding that Liv's forfeiture at divorce was an illegal diversion of benefits in violation of ERISA's provision against such diversion (or "alienation"). The Fifth Circuit held that a divorce decree is technically not a QDRO.

BENEFICIARY DESIGNATIONS: A SUPREME DECISION

The Fifth Circuit's decision was in contrast to other Circuit Courts which have ruled that a divorce decree can amount to a waiver of benefits, even if it technically was not a QDRO required by ERISA. This split among Circuit Courts set the stage for the Supreme Court decision.

The Supreme Court answered two questions.

Question 1. Can pension plan benefits be waived in a divorce decree that does not technically amount to a QDRO?

The Court answered this question in the affirmative. It held that a waiver, which only gives the right to benefits back to the plan participant and any future designee or estate beneficiary yet-to-be-determined, is not a prohibited assignment or alienation to another party.

The Court first ruled that, under ERISA, a divorcing spouse could waive plan benefits through a divorce decree under state law. Consulting the law of trusts, the Justices concluded that an ex-spouse can disclaim an interest in benefits during a divorce proceeding. The Court found that Section 1056(d) (1) is similar to a spendthrift trust provision barring assignment of a benefit. The general principle that a designated spendthrift beneficiary can disclaim his trust interest magnifies the improbability that a statute written with an eye on the old law would effectively force a beneficiary to accept an interest. The Treasury reads its own regulation to mean that the anti-alienation provision is not violated by a beneficiary's waiver "where the beneficiary does not attempt to direct her interest in pension benefits to another person." Disagreeing with the Fifth Circuit, the Court said "we think that the better view is that [Liv's] waiver" was not an alienation or assignment that was illegal under ERISA.

Question 2. Do plan administrators have to give effect to waivers that conflict with plan documents?

The Court answered this question in the negative and stated that the plan administrator did its statutory ERISA duty by paying the benefits to Liv in conformity with the plan documents.

The Court reasoned that plan administrators, who are required by law to follow plan documents, should be entitled to rely on those plan documents in distributing assets in a timely and efficient manner, without worrying about whether and how to give effect to purported waivers outside those documents. In this case, where the plan set forth clear instructions for changing beneficiaries and disclaiming interest in an

account, but neither William nor Liv followed those instructions, William's original designation of Liv was still effective and the plan administrator properly distributed the benefits to her.

It concluded: "William's designation of Liv as his beneficiary was made in the way required; Liv's waiver was not." By giving a plan participant a clear set of instructions for making his own instructions clear, ERISA forecloses any justification for inquiries into expressions of intent, in favor of the virtues of adhering to an uncomplicated rule. Less-certain rules could force plan administrators to examine numerous external documents purporting to be waivers and draw them into litigation over those waivers' meaning and enforceability.

Nonetheless, the Court noted that the estate may be able to sue Liv under state law to try to obtain the funds. The Court explicitly stated that it did not decide the question of whether the estate could have sued to recover the benefits from Liv after she received them. The Court mentioned prior rulings that seemed to say that a prior contractual agreement to forfeit funds may be enforceable after the distribution without violating ERISA. Once the money is paid out, it loses its ERISA protection, those rulings had indicated.

Kennedy v. Plan Administrator for DuPont Savings and Investment Plan provides a story for estate planning attorneys to relay to clients regarding updating their beneficiary designations. It also points to the need for estate planning attorneys to work with client to ensure that beneficiary designations are accepted by the plan administrator, especially with the Court's holding that administrators must be able to rely upon their plan documents in determining beneficiaries.

TRUSTS AND NONQUALIFIED ANNUITIES: LOOK BEFORE YOU LEAP

BY JOSEPH A. CIPPARONE

Integrating commercial annuities into the estate plan of clients can present a number of potential problems. Financial advisors do not always understand the intricacies of annuities they sell, and sometimes change the ownership or beneficiary designations of annuities without the involvement of estate planners. The estate planner must find time to review the annuity contract and coordinate a client's trusts with these complex investment vehicles. Failing to focus on the ownership of and beneficiary designations of commercial annuities can result in unintended consequences.

When a client's assets include a commercial annuity, first determine whether the client owns the annuity inside or outside a retirement plan. If the client owns the annuity inside a retirement plan ("a qualified annuity"), treat it just like any other retirement plan asset. See, IRC §§401, 402 and 408 and the accompanying regulations. More on this topic later.

Annuities held outside a retirement plan are known as "nonqualified annuities." Most clients purchase deferred annuities as opposed to immediate annuities. Clients invest in deferred nonqualified annuities to take advantage of deferring income taxes on the interest, dividends and capital gains of the annuity investments. The term "deferred annuities" does not actually refer to the tax deferral feature but to the deferral of annuity payments until some time in the future. In contrast, immediate annuities provide a client with a payment every month or year and those payments begin within one year of purchase.

Deferred annuities pose much greater problems for an estate with a trust than immediate annuities. Deferred annuities will always have a death benefit if annuity payments have not begun, or if the annuity payments have begun but have not completed a term certain when an owner dies. Immediate annuities will only have a death benefit if the annuity has a refund feature or lasts for a term of years. If an annuity has a refund feature, upon the annuitant's death, the annuity company will refund the difference between the original investment and the amount distributed under the annuity. If an immediate annuity does not have a refund feature and distributions terminate at death, the immediate annuity will have no consequences at death and do not affect a client's estate plan.

A. USING A TRUST AS OWNER OF A NON-QUALIFIED ANNUITY

Ownership of an annuity by a *revocable* trust makes little sense. An annuity passes outside of probate through a beneficiary designation. Why not simply make the annuity payable to the revocable trust through a beneficiary designation? All of the funding of the subtrusts for family members under a revocable trust usually occurs upon the death of the owner of the annuity. Annuity death benefits pass to the revocable trust outside probate just like a revocable trust. The estate planner may want the revocable trust to own the deferred annuity to avoid complications if the owner becomes legally incompetent. Yet, the client can use a durable power of attorney to avoid that problem.

Ownership of an annuity by an *irrevocable* trust may make sense. The client may be able to remove part or all of the value of the annuity from his or her taxable estate by changing the owner and beneficiary of the policy to the irrevocable trust. The client will need to obtain a change of ownership form and obtain a tax identification number for the trust. If the client has not yet purchased the annuity, the client could transfer cash to the irrevocable trust and the trustee could purchase the annuity.

Before changing the ownership of an annuity to an irrevocable trust, the attorney must consider the income and gift tax consequences and Medicaid consequences of such an ownership change.

INCOME TAX ISSUES

If the cash surrender value of an annuity exceeds the investment the owner made in the annuity, a gain results. The estate planner must know when the gain will be recognized for income tax purposes. The transfer of an annuity to another owner including an irrevocable trust may trigger recognition of all gain in the contract. Before recommending such a transfer, the estate planner needs to understand the cash surrender value of the annuity, the investment

If an individual who holds an annuity contract transfers it without full and adequate consideration, such individual shall be treated as receiving an amount equal to the excess of --

TRUSTS AND NONQUALIFIED ANNUITIES: LOOK BEFORE YOU LEAP

- (I) the cash surrender value of such contract at the time of transfer, over
- (II) the investment in such contract at such time, under the contract as an amount not received as an annuity.

If an amount is not received as an annuity, the distribution is considered a redemption of the annuity contract and the annuity owner will owe income taxes on the amount redeemed. Treas. Reg. §1.72-11. If an annuity is redeemed, the Code defines the investment in the contract as the aggregate amount of premiums or other consideration paid for the contract minus the aggregate amount received under the contract to the extent that such amount was excludable from gross income. IRC §72(c)(6). For instance, if the cash surrender value of the annuity contract is \$100,000, the amount the client invested in the contract is \$70,000, and the client made no tax-free withdrawals, the holder of the annuity will incur a gain of \$30,000. This gain is taxed as ordinary income, not as capital gain. Rev. Rul. 69-102. If the excess of the cash surrender value over the investment in the contract is small or non-existent, however, the income tax consequences of changing the ownership of an annuity to an irrevocable trust may not present a significant hurdle.

Even if the gain upon change of ownership would be significant, an irrevocable trust that satisfies the grantor trust rules could avoid the adverse income tax consequences of IRC §72(e)(4)(C). Generally, transferring property to a grantor trust has no income tax consequences because the grantor is treated as the owner of the trust for income tax purposes. IRC §671. Trust provisions that could make an irrevocable trust a grantor trust for income tax purposes include:

- (1) allowing the grantor to substitute property of equal value (IRC §675(4));
- (2) giving the grantor a special power of appointment (IRC §674);
- (3) giving the grantor the power to borrow from the trust without giving adequate security (IRC §675(2));
- (4) giving a nonadverse trustee (like the grantor's spouse or child) the power to sprinkle income among a class of beneficiaries (IRC §674); or
- (5) payment of trust income to a grantor's spouse (IRC §677).

GIFT TAX ISSUES

Any transfer of an existing annuity to an irrevocable trust will also have gift tax consequences. The amount of the gift will equal the replacement cost of the annuity. Treas. Regs. §25.2512-6. The replacement cost is the single premium that the same commercial annuity issuer would charge for a like contract if taken out on the date of the gift to cover the life of a person of the annuitant's age on the gift date. *Id.* Because a gift to a trust constitutes a gift of a future interest, the annual exclusion may not apply. IRC §2503(b). The annual gift tax exclusion will apply to any ascertainable, mandatory income interest in the trust based on the 7520 rate and IRS Table S. See, Treas. Regs. §§25.2512-5(d)(1), 25.7520-1(a)(1), and IRS Publication 1457, which contains Table S. A Crummey withdrawal right would normally not seem appropriate in such a trust because there are typically no contributions to a trust that holds an annuity policy other than the initial contribution. Thus, that method of qualifying for the annual gift tax exclusion would not apply unless a demand right is given over the entire trust property. See, Rev. Rul. 73-405. Such a demand right would defeat the purpose of using a trust to make the gift.

MEDICAID ISSUES

What are the Medicaid consequences of transferring an annuity to an irrevocable trust? The Connecticut Department of Social Services considers converting an asset into the form of a trust to be a transfer to the extent that it is no longer available to the individual. Connecticut Uniform Policy Manual §3029.11(A) (proposed regulations made effective 4/1/07 but rejected without prejudice by Connecticut General Assembly's Regulations Review Committee) [hereinafter "Conn. UPM"]. The look-back date for transfers to trusts is 60 months before the individual is 60 months before the individual is institutionalized and applies for Medicaid. Conn. UPM §§3028.05, 3029.05 (proposed regs). Consequently, any transfers to an irrevocable trust more than 5 years before the settlor is institutionalized and applies for Medicaid will not render the settlor ineligible for Medicaid. Of course, if the client retains any right to the income or principal of the trust under any circumstances, it will be considered an available asset. Conn. UPM §3029.11(C) (proposed regs). Consequently, any transfers to an irrevocable trust more than 5 years before the settlor is institutionalized and applies for Medicaid will not render the settlor ineligible for Medicaid. Of course, if the client retains any right to the income or

TRUSTS AND NONQUALIFIED ANNUITIES: LOOK BEFORE YOU LEAP

principal of the trust under any circumstances, it will be considered an available asset. Conn. UPM §3029.11(C) (proposed regs).

The purchase of an annuity after February 8, 2006, will violate the transfer of asset rules under Medicaid unless the annuity names the State of Connecticut as (i) the primary beneficiary or (ii) the contingent beneficiary if the applicant names a spouse or a disabled or minor child as primary beneficiary. 42 USC §1396p(c)(1)(F); Conn. UPM §3029.12. The term "purchase" includes any action that changes the course of payments to be made by the annuity or the treatment of the income or principal of the annuity. Enclosure Section 6012 to State Medicaid Director Letter #06-1018 from Centers for Medicare & Medicaid Services, July 27, 2006, at 5 (Changes in Medicaid Annuity Rules under the Deficit Reduction Act of 2005 (Pub. L. 109-171)). Consequently, changing the ownership of an annuity purchased more than 5 years ago and before February 8, 2006, to an irrevocable trust would convert that annuity from being exempt under the new annuity rules of the Deficit Reduction Act to an annuity subject to the Act. *Id.* In addition, naming an irrevocable trust as owner and beneficiary of an annuity within the last 5 years will constitute a transfer for less than fair market value. Conn. UPM §§3029.12 and 4030.47 (proposed regs). Transfers for less than fair market value within 5 years of the settlor applying for Medicaid will result in a penalty period based on the value of the asset. Conn. UPM §3029.05 (proposed regs). The client's equity in an annuity is a counted asset to the extent that the client can sell or otherwise obtain the entire amount of equity in the investment. Conn. UPM §4030.47 (proposed regs).

The Medicaid transfer of asset rules do not apply to annuities transferred to irrevocable *self-settled* special needs trusts (SNT). 42 USC §1396p(d)(4)(A). Only individuals under age 65 who are disabled can have SNTs for their benefit. Conn. UPM §3029.11.D (proposed regs). The SNT must have a payback provision allowing payment of the State of Connecticut upon the death of the disabled individual to the extent of medical assistance paid by the state. Conn. UPM §3029.11.D.1.b (proposed regs); §4030.80.D.6.b (proposed regs); 42 USC §1396p(d)(4)(A). Only a parent, grandparent, legal guardian, or a court can create a SNT of the disabled individual; the individual who needs the SNT cannot create the trust. *Id.* The Trustee purchases the annuity with funds provided by the disabled individual.

Of course, most clients do not wish to transfer their annuity to an *irrevocable* trust because it is irrevocable and, unless the

trust is a Special Needs Trust for the client, he or she will lose the benefit of the annuity. Clients usually obtain an annuity to provide income and security for life. Thus, it is rare to see an annuity owned by an irrevocable trust except in the special needs context.

B. NAMING A TRUST AS BENEFICIARY OF AN ANNUITY.

Before designating a trust as beneficiary of an annuity, review the options allowed by the annuity contract. Just knowing what the contract allows could prove crucial even after the death of a client. *See, e.g.*, TAM 9346002 (the annuity contract required all beneficiaries to choose the same distribution option). An annuity contract may not allow a trust the same beneficiary rights as named individuals. *See, e.g.*, PLR 200313016 (the annuity contract only allowed beneficiaries who are individuals to elect the life expectancy method for distributions). Unfortunately, clients do not readily receive the annuity contract from the financial advisor or the insurance company. Instead, sales literature often substitutes for the annuity contract. Obtaining the annuity contract may require an attorney or paralegal contacting the financial advisor. It is not unusual for an estate planner to learn after the fact that a client has purchased or exchanged an annuity or changed the ownership or beneficiary designation of an annuity without coordinating the annuity with the rest of the estate plan. Understandably, many estate planners caution their clients to avoid purchasing, modifying or changing the ownership of an annuity without first consulting them.

Naming a revocable trust as beneficiary of an annuity in a retirement plan ("a qualified annuity") will usually lead to distributions based on the age of the oldest beneficiary in the calendar year after the participant's death. Treas. Reg. §1.401(a)(9)-5. If the client dies after his required beginning date (usually age 70½) and the client is younger than the oldest beneficiary, the trust beneficiaries must base distributions on the age of the client at death. Treas. Reg. §§1.401(a)(9)-4, 1.401(a)(9)-5. The tax rules that apply to trusts as retirement plan beneficiaries are quite complex so the estate planner must become familiar with these rules before designating a trust as beneficiary of a retirement plan. *See*, Natalie Choate, *Life and Death Planning for Retirement Benefits*, Chapter 6 (6th ed. 2006).

For a nonqualified annuity, if the annuity contract only allows a lump sum distribution upon death, the trust will owe income tax on the amount received from the annuity less

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the decedent's investment in the contract. Rev. Rul. 2005-30 (2005); Rev. Rul. 79-335 (1979); IRC §72(c)(2). The amount received in excess of the decedent's investment in the contract is income in respect of a decedent (IRD). Rev. Rul. 2005-30(2005); IRC §691(a). The amount received in excess of the investment in the contract is taxed as ordinary income. Rev. Rul. 2005-30(2005); IRC §§72(c)(2)(B), 72(c)(5)(E). If the annuity contract allows either periodic payments or a lump sum payment and the Trustee elects to take a lump sum, then the same rules will apply. The Trustee can transfer the income tax consequences to the beneficiaries by distributing the lump sum payment to the beneficiaries. IRC §661. Of course, distributing the lump sum payment may defeat the purpose of having the trust. The settlor may not have created the trust if the settlor knew the Trustee would have to distribute a lump sum outright to the beneficiaries to avoid income taxation at the trust's higher tax rates.

If the annuity contract only allows periodic payments or the annuity contract allows beneficiaries to elect a lump sum or periodic payment and the Trustee would prefer the periodic payment, the decedent's naming of a trust as beneficiary instead of an individual as beneficiary could also result in additional income taxes. IRC §72(s)(1) contains the required distribution rules for annuities upon death:

A contract shall not be treated as an annuity contract for purposes of this title unless it provides that:

- (A) if any holder of such contract dies *on or after* the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and
- (B) if any holder of such contract dies *before* the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.

In other words, if the holder dies after the annuity starting date, the beneficiary must receive the same payments that the holder was receiving or, if the holder dies before the annuity starting date, the entire interest must be distributed within five years of the annuitant's death. The annuity starting date is the first day of the first period for which an amount is received as an annuity, which is the later of (i) the date upon which the obligations under the contract become fixed or (ii) the first day of the period which ends on the date of the first

annuity payment. IRC §72(c)(4); Treas. Reg. §1.72-4(b)(1). If the decedent held a deferred annuity until death without ever annuitizing it and the owner died before the annuity starting date, the entire interest must be distributed within 5 years of the owner's death.

Two important exceptions to IRC §72(s)(1) exist. IRC §72(s)(2) provides an exception when an annuity has designated beneficiaries:

If (A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary, (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary) and (C) such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe, then for purposes of paragraph (1) [§72(s)(1)], the portion referred to in subparagraph (A) [§72(s)(2)(A)] shall be treated as distributed on the day on which the such distributions begin.

In other words, if the annuity passes to a designated beneficiary over a period not to exceed the beneficiary's life expectancy and the annuity payment begins within one year of the decedent's death, the annuity does not have to be distributed within 5 years of the holder's death. The term "designated beneficiary" means any individual designated a beneficiary by the holder of the contract. IRC §72(s)(4).

In PLR 200313016, a life insurance company proposed a nonqualified deferred variable annuity contract that included a guaranteed minimum death benefit and allowed the named beneficiaries who are individuals to receive distributions using the life expectancy fraction method, the fixed amortization method, or the fixed annuitization method. The insurance company asked that the Service to allow these distribution methods in situations where the annuity owner dies before the annuity starting date. The life expectancy method divides the account balance on December 31 of each year by the life expectancy factor allowed under Treas. Reg. §1.401(a)(9)-5 (just like IRAs).

The retirement plan distribution rules do not apply to nonqualified annuities. IRC §72(s)(5). Thus, the favorable trust rules that apply to distributions from retirement plans do not apply to nonqualified annuities. Cf., Treas. Reg. §1.401(a)(9)-4, Question A-5 (trust look-through rules for

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retirement plans). No IRS regulations or case law allow beneficiaries of a nonqualified annuity to look through a trust to determine who are the beneficiaries.

Without IRS regulations on trusts as beneficiaries of nonqualified annuities, the issue arises as to whether the definition of "designated beneficiary" in IRC §72(s)(4) eclipses the parenthetical words "(or for the benefit of)" in IRC § 72(s)(2)(A). Certainly, the definition of designated beneficiary is restricted to individuals. Nevertheless, the words "for the benefit of" in IRC §72(s)(2)(A) implies that a trust which has designated beneficiaries (i.e.- individuals as opposed to charities or other entities) could receive distributions over the life expectancy of the beneficiary. This author has found no private letter rulings, revenue rulings, Treasury regulations, or cases that resolve this issue. For a good discussion of this issue, see John L. Olsen & Michael E. Kitces, *The Annuity Advisor* 119 (The Natl. Underwriter Co. 2005)[hereinafter Olsen & Kitces]. Olsen & Kitces recommend against naming a trust as beneficiary of a nonqualified annuity unless there is a very good reason for doing so and you are sure of the results of the designation (including when the insurance company will pay a benefit and under what conditions any death benefit enhancements will be payable). Olsen & Kitces at 128. Given the uncertainty in the law, the annuity contract and the insurance company will likely control whether a trust named as beneficiary can use a life expectancy, fixed amortization, or fixed annuity method for distributions.

The second exception to IRC §72(s)(1) involves spouses. The holder's surviving spouse can continue to defer distributions until the annuity starting date. IRC §72(s)(3). Where the spouse receives most of the client's assets, the clients should usually name the spouse as beneficiary. The spouse can both delay distributions to decedent's annuity starting date in the contract, and, depending on the annuity contract provisions, the insurance company may allow the spouse to take distributions over her life expectancy.

Although naming the spouse as beneficiary provides the simplest approach with the greatest flexibility, a client may be more comfortable having the annuity paid to his or her revocable trust or directly to a subtrust established under the revocable trust. For instance, a client with children from a

prior marriage may want the children to receive a trust distribution after the death of the spouse. A client could also have serious concerns about the ability of the spouse to manage the asset and would prefer to use a trust.

A married annuity owner with a revocable trust that divides the trust property into a credit shelter share and a marital share for estate tax minimization purposes will have additional issues to consider. The trust funding formula could accelerate the recognition of income in respect of a decedent (IRD) unless the trust has a fractional formula. Treas. Reg. §1.661(a)-2(f). Depending on the circumstances, it may make more sense to name one of the subtrusts as the beneficiary of the annuity rather than naming the revocable trust as the beneficiary.

What if the client has died survived by his spouse and the trust was named as beneficiary? In PLR 200323012, a couple transferred two deferred variable annuities to a joint revocable trust and named the trust as beneficiary. The couple served as Co-Trustees. The joint revocable trust had a credit shelter and marital trust for the surviving spouse. The surviving spouse had the right to allocate funds between the credit shelter and marital trust at the decedent's death and to withdraw all of the marital trust. The surviving spouse proposed to transfer the annuities to the marital trust and then exchange the annuities for a new deferred variable annuity in the name of the surviving spouse.

PLR 200323012 emphasizes the need to discuss with clients the consequences of beneficiary designations. Naming the spouse as beneficiary instead of a trust would avoid the effort and cost of obtaining a private letter ruling from the IRS. Naming a trust instead of a spouse as primary beneficiary of a nonqualified annuity should occur only after reviewing the annuity contract and discussing the pros and cons of such a beneficiary designation with the client. For added post-death flexibility, many estate planners will name the spouse as primary beneficiary and the revocable trust as contingent beneficiary with the understanding that the spouse may use a disclaimer after the annuity owner dies to fund the trust if it is prudent.

In conclusion, mixing trusts and nonqualified annuities may result in unintended consequences. Attorneys must exam-

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ine the annuity contract and understand the provisions of IRC §72 and, if applicable, the Connecticut Medicaid regulations and gift tax rules, before naming a trust as the owner or beneficiary of a nonqualified annuity. Only after discussing with the client the consequences of the ownership and beneficiary designation of each annuity can the estate plan capture the client's true intent regarding those annuities. Given the complexity of trusts and annuities, the estate planner must not close the file until assured that the client and his or her financial advisor have followed the recommended approach.

CONNECTICUT GOES ROGUE BY ELIZABETH L. LEAMON

Remarkable for a state not generally considered tax friendly and all the more remarkable given the current economic and budgetary crises, Connecticut raised its estate and gift tax exemptions and lowered both sets of tax rates for decedents dying or gifts made on or after January 1, 2010. Once in effect, Connecticut will have one of the highest estate tax exemptions and lowest estate tax rates among its neighbors in the Northeast. It will also be entirely out of step with those states with an estate tax that adopted the old Federal state death tax credit table.

Although these changes may appear of little general interest, estate planners will likely witness an impact on (1) multi-jurisdictional estates, and (2) even broader implications for the entire system of states that de-coupled from the Federal system and have their own state estate tax. Indeed, Connecticut may have inadvertently begun the process of unraveling state taxation of estates. And if other states follow the Connecticut example, the once fairly harmonious division of estate taxation among the states may come unglued.

Effective January 1, 2010, Connecticut's gift and estate tax exemptions will rise from \$2 million to \$3.5 million.¹ Connecticut has also lowered estate tax rates by reworking the old Section 2011 state death tax credit or pick-up table. Connecticut, like many other states, adopted the Federal state death tax credit table in 2005 in setting the rates for Connecticut's estate tax. Connecticut's new estate tax table eliminates the tax of assets below the exemption amount, the so-called cliff, and

reduces the base amounts and the percentages to use in calculating the tax. As compared to the 2009 version of the tax, which used the old pick-up tax table, the estate and gift tax rates have decreased by about 25% once an estate or aggregate Connecticut taxable gifts exceed the applicable exemption.

Interesting issues created by Connecticut's new estate tax table arise in the context of the multi-jurisdictional estate. For example, consider the effect of having a taxable Connecticut estate, 10% of which consists of real estate located in another state that uses the old pick-up tax table. Because Connecticut only allows a credit for taxes paid to other states equal to the lesser of (i) the actual tax paid or (ii) the fraction of the gross estate represented by the out-of-state property multiplied by the Connecticut tax, the tax imposed by the other state will exceed the credit allowed by Connecticut. Thus, the estate will have paid more in tax to a foreign jurisdiction than it receives in credit from Connecticut.

Conversely, a non-resident Connecticut estate will pay less than the allocation made by the domiciliary state to the Connecticut property. Subject to the constitutional issue discussed below, the domiciliary state will often only give a credit equal to the Connecticut tax paid. In that case, who gets the "windfall"—the estate or the domiciliary state?

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These simple examples illustrate the unintended consequences that occur when one or more states start to play by different rules. If a Connecticut resident has out-of-state real property located in a state that uses the old death tax credit table, he or she may be well advised to convert real estate into intangible personalty, say by transferring the property into a two or more member LLC; thereby coming under the more favorable Connecticut tax umbrella. However, a Rhode Island resident owning property in Connecticut with an estate over its new exemption of \$850,000 and below \$3.5 million, will want to do the opposite, because a non-resident Connecticut estate worth less than \$3.5 million will pay no Connecticut tax. Going forward, we could see such out-of-state residents with larger estates and Connecticut real property consciously planning to have their Connecticut property taxed by Connecticut.

The repercussions of Connecticut's break from the old Section 2011 estate tax credit table will likely be felt by neighboring states on the eastern seaboard; namely, those states that de-coupled from the Federal system and have their own state estate tax. Looking at the statutes of certain eastern commercially important states with an estate tax, namely, Delaware, Massachusetts, New Jersey, New York and Rhode Island, these states all use the old Section 2011 state death tax credit table to compute their taxes.² Based on a review of the statutes only, a majority of the reviewed states follow the Connecticut pattern to compute the credit for out-of-state estate tax payments, namely, the lesser of (i) the actual tax paid or (ii) the fraction of the gross estate represented by the out-of-state property multiplied by the state death tax credit table. The exceptions are Rhode Island, whose statute only taxes in-state property, and New York whose statute invariably uses the state death tax credit table to compute the credit allocable to out-of-state property.

The statutory lack of fit poses a constitutional problem as well. The issue first arose in Connecticut in 2005-2006. The Connecticut Department of Revenue Services asked the Attorney General what to do about real or tangible personal property located in states like Florida that had no state estate tax. In an opinion issued on August 1, 2006, the Connecticut Attorney General agreed with the Department that Connecticut, as a matter of Federal constitutional law, could not im-

pose a Connecticut tax on anything other than Connecticut real property and tangible personal property and intangible personal property owned by a Connecticut resident.³ Hence, Connecticut would not seek to impose in effect a Connecticut tax on the Florida portion of the estate, and that property would escape taxation at the state level.

The question of disparate taxes and rates was never raised in the opinion and the problem seemed largely theoretical as long as every taxing state used the same table and rates. In much the same way as the now defunct credit worked, the taxes were allocated among the states in proportion to the property located therein.

However, beginning in a few short weeks, for anyone dealing with Connecticut, either from without or within, the problem has become quite real. The reasoning in the August 1, 2006 opinion ought to result in the windfall posited above inuring to the estate; otherwise, the domiciliary state will be imposing its tax on property over which it has no constitutional taxing jurisdiction. In practice, this seems to represent the general procedure.

Connecticut has never operated as a leader in tax reduction, and the notion that it would evolve into a tax haven, relatively speaking, probably boggles the mind of most Connecticut trust and estate lawyers. Consequently, it seems unlikely that this comparative tax advantage will remain long-lived. As other states adopt their own rates and exemptions, the existing crazy quilt of state taxation of estates appears headed for increased dysfunctionality. Whether Connecticut has inadvertently started the process of pacing off the last mile of state taxation of estates remains to be seen. One can reasonably anticipate that the issues raised above will become more complex as, in all likelihood, the economy picks up steam and more states compete by abandoning the old Section 2011 table in favor of greater freedom and creativity.

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1. Assume for the moment that the 2009 Federal estate exemption is extended by Congress, the Federal system and the Connecticut system would, putting prior taxable gifts to one side, become synchronized. And if Congress maintains the gift and estate tax exemptions at that level, the Federal and Connecticut systems would generally harmonize.

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2. Del. Code Title 30, § 1501 et seq.; Mass. Gen. Laws ch. 65C § 2A ;N.J. Stat. § 54:38-1; N.Y. Tax Law § 952; R.I. Gen. Laws § 44-22-1.1.
3. Formal Opinion 2006-018, Attorney General State of Connecticut.

About the author: Elizabeth L. Leamon is an associate at the Madison, Connecticut office of Murtha Cullina LLP, where she practices in the area of wealth management, including estate planning, estate settlement and probate litigation. Her e-mail address is eleamon@murthalaw.com.

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DEFALCATION BY ANTHONY LUDOVICO

The State Judicial Department has expressed concern about the ongoing incidence of defalcations among attorneys who act as fiduciaries for client funds or property. The State Bar Association has asked the Estates and Probate Section's Executive Committee to consider the matter and to try to develop recommendations for measures that might curtail or prevent such defalcations from occurring. The request was received with a bit of caution that, should the Section not be able to come up with viable recommendations, the Judicial Department or the Bar Association, or both, might develop and impose rules or regulations of their own making. We are told that if such rules are imposed, they might very well include a requirement that all attorneys serving as fiduciaries register as such and, perhaps, provide a bond as prerequisite to serving in such capacity.

The Section's Executive Committee gave the matter its serious attention. No fewer than 10 attorneys volunteered to serve on a subcommittee on Integrity of the Practice and studied the issue for many months during which no fewer than 12 different suggestions were explored within the subcommittee. Throughout the deliberations, the subcommittee weighed the merits of each suggestion, all the while troubled, I think, with two thoughts: that not one of the many and good suggestions (including that of registration and bonding of attorneys) would likely prevent defalcations, and that the imposition of additional regulation by the broad brush painting of all attorney-fiduciaries (and only attorney-fiduciaries) as potential evil-doers would be an unfortunate commentary upon our chosen discipline .

Defalcation, embezzlement, is a crime. There seem to be at least five ways in which we, as attorneys, might respond to a charge that portrays us as suspect for criminal activity. We could, I suppose, heed the Miranda warning. We have the right to remain silent, to say nothing in response to the request that we assist in developing recommendations to resolve the crime. Yet, we are told that silence will gain us nothing but the likelihood of regulatory expense and tedium for the area of practice to which we have dedicated our life's work.

For those of us nearing the end of our practicing lives, silence may at first blush seem like an easy approach to the matter. Certainly, the frustration of developing recommendations without receiving some acknowledgment of their usefulness is enough to make one want to remain silent. But, such a posture of non-involvement, an uncaring lack of response is not at all viable for those newly setting out as T&E attorneys. They have a significant stake in the resolution of the issue. In truth, something in our calling suggests that silence is not an acceptable option for any of us. For, upon admission to the bar, we chose to uphold the standards of the profession and to strive to improve it.

The other end of the spectrum may also seem an attractive approach to the charge. We could, for example, stop by the supermarket on the way home, pick up an empty Ivory Snow soapbox, and stand on it to assert how pure we are, and how wrong the charge is that all attorney-fiduciaries are latent predators and must register like pedophiles, be shackled and bonded. We already pay into a Client Security

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Fund; why should we, who come with clean hands, be taxed for the sins of others? We pay dues to an Association that should be looking out for our interests, we might proclaim. Perhaps, we might insist that the Bar Association join with us in a public petition to Judicial Department that seems headed down the wrong path in suggesting new rules upon a select segment of the Bar.

Yet, who would listen? The public? Would the proclamation of our indignation serve to abate the centuries old, undesired stereotyping of attorneys as "sharks," even as the acts of relatively few others among us who commit defalcations continue to mar our own reputations.

Realistically, we must consider other approaches. The Section's subcommittee has recommended that three of its numerous suggestions deserve some consideration. We believe that the Judicial Department and the Bar Association have approached our Section's Executive Committee for its familiarity and experience with fiduciary relationships. As representative leaders of the Section, the Executive Committee would seem to be not only in an ideal position to address the issue among Section members, but also equipped with the expertise to do what the Executive Committee does, I think, better than any one else in the Bar—namely, to educate all members of the Bar about the issue.

To that end, the subcommittee has recommended that the Executive Committee resolve to conduct at least one seminar annually, either as a stand-alone program or as part of other Bar Association educational activities, to familiarize attorneys about the issue and to provide guidance on how to avoid involvement in defalcation. Further, if the Judicial Department and the Bar Association are as serious as they tell us they are, if the issue as important to the State as we understand it to be, then it would seem appropriate that the Executive Committee, the Bar Association, and the Judicial Department find a way to enable such seminars to be held without additional cost to attorneys, so as to minimize reasons for non-attendance.

Even more important than an educational response is the need for development and promulgation of standards to guide attorneys who serve as fiduciaries of client funds. Trust and Estate attorneys take some pride in their familiarity with the rules that govern fiduciary activity. Knowledge of those rules is garnered only by continual exposure to, reading of, and working with court decisions and treatises on common law

pertaining to trusts and estates. But, nowhere have we shared a very basic set of fundamental standards unique to our discipline. Is it any wonder that those who practice only occasionally in our field look at us cross-eyed when we try to explain why certain things "must" be done. The words of Judge Cardozo speaking of fiduciary duty in Meinhard vs. Salmon resound in our mind: "...not honesty alone, but the punctilio of an honor most sacred." If we would abide by that, why do we not encourage others to do likewise? Would it be asking too much of the Section to commit to having a set of standards set forth as prefatory guidance to all of its seminar materials?

Finally, if the Judicial Department is intent on requiring the registration of all attorneys serving as fiduciaries, we would recommend that the initial requirement be a disclosure of only the fact of such activity, not of the names of clients or account numbers involved. For, we sense that once it becomes known just how many attorney-client relationships are imbued with fiduciary service, the Department may be able to gain a better appreciation for the fact that the potential for defalcation by attorney-fiduciaries extends well beyond probate or trust matters. It would then be better able to decide what resources might be needed to address the issue.

CONNECTICUT BAR ASSOCIATION

30 Bank Street
P.O. Box 350
New Britain, CT 06050-0350

Phone: 860-223-4400
Fax: 860-223-4488

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