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SIMPLE SOLUTIONS TO COMMON PROBLEMS:
WHAT SHOULD BE IN YOUR BAG OF TRICKS

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November 21, 2013

Listed below are several common estate planning, financial planning, business planning and estate administration problems or issues. Many of the problems have well known methods of resolution, but there may be more simple approaches that are equally effective, more understandable, and less expensive for the client. Some of the approaches may seem intuitive and others more subtle. It may be relatively easy to understand how each suggestion below might work, although some require a relatively high and sophisticated level of knowledge to understand why they work. Some involve common traps that are frequently encountered, and sprung, by the uninitiated. Consider these problems and solutions:

I.
HOW TO AVOID PROBATE OF REAL ESTATE

It is a general belief that probate is something bad and is to be avoided, especially in states, such as Wyoming, that have not adopted the Uniform Probate Code. In states having the Uniform Probate Code, such as Colorado, it is not so true. For estates that are expected to be contentious and may require a judicial referee, a probate provides a built-in judge and might be a better arrangement. Assuming that we are in Colorado or otherwise have concluded that probate should be avoided, what steps should be taken? Most planners are well aware of the use of a revocable inter vivos trust for the avoidance of the probate. Most planners also are aware of the use of joint tenancy with right of survivorship, or tenancy by the entireties for real estate in the limited number of states where it is recognized,[1] as a "poor man's trust" for the avoidance of probate at the time of the first death. Most planners are also aware of the possible use of TOD and POD designations for intangible assets where available (which is discussed at greater length in Article II below), and in certain states the possible use of a "beneficiary deed" for realty.[2]

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[1] Colorado does not recognize tenancy by the entireties, rather any deed purporting to create a tenancy by the entireties will be treated as creating a joint tenancy. See C.R.S. § 38-31-201.

[2] Colorado's beneficiary deed statute is located at C.R.S. §15-15-402; Wyoming's statute is located at Wyo. Stat. § 2-18-103.

<u>The Deed in the Desk Drawer</u>. Less well known is what I call the "deed in the desk drawer trick," which was used with some frequency by lawyers long ago, with the practice dying out during the early years of my career. The technique is exactly how it sounds: a client would sign a deed granting the client's real estate to the client's children, and the lawyer would put it in the lawyer's desk drawer until the lawyer heard about the death of the client. If the client had not sold the property or countermanded his instructions and told the lawyer to destroy or withhold the deed, then at the time the client died the lawyer would take the deed to the County Clerk and record it, causing the children to appear to be the owners of record of the real estate. This obviously presented a substantial benefit in cost-saving for the children, and was harmful only to the Clerks of the District Courts who lost out on probate filing fees and appraisal filing fees, and possibly was harmful to creditors who were less than delinquent if there were any unpaid debts at the date of death. Under the Colorado title standards, which were last updated by the Colorado Bar Association on July 1, 2010, the fact that a deed is recorded after death does not impact the marketability of title.[3] This was all well and good, but as a matter of law legal title to the property conveyed by such a deed is extremely fragile and may not withstand judicial scrutiny. Here is why:

(i) <u>Lawyer is an "Agent."</u> The lawyer who prepared the deed and placed it in his desk drawer was an agent of the client. Although there is no Colorado case expressly defining the attorney's role in these terms, it is clear that the circumstances create an implied agency pursuant to *Victorio Realty Group, Inc. v. Ironwood IX.* [4] ("An agent is one who acts for another by the authority from him or one who is entrusted with the business of another.")

(ii) <u>Authority of Agent Expires on Death</u>. A basic principle of the common law of agency is that the authority of an agent expires when the principal expires:

> [N]o principle is better settled than that the powers of an agent cease on the death of his principal. If an act of agency be done subsequent to the decease of the principal, though his death is unknown to the agent, the act is void."[5]

An exception to this rule is available if the authority of the agent is "coupled with an interest." Without going too far afield to discuss principles of agency law, it should suffice to say that the lawyer's authority as an agent is not coupled with an interest, and

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[3] **Standard 3.2.1 Delivery of Deeds- Presumption**: The statutory presumption of delivery, resulting from the acknowledgment and recording of a deed, should be relied upon despite the fact that it appears the deed was recorded after the death of the grantor, regardless of the time which may have elapsed between the date of the deed and the recording thereof.

[4] 713 P.2d 424 (Colo. 1985) (citing *Shriver v. Carter*, 651 P.2d 436, 439 (Colo. 1982)).

[5] *Long v. Thayer*, 150 U.S. 520 (1893).

therefore the lawyer's authority expires.[6] The reason is clarified at greater length in the discussion below regarding the "delivery" requirement for validity of the deed in the desk drawer. In summary, the client's use of the deed as a testamentary device, being as revocable as a will and thus not a completed gift, does not give the lawyer any "interest" that can be coupled with the lawyer's duties to retain and subsequently deliver the deed.

(iii) Deed is Invalid Without Delivery. The legal principle required to be fulfilled is that a deed not only be executed (signed) and acknowledged (notarized), but that it also be "delivered." Recording with the office of the County Clerk and Recorder is deemed to be constructive "delivery."[7] If it can be proven that the deed in the desk drawer was delivered to the grantees prior to death (which would be hard to do if it never left the desk drawer until the client died) then it would be irrelevant that an agent with lapsed authority made an invalid effort to "deliver" the deed by recording it after death. Delivery needs to occur prior to death:

> Since the delivery must be made by the grantor, or by the grantor's agent, in order to be effective, there can be no delivery after the grantor's death. A deceased grantor can obviously not make delivery, and the agent's authority necessarily comes to an end upon the death of the principal. However, where the grantor delivers the deed to a third party to be delivered to the grantee after the grantor's death, an effective legal delivery can occur. No delivery occurs where the deed remains under the grantor's control and is subject to being recalled or revoked by the grantor, or where it is merely given to the third party for safekeeping.[8]

In arriving at the same position on this issue, the Colorado Supreme Court applied common law principles:

> It is an indispensable feature of each delivery of a deed that grantor part with possession and control or any power over it for the benefit of grantee, and the grantor's act or word must be such as to deprive him of all authority or the right to recall and must evidence an intention to part presently and unconditionally with the deed; otherwise there is no delivery.[9]

Thus, the most common set of facts that would surround the typical deed in the desk drawer arrangement would lead a court to conclude that the real estate still needed to be probated because the deed failed for lack of delivery. Likely the old time lawyers knew this but also trusted that there would be no problems and assumed that any of their

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6 *See* RESTATEMENT (SECOND) OF AGENCY § 120(1) (1958).
7 Like Wyoming, Colorado appears to utilize a "race-notice" method of determining the effect of a recording or failure to record. C.R.S. § 38-35-109.
8 4 TIFFANY REAL PROP. § 1036 (2011) (citations omitted).
9 *Barnes v. Spangler*, 25 P.2d 732, 733 (Colo. 1933).

brethren called upon to examine an abstract of title (these were back in the days before title insurance) would raise no questions regarding the lengthy time period between the date of execution and the date of recording. The willingness for lawyers to take such risks at present has waned, or certainly should wane, due to the faster pace of our current economy, the vastly more prominent use of leverage, the greater disintegration of families and dissolutions of marriage, etc. The deed in the desk drawer was a practical solution only if nothing went wrong, and how many professionals today are so confident that nothing will go wrong in their careers that they are willing to proceed without malpractice or E&O insurance?

A Simple Solution. So is there nevertheless a safe way to continue utilizing the relatively simple "deed in the desk drawer" trick? Yes there is. Unlike the authority of an agent, the authority of a trustee does not lapse at the death of the principal/settlor. If the deed in the desk drawer trick could be converted into a trust arrangement whereby the lawyer is a trustee, or an agent for a trustee, then the legal frailty described above should no longer exist. A simple document can be drafted that would effectively create a trust that would be deemed to legally exist pursuant to Colorado common law.[10] This additional "trick" to render viable the deed in the desk drawer is akin to what is known as a "Illinois Land Trust," the description which is beyond the scope of this presentation, but it is what led me to develop a short two page form of declaration of trust. This declaration of trust also serves to address the second and third problems discussed immediately below regarding the avoiding probate of personalty and the assisting of a parent by the children through joint signature authority over assets. This simple approach calls for the client to sign the trust document, the grantee(s) to sign the trust document, and the deed in the desk drawer to be described as one method by which the trustees may hold property. The terms of the trust need only state that the trustees will do what the settlor wants during life and should spell out the method of the division of the property at death, which might match exactly the designation of grantees in the deed. The attorney then acts as agent for the grantees rather than the grantor, and is only indirectly responsible to the grantor because the grantees themselves are subject to the instructions of the grantor for so long as the "trust" is revocable or amendable. The lawyer is thus agent for a trustee pursuant to a valid delegation of administrative or ministerial responsibility by a trustee pursuant to C.R.S. §15-1-804 and prior common law.[11] When

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10 *See In re Granberry's Estate*, 498 P.2d 960, 963 (Colo. 1972) setting forth the elements necessary to create an express trust: (1) settlor's capacity to create a trust; (2) his intent to create a trust; (3) a declaration of trust or a present disposition of the res; (4) an identifiable trust res; (5) a trustee: and (6) identifiable beneficiaries.

11 *See Green v Whitehead* (1929) 142 LT 1, 49 TLR 11 (CA). In that case two trustees for sale had contracted to sell certain land to a purchaser. They tendered a conveyance which was executed by one of them and by an attorney appointed by the other under a wide power of attorney which purported to delegate "the sole and absolute control of all my property real and personal of every description...". Eve J looked at the terms of the power of attorney and held that such a wide delegation exceeded what was permissible under s 23: [1930] 1 Ch 38. On appeal, the Court of Appeal looked at the function that it was sought to delegate - the execution of a conveyance - rather than the width of the power of delegation. As Lawrence LJ explained, "[h]ere no question arises of any exercise of the trustees' discretion by an attorney because the trustees themselves have entered into the contract for sale. The delegation of the ministerial act of executing the conveyance was... authorized by

the principal/settlor dies, the trustee does not die, and the authority of the trustee does not lapse, including the authority to have an agent of the trustee perform a ministerial act such as the recording of the deed.

II.
HOW TO AVOID PROBATE OF PERSONAL PROPERTY

For personalty, as well as for realty, the standard answer in the estate planning community might once again be the revocable living trust if the estate of the client exceeds the $60,000 limit for summary administration under C.R.S. § 15-12-1201 *et seq*.[12] Clients, left to their own devices, may place things in joint names, which works best between a parent and a child if probate is desired to be avoided for the parent, but does not work so well for a husband and wife unless the survivor quickly adds a new joint owner at the time of the first death. Colorado has adopted "POD" enabling legislation allowing a death beneficiary to be designated with respect to a financial account,[13] and most clients likely now know about this or are told about it by their bankers. Similarly, legislation was also created which permitted "TOD" or "POD" designations to be made for securities and security accounts.[14] The custodian financial institution or the securities issuer need not offer these alternatives, but where available they offer excellent probate avoidance opportunities without any particular tax or creditor risks or other unintended consequences not anticipated or expected by the client.

Clients nevertheless tend to utilize joint titling and joint ownership as a standard means of probate avoidance (and of incapacity planning as discussed in Article III below), not knowing what they might be doing to themselves. Even with POD or TOD registrations, clients sometimes misunderstand what the rights and duties of the designated beneficiary may be. One common occurrence is for a parent to designate the child who resides locally to be designated as a beneficiary or joint owner, under a belief that that child will then use the amounts remaining at death to "take care of everything." Many times a situation will arise where the non-designated children were under a belief that the designated beneficiary/child was to have used the POD or TOD or joint assets to pay bills and then divide the balance among all of the children, but typically the account agreements and the Colorado statutes vest outright ownership in the beneficiary. In those situations, where the beneficiary does not want to part with control of the TOD or POD

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section 23 of the Trustee Act 1925...": (1929) 142 LT 1, 4 (cf 49 TLR 11, 12, where Lord Hanworth MR's judgment is rather cryptically reported). However, the Court went on to hold that that power did not authorize the disposition of property held on trust for sale and therefore affirmed Eve J. See too Robert D Carswell, Trustee Acts (Northern Ireland) (1964) p 55.

[12] In Wyoming, that dollar limit is set at $200,000. *See* Wyo. Stat. § 2-1-201 *et seq*.

[13] C.R.S. § 15-15-212(2).

[14] C.R.S. § 15-15-301 *et seq.* (Uniform TOD Security Registration Act, which has been adopted by all states, except Texas and Louisiana)

or joint assets, the children will be forced to seek to impose a "constructive trust."[15] A second type of concern would be whether the creditors of a child, as the apparent joint owner of an asset, would have any access to the jointly-titled assets to satisfy the obligations of the child.[16]

Ownership at Death. With respect to the entitlement to a joint account at death, C.R.S. § 15-15-212(1) provides that “on death of a party sums on deposit in a multiple-party account belong to the surviving party or parties.” Many account agreements or "signature cards" include language describing a survivorship intention, and the more salient point is that the planner will not know what kind of account this is if presented with a client having or seeking to have accounts named jointly with a child or other persons.

As to POD and TOD designations, the treatment of the designated beneficiary as outright owner does not rely upon a presumption but rather is expressly established by the language of the statutes creating these exceptions to the Statute of Wills.[17] The enabling statutes for POD financial accounts and TOD/POD securities accounts both indicate that the designated beneficiary shall be the legal owner, but only if the beneficiary survives the account holder. In the case of both a POD financial account and a TOD/POD securities account, the statutes do expressly state that the designated beneficiary becomes the owner of the account following the death of the original owner, but if the beneficiary dies before the original owner, the statute says the securities belong to the estate of the original owner rather than to the estate of the beneficiary.[18] In either case, it may be even more difficult for the disappointed siblings of the designated beneficiary to attempt to impose a constructive trust in order to enforce the understanding that the parent had intended that the beneficiary simply "take care of everything."

A Simple Solution. Presented with this situation, how can the estate planner protect the intention of the client that the assets be shared? It turns out that this is another job for the two page declaration of trust document. By having the joint owner and/or designated beneficiary sign the document to indicate that the naming of the beneficiary or creation of the joint ownership is actually the creation of the trust, with the beneficiary/joint owner as the trustee, clear duties are imposed on the beneficiary/joint owner. The alternative of writing a letter or creating other evidence of instructions to the beneficiary forces the remaining heirs to have to prove a set of facts that could include contradictory verbal evidence from the designated beneficiary, whereas a signed two

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[15] *See Weeks v. Esch*, 568 P.2d 494, 495-96 (Colo. 1977) (applying a constructive trust to both real property and bank accounts). Generally, cases concerning a claim over funds in a joint account involve one of the parties claiming the other party unduly influenced the decedent to make him a joint owner to the account. *See* Dickinson v. Dickinson, 87 S.W.3d 438, 443 (Mo. Ct. App. 2002).

[16] This topic is discussed in Section III below regarding planning for incapacity, which also can be accomplished through the same structures utilizing a nominal form of joint ownership.

[17] 32 Hen. 8, ch. 1 (1540), adopted as the law of Colorado pursuant to C.R.S. § 2-4-211.

[18] C.R.S. § 15-15-212(2)(b) and § 15-15-307.

page trust agreement (which excludes verbal revocation) is rather irrebuttable. You will see this two page trust technique surface again as a possible solution to another common problem described below. The documents that might be involved regarding arrangements for personalty that would be akin to the deed in the desk drawer for realty might include a deposited stock power or bill of sale or endorsed certificate of title, etc.

III.
HOW TO PLAN FOR INCAPACITY

Most planners are fully aware of the availability of a durable power of attorney and the ability of a person, while competent, to designate an agent to manage his or her affairs either immediately upon execution of the durable power of attorney or after the person becomes incompetent, with the authority to continue managing the principal's affairs during incompetency until notice of the death of the principal.[19] Most planners also know that a revocable living trust can be structured to designate a successor trustee to manage assets held in the trust during the settlor's life while competent. Clients are less knowledgeable of those techniques and more likely to simply put a child on their bank account or other asset title with the thought that the child can take care things when they get sick and that the child will use the assets to pay bills and carry out the terms of the parent's desired estate plan after death. What most clients do not know is that such joint name arrangements can give the creditors of the child access to those assets, as well as the child being able to claim full ownership at the death of the parent without obligation to pay all of the bills with the joint assets (unless there are no other assets to use as a source for bill payment).

Creditor Risk**.** When assets are held in a joint account and one of the joint owners is liable to a creditor, the judgment creditor can only reach those funds equitably owned by the judgment debtor.[20] The assets held in a joint account are presumed to be owned in proportion to the net contributions of each party to the sums on deposit, unless there is clear and convincing evidence of a different intent.[21] Although there is no readily apparent law in Colorado on the topic, in Wyoming the burden is on the non-debtor account owner to prove "what funds in the bank account, held jointly by the judgment debtor and another depositor, are not subject to execution."[22]

Gift Tax Risk. A technical concern, but not a significant practical concern, is that the creation of certain kinds of joint ownership represents the making of a taxable gift. If a child is placed on the title to a parent's asset as a joint owner, and if the child's name cannot be removed from title without the child's signature, the gift of one-half of the value of the asset likely has been made to the child. Taxable gifts occur when a child is

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[19] Colorado has adopted the Uniform Power of Attorney Act. See C.R.S. §15-14-701 *et seq.*
[20] *Harvey v. Harvey*, 841 P.2d 375, 378 (Colo. 1992).
[21] C.R.S. § 15-15-211(2).
[22] *Hancock v. Stockmens Bank & Trust Co.,* 739 P.2d 760, 761-62 (Wyo. 1987).

added to a joint bank account only when the child makes a withdrawal from the account.[23] Likewise, if a securities account is opened and the parent is able to single-handedly close the account and transfer the funds back into the sole name of the parent (even if it requires the receipt of a joint check which the parent can then "launder" through a joint bank account in order to withdraw the entire amount), then no gift has occurred. The reason this is more technical than practical is that those clients who worry about gift tax likely are adopting a more sophisticated estate plan in any event. Nevertheless, even clients with smaller estates should not be put in a position of needing to file a gift tax return.[24]

A Simple Solution. The declaration of trust, the magic trick used to convert deeds in the desk drawer into trusts, also can come to the aid of a parent who does not want to make an inadvertent gift and whose child is besieged by creditors who have discovered that the child is named on the parent's assets as a joint owner. In the declaration of trust, the child is described as a trustee having signature authority solely for the purpose of assisting the parent during life, and/or the child is named as a survivor and described as a joint owner solely as a testamentary device to be effective only after the death of the parent. The child is not a vested beneficiary due to the provisions in the two page agreement indicated the parent may revoke it, and thus has no vested right that can be attached by a creditor. The child cannot attempt to retain ownership if the child becomes crosswise with the parent, and no taxable transfer has occurred because the arrangement is entirely revocable.

IV.
HOW TO MAKE A GIFT WITHOUT MAKING A GIFT

Most planners are aware that clients can make annual $14,000 gifts and have a lifetime exemption that can be used to reduce the size of the client’s estate. Most clients with sufficiently substantial wealth to have tax exposure are generally aware of their tax exposure. Nearly all clients, and a good number of estate planners, are unaware that there are additional steps that can be taken even if the client’s net worth exceeds the amounts that can be given away or exempted at death under the current exemptions and exclusions.

A Not So Simple Solution. For clients with larger estates who have already exhausted their $5,250,000 lifetime exemption and have utilized their $14,000 annual exclusions, but still want to do more to reduce the size of their estates, the three primary opportunities remaining available involve discounting arrangements,

[23] Treas. Reg. § 25.2511-1(h)(4).
[24] The failure to file penalty is described in Internal Revenue Code § 6651. The penalty rate is 5% of the tax due per month, up to a maximum of 25%. Likely no tax will be due and therefore no penalty will be due under this provision. The new (as of 2008) $135 minimum penalty for failure to file only applies to taxes imposed by Chapter 1 of the Internal Revenue Code, i.e. income taxes.

freezing arrangements, and charitable/marital arrangements. Much has been written about the use of "family limited partnerships," which actually are better effected utilizing LLCs in most jurisdictions, and the common attacks against FLPs by the IRS, primarily under Internal Revenue Code § 2036. Much has also been written about the freezing techniques involved with a GRAT, an installment sale to a "defective" grantor trust, and a preferred partnership freeze. The current low interest rate environment will be very accommodative of a charitable lead annuity trust (CLAT). Marital gifting, or an inter vivos QTIP trust for those who are not so trusting of their spouse, will avoid the risks and concerns of relying on portability. As I say, much has been written, and I therefore suggest you read it. These are not simple solutions.

V.
HOW TO MAKE SURE A PRESENT GIFT IS MADE WHEN A GIFT IS MADE

A more common concern is how to be assured that a present interest gift be made when it is intended to be made. The $14,000 annual exclusion must involve a gift of a "present" interest. Gifts made in trust or otherwise restricted to an extent that the beneficiary cannot have substantial present enjoyment will not qualify for the annual $14,000 present interest exclusion. For trusts, this issue historically was circumvented through use of the 2503(c) trust for a person aged 21 and younger, or through the inclusion of a Crummey provision in an irrevocable trust. There have been rulings determining that gifts not in trust of a type of asset that restricts substantial present economic benefit will not qualify.[25] Gifts of closely-held business interests cannot be so restricted in the planner's zeal to create a valuation discount for transfer purposes that the recipient is deemed not to receive a substantial present economic benefit. These cases involve the usual "facts and circumstances" analysis employed by the Tax Court.

A Simple Solution. Some planners have adopted Crummey powers within their family LLC or family partnership documents as a result. Others have carefully reviewed their partnership agreements or operating agreements to assure that the fiduciary duties of the controlling parties have not been waived, that the interest of the donee is transferrable beyond the right to assign a mere "assignee" interest and/or, or there is a reasonable expectation of distributions, etc.

VI.
HOW TO KEEP A TRUST/CUSTODIANSHIP FROM ENDING WHEN IT IS ENDING

Estate planners sometimes encounter a situation where a minor will soon be turning 21 and will become entitled to outright ownership of assets previously given under the Colorado UTMA, or where a young or irresponsible person is on the verge of

[25] *Hackl v. Commissioner*, 335 F.3d 664 (7th Cir. 2003); *Price v. Commissioner*, T.C. Memo. 2010-2.

being entitled to a distribution from an estate or from a terminating trust. In those cases where it is apparent that the beneficiary is his or her own worst enemy and the outright receipt of substantial assets is likely more harmful than helpful, the only express remedy under Colorado law might be the involuntary appointment of a conservator as being "mentally incompetent." There is a vast distinction between irresponsible judgment and incompetent judgment and that form of remedy is rarely available.

A Simple Solution. The UTMA custodian or the executor of the estate or the trustee of the trust might be able to structure the assets held in a manner that will provide the beneficiary with some protection after distribution. Executors, guardians and trustees certainly are authorized to invest in a manner which is prudent.[26] Under the Colorado Prudent Investor Act, a fiduciary "may invest in any kind of property or type of investment consistent with the standards" of the UPIA, subject to a duty on the part of the fiduciary to use "reasonable care, skill and caution."[27] The duty of prudence appears to be fulfilled if the value of the assets is unimpaired. Furthermore, the fiduciary can take into account the beneficiary's needs for liquidity and can consider the need for "preservation of capital."[28] Thus, it would seem that an "investment" by a fiduciary in a limited partnership or LLC or other non-liquid structure, where perhaps the fiduciary happens to be the manager or general partner, should pass muster as a prudent investment and otherwise comply with the requirements of Colorado law. Many clients may think that it is a worthwhile risk to deliver to the irresponsible beneficiary some shares of an LLC or other closely-held entity that the fiduciary continues to manage in a different capacity, and let the beneficiary convince a court that the fiduciary has somehow harmed the beneficiary.

VII.
HOW TO AVOID EARNING UNEARNED INCOME

One troublesome aspect of the use of entities that are taxable as partnerships in connection with a client's estate planning is that the income of the partners/members may be treated as self-employment income if the entity is engaged in a trade or business.[29] In the case of a limited partnership, this is the result only for the general partner. In the case of an LLC, all members may be considered to be general partners if the LLC is member-managed. In a manager-managed LLC, if a member is also a manager, it is possible that the member/manager can bifurcate his or her income as between two distinct interests if that actually is the case (but which is rarely the case).[30] The employment taxes associated with an LLC member’s distributive share being deemed self-employment income total 15.3% on the first $113,700 of self-employment income, and above that

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[26] C.R.S. §§ 15-1.1-101 through 15-1.1-114.
[27] C.R.S. § 15-1.1-102.
[28] C.R.S. § 15-1.1-102 (c)(7).
[29] *See* INTERNAL REVENUE CODE § 301(b).
[30] PROP. REG. § 1.1402(a)-2(h)(3).

amount the Medicare tax component (2.9%) of the employment taxes continues to be imposed, and an additional 0.9% Medicare tax kicks in above $200,000 of income for single filers and $250,000 for married filing jointly.

A (Somewhat) Simple Solution. Distributions of profits to shareholders of an "S" corporation are not subject to these taxes. Employee-owners of corporations can control to some degree the amount of compensation paid to themselves, which must be "reasonable" to be in compliance with IRS requirements. To the extent that a client is receiving a distributive share of LLC income, possibly the client can assign the client's membership interest to an "S" corporation and then the client can pay himself or herself an amount of reasonable compensation from the corporation which might be less than the income flowing through from the LLC to the "S" corporation. Many law firms and accounting firms are structured as partnerships, the partners of which are "S" corporations, for this reason.
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VII.
HOW TO AMEND THE NONAMENDABLE

The basic legal principle governing irrevocable trusts is that they cannot be revoked nor amended. At common law certain principles are applicable to allow the interested parties to modify or terminate a trust. At common law this is limited to those situations where it would not violate a "material purpose" of the settlor of the trust, such that a modification may be necessary to further the purpose of the trust.[31] Under the Uniform Trust Code, modifications can be adopted which are even contrary to the stated purpose or intent of the trust so long as the settlor and all beneficiaries agree.[32]

In addition to possible modification, a trustee might be able to "decant" a trust, meaning that the trustee can "pour" the trust assets into a new trust "decanter." Several states have statutes permitting the decanting of a trust.[33] Literature suggests that the statutes simply codify already existent common law ability of a trustee to decant.[34] The general requirement is that the trustee have the power to invade the trust's principal. The legal theory is that a trustee with discretion to do so can use the power to create an estate in trust that is less than the estate set forth in the initially governing instrument, so long as that instrument does not indicate a contrary intent.[35] No case law in Colorado discusses

[31] *Saunders v. Muratori*, 251 P.3d 550, 554 (Colo. 2010).
[32] *See* UNIFORM TRUST CODE § 201(b) cmt. (2005).
[33] ALASKA STAT. § 13.36.157 (2013); DEL. CODE ANN., tit. 12 § 3528 (2013); NEV. REV. STAT. §§ 163.556 (2013); N.H. REV. STAT. ANN. § 564-B:4-418 (2013); S.D. CODIFIED LAWS § 55-2-15; WYO. STAT. § 4-10-816(a)(xxviii).
[34] William R. Burford & Patricia H. Char, Renegotiation the Irrevocable Trust: Amending, Decanting, and Judicially Modifying, SP035 ALI-ABA 325, 333 (2009).
[35] Alan Halperin & Michelle R. Wandler, *Decanting Discretionary Trusts: State Law and Tax Considerations*, 29 TAX MGM'T ESTS., GIFTS, & TR. J. 219 (Sept. 2004); *see* Jonathan G. Blattmachr & Diana S. C. Zeydel, *Tax Effects of Decanting—Obtaining and Preserving the Benefits*, 111 J. TAX'N 288, 289 (Nov. 2009); William R.

decanting; however, if the common law can be used to modify a trust, it is arguable that it may also be used to decant a trust. Trustees may want to "decant" in order to extend creditor protection, change trust situs, reduce state income taxation, extend the period for vesting, and otherwise achieve the typical estate planning objectives of minimizing taxes, protecting beneficiaries from their own bad judgment and from creditors.[36]

A further alternative to a modification of an irrevocable trust or the decanting of the assets of an irrevocable trust into another trust is through the power of a trustee to merge the trust with another trust that may be governed by a somewhat similar terms. Well-drafted trusts often grant an express power to the trustee to divide or combine trusts. Under the Uniform Trust Code, a trustee has the ability to combine two or more trusts into a single trust or to divide a trust into two or more separate trusts so long as the result does not impair the right of any beneficiary or adversely affect the achievement of the purposes to the trust.[37] A trust can be established by a declaration under the laws of most states, and the establishment of a new trust followed by a merger of the "old" trust into the new trust can be utilized to change situs or otherwise achieve a desired modification so long as the beneficiaries' rights and the purposes of the trust are not materially impacted.

The typical uses for modification, decanting or merging to bring about a change in the wording of the trust include the achievement of simple administrative changes, changing investment limitations, defining or limiting the rights of beneficiaries to information, changing the governing law, changing the trustee, providing for the addition of trust protectors or advisors or directed trustees, correcting scrivener's errors or ambiguities, creating supplemental needs trust provisions, converting a non-grantor trust to be a grantor trust, or vice versa. Whether a modification or decanting or merger can limit a beneficiary's rights or eliminate a beneficiary or add a beneficiary, is usually a difficult question. Thorny issues regarding judicial versus non-judicial structure, parties entitled to notice and parties entitled to participate all require a fair amount of consideration. Tax planning for the altered or the "new" trust requires consideration of whether a new tax identification number is needed.[38] When the income tax treatment of the trust is being altered as between a grantor trust and a non-grantor trust, consideration needs to be given as to whether liabilities in excess of basis may cause recognition of gain.[39] If the modification/decanting/merger event changes the quality of a beneficiary's

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Culp, Jr., & Briani Bennet Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROPERTY TRUST AND ESTATE L.J. 1, 4 (2010).

[36] A thorough discussion of modification and decanting and the tax, asset protection and other benefits available, can be found in Christopher M. Reimer, *The Undiscovered Country: Wyoming's Emergence as a Leading Trust Situs Jurisdiction,* 11 WYO. L. REV. 165 (2011)

[37] *See*, *e.g.*, Wyo. Stat. §4-10-418 for Wyoming's version of this provision of the Uniform Trust Code.

[38] *See* PLR 200736002, which permits the use of the same EIN for a second trust involved in a decanting transaction that was newly created for purposes of decanting and was the recipient of all assets of the initial trust.

[39] *See Madorin v. Commissioner*, 84 T.C. 667 (1985) suggesting there is risk of recognition of gain from conversion of a grantor trust to a non-grantor trust, and *see* Rev. Rul. 2004-64, 2004-2 C.B. 7, indicating the conversion from non-grantor trust to grantor trust status does not appear to have any income tax consequence.

interest, and the beneficiary's consent (or possibly the court's approval) is required for the decanting, it is possible that the beneficiary may recognize gain.[40] Likewise, if a beneficiary can block a modification/decanting/merger transaction which diminishes the interest of the beneficiary and enhances the interest of another party, failure to object may be deemed a taxable gift by the beneficiary.[41] If so, the beneficiary's taxable estate might nevertheless include the gifted interest under any one of Internal Revenue Code sections 2035-39 or 2042.[42] Alteration of a trust that was irrevocable on September 30, 1985 risks loss of the grandfathering from generation-skipping transfer tax unless the law of the state governing the trust at the time of its creation permitted the type of decanting or other transaction that caused any kind of extension of the period for vesting of a beneficial interest, and providing that any such extension does not go beyond the permissible perpetuities period permitted pursuant to such law of origin.[43] Another issue to consider in addition to tax questions is whether a change of name of the trust might require re-titling of trust assets.

IX.
MAKING A GIFT OF A SPECIFIC VALUE WHEN THE VALUE IS NOT KNOWN

There is an inherent problem associated with the gifting of an asset that does not have a readily determinable market value. Title needs to transfer on a specific date. An appraiser needs to know the specific date for valuation purposes. The appraiser cannot produce an appraisal on the very date of the gift and can take weeks or months in order to produce an appraisal report. If the donor's intention is to make a gift of a specified dollar amount, such as a $14,000 annual exclusion gift or a $5,250,000 lifetime exemption gift, how does the donor know the amount of property to give? Backdating the gift documents after the appraisal amount is known usually is not a very good idea.[44] The client does not always have the luxury of making a gift early in the year, obtaining an appraisal to determine the value of the gift, and then gifting the balance of the lifetime exemption or annual exclusion amounts through the making of a further gift prior to the end of the year. The client would like to come as close as possible to utilizing all of the exclusion and/or lifetime exemption, especially last year when the exemption looked like it might turn out to be "use it or lose it," but most clients do not want to go a penny over the limit. How can this chicken and egg problem be solved?

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[40] This has been suggested as a possible application of the doctrine of *Cottage Savings Association v. Commission,* 499 U.S. 554 (1991), *see* Blattmachr*, An Analysis of the Tax Effects of Decanting,* 47 Real Property, Trust & Estate Law Journal 141 (Spring 2012).

[41] See Blattmachr, s*upra*, pages 160-164.

[42] See Blattmachr, s*upra*, pages 164-165.

[43] Treas. Reg. §26.2601-1(b)(4)(i)(A). An alternative would be that the alteration of the trust not shift a beneficial interest to any beneficiary occupying a lower generation and the trust alteration does not extend the time for vesting beyond that established initially in the trust.

[44] *See*, for example *Cross v. State,* 221 P.3d 972 (Wyo. 2009). See Section XI of this paper below regarding backdating in general.

<u>A (Relatively) Simple Solution.</u> The logical solution would seem to be to simply give "$14,000 worth of XYZ Corp stock," rather than to give a specified number of shares. In other words, a possible solution might be to define and denominate the gift in terms of a dollar value rather than in terms of a quantity of the donated property itself. Documentation to define a gift according to its value rather than its physical quantity is known in the literature as the use of a "defined value" clause. Defined value clauses may be commonly used by taxpayers to limit the amount of a gift that is subject to gift tax. In general, a defined value clause is intended to limit the amount of assets gifted or sold to the specified dollar value of the gift or sale. A defined value clause should be as valid as other value definition formulas which are used in similar gift tax contexts, e.g. formula pecuniary marital gifts, formula disclaimers, GRAT revaluations, etc.

It is important to understand the reasoning behind the various courts' analyses of valuation clauses and the distinction between an acceptable "valuation clause" and a "price adjustment clause" which is frowned upon at least one court.

Price Adjustment Clauses

In *Procter v. Commissioner*[45], the Fourth Circuit Court of Appeals held that a price adjustment clause did not operate to fix the value of a gift. The Fourth Circuit court of appeals concluded that a price adjustment clause was contrary to public policy for three reasons. First, the clause discourages the collection of tax by the tax agency because the only effect of an attempt to enforce the tax would be to defeat the gift. Second, the effect of the clause would be the obstruction of the administration of justice by requiring the courts to pass on a moot case. Third, the court stated that the final judgment of a court would be rendered meaningless because of the consequence of the clause. Unlike in *Procter*, where the transferor transferred a <u>specified quantity</u> (i.e. the entire vested remainder interest of Mr. Procter in the two trusts he assigned in further trust for the benefit of his children), rather than a <u>specified dollar value</u>, of the asset in question, this defined-value type of clause does not attempt to adjust or defeat or take back the gift that was made, but instead simply does not make the excess gift in the first place. Permitting this type of clause does not discourage taxation or investigation by the Service. If anything, any recalculation of transferred stock or LLC interest merely defers taxation by including any remaining amount later in the taxpayer's gross estate. Indeed, due to the inclusive versus exclusive nature of the estate and gift tax respectively, the Service is likely to collect more tax through the estate as compared to what might have been collected through the gift and the Treasury thus would be enriched by a successful audit even though no current tax revenue might be collected.

[45] 142 F.2d 824 (4th Cir. 1944).

The Tax Court in *Estate of Christiansen*[46] specifically distinguished the *Procter* case and determined that the three reasons cited in *Procter* were not applicable.[47] As to reasons (2) and (3) in *Procter*, the Tax Court's reasoning in *Christiansen* is applicable to defined value clauses generally:

> This case is not Procter. ... If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

Defined Value Clauses

Rather than fixing the quantity upon the initial transfer of a gift, a defined value clause initially fixes only the dollar value of the asset sold or gifted. The exact quantity of assets transferred remains uncertain until values are finally determined. In a basic defined value clause, the excess over the defined value amount remains with the donor. In the event that the value of the assets used as the basis for the original transfer is later determined to be incorrect, the quantity of the assets originally transferred must be corrected to the extent an incorrect quantity may have been previously reported or relied upon. This can be accomplished by rescinding any formal transfer of the excess or retrieving the appropriate amount of assets by the donor asset custody was incorrectly shifted. Alternatively, the excess amount in several reported cases involving defined value clauses was to be transferred to a charity. Any deficiency in the quantity of assets transferred to satisfy a defined value gift or sale could be similarly resolved.

Defined value clauses that allocate property transferred among two or more transferees have been condoned by the courts. In *Succession of McCord*[48], the taxpayers each transferred a 47% interest in a limited partnership to (1) their sons, (2) trusts for their sons and (3) named charities. The assignment executed by the taxpayers effectuating the transfers stated that the portion of each gift that was to be given to the sons and to the trusts was that portion of the 47% interest that had a $3.4 million dollar value. Said otherwise, the taxpayers made a $3.4 million dollar defined value transfer. The excess was to pass to charities. The donees, including the charity, were responsible for allocating the transferred limited partnership interests among themselves. Under these circumstances, the Service argued that the valuation allocation clause should not be respected because (1) principles of *Procter v. Commissioner* applied and (2) the various steps were all part of a plan designed to limit the share that went to the charities and to deliver the balance of the property to the taxpayers' sons and their trusts. Declining to adopt the Commissioner's arguments, the Court held that the allocation clauses were valid, stating that the plain wording of the assignment agreement established the value of

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[46] *Estate of Christiansen*, 130 T.C. 1 (2008).
[47] *Id*.
[48] 461 F.3d 614 (5th Cir. 2006).

the partnership interests transferred. Similar outcomes followed in *Estate of Christiansen*,[49] *Estate of Petter*,[50] and *Estate of Hendrix.*[51]

The fact that a charity receives additional (or fewer) amounts of the gifted assets when the original valuation is determined to be too high (or too low) is not determinative of the efficacy of this method of defining the gift. It is important to note that under the facts of each of the above cited cases, the donee received the same "value." It is an ancillary fact of no relevance whatsoever to the donee that the charities may have received more (or less) and that an adjustment to the charitable deduction may have been reported by the donor or his estate. These conclusions are also supported by the Tax Court's decision in *Estate of Petter v. Commissioner.*[52] In *Petter*, the taxpayer transferred membership units in an FLLC (1) in part as a gift and in part as a sale to two separate trusts and (2) to two separate charitable foundations. The transfer documents included a defined value clause which assigned to the trusts a number of the LLC units worth a specified dollar amount and assigned the remainder of the units to the foundations. The transfer documents also contained a reallocation clause which obligated the trusts to transfer additional units to the foundations if the value of the units the trusts received initially was determined for gift tax purposes to exceed the specified dollar amount. Based upon an initial appraisal of the LLC units, each foundation received a particular number of units. But, after audit, the Service determined that the units had been undervalued. To the extent they were undervalued, the foundations were entitled to receive additional units. With respect to the gifts that were given in the case, the relevant sections of the gift document provided:

> C. Transferor wishes to assign 940 Class T Membership Units in the Company (the “Units”) including all of the Transferor’s right, title and interest in the economic, management and voting rights in the Units as a gift to the Transferees.
> ***
>
> 1.1 Subject to the terms and conditions of this Agreement, Transferor:
>
> 1.1.1. assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the [maximum]dollar amount that can pass free of federal gift tax by reason of Transferor’s applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and

[49] *Estate of Christiansen*, 130 T.C. 1 (2008).
[50] T.C. Memo. 2009-280.
[51] T.C. Memo. 2011-133.
[52] T.C. Memo. 2009-280, aff'd (9th Cir. 2011).

> 1.1.2 assigns to The Seattle Foundation as a gift the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.[53]
>
> 1.2 The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.[54]

It is important to note that the understanding of the parties in *Petter* was that if the net fair market value of the units had been incorrectly determined, then within a reasonable period after the fair market value is finally determined for federal gift tax purposes, the number of units transferred was to be adjusted as soon as was practicable.[55] Further, in *Petter*, it was stipulated by the parties that the *original* charitable deduction should be allowed. The issue in *Petter* became whether the taxpayer's estate should be allowed a charitable deduction on the *additional* units transferred to the charity as a result of a reduced valuation. The Commissioner argued that the formula clauses were void because they violated public policy. However, the 9th Circuit affirmed the Tax Court and held that the formula clauses were not in violation of public policy. It would make little sense for the Treasury and the Service to create a situation whereby taxpayers may only use a defined value clause if they make a corresponding gift to charity. Whether any excess of any gift goes to a charity has little to do with whether such a clause is void for public policy.

The Tax Code should not be allowed to define when a gift is made or the nature and extent of the property interest given under State law. In *Commissioner v. Estate of Bosch*,[56] the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. The Colorado State Supreme Court has spoken multiple times on what constitutes a gift in Colorado and has indicated that a gift cannot be made unless there is intent to make a gift. The clear definition of the intent-based rights of the donor/seller and donee/buyer provided under Colorado law cannot be superseded by some public policy of perceived greater importance. Unless there is a federal constitutional issue associated with the claim by the IRS that it should not be deprived of immediate and current gift tax revenues (while nevertheless gaining deferred but potentially greater estate tax revenues), then federal law and federal officers must respect the attributes bestowed

[53] T.C. Memo 2009-208 at pg. 12.
[54] *Id*.
[55] T.C. Memo 2009-280 at 13.
[56] 387 U.S. 456, 87 S. Ct. 1776, 18 L. Ed. 2d 886 (1967).

upon a transaction by state law. The concerns by the IRS about its incentive to audit were not even recognized as correct or legitimate in *Christiansen*, let alone as having a constitutional magnitude.

Use of Defined Values in Other Transfer Tax Areas

The Internal Revenue Service should not prohibit the use of a defined value clause in the narrow area of gifting when it has condoned the concept of such clauses in other areas of tax law. Defined value concepts are established and accepted in several instances in the transfer tax area.

1. Marital Deduction and Bypass Trust Funding.

One area in which defined value clauses are used is where taxpayers divide assets between a bypass trust and the marital share or trust in a manner to avoid any out-of-pocket estate tax liability, and these types of value allocation clauses have been administratively accepted by the IRS for decades. Estate planners have devised numerous ways in which to draft formula marital deduction clauses that are designed to minimize the overall tax burden on an estate. In short, the goal of such clauses is to pass sufficient assets to the surviving spouse that qualify for the marital deduction, such that the taxable estate will equal the applicable exclusion amount. The tax imposed on the estate will equal the amount of applicable credit so that no federal estate tax is payable. The most commonly used formula for optimizing the marital deduction is a pecuniary formula. Once the amount of the marital deduction is determined, the personal representatives or trustees must value the assets to be used to fund it. Courts do not find such clauses to improperly thwart the collection of tax or the incentive to audit. This use of such formula planning at death has long been condoned by the IRS. Specifically, Rev. Proc. 64-19 sanctioned pecuniary funding based on estate tax values if the personal representative does not have the discretion to distort the value of the property passing to the surviving spouse.[57] To require taxpayers to distinguish between (1) a bequest to a surviving spouse of a pecuniary amount that results in the smallest amount necessary to eliminate estate tax, and (2) a gift of an asset that has a similar specific defined pecuniary value, would be meritless.

2. Disclaimers

Disclaimers are also expressly allowed to be structured in terms of a fixed dollar or pecuniary amount or a fractional share. Indeed, disclaimers using defined valuation

[57] See Rev. Proc. 64-19.

formulas can indirectly accomplish the same type of "capping" of gift tax liability as is used more directly with defined value clauses in gift or sale transactions.

In *Estate of Christiansen v. Commissioner*,[58] a sole beneficiary fractionally disclaimed all of an estate in excess of $6,350,000. The disclaimed assets passed 75% to a charitable lead annuity trust and 25% to a foundation. With respect to the 25% that passed to the foundation, the Service argued that such disclaimers fail to preserve a financial incentive for the Commissioner to audit an estate's return. Under such a disclaimer, argued the Commissioner, any future adjustment to the value of an estate would only result an increased charitable donation.[59] Because no possibility of increased tax receipts would exist under this scenario, the Commissioner argued that there is no incentive to audit the return and ensure accurate valuation of the estate.[60] As such, the Commissioner argued that a policy supporting audits as a means to enforce accurate reporting requirements required disallowance of fixed-dollar-amount partial disclaimers because of the "potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."[61]

While the Court indicated that it agreed with the Commissioner that allowing such disclaimers may marginally detract from the incentive to audit estate returns, it rejected the IRS's argument. For several reasons, the Court disagreed with the Commissioner's argument that the Court must interpret the statute and regulations in an effort to maximize the incentive to audit.[62] First, the Court noted that the Commissioner's role is not merely to maximize tax receipts.[63] Rather, the Court found that the Commissioner's role is to enforce the tax laws.[64] Secondly, the Court found no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevance of having a charitable beneficiary as the recipient of any excess value was relegated to an "even if" analysis in the event these two findings were incorrect.

Due to the nebulous nature of valuations and the arguments that are often made by the Service in relation to such valuations, donors may seek to execute a gift defined by value in order to avoid the possibility of making an unintentionally larger or smaller gift. If there is a reason to be concerned about the possibility of a challenge by the IRS, that is one of the reasons why they may wish to characterize their gift in terms of value (as

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[58] *Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009).
[59] *Id*. at 1064-1065.
[60] *Id*.
[61] *Id*.
[62] *Id*.
[63] *Id*.
[64] *Id*. citing IRC § 7801 (a)(1) ("[T]he administration and enforcement of [the Tax Code] shall be performed by or under the supervision of the Secretary of the Treasury."); § 7803(a)(2) ("The Commissioner shall have such duties and powers as the Secretary may prescribe, including the power to (A) administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes and tax conventions to which the United States is a party . . . .").

opposed to a number of shares or percentage of LLC membership interest or fraction of real estate. Taxpayers are entitled to account for and minimize taxes in their planning, and to arrange their affairs with an eye toward keeping their taxes at a level consistent with their intentions.[65]

The above several pages regarding defined value gifts were authored prior to the Tax Court decision in *Wandry v. Commissioner,* T.C. Memo 2012-88 (March 26, 2012). The IRS issued an Action on Decision which non-acquiesced in *Wandry* on November 13, 2012. The IRS initially appealed to the 10th Circuit and then withdrew its notice of appeal and allowed the case to stand. Attorneys Steven Anderson and Richard D'Estrada from Littleton, Colorado won a great victory, based upon formula language that had been utilized by Highlands Ranch resident Albert Wandry, and convinced the Tax Court that a defined value clause couched in terms of dollars rather than units of entity ownership without any sort of charitable backstop was effective to make a gift at the defined value. The formula provided that a gift was made of "a sufficient number of my Units as a Member… so that the fair market value of such Units for federal gift tax purposes shall be (specified dollar amounts)." The Assignment and Memorandum of Gifts included an additional paragraph that declared that "the number of Units gifted is fixed as of the date of the gift," based on fair market value, but the same cannot be known as of the date of the gift and furthermore any such valuation would be subject to challenge by the IRS and would perhaps need adjustment "… in the same manner as a federal estate tax marital formula deduction amount would be adjusted for a valuation determination by the IRS and/or a court of law." The floodgates were opened just in time for the mass gifting frenzy that took place at the end of 2012. Countless numbers of those year-end undoubtedly took place pursuant to formula, and the IRS reaction to the same likely will be forthcoming in the near future.

X.
DETERMINING THE TYPE OF DEED TO USE FOR ESTATE PLANNING TRANSFERS

Most professionals are aware of the basic difference between a warranty deed and a quitclaim deed. A somewhat lesser number may be aware of the attributes of a "special" warranty deed which warrants title against any claims arising through the grantor but not through the grantor's predecessors in title. Most attorneys and others have a standard form of deed that they use, and I have to say that I see far too many quitclaim deeds being used in situations where warranty deeds would be far more appropriate. A quitclaim deed has the benefit of relieving the grantor of any liability whatsoever with respect to any title problems or defects, but sometimes in estate planning and business

[65] *See Gregory v. Helvering* 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

transactions, the far wiser approach would be to allocate the risk to the grantor rather than the grantee.

When a deed is being used to fund a revocable trust, or to transfer family property to a family limited partnership or family LLC, a warranty deed often is the preferred choice and the draftsman of a quitclaim deed may be harming his or her client by using a quitclaim deed.

In an unpublished case, the insured transferred his Wyoming ranch to a trust by quitclaim deed.[66] The court held the "policy clearly and unambiguously limited coverage to [the insured] and his heirs, devisees, and personal representatives, which, according to Wyoming law, did not include the . .. Trust." *Id.*

In an unpublished decision from Michigan, the court held that because the title insurance policy only protected the grantor, the policy terminated when the entire title interest was transferred "by quit-claim deed to another person."[67] The plaintiff contended that because the transfer was made only for estate tax planning, that it should not terminate the policy.[68] However, the court considered that argument "without merit," and that the law does not recognize the plaintiffs "proposed dual interest in property, one for . . . [IRS] purposes and the other for all other legal purposes."[69]

The 2006 ALTA form of title insurance policy may no longer cut off title insurance in such a case, but all prior policy versions did so. The 1970 and 1992 ALTA owner's title policies for their definition of "insured" included "those who succeed to the interest of such insured by operation of law," in distinction to those who succeeded as a result of a purchase or voluntary conveyance. The new 2007 ALTA owner's and loan policies recognize as an "insured" certain "voluntary" conveyances by the named insured that are made without receipt of valuable consideration, including (in the owner's policy) where the grantee is the trustee or beneficiary of a trust established by the named insured for estate-planning purposes. Most clients as this point will present themselves to a planner with property that has been owned for more than six years, and thus the use of a quitclaim deed risks the loss of title insurance. By use of a warranty deed, the grantee trust will have a claim against the grantor, who in turn may call upon the title insurer to defend and indemnify with respect to any insured defect in title.

XI.
BACK-DATING DOCUMENTS "AS OF" A PRIOR DATE

66 *Covalt v. First American Title Ins. Co.*, No. 96-8049, 1997 WL 4273 (10th Cir. Jan. 7, 1997) (unpublished).
67 *General Medicine, P.C., v. Metropolitan Title Co.*, No. 216012, 2001 WL 721359 at 2-3 (Mich. App. Mar. 2, 2001) (unpublished).
68 *Id.* at 3.
69 *Id.*

Most lawyers have on more than one occasion drafted a document that is dated "as of" a particular date that may have come and gone before the document is actually signed by all parties to the document. To the lay person, backdating connotes wrongdoing, which unfortunately provides an explanation to a large portion of the population as to why lawyers do it. Certainly any backdating that actually fabricates an event that never happened is improper, and there are multiple cases so holding as to backdated documents intended to make unconditional receipts appear to be loans,[70] assignment of rights to a different party rather than the one actually holding the rights,[71] to claim tax deductions,[72] etc. The same level of impropriety exists even when the event described by the backdated document actually occurred, albeit at a date subsequent to the date reflected in the backdated document. This frequently occurs when the backdating attempts to show that a transfer took place before rather than after a creditor claim arose against the transferor.[73] Accelerating the date of a document can also accelerate recognition of revenue for financial statement reporting purposes or for receipt of the benefit of an earlier, lower, tax bracket.[74] When deadlines are missed for tax reporting purposes, backdating might make it appear that the taxpayer qualified for special treatment that otherwise might not have been available; this for example occurs when the 45 day time period for the identification of replacement property is missed in connection with a 1031 like-kind exchange of real estate.[75] All such conduct is clearly wrongful.

On the other hand, backdating that simply memorializes an event that occurred and actually transpired on the earlier date, is not a fabrication and simply memorializes the earlier event. This of course is always the primary defense of a party accused of improper backdating and thus it is a very fact-laden inquiry to resolve any questions of propriety that subsequently arise. Examples of proper backdating include the execution of corporate minutes that memorialize a meeting that actually occurred at an earlier date, and some states even provide statutory permission to allow subsequent written consents to be described as if involving participation in an earlier actual meeting.[76] Courts recognize that backdating can be appropriate to memorialize a prior event that actually

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[70] *United States v. Wilson,* 118 F.3d 228, 281-232 (4th Cir. 1997) (involving an attorney's effort to conceal a client's assets from the IRS by backdating promissory notes to make it appear that the client was obligated to repay funds that actually had been received unconditionally).

[71] *Quick v. Samp*, 697 N.W.2d 741, 743 (S.D. 2005) (involving a malpractice suit against a lawyer who backdated a document to make it appear that a corporation had assigned contractual rights to the sole shareholder in order to cover up the attorney's error in naming the shareholder rather than the corporation as the plaintiff in a breach of contract suit).

[72] *Medieval Attractions N.V. v. Commissioner,* 72 T.C.M. (CCH) 924, 937-44 (1996) (involving an effort to claim tax deductions by backdating in order to make it appear that intangible property had been transferred to a related party so that payments to the related party could be treated as deductible royalty payments).

[73] *See Committee on Professional Ethics & Conduct of the Iowa State Bar Association v. O'Donohoe,* 426 N.W.2d 166, 169 (Iowa 1988).

[74] *U.C. Castings Co. v. Knight*, 754 F.2d 1363, 1370-71 (7th Cir. 1985).

[75] *Dobirch v. Commissioner,* 1999 W.L. 650572 (9th Cir. 1999).

[76] *See, e.g.,* WYO. STAT. § 17-16-704(c).

occurred.[77] Backdating which fabricates as opposed to backdating which memorializes are not always easy to distinguish. Often it is not entirely clear when a contract arises, for example, if the backdating was intended to memorialize the agreement, primarily because an agreement will evolve over time through a series of negotiations and the precise date on which the agreement is reached may not be readily apparent. The presence of a contingency also may cloud the legal issue of when an agreement first came into legal existence; if treated as a "condition precedent" the contract did not yet exist, but if treated as a "condition subsequent," the contract came into existence but its continuation was threatened by the contingency.[78] Whether backdating fabricates or memorializes the conveyance of property raises troublesome questions because it is not always clear when the transfer of ownership occurs. For transfer of realty, the transfer is not complete until there is "delivery," and that is a fact question. For tax purposes, ownership often is found by courts to have occurred even before a deed was delivered.[79] Courts typically consider when the economic benefits and burdens of ownership have transferred, whether conditions precedent exist and have been satisfied, whether there is uncertainty regarding the property and whether a purchase price has been paid.[80] Finally, the facts simply may be uncertain because records are ambiguous, memories are incomplete and subject to human frailty, information provided by others may be less than reliable or truthful, etc. What, then is a draftsman of a document or a party who is completing the form to do?

One easy principle is that parties to an agreement can make their agreement effective on whatever date they wish, provided that no third party rights are compromised by the action.[81] An employment agreement can be backdated to whatever date the employer is willing to be liable for the payment of salary, a lease can be backdated to whatever date from which the tenant is willing to be obligated to pay rent, and an insurance policy can be backdated to whatever age the insurer and insured can agree with respect to premium payment liability and mortality risk adjustments, etc. As long as no laws are violated and no third parties are harmed, such a backdated agreement will be enforced even if the backdating harms the parties involved.[82] Such backdating must have neither a bad purpose nor a bad effect as to third-parties or the law.

Should backdating be disclosed? A backdated document inherently has potential to mislead a court or government agency into believing it was executed on the date the

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[77] *United States v. Micke,* 859 F.2d 473 (7th Cir. 1988) ("if the [deal had been agreed on in December rather than January] the backdating was legitimate and the returns were not fraudulent . . ."); *Baird v. Commissioner,* 68 T.C. 115 (1997).

[78] *See* 13 Williston & Lorde, A TREATISE ON THE LAW OF CONTRACTS, §§ 38:4, 38:7, 38:10.

[79] *See, e.g., Commissioner v. Union Pacific R.R. Co.*, 86 F.2d 637, 638-39 (2nd Cir. 1936). *Baird v. Commissioner, supra; Pomeroy v. Commissioner,* 54 T.C. 1716, 1724-26 (1970).

[80] *See* Alex Raskolnikov, CONTEXTUAL ANALYSIS OF TAX OWNERSHIP, 85, B. U. L. Rev. 431 (2005).

[81] *See* 2 Williston & Lorde*, supra,* § 6:61

[82] *See, e.g., American Cyanamid Co.,* 286 S.E.2d 2 (1983); *Diamond International Corporation v. Glad,* 330 N.W.2d 526 (S.D. 1983).

event occurred. Disclosure of the backdating would mitigate this, and would mitigate the possibility of unintended harm to a third party and would clearly refute any claim of intent to deceive. The most straightforward way of disclosing the backdating is for the document to identify the date or dates on which it was actually executed. This does risk the creation of ambiguity to the extent it is not crystal clear that the earlier date is intended to govern for all purposes in spite of the later listed date of execution.[83] This type of approach appears to be somewhat rare and apparently not the accepted practice.[84] The more common approach is the utilization of "as of" dating. Courts have confirmed that "as of" dating avoids accusations of an attempt to mislead.[85] Use of "as of" dating is neither correct or incorrect as a drafting technique *per se*, but rather the purposes for which the technique is utilized will determine its propriety. So long as it is simply a memorialization of a prior event with no intent to deceive or harm a third party or otherwise would be known not to affect the rights of a third party or violate a law, backdating in this manner would be appropriate. When backdating occurs, it should always be disclosed, utilizing "as of" dating being the most appropriate method of disclosure in most cases. The draftsman of the backdated documents should never turn a blind eye toward the possibility that claims of the occurrence of the prior event may be untrue and diligence should be utilized to critically evaluate the evidence presented to the draftsman before a conclusion is reached as to when the event actually occurred.

XII.
HOW TO AVOID COLORADO INCOME TAX

A significant portion of my law firm's practice involves assisting others with the migration of their trusts, business entities, or entire family to Wyoming in order to escape the tax authorities in the state of their former residence. A few of the new Wyoming residents are fugitives from Colorado; far more are fugitives from California. Some have migrated to Wyoming for non-tax reasons related to favorable laws, but the predominant motivation is related to taxation.

For non-resident individuals who wish to subject some or all of their income to taxation at the Wyoming rate, there are limited opportunities. Pass-through taxation of partnership-type entities and grantor trusts thwart any benefit of having the entities or trusts domiciled in Wyoming. Although "C" corporations domiciled in Wyoming may escape Colorado corporate taxation, the more compressed federal brackets and the double taxation issues, coupled with the likelihood of the payment of state income tax on any dividends, have caused this type of migration to be a relatively rare occurrence. So what can a Colorado resident do?

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[83] *Sweetman v Strescon Industries, Inc,* 389 A.2d 1319 (Del. Super. Ct. 1978).
[84] *See* Kwall & Duhl, BACKDATING, 63 Bus. Law. 1153, 1177 (2008).
[85] *In re Blazina*, 1999 W. L. 802836 (Ill. Attorney Registration & Disciplinary Commission, 2/25/1999); *Moore v. Commissioner, supra.*

One alternative is the establishment of a "WING" trust (**W**yoming **I**ncomplete **N**on-**G**rantor trust). This type of trust will permit the earnings produced by the trust assets to be taxed at Wyoming rates, provided that the earnings are not distributed to a non-Wyoming beneficiary in a manner that carries out the earnings. Some states have a look-back rule that will tax the beneficiaries if they are distributed earnings in a later year.[86] A WING (or DING or NING or similar variation) needs to be in the form of a domestic asset protection trust; if the trust assets are subject to the claims of the settlor's creditors, then grantor trust status can be triggered.[87] Only 12 states permit this kind of a trust, and an even fewer number of states combine the authorization of this type of trust plus the absence of state income taxation, and only one such states shares a border with Colorado. The primary concern of most settlors of WINGs is how they might be able to benefit themselves from trust distributions without losing the non-grantor trust status. Under Internal Revenue Code § 677, a trust will be a grantor trust if trust income, without the approval or consent of an adverse party, may be distributed to the settlor or the settlor's spouse or held or accumulated for future distribution to the settlor or the settlor's spouse. This section also applies if the income can be utilized for payment of premiums for life insurance on the life of the settlor.[88] Also, the grantor of the trust obviously does not want to have a reversionary interest that would trigger grantor trust taxation under Internal Revenue Code § 673, would not want to have a power to control beneficial enjoyment that would trigger grantor taxation under Internal Revenue Code § 674, and would not want to have a power to revoke the trust which would trigger grantor trust taxation under Internal Revenue Code § 676. In addition to being a non-grantor trust for income tax purposes, in most cases the settlor does not want the trust to be a completed gift.

The broader approach to avoidance of Colorado income tax on non-Colorado source income would be to change residence to a non-taxing state such as Wyoming. Under Colorado law, income taxation is applicable to all income of a "resident individual," which is defined as a person domiciled in Colorado, or a person who maintains a permanent place of abode within Colorado and spends in the aggregate more than six months of the taxable year within the State of Colorado.[89] With respect to any test involving physical presence, the key is not that the individual be present in Wyoming more than six months, but rather that the individual be absent from Colorado more than six months. Even in such a case, Colorado law would still tax the income of an individual if the individual has a "domicile" in Colorado. The difference between domicile and residency is slight, but the differences are typically critical under the tax laws of many states. Individuals can establish residency solely by acts of habitation in a

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[86] For example, California has a five year look-back period in determining whether the income that was previously taxed to the trust at the federal level should also be taxed as California income when received by the beneficiary.

[87] Treas. Reg. § 1.677(a)-1(d) states that a trust will be a grantor trust if the grantor's creditors may satisfy claims against the grantor out of the trust's assets.

[88] I.R.C. § 677(a)(3); Treas. Reg. § 1.677(a)-1(b)(2)(iii).

[89] C.R.S. § 39-22-103(8)(a).

particular place.[90] Domicile, on the other hand, is difficult to define, but the law generally considers it the place of residence with the additional element that there be an intention to remain there permanently.[91] A person may have multiple residences (or none at all in some cases), but each person must have exactly one place of domicile at any given time.[92] The legal distinction in practice is not always apparent. In decisions, particularly in cases concerning venue, courts tend to use the terms synonymously.[93] In order to change domicile, three essential elements need to be proven; (1) definite abandonment of the former domicile; (2) actual removal to, and physical presence in, the new domicile; and (3) a *bona fide* intention to change domicile and remain in the new location permanently or at least for an indefinite amount of time.[94] Abandonment of the former domicile is perhaps the most difficult element to establish because the former jurisdiction may prove to be a true adversary while the State of Wyoming for the most part (resident college tuition and hunting/fishing licenses aside) will accept an expression of intent and gladly welcome any individual desiring to become a domiciliary of the State. The new physical residence is essential to the abandonment of the former domicile.[95] Simply declaring abandonment of the former domicile with no intent ever to return, followed by extensive travel prior to final settlement in a new location, does not constitute a change of domicile until completion of the travel.[96] This was the result in one case even though mail forwarding was adopted utilizing an address in a new state, driver's licenses were obtained by family members in the new state, a bank account was opened in the new state, vehicles were registered in the new state, voting registration was undertaken in the new state, credit cards were obtained through banks in the new state, etc.[97] Once the old domicile has been abandoned and the new domicile has been acquired, so long as there is an indefinite intention to remain: "A change of residence even for a short time with the intention in good faith to change the domicile has that effect. A day or an hour will suffice."[98] Courts look at many factors, and change of driver's license and voter registration is often far less important than the more "real" day-to-day aspects of life and the apparent involvement of a person in the new community, not the least of which is having a "local" Wyoming attorney.

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[90] C.S. Patrinelis, Annotation, *Relationship Between "Resident" and Domicil" Under Venue Statutes,* 12 A.L.R.2d 757, § 2 (1950).

[91] Kossuth Kent Kennan, *A Treatise on Residence and Domicile* 1-7 (1934). Early attempts at definition are often more contradictorily worded, such as "permanently at least for a time." *Id.* 18.

[92] Restatement (Second) of Conflicts of Laws § 11 (1971).

[93] Patrinelis, *supra*, § 3.

[94] Kennan, *supra*, at 194.

[95] *Schultz v. Chicago City Bank Trust Co*, 51 N.E. 2d 140 144 (Ill. 1943).

[96] *Stubbs v. Stubbs*, 211So. 2d 821, 825 (Miss. 1968).

[97] *Id.*

[98] *Bonneau v. Russell*, 117 Vt. 134, 137 (1952).