FUNDING TESTAMENTARY TRUSTS:
TAX AND NON-TAX ISSUES

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State Bar of Texas
19th ANNUAL
ADVANCED ESTATE PLANNING STRATEGIES COURSE
April 4-5, 2013
Santa Fe, New Mexico

CHAPTER 5.2

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· Author/Speaker: Update on Administering 2010 Estates–What Have We Learned So Far?, State Bar of Texas 35th Annual Advanced Estate Planning and Probate Course, 2011; Houston Business and Estate Planning Council, 2011; Texas Society of CPAs Advanced Estate Planning Conference, 2010.

TABLE OF CONTENTS

FUNDING TESTAMENTARY TRUSTS

I. INTRODUCTION.

The goal of this outline is to provide you with practical advice about issues that arise when funding various gifts made under testamentary transfers, especially upon a first spouse's death. Specifically, the outline reviews the thought process to be used when deciding (i) which assets to allocate to which gift, (ii) how to allocate post-death appreciation and income, and (iii) how to make sure that the executor documents and implements the funding. The focus of the outline is on how to fund gifts made under a Will which is designed to achieve the optimum federal estate tax marital deduction by the use of a formula. These gifts typically involve dividing the bulk of a married person's estate into two portions, one qualifying for the federal estate tax marital deduction, and one designed to be sheltered from estate tax by the testator's unified federal estate tax exemption. Of course, bequests made under Wills (and trusts used as Will substitutes) come in a variety of forms, from specific bequests of assets or specific sums of money, to gifts of fractional interests, to gifts of present and future interests in property. While this outline focuses primarily on marital deduction and bypass gifts, many of the ideas discussed will apply to funding issues that may arise in any estate.

A. Overview.

The outline begins by reviewing the concept of probate and non-probate assets to identify which assets are available to fund testamentary gifts. It then discusses the various changes that occur in probate assets during a typical estate administration, and the impact of those changes on the gifts described under the Will. Next, the outline examines the impact of the Texas Probate Code on allocations of estate income and expenses. The discussion then moves to the topic of "optimal" marital formulas, and notes the often-conflicting goals with which estate planning professionals struggle in designing and implementing these formula gifts. The various formulas commonly used in estate planning are then reviewed, and the competing advantages and disadvantages of these various approaches are noted. Having identified the various formulas that one might encounter in funding the formula bequests in a Will, the outline then reviews the rationale that estate advisors should consider in deciding specifically which assets to select in funding the bypass and marital gifts. Other important tax consideration that arise when funding these gifts and terminating the estate are noted. Finally, specific steps in funding and sample funding documents are reviewed.

B. Scope.

This outline is not designed to help one select the "best" formula to use in designing an estate plan. Rather, the outline assumes that this decision has been made. The material is intended to help the estate planning professional identify which of the numerous approaches the drafter of the Will has selected for the particular estate in question. Having identified the formula, the outline then suggests issues to consider in selecting among the various assets subject to administration to transfer in satisfaction of each bequest. While the outline typically speaks of formulas in a decedent's Will, the analysis generally applies as well to estate planning undertaken by use of a revocable inter vivos or "living" trust used as a Will substitute. The outline then briefly addresses a number of other issues associated with the selection of particular assets to fund various gifts, including the practicality of the mix of assets funded into any given trust; problems associated with the use of pass-though entities in funding trusts (and especially when funding trusts which must distribute all of their income on a current basis); and the subjective preferences of the various beneficiaries of the estate, both current and remainder.

II. IDENTIFYING WHICH ASSETS ARE SUBJECT TO THE WILL.

A. Probate vs. Non-Probate Assets.

In order to fund gifts made by the Will, the executor must first identify which assets are within his or her control. Estate planning professionals know that while a variety of assets may transfer wealth as a result of a client's death, only some of those assets will be controlled by the terms of the decedent's Will. This fact often comes as a surprise to many executors (and beneficiaries).

1. <u>Non-Probate Assets.</u>

When an individual passes away, there are a number of assets which are not controlled by the terms of the decedent's Will. These assets typically involve contracts, beneficiary designations, or other arrangements which identify the recipient of the assets. Broadly speaking, non-probate assets fall into three categories.

a. Life Insurance.

The passage of life insurance proceeds is not governed by the terms of the Will, unless the policy is payable to the estate or the executor in that capacity. Instead, the person entitled to life insurance proceeds is the person identified as the "beneficiary" on the application for insurance (or subsequent change-of-beneficiary designation). Thus, if the decedent dies owning a contract of life insurance payable to his spouse or to a child, the executor of the decedent's estate typically has no control over those life insurance proceeds, and may not utilize the insurance proceeds to fund the various gifts established by the Will.

b. Retirement Accounts.

A whole host of assets broadly described as "retirement accounts" pass by the beneficiary designation that the decedent has established for those funds. These assets include pension plans, profit sharing plans, IRAs, 401(k)s, KEOGH plans, SEPs, and similar qualified and non-qualified tax-deferred accounts.

(1) Participant-Spouse's Interest.

While a single participant is generally entitled to name any beneficiary of his or her retirement accounts, special rules apply to married participants. For retirement funds held in retirement accounts subject to ERISA, the benefits of a married participant must be in the form of a joint and survivor annuity payable over the lifetimes of the participant and the spouse unless the non-participant spouse consents to another designation. (Although an employer plan may limit spousal benefits to persons married throughout the one-year period ending on the earlier of the participant's annuity starting date or the participant's death, most plans do not do so.)

(2) Non-Participant Spouse's Interest.

The Texas Supreme Court has held that, although retirement accounts were non-probate assets as to the participant or employee, they are probate assets to the spouse of the participant or employee, to the extent of the spouse's community property interest in those assets. *See Allard v. Frech*, 754 S.W.2d 111 (Tex. 1988). The U.S. Supreme Court ruled, however, that as to retirement accounts governed by ERISA, federal law preempts state community property laws, and the non-participant spouse has no devisable interest in those plans. *Boggs v. Boggs*, 520 U.S. 833, 138 L. Ed. 2d 45 (1997). Since IRAs are not governed by ERISA, Texas common law apparently continues to apply to retirement assets held in that form.

c. Rights of Survivorship.

Chapter XI of the Texas Probate Code deals at great length with so-called "Nontestamentary Transfers." This statute provides a comprehensive set of rules for determining the ownership of assets without regard to the language of the deceased owner's Will. These nontestamentary transfers fall into two broad categories.

(1) Community Property with Rights of Survivorship.

Historically, courts in Texas interpreted the Texas Constitution to provide that community property could not be held with "rights of survivorship." Courts consistently held that upon the death of one spouse, community property assets were divided into two equal shares, one belonging to the surviving spouse, and the other passing as part of the probate estate of the deceased spouse. Written agreements between the spouses to the contrary were invalid. In 1989, the Texas Constitution was amended to permit spouses to own community property with "rights of survivorship." Since this modification to the Constitution, many people now own substantial sums in bank and brokerage accounts in the name of the husband and wife as "joint tenants with rights of survivorship." All of the assets subject to this form of designation pass outright to the surviving spouse, and none pass as a part of the deceased spouse's probate estate. Accordingly, the entire account passes without regard to whether the deceased spouse's Will makes any provision for the surviving spouse. This arrangement can have unfortunate consequences for clients who have established trusts in their Wills to achieve estate tax savings and other objectives. Since the survivorship account assets pass outright to the surviving spouse, they are unavailable to fund the trusts in the decedent's Will (unless post-mortem estate planning steps are undertaken).

(2) Pay on Death, Trustee, and other Survivorship Accounts.

A similar situation arises with accounts which are styled in the name of two depositors who are not husband and wife, who own accounts with "right of survivorship." Tex. Prob. Code § 439. An account styled in the name of one depositor as "Trustee" for another individual, but for which no separate Will or trust agreement establishing a trust exists, passes to that individual on the death of the "Trustee." Tex. Prob. Code § 447. Accounts which are in the name of one depositor but marked "payable on death" or "P.O.D." to another party pass to that party. Tex. Prob. Code § 446. Again, under those circumstances, if one depositor survives the other, or if the P.O.D. payee survives the depositor, the amount in that account passes to the payee regardless of the terms of the deceased account owner's Will.

2. Probate Assets.

The balance of the decedent's assets are generally available to fund testamentary gifts. They are either a part of the probate estate and thus governed by the decedent's Will, or are assets of a "living" trust which contains relevant dispositive provisions. These assets generally include real property, tangible personal property (such as clothing, jewelry, furniture, furnishings, automobiles, and the like), and intangible property (including cash, stocks and bonds and other investment assets not held in a retirement or survivorship account).

B. Non-Probate Assets Used in Funding.

Frequently, when couples establish Wills (or revocable trusts) that include estate tax planning, their estate tax advisor will assist them in identifying non-probate assets, so that they can evaluate how the passage of these non-probate assets will impact upon their estate planning. Under those circumstances, it is not unusual for the estate planning attorney to recommend that the couple review their accounts to ensure that they do not own material assets as joint tenants with rights of survivorship, and do not own "Trustee" or P.O.D. accounts. The goal of this advice is to ensure that the maximum amount of financial assets and cash pass pursuant to the estate plan as set forth in the Will. In addition, the estate planning attorney frequently recommends that the couple modify beneficiary designations so that insurance proceeds become payable to the estate of the insured (or more commonly, to the trustee named in the Will of the insured, or of the "living" trust). A similar beneficiary designation may be made for pension and other assets.

1. Payment to Estate or Trustee.

If the beneficiary designation provides that it is payable to the owner's or insured's estate, or to the "trustee named in the Will," these non-probate assets pass pursuant to the Will. The Will must then include language which directs the executor or trustee to allocate the funds received to the various trusts established by the Will (or to the surviving spouse, to the extent of his or her community property interest). Under these circumstances, although pension and insurance assets are not generally considered probate assets, they will nonetheless flow into the trusts established by the Will, and must be considered when selecting assets to fund the trusts. (Note that for qualified plans, IRAs, and other retirement assets subject to the "minimum required distribution" rules of Section 401(a)(9) of the Internal Revenue Code, designating the participant's "estate" as the beneficiary may limit the ability of the estate's beneficiaries from postponing distributions after the participant's death. Therefore, designating the trustee named in the participant's Will is usually preferable. Either form of payment, however, makes these assets available to fund testamentary bequests.)

2. Contingent Payment to Estate or Trustee.

Many commentators caution that the payment of retirement accounts directly to the account owner's estate or trustee might mean that all unpaid income tax associated with the retirement accounts will become due and payable upon the account owner's death, with limited deferral opportunities. If the account owner is survived by a spouse, he or she may prefer to make those assets payable to the surviving spouse, since the surviving spouse may place those assets in a rollover IRA, and thereby defer income taxation until the surviving spouse withdraws the assets or dies. It is not unusual, however, for the community property one-half of the employee-spouse's non-retirement accounts to be less than the federal estate tax exemption equivalent. In those circumstances, the employee may want to utilize some or all of the retirement accounts to fully fund the bypass trust. Most couples confronted with this situation prefer to wait until the death of the first spouse to determine exactly how much of their retirement assets should be rolled over, and how much, if any, should pass into the bypass trust. In order to provide for this "second look," the estate tax advisor may counsel the couple to name the spouse as the primary beneficiary of retirement accounts, while naming "the trustee named in the participant's Will" as the secondary beneficiary. Upon the death of the account owner, if the spouse is then living, he or she can then disclaim all or part of the retirement accounts, causing the assets so disclaimed to become payable to the trustee. To the extent that the surviving spouse files a qualified disclaimer of retirement accounts, the disclaimed assets will flow into the trusts established by the Will, and can be utilized when selecting assets to fund the trusts. For an excellent discussion of the difficult estate planning choices presented when retirement accounts form a significant part of an estate, see Gerstner, Selected Issues in Estate Administration–Dealing with Qualifed Plans and IRSs, State Bar of Texas 19th Annual Advanced Estate Planning Strategies Course (2013); *see also* Perrin, Beyond the Beneficiary Designation: Drafting for Employee Benefits and Life Insurance, State Bar of Texas Advanced Drafting: Estate Planning and Probate Course (1993).

III. CHANGES IN ASSETS DURING ADMINISTRATION.

A. Payment of Debts and Expenses.

The Texas Probate Code envisions that one of the executor's primary responsibilities during the administration process is the payment of the debts and expenses of the decedent and the estate. In fact, a substantial amount of the Probate Code deals with the procedure for filing claims against estates, the procedure for executors to evaluate and pay those claims, identification of assets used to pay claims, and the order in which the bequests "abate" or are diminished to the extent that assets are used to pay debts and expenses. *See* Tex. Prob. Code §§ 294-330. Thus, part of the process in administering an estate is insuring that all debts of the decedent are paid or provided for to the extent that the estate has the resources to do so. Obviously, to the extent that assets are used to pay estate creditors, they are unavailable to fund testamentary gifts.

B. Apportionment of Taxes.

In those estate in which estate or inheritance taxes are owed, some assets of the estate will necessarily be utilized in paying those taxes. In the absence of specific instructions contained in the Will to the contrary, the Texas Probate Code sets forth an elaborate mechanism to allocate taxes, interest and penalties among the various beneficiaries of the Will. *See* Tex. Prob. Code § 322A.

C. Other Changes in Assets During Administration.

In addition to the payment of debts, expenses, and taxes, the assets of the decedent's estate are likely to undergo a number of other changes during administration. As a result of these changes, the assets used to fund the marital gift and bypass gift are rarely identical to those on hand at the date of the decedent's death. These changes in assets can take a variety of forms.

1. Income Earned During Administration.

If the decedent owns income-producing assets, the executor will earn income during the administration of the estate. For decedents dying after September 1, 1993, the income generated by estate assets are allocated among beneficiaries pursuant to Section 378B of the Texas Probate Code, discussed below beginning at page 11.

2. Sales and Exchanges of Estate Assets.

It is not unusual for the executor to dispose of assets during the administration process. In fact, it is frequently necessary for an executor to sell one or more of the assets of the estate in order to acquire sufficient cash to pay debts and expenses as they come due. Moreover, the executor may dispose of assets in the exercise of prudent discretion, to protect and preserve the value of the estate. For example, an asset that is declining rapidly in value may be converted into an asset of more stable value. Although it is unusual for an executor to actively acquire new assets with cash (except safe, short-term investment assets), it is not uncommon for assets in the estate to change form during administration. Thus, for example, an executor may determine to incorporate a proprietorship or partnership operated by the decedent. This incorporation may be undertaken to minimize liability of the estate to the claims of the business. As a result of this transaction, the business assets formerly owned outright by the decedent are converted into stock in the new enterprise. An executor may transfer assets to a partnership or limited liability company in order to provide a convenient mechanism to manage assets that might otherwise be distributed in undivided interests among beneficiaries. In this case, assets formerly owned outright are converted into partnership interests. Whenever an estate owns an interest in a closely-held business, the executor must proceed with caution to avoid liability for the estate on the one hand, and to avoid personal liability on the other. *See* Davis, Income Tax Consequences (and Fiduciary Implications) of Trusts and Estates Holding Interests in Pass-Through Entities, State Bar of Texas 25th Annual Advanced Estate Planning and Probate Conference (2001).

3. Appreciation and Depreciation.

Many executors do not give much thought to capital gains and losses that may be incurred upon the disposition of estate assets. Except for certain decedents dying during 2010, the estate receives an unlimited new cost basis in most of the assets of the decedent equal to their fair market value at the date of death. As a result, tax on all pre-death appreciation and depreciation is forever foregone. *See* IRC § 1014(b). No basis adjustment occurs, however, for assets constituting a right to receive income in respect of a decedent. IRC § 1014(c). (For decedents dying during 2010 whose executors elected to have the federal estate tax not apply, the step-up in basis was generally limited to $1,300,000, plus an additional $3,000,000 for property passing to a spouse or qualified trust for a spouse. IRC § 1022.) Unfortunately, asset values do not stay static during administration. Assets continue to fluctuate in value, so that the value of assets at the date of distribution may differ from their values at the date of death. In many cases, depending upon the nature of the decedent's assets and the duration of the administration, this fluctuation in value may be minimal. In other estates, the fluctuation may be more dramatic. Growth stocks, for example, owned by the decedent could appreciate 20% or more if the administration spans a healthy bull market. More recently, stock market activity suggests a similar change in the opposite direction. By the same token, stock in the decedent's closely-held business may decline in value when the efforts of the decedent are no longer involved in maintaining the viability of the business. Alternatively, its value may increase substantially if managers are able to take the business in new directions, unencumbered by the decedent's controls.

IV. IDENTIFYING THE STAKES.

A. Outlining Objectives.

In an ideal world, the Will would be designed, and the estate administered, so that all possible tax and non-tax attributes of assets would be easy to identify, and all goals could be easily achieved. Unfortunately, in the real world, our knowledge is far from perfect. Even with perfect knowledge, we must be willing to accept some disadvantages in order to obtain maximum advantage for the parties at issue. Even if all goals cannot be met, however, it is important to identify the objectives to be achieved in a perfect world. Only then can those objectives be evaluated and a suitable compromise obtained.

1. <u>Appreciation and Depreciation</u>.

Ideally, no assets would decline in value during administration. All appreciation that occurred during the administration of an estate should be allocated fairly among estate beneficiaries. For an estate with federal estate tax planning objectives, and in which the same individuals are the ultimate beneficiaries of the marital and bypass bequests, it would be ideal for all appreciation to fall untaxed into the bypass trust. The assets passing to this trust, which avoid estate tax at the decedent's death due to the federal estate tax exemption, will also avoid estate tax at the death of the surviving spouse. *Therefore, one goal in the funding process is to maximize assets held by the bypass trust.* A strategy which allocates all growth during the administration process into this trust would best satisfy this goal. On the other hand, property used to fund the marital deduction gift, whether that gift is in trust or outright to the surviving spouse, may be taxed at the surviving spouse's death. Therefore, it would be best, all other factors being equal, to select assets which have declined in value (or have appreciated the least) during the administration of the estate to fund the marital gift. By allocating depreciation to the marital gift, less estate tax will ultimately be paid by the heirs on the assets used to fund this gift. Usually, shifting appreciation to the bypass trust and away form the marital gift is a function of the formulas and funding methods employed by the estate planner in drafting the Will. The IRS has published guidance which constrains estate planners from becoming over-zealous in attempting to achieve this goal when drafting Wills and other testamentary documents. If the funding formula provides too much latitude to the executor in allocating depreciation to the marital share, the marital deduction may be denied. *See* Rev. Proc. 64-19, 1964-1 CB 682.

2. <u>Maximizing Basis Step-Up</u>.

For persons dying in 2010 whose executors elected to not have the federal estate tax apply, the step-up in basis of assets was generally limited to $1.3 million. IRC § 1022(a). For assets passing to a surviving spouse or qualifying trust (essentially a trust with QTIP terms), an additional $3 million of step-up was available. IRC § 1022(c). As a result, in an estate with substantially appreciated assets (and if the surviving spouse's community property interest in step-up assets is insufficient to use all of the additional $3 million), it would have been best to allocate those appreciated assets to the QTIP trust. This allocation would maximize the available step-up and, since no "QTIP" election is required, the property in the trust should be excluded from the estate of the surviving spouse if the estate tax is in force at the time of his or her subsequent death.

3. <u>Income Production</u>.

Assets which produce substantial income are typically best allocated to the bypass trust. Congress permits a bypass trust to be designed as a complex trust, which can be utilized to shift income among the trust's various beneficiaries. Alternatively, the bypass trust's income can be accumulated within the trust at the trust's income tax rates (although since the advent of income tax rate compression for estates and trusts, this opportunity is limited). Thus, *maximum flexibility is attained by holding assets productive of income in the bypass trust*, where the trustee can be given the authority to allocate the income to the beneficiary or entity with the lowest effective income tax rate. The marital deduction assets, if not productive of income, are more likely to be consumed by the surviving spouse during his or her lifetime. Therefore, fewer of those assets are apt to be on hand at the time of the surviving spouse's death, resulting in lower overall transfer tax costs. Income from assets passing outright to a spouse is owned by the spouse, and may not be shifted to others. If a "QTIP" marital deduction trust is utilized, the Internal Revenue Code mandates that all of the trust's net income be distributed to the spouse at least annually, so that income may not be shifted or accumulated. It should be noted that in a QTIP trust, the surviving spouse must be granted the power to require that all assets in the trust be converted to income-producing assets within a reasonable period of time. Although the surviving spouse must possess this power, there is no requirement that the power be exercised.

4. Capital Gain Avoidance.

As discussed in more detail below, a distribution of assets to fund a bequest of "a specific dollar amount," including formula pecuniary bequests, is treated from an income tax standpoint as a sale of those assets by the estate to the beneficiary, in exchange for the amount of the bequest. As a result, if assets appreciate in value between the date of death and the date of funding (or if assets representing income in respect of a decedent are distributed by the estate), gain will be recognized to the extent that the formula gift is funded with those assets. On the other hand, assets passing to residuary beneficiaries can be distributed without accelerating the recognition of capital gains. Therefore, *capital gains taxes are minimized if the executor is able to fund pecuniary bequests with assets that have little post-death appreciation* (so that their cost basis is at or near their fair market value at the date of funding). Assets with substantial post-death appreciation (or assets representing income in respect of a decedent) can avoid gain recognition at funding if they are distributed as a part of the residue of the estate (or if they are the subject of a specific bequest under the Will).

B. Income Taxation of Estate Distributions.

An inheritance received by the beneficiary of an estate is usually thought of as being free from income tax. IRC § 102(a). Nevertheless, there are four important income tax issues that arise when estate assets are distributed. These areas are (i) the carry out of estate income; (ii) the recognition of gain by the estate at the time of funding certain gifts; (iii) the impact of making non-pro rata distributions of assets in kind; and (iv) the impact of distributing assets which represent so-called "income in respect of a decedent" ("IRD"). The tax impact of distributing property is highly dependent both upon the language included in the governing instrument and the steps taken and elections made by the executor in the administration of the estate.

1. DNI Carry Out Rules.

The general rule is that any distribution from an estate will carry with it a portion of the estate's distributable net income ("DNI"). Estate distributions are generally treated as coming first from the estate's current income, with tax free distributions of "corpus" arising only if distributions exceed DNI. If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata. For example, assume A and B are beneficiaries of an estate worth $1,000,000. During the year, the executor distributes $200,000 to A and $50,000 to B. During the same year, the estate earns income of $100,000. The distributions are treated as coming first from estate income. Unless the separate share rule, discussed below, applies, estate distributions are treated as carrying income out to the beneficiaries pro rata. Therefore, in our example, A would report income of $80,000 ($100,000 x ($200,000/$250,000)); B would report income of $20,000 ($100,000 x ($50,000/$250,000)). The estate would be entitled to a distribution deduction of $100,000. If the estate had instead distributed only $50,000 to A and $25,000 to B, each would have included the full amount received in income, and the estate would have received a $75,000 distribution deduction. As a result, the estate would have reported $100,000 as income, less the $75,000 distribution deduction, leaving the remaining $25,000 as taxable income on the estate's income tax return. Section 663(b) of the Code has permits estates and complex trusts to treat distributions made during the first 65 days of the entity's tax year as though they were made on the last day of the preceding tax year. This election enables executors and trustees to take a second look at DNI after the entity's books have been closed for the year, to shift income out to beneficiaries. The general rule regarding DNI carry-out is subject to some important exceptions.

a. Specific Sums of Money and Specific Property.

Section 663(a)(1) of the Code contains a special provision relating to gifts or bequests of "a specific sum of money" or "specific property." If the executor pays these gifts or bequests all at once, or in not more than three installments, the distributions will effectively be treated as coming from the "corpus" of the estate. As a result, the estate will not receive a distribution deduction. Conversely, the beneficiaries will not be taxed on the estate's DNI as a result of the distribution. For example, if the Will makes a bequest of "my piano to Fred," and "$10,000 to Bob," the executor's distribution of the piano or the $10,000 would not cause income to be carried out to Fred or Bob (nor would it permit the estate to receive a distribution deduction). Distribution of these bequests are typically tax neutral.

(1) Requirement of Ascertainability.

In order to qualify as a gift or bequest of "a specific sum of money" under the Treasury Regulations, the amount of the bequest of money or the identity of the specific property must be ascertainable under the terms of the governing instrument as of the date of the decedent's death. Treas. Reg. § 1.663(a)-1(b)(1). In the case of the decedent's estate, the governing instrument, of course, is the decedent's Will.

(2) Formula Bequests.

Under the Treasury Regulations, a marital deduction or bypass formula bequest typically *does not* qualify as a gift of "a specific sum of money." The identity of the property and the exact sum of money specified are both dependent upon the exercise of the executor's discretion. For example, if the executor elects to deduct administration expenses on the estate's income tax return, the amount of the formula marital gift will be higher than if those expenses are deducted on the estate tax return. Since the issues relating to the final determination of the marital deduction bequest cannot be resolved on the date of the decedent's death, the IRS takes the position that the bequest will not be considered "a specific sum of money." Treas. Reg. § 1.663(a)-1(b)(1); Rev. Rul. 60-87, 1960-1 CB 286. Thus, funding of formula bequests whose amounts cannot be ascertained at the date of death *will* carry out distributable net income from the estate.

(3) Payments from Current Income.

In addition, amounts that an executor can pay, under the express terms of the Will, only from current or accumulated income of the estate will carry out the estate's distributable net income. Treas. Reg. § 1.663(a)-1(b)(2)(i).

(4) Distributions of Real Estate Where Title has Vested.

The transfer of real estate does not carry out DNI when conveyed to the devisee thereof (including a remainder beneficiary) if, under local law, title vests immediately in the distributee, even if subject to administration. Treas. Reg. § 1.661(a)-2(e); Rev. Rul. 68-49, 1968-1 CB 304. Title vests immediately under Section 37 of the Texas Probate Code. *See Welder v. Hitchcock*, 617 S.W.2d 294, 297 (Tex. Civ. App.--Corpus Christi 1981, writ ref'd n.r.e.). Therefore, a transfer by an executor of real property to the person or entity entitled thereto should not carry with it any of the estate's distributable net income. Note, however, that the IRS Office of the Chief Counsel released an IRS Service Center Advice Memorandum (SCA 1998-012) which apparently limits this Ruling to specifically devised real estate (not real estate passing as part of the residuary estate) if the executor has substantial power and control over the real property (including a power of sale). Of course, specifically devised real estate would not carry out DNI in any event (since it is a specific bequest). As a result, the the SCA's interpretation would make the cited Treasury Regulation meaningless and unnecessary.

b. The Separate Share Rule.

Generally, in the context of estate distributions made to multiple beneficiaries, DNI is carried out pro rata among the distributees of the estate. For example, in a year in which the estate has $10,000.00 of DNI, if the executor distributes $15,000.00 to A and $5,000.00 to B, A will include $7,500.00 of DNI in his income, and B will include $2,500.00 in his income, since the distributions were made 75% to A and 25% to B. The Taxpayer Relief Act of 1997 made a substantial modification to the pro rata rule by applying the "separate share rule" to estates for estates of decedents dying after August 5, 1997 (the date of enactment). Under this rule, DNI is allocated among estate beneficiaries based upon distributions of their respective "share" of the estate's DNI. IRC § 663(c). The Committee Report describing this change provides that there are separate shares of an estate "when the governing instrument of the estate (e.g., the will and applicable local law) creates separate economic interests in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries." The Committee Report also notes that, as with trusts, the application of the separate share rule to estates is mandatory where separate shares exist. As a result of this statutory change, the executor must determine whether the Will (or the intestate succession law) creates separate economic interests in one beneficiary or class of beneficiaries. For example, if a Will bequeaths all of the decedent's IBM stock to X and the farm to Y, income earned from the IBM stock during the administration of the estate, if distributed to X in the year of collection, will carry DNI attributable to that dividend out to X. Similarly, the net income from farming operations, if distributed on a current basis to Y, will be included in Y's income. Before the adoption of the separate share rule, the total distributions to X and Y (ignoring the distribution of the stock and farm themselves) would have simply been aggregated and the total DNI of the estate in the year of distribution would have been carried out pro rata. Thus, application of the separate share rule more accurately reflects the economic interests of the beneficiaries resulting from estate distributions. Distributions to beneficiaries who don't have "separate shares" continue to be subject to the former "pro rata" rules. As noted above, application of the separate share rule is mandatory. The executor doesn't elect separate share treatment, nor may it be elected out of. Apparently, application of the separate share rules to estates was simply one of a host of small statutory changes that sought to bring the taxation rules for trusts and estates in line with one another. In practice, however, application of the separate share rules to estates can be very complex. Unlike separate share trusts, which are typically divided on simple fractional lines (e.g., "one-third for each of my children") the "shares" of estates may be hard to identify, let alone account for. Under final Treasury Regulations issued December 27, 1999, a revocable trust that elects to be treated as part of the decedent's estate is a separate share. The residuary estate (and each portion of a residuary estate) is a separate share. A bequest of a specific sum of money paid in more than three installments (or otherwise not qualifying as a specific bequest under Section 663(a)(1) of the Code) is a separate share. A gift of a specific sum of money or a specific bequest of property is *not* a separate share. The income on bequeathed property, however, is a separate share if, as in the case in Texas, the recipient of the specific bequest is entitled to that income. Treas. Reg. § 1.663(a)-4. For a good discussion of some of the complexities associated with the application of the separate share rules to estates, see Cantrell, Separate Share Regulations Propose Surprising Changes, TRUSTS & ESTATES, March, 1999 at 56.

c. Income From Property Specifically Bequeathed.

Note that under Section 37 of the Texas Probate Code, property that is the subject of a specific bequest vests immediately in the beneficiary, subject to the right of the personal representative to administer the property. The Texas Trust Code has long provided that if the beneficiary of an estate is a trust, the trust's right to income arises at the date of death. Former Tex. Prop. Code § 113.103(a). The Uniform Principal and Income Act carries this idea forward. Tex. Prop. Code § 116.101(c)(2). Moreover, the Texas Probate Code expressly applies this principle to all distributions of property specifically bequeathed. Tex. Prob. Code § 378B(c). A specific devisee is thus entitled to receive income from the property specifically devised to him, less expenses associated with that income. *See also Zahn v. National Bank of Commerce*, 328 S.W.2d 783 (Tex. Civ. App.--Dallas, 1954, writ ref'd n.r.e.). Before the application of the separate share rule to estates, if the property was distributed by the estate, together with the income to which the devisee was entitled, the distribution of income might or might not have been treated as taxable income by the beneficiary. Until the adoption of the separate share rules, DNI was distributed on a pro rata basis among all beneficiaries receiving distributions. The items of income were not specifically identified and traced. As a result, the beneficiary may well have been taxed not on the income item actually received, but on his or her pro rata share of all income distributed to beneficiaries. However, since the income earned on property specifically bequeathed is a "separate economic interest in one beneficiary or class of beneficiaries such that the economic interests of those beneficiaries (e.g., rights to income or gains from specific items of property) are not affected by economic interests accruing to another separate beneficiary or class of beneficiaries . . .", the separate share rules apply to this income. Rpt 105-220 to HR 2014, 105th Cong. 1st Sess. (July 20, 1997 at 713. The effect of this change is to cause a current distribution of income earned from specifically bequeathed property to carry the associated DNI out to that beneficiary, regardless of the amount of the estate's other DNI or distributions.

2. Gains and Losses from Distributions In Kind.

Unless the executor elects to recognize gain upon the distribution of property, the amount of a distribution to a beneficiary for income tax purposes is usually treated as a distribution of the lesser of the adjusted basis in the property before distribution, or the fair market value of the property at the time of the distribution. IRC § 643(e). This general rule is subject to three important exceptions:

a. Distributions Satisfying the Estate's Obligations.

Distributions which satisfy an obligation of the estate are recognition events for the estate. As a result, the fair market value of the property is treated as being received by the estate as a result of the distribution, and the estate will recognize any gain or loss if the estate's basis in the property is different from its fair market value at the time of distribution. Rev. Rul. 74-178, 1974-1 CB 196. Thus, for example, if the estate owes a debt of $10,000, and transfers an asset worth $10,000 with a basis of $8,000 in satisfaction of the debt, the estate will recognize a $2,000 gain.

b. Distributions of Assets to Fund Pecuniary Gifts.

A concept related to the "discharge of obligation" notion is a distribution of assets to fund a bequest of "a specific dollar amount," including formula pecuniary bequests. For example, a formula gift requiring an executor to distribute $400,000 worth of property, if funded with assets worth $400,000 at the time of distribution, but worth only $380,000 at the date of death, will cause the estate to recognize a $20,000 gain. The rules governing this area should not be confused with the "specific sum of money" rules which govern DNI carry outs. As noted above, formula gifts do not constitute gifts of a "specific sum of money," because they cannot be fixed exactly at the date of death. As a result, DNI is carried out upon funding. At the same time, these formula bequests are treated as bequests of "a specific dollar amount" if they describe a pecuniary amount as opposed to a fractional share of the residue of the estate, *regardless* of whether they can be ascertained exactly at the date of death. As a result, gain will be recognized if a pecuniary (i.e., dollar amount) formula gift is funded with appreciated assets, even if the amount of the gift is not ascertainable at the date of death. *Compare* Treas. Reg. § 1.663(a)-1(b) (to qualify as bequest of specific sum of money or specific bequest of property, and thereby avoid DNI carryout, the amount of money or the identity of property must be ascertainable under the Will as of the date of death) *with* Treas. Reg. § 1.661(a)-2(f)(1) (no gain or loss recognized unless distribution is in satisfaction of a right to receive a specific dollar amount or specific property other than that distributed). *See also* Treas. Reg. § 1.1014-4(a)(3); Rev. Rul. 60-87, 1960-1 CB 286.

c. Section 643(e)(3) Election.

The executor may elect under Section 643(e)(3) of the Code to recognize gain and loss on the distribution of appreciated and depreciated property. If this election is made, the amount of the distribution for income tax purposes will be the fair market value of the property at the time of the distribution. The Section 643(e) election must be made on an "all or nothing" basis, so that the executor may not select certain assets and elect to recognize gain thereon. Of course, if the executor wants to obtain the effect of having selected certain assets, he or she may actually "sell" the selected assets to the beneficiary for the fair market value of those assets, recognizing gain (but generally not loss) in the estate. The executor can thereafter distribute the sales proceeds received to the beneficiary who purchased the assets.

d. Reasons for Making the Election.

While it might seem counter-intuitive to elect to accelerate the recognition of gains, there are several possible reasons why an executor may choose to do so. Note that in most cases, when an executor distributes assets in kind, the beneficiary's basis becomes the estate's basis, plus or minus the gain recognized by the estate upon distribution, if any. Suppose than an estate passes equally to A and B, and that at the date of death, the estate held $800,000 worth of stocks and $1,000,000 worth of bonds, so that A and B each expects to receive $900,000. At the time of distributions, assume that the stocks have grown in value to $1,000,000, while the bonds have kept their value. If the executor elects to distribute the stocks to A and the bonds to B each beneficiary would receive $1,000,000, but if the assets were later sold, A would recognize $200,000, while B would recognize no gain. (A similar result would arise if the executor made any other non-pro rata distribution of assets.) The executor could conclude that since A and B each benefitted from the $200,000 in appreciation that occurred during the administration, they should each bear a portion of the associated capital gain tax. A Section 643(e)(3) election would cause the gain to be recognized by the estate, and then be carried out equally to A and B, providing more equitable after-tax treatment for the beneficiaries. Note also that in general , the estate's DNI is carried out by in-kind distributions based upon the lesser of the basis or fair market value of the asset. A Section 643(e)(3) election increasing the estate's basis in distributed assets may be beneficial if the estate is trying to maximize the distribution of DNI to the estate's beneficiaries.

e. Recognition of Gain vs. Loss.

If appreciated assets are distributed in satisfaction of a pecuniary gift, or if a Section 643(e)(3) election is made, the distributing entity will recognize gains. Under prior law, in the context of estates distributing assets which had *declined* in value, these mechanisms caused the estate to recognize losses, since under the principles of Section 267 of the Code, the estate and its beneficiary were not related taxpayers. The Taxpayer Relief Act of 1997 amended Section 267 of the Code to provide that for estate fiscal years beginning after August 1, 1997, estates and their beneficiaries will be treated as related parties, resulting in a denial of loss treatment for transactions between them. Although the Taxpayer Relief Act of 1997 applies this rule for most purposes, an estate may still recognize a loss if it distributes an asset that has declined in value in satisfaction of a pecuniary bequest. IRC § 267(b)(13). Revocable "living" trusts acting as estate surrogates must recognize gains, but no loss recognition is available because a trust and its beneficiaries are related parties pursuant to Section 267(b)(6) of the Code for all purposes. Of course, a qualified revocable trust electing to be treated as an estate under Section 645 of the Code should be entitled to utilize the estate's pecuniary bequest exception. For estates of persons dying in 2010 whose executors elected not to have the estate tax apply, the step-up in basis was limited by Section 1022 of the Code, but gain on the funding of pecuniary bequests applied only to post-death appreciation. IRC § 1040.

3. Non-Pro Rata Distributions.

If an estate makes an unauthorized non-pro rata distribution of property to its beneficiaries, the IRS has ruled that the distribution is equivalent to a pro rata distribution of undivided interests in the property, followed by an exchange of interests by the beneficiaries. This deemed exchange will presumably be taxable to both beneficiaries to the extent that values differ from basis. For example, suppose an estate passes equally to A and B, and contains two assets, stock and a farm. At the date of death, the stock was worth $100,000 and the farm worth $110,000. At the date of distribution, each are worth $120,000. If the executor gives the stock to A and the farm to B *and if the will fails to authorize non pro rata distributions,* the IRS takes the view that A and B each received one-half of each asset from the estate. A then "sold" his interest in the farm (with a basis of $55,000) for stock worth $60,000, resulting in a $5,000 gain to A. Likewise, B "sold" his interest in the stock (with a basis of $50,000) for a one-half interest in the farm worth $60,000, resulting in a $10,000 gain to B. *See* Rev. Rul. 69-486, 1969-2 CB 159. To avoid this result, the governing instrument or local law must expressly authorize non-pro rata distributions. Absent express authority in the governing instrument, an executor apparently has no such authority in Texas. *Gonzalez v. Gonzalez*, 469 S.W.2d 624 (Tex. Civ. App.–Corpus Christi 1971, writ ref'd n.r.e.). *See also McDonough v. Cross*, 40 Tex. 251 (1874) ("It can hardly be thought that the executor is authorized by such a will to change the devise of the testator from an undivided part of the estate into a specific part thereof, selected and designated by him at his mere will and pleasure, especially when he is one of the devisees among whom it is to be partitioned"). It is possible, however, that a non-pro rata division could be implemented by proper application to the Probate Court, even by an Independent Executor, and thus be allowed by local law. Tex. Prob. Code § 150; *See In re Estate of Spinder*, 840 S.W.2d 665, 667 (Tex. Civ. App.–Eastland 1992, no writ), *on reh'g in part*. For a discussion of an analogous issue in the context of non-pro rata divisions of community property between the estate and the surviving spouse, see Section X.C. below at page 34.

4. Income in Respect of a Decedent.

Income in respect of a decedent ("IRD") is not defined by statute, and the definition in the Treasury Regulations is not particularly helpful. Generally, however, IRD is comprised of items which would have been taxable income to the decedent if he or she had lived, but because of the decedent's death and tax reporting method, is not includable in the decedent's final Form 1040. Examples of IRD include accrued interest, dividends declared but not paid, unrecognized gain on installment obligations, bonuses and other compensation or commissions paid or payable following the decedent's death, and amounts in retirement plans upon which the decedent has not been taxed. A helpful test for determining whether an estate must treat an asset as IRD is set forth in *Estate of Peterson v. Commissioner*, 667 F.2d 675 (8th Cir. 1981). The estate's basis in an IRD asset is equal to its basis in the hands of the decedent. No step-up is provided. IRC § 1014(c). If the executor distributes an IRD asset in a manner which will cause the estate to recognize gain on the distribution (for example, if the asset is used to fund a pecuniary bequest), or if a Section 643(e)(3) gain-recognition election is made by the executor and the asset is distributed in the year of the election, the result will be to tax the income inherent in the item to the decedent's estate. Absent one of these recognition events, if the estate of the decedent transmits the right to an IRD asset to another person who would be entitled to report that income when received, the transferee, and not the estate, will recognize the income. Thus, if a right to IRD is transferred by an estate to a specific or residuary legatee, only the legatee must include the amounts in income when received. Treas. Reg. § 1.691(a)-4(b)(2). If IRD is recognized by the estate, the tax costs may be substantial. In a setting where a substantial IRD asset is distributed from the estate in a manner causing recognition, a material decrease in the amount passing to other heirs might result. For example, assume that a decedent dying in 2010 leaves a $5.4 million estate, with a Will that makes a formula marital gift of $400,000 to the spouse, leaving the rest of the estate to a bypass trust. If an IRD asset worth 400,000, but with a basis of $0 is used to fund this marital gift, the estate would recognize a $400,000 gain. The spouse would receive the $400,000 worth of property, but the estate will owe income tax of about $112,000, presumably paid from the residue of the estate passing to the bypass trust. Payment of this tax would leave only $4,888,000 to fund the bypass trust. Under those circumstances, the testator may wish to consider making a specific bequest of the IRD asset to insure that the income will be taxed to the ultimate beneficiary as received, and will not be accelerated to the estate.

V. ALLOCATION OF INCOME AND EXPENSES DURING ADMINISTRATION OF A DECEDENT'S ESTATE

A. Allocation of Income.

1. Statutory Allocation of Income and Principal in Estates.

Until 1993, Texas did not have a statute dealing with the allocation of income and expenses during the administration of estates. Section 378B of the Texas Probate Code adopted a new statute based upon Section 5 of the Revised Uniform Principal and Income Act. This statute was effective for estates of decedents dying after September 1, 1993. In 2003 the Texas legislature modified the statute to reflect the adoption of the Uniform Principal and Income Act, effective January 1, 2004. The Probate Code applies the provisions of the Uniform Principal and Income Act (but not the Uniform Prudent Investor Act) to estates as well as trusts. In summary, the current rules contain the following provisions:

a. Determination of Income.

The Probate Code provides that, unless the Will provides otherwise, "income" from the assets of a decedent's estate that arises after the date of death and before distribution, is to be determined in the same manner as income is determined under the Texas Trust Code. Tex. Prob Code Ann. § 378B(b). The income, as measured under the Trust Code, is to be distributed as set forth in Section 378B of the Probate Code. The Texas Trust Code rules are summarized beginning at page 16, below. Note that the Texas Trust Code's adoption of a "Texanized" version of the Uniform Principal and Income Act means that the definition of income has changed substantially from the rules in effect before January 1, 2004. For example, as outlined in more detail below, partnership income is now based principally upon partnership distributions and not upon generally accepted accounting principles; depletion is to be allocated "equitably," with a presumption that an allocation to principal of the depletion allowed for income tax purposes is equitable; and minimum required distributions from retirement plans (but generally not other distributions) are allocated to income to the extent of four percent of the fair market value of future payments.

b. Charges Against Income.

Section 378B(a) provides that debts, funeral expenses, estate taxes (and any interest and penalties thereon), and the family allowance are charged against principal. The executor may allocate attorney fees, accounting fees, fees of other professional advisors, executors' commissions, court costs, and similar fees and expenses relating to the administration of the estate between income and principal as the executor determines to be "just and equitable," unless the Will provides some express allocation.

c. Allocation of Net Income.

Once the executor has determined which receipts constitute "income," and has properly allocated appropriate expenses to that income, the statute then instructs the executor to distribute the net income in accordance with the following rules.

(1) The net income earned from property specifically bequeathed is allocated first to the specific devisee. So, for example, if a Will specifically leaves 1,000 shares of IBM stock to X, the dividends received by the executor on that stock during administration of the estate are payable to X. Income payable pursuant to a specific bequest is determined after deducting all expenses directly allocable to the specifically devised property, including property taxes, ordinary repairs, insurance premiums, interest accrued after the death of the testator (for example, interest on a mortgage encumbering specifically devised real estate), expenses of managing and operating the property, and income taxes imposed upon income that accrues with respect to the property during administration. As a result, if the IBM stock bequeathed to X paid $400 in dividends in Year 1, but was not distributed until Year 2, the estate would pay income tax on those dividends for Year 1. If income taxes were $140, then X would be entitled only to $260 ($400 - 140) in Year 2. The $260 would be tax-free to X, since it represents income from a prior year, and not currently distributed net income. Any dividends received by the estate in Year 2 before distributing the stock, would be distributable to X, who would be responsible for paying the tax thereon.

(2) Any net income remaining after income from property specifically bequeathed is allocated among the remaining beneficiaries "in proportion to their respective interests." As noted below, the "respective interests" of beneficiaries may change if, for example, the value of property changes during administration, interim distributions are made, or income-producing assets are disposed of to pay creditors.

(3) Before January 1, 2004, the statute required, without regard to the foregoing rules, that a devisee of a pecuniary bequest (that is, a gift of a fixed dollar amount), whether or not in trust, was entitled to interest on the bequest, beginning one year after letters testamentary were granted. Former Tex. Prob. Code

§ 378B(f). The provision for paying interest on pecuniary bequests did not limit itself to payments from estate income. Although the statute was rather vague, the executor presumably charged this "interest" expense to income in determining the estate's "net" income to be allocated to other beneficiaries. For decedents dying on or after January 1, 2004, interest accrues beginning one year from the date of death, and is clearly charged against other estate income. Tex. Trust Code § 116.051(3), (4). For a discussion of the income tax issues associated with the payment of this "interest," see page 33, below.

(4) The statute gives the executor the "sole and absolute discretion" to determine "the frequency and method of determining the beneficiaries' respective interests in the undistributed assets of the estate." Tex. Prob. Code § 378B(h). Thus, in order to give the executor the maximum amount of flexibility, the executor is given the authority to determine whether assets should be revalued, and how often, for purposes of determining the relative interests of the beneficiaries of the estate's income. For example, if A and B are equal beneficiaries of a $1 million estate, and A receives a $400,000 distribution from the estate, the statute permits (but does not require) the executor to allocate income received after the distribution 5/6ths to B and 1/6th to A.

2. <u>The Texas Trust Code</u>.

Section 378B(b) of the Texas Probate Code expressly applies the provisions of the Texas Trust Code to executors when allocating receipts and disbursements between principal and income. A detailed discussion of the principal and income allocation rules of the Texas Trust Code is set forth below, beginning at page 16.

B. Apportionment of Expenses.

As discussed above, Section 378B of the Texas Probate Code allocates expenses between the estate's principal and income. Some of these allocations are expressly described in the Probate Code. In other cases, the allocation is made by reference to the Texas Trust Code. Expenses charged to income are included in the measurement of net income, distributable under Section 378B. But what about expenses charged to principal? State law sets forth, in the absence of specific directions in the will, a specific order in which property (i.e., principal) in the probate estate of the decedent will be charged. Detailed rules are adopted for apportionment of federal estate taxes, inheritance taxes and interest, penalties and expenses incurred in determining or apportioning taxes. A separate set of rules is established for other expenses of administration. A detailed discussion of the apportionment and abatement statutes is beyond the scope of this outline. Generally speaking, however, taxes (and charges associated therewith) are charged to the property generating the tax on a pro rata basis, whether or not the property is part of the probate estate. Taxes may be collected by the executor from a beneficiary if the property generating the tax is not an asset subject to probate administration (e.g., life insurance proceeds payable to an individual). Tex. Prob. Code § 332A. Expenses other than taxes are borne by the probate estate. All such expenses are payable from the "decedent's property" in the following order:

1. Property not disposed of by will, but passing by intestacy (which will be nonexistent if the decedent dies with a properly drawn will);
2. Personal property of the residuary estate (which would presumably be composed of principal and most of the estate's income);
3. Real property of the residuary estate;
4. General bequests of personal property;
5. General devises of real property;
6. Specific bequests of personal property; and
7. Specific devises of real property.

The foregoing provisions do not affect the rights of secured creditors who elect to recover their indebtedness only from their collateral under Section 306 of the Texas Probate Code. Tex. Prob. Code § 322B. For a comprehensive discussion of the apportionment rules *See* Donaho, <u>Tax Apportionment</u>, State Bar of Texas Advanced Estate Planning Course (2006); Ice, <u>Paying Debts, Allowances and Taxes and Satisfying Gifts under the Will a Guide to the Independent Executor (of a Potentially Insolvent Estate)</u>, (2004) available at:
http://www.trustsandestates.net/Articles/2007_Paying_Debts_Allowances_and_Taxes_and_Satisfying_Gifts_Under_The_Will_A_Guide_To_The_Independent_Executor.pdf

C. Deduction of Expenses for Tax Purposes.

In addition to apportioning expenses among the various beneficiaries of the estate, and allocating expenses between fiduciary accounting income and corpus of an estate, the executor must allocate expenses between the decedent, the estate, and so-called "deductions in respect of a decedent." Even after determining amounts which are proper estate expenses, the executor is often confronted with a choice of deducting expenses on the estate tax return, or the estate's income tax return. In most instances, double deductions are disallowed. IRC § 642(g). For decedents dying between 2002 and 2009, the decision about where to deduct an expense was simplified by the fact that the lowest effective federal estate tax bracket (45%) was always higher than the highest marginal income tax bracket applied to estates (35%). In 2013, with a top income tax rate of 39.6% and a possible Medicare surtax of 3.8%, executors are once again faced with deciding whether the deduction on the estate's income tax return (with a top combined tax bracket of 43.4%) may be of greater benefit than deducting expenses on the estate tax return, where the top bracket is effectively 40%.

1. Section 642(g) Expenses.

In many cases, the executor must make an election under Section 642(g) of the Internal Revenue Code to take administration expenses as a deduction for income tax purposes by virtue of Section 212 of the Code, or to deduct those same expenses as an estate tax deduction under Section 2053 of the Code. No double deduction is permitted. Expenses to which the election applies include executors' fees, attorneys' fees, accountants' fees, appraisal fees, court costs, and other administration expenses, provided that they are ordinary and necessary in the collection, preservation, and management of the estate. There is no requirement that the estate be engaged in a trade or business or that the expenses be applicable to the production of income. Treas. Reg. § 1.212-1(i). Note, however, that expenses attributable to the production of tax-exempt income are denied as an income-tax deduction to estates, just as they are to individuals, under Section 265(1) of the Code. Interest on estate taxes deferred under Section 6166 of the Code now accrues at 2% for th tax on the first $1,000,000 (adjusted for inflation to $1,430,000 in 2013), and at 45% of the regular rate for interest on under payments in excess of that amount. IRC § 6601(j). The reduced interest, however, is no longer allowed as an estate tax or an income tax deduction. IRC §§ 2053(c)(1)(D); 163(k).

2. Method of Election.

Technically, the Code and Treasury Regulations require the executor to file with the estate's income tax return a statement, in duplicate, to the effect that the items have not been allowed as deductions from the gross estate of the decedent under Section 2053 or 2054 and that all rights to have those items allowed at any time as deductions under Section 2053 or 2054 are waived. Treas. Reg. § 1.642(g)-1. Some executors tentatively claim expenses on both returns, filing the income tax return waiver statement only after the estate has received a closing letter and deductions on the estate tax return have proven unnecessary. This approach can be dangerous, however, if deductions are taken on the estate tax return, and the estate receives a closing letter without examination of or adjustment to the return. Under these circumstances, presumably, the income tax waiver statement could not lawfully be filed, since the deductions in question will have been "allowed" as deductions from the gross estate.

3. Charging Expenses to Deductible Bequests.

In estates which provide for an unlimited marital (or charitable) deduction, the tax interests of the estate are usually best served by deducting administration expenses on the income tax return, since no federal estate taxes will be due regardless of whether those fees are deducted on the estate tax return. Where, however, the marital deduction gift is funded by the residuary estate, and the residuary estate is encumbered by an obligation to pay debts, the marital deduction is reduced to the extent of the encumbrance. IRC § 2056(b)(4)(B). Thus, for example, in an estate of $6.0 million, if $5,000,000 is given to a bypass trust and the "residue" is given to the spouse, and if the estate incurs $100,000 of administration expenses, the marital deduction gift is "encumbered" by these expenses. Since only $900,000 ($6,000,000, less $5,000,000 going to the bypass trust, less $100,000 in expenses) is available to pass to the surviving spouse, the marital deduction is limited to $900,000. As a result, expenses paid from a deductible gift must be taken as a deduction on the federal estate tax return to avoid generating estate tax. The effect of taking those expenses as a deduction on the estate tax return is to "waste" these deductions, since they are thereby disallowed on the estate's income tax return. This problem can be compounded if the estate taxes generated by failing to claim the expenses on the estate tax return are also payable from the marital deduction gift. Under those circumstances, additional estate taxes (the tax on the tax) will be due. This tax-on-the-tax problem causes the estate to pay estate taxes at a rate equal to taxes otherwise payable, divided by one minus the tax rate. For example, $100,000 in expenses charged to the marital share but not deducted on the estate's Form 706 would generate a $40,000 estate tax (using 2013 rates). If the marital share were further liable for the payment of this estate tax, total transfer taxes of $66,667 ($40,000 divided by one minus 40%) would be payable after giving effect to the tax-on-the-tax. In other words, the marital deduction gift would be reduced by $166,667 ($100,000 going to pay expenses, and $66,667 going to pay estate taxes), forty percent of $166,667 being $66,667.

4. Charging Expense to Estate Income.

To avoid losing the benefit of these expenses and the resulting application of the tax on the tax, executors have sometimes argued that estate administration expenses are properly chargeable under local law not to estate principal otherwise passing to the spouse, but to income earned by the estate during administration. As a result, the marital deduction is not "encumbered" or reduced by those expenses, even though the residuary marital gift might otherwise be liable for taxes under local law. Thus, in our example above, if the estate had earned, say, $150,000 in income, the $100,000 in expenses could be paid from that income, leaving the "residue" of $1,000,000 (plus $50,000 in "net" income accruing after death) intact to pass to the spouse. Although the IRS disagreed with this approach, the United States Supreme Court, in *Commissioner v. Estate of Hubert*, 520 U.S. 93 (1997), affirmed the decision of the Tax Court permitting the taxpayer to deduct administration expenses against income. In a concurring opinion written by Justice O'Connor, she noted that since the regulations written by the IRS that were in force at the date of death did not establish a meaningful measure of how a marital gift might be materially encumbered by expenses, no loss of the marital deduction was appropriate. Justice O'Connor specifically noted, however that "[t]here is no reason why this labyrinth should exist, especially when the Commissioner is empowered to promulgate new regulations and make the answer clear. Indeed, nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation." *Id*. at 122.

5. Regulatory Guidance.

Not surprisingly, the Treasury Department, responding to Justice O'Connor's invitation, adopted regulations, effective for estates of decedents dying on or after December 3, 1999. Treas. Reg. §§ 20.2013-4(b)(3), 20.2055-3; 20.2056(b)-4(d). The regulations permit deducting some estate administration expenses on the estate's income tax return without decreasing the marital or charitable gift bearing those expenses. In particular, the regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. Expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

a. Estate Management Expenses.

Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§ 20.2055-3(b)(1)(i); 20.2056(b)-4(d)(1)(i).

b. Estate Transmission Expenses.

Estate transmission expenses are all estate administration expenses that are not estate management expenses. These expenses reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Examples of these expenses could include executor commissions and attorney fees (except to the extent of commissions or fees specifically related to investment, preservation, and maintenance of assets), probate fees, expenses incurred in construction proceedings and defending against will contests, and appraisal fees. Treas. Reg. §§ 20.2055-3(b)(1)(ii); 20.2056(b)-4(d)(1)(ii).

c. Reduction for Unrelated Estate Management Expenses.

In addition to reductions for estate transmission expenses, the final regulations require that the marital deduction be reduced by the amount of any estate management expenses that are "paid from the marital share but attributable to a property interest not included in the marital share." Treas. Reg §20.2056(b)-4(d)(1)(iii)(4). Similar language is applied to charitable gifts. Treas. Reg. § 20.2055-3(b)(4).

d. Special Rule for Estate Management Expenses Deducted on Estate Tax Return.

If estate management expenses are deducted on the estate tax return, the marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3); 20.2056(b)-4(d)(3). The justification for this position is the language in Section 2056(b)(9) of the Code, which provides that nothing in section 2056 or any other estate tax provision shall allow the value of any interest in property to be deducted for federal estate tax purposes more than once with respect to the same decedent. This rule is further illustrated by an example. In that example, $150,000 of life insurance proceeds pass to the decedent's child, and the balance of the estate passes to the surviving spouse.

The decedent's applicable credit amount had been fully utilized before death. If estate management expenses of $150,000 were deducted for estate tax purposes, the marital deduction would have to be reduced by $150,000. Otherwise, according to the example, the estate "would be taking a deduction for the same $150,000 in property under both sections 2053 and 2056." As a result, the deduction would have the effect of sheltering from estate tax $150,000 of the insurance proceeds passing to the decedent's child. Treas. Reg § 20.2056(b)-4(d)(5), Ex.4.

6. Interpreting Wills Under the *Hubert* Regulations.

If an expense is a "management expense" and if the Will or local law permits the executor to pay the expense out of the share passing to a marital or charitable share, doing so will generally maximize the amounts passing to other beneficiaries. Any management expense paid out of the marital or charitable share that is incurred in connection with property passing to a beneficiary other than the spouse (or charity) must reduce the amount of the marital or charitable deduction. In view of the uncertainty surrounding the notions of "estate management expenses" and "estate transmission expenses," the IRS may attempt to recharacterize expenses after the estate's income and estate tax returns are filed, arguing for a reduction in the marital (or charitable) bequest. A well drafted formula bequest, which readjusts after a successful recharacterization, should eliminate most of the tax risks associated with this issue. For an excellent discussion of the issues and uncertainties raised by the *Hubert* regulations, see Akers, Postmortem Planning Considerations, a Review of Income, Gift, and Estate Tax Planning Issues, ALI-ABA Estate Planning for the Family Business Owner, 2007, p. 170.

D. Express Application of the Texas Trust Code to Estates.

1. Allocation of Income.

a. General Rule.

Section 378B of the Probate Code provides that for decedents dying after September 1, 1993, "income" is to be determined in the same manner as income is determined under the Texas Trust Code, and on or after January 1, 2004, as provided in the Texas Uniform Principal and Income Act (the "Act"). The Act provides that allocations between income and principal will be made in accordance with the specific provisions of the governing instrument. Provisions in the will should therefore control allocations of estate income and expense, so long as they are specific enough to show that the testator chose to define a specific method of apportionment. *See Interfirst Bank v. King*, 722 S.W.2d 18 (Tex. App. -- Tyler 1986, no writ). In the absence of specific provisions in the instrument, the provisions of the Texas Trust Code control allocations between income and principal. Tex. Prob. Code § 378B(b); Tex. Prop. Code § 116.051. Note that if the will grants the executor the discretion to allocate income or expenses (even "absolute" or "uncontrolled" discretion), the discretion is not unlimited. The fiduciary must not act outside the bounds of reasonable judgment. *Thorman v. Carr*, 408 S.W.2d 259, 260 (Tex. Civ. App.--San Antonio 1966) *aff'd per curium*, 412 S.W.2d 45 (Tex. 1967). The Uniform Principal and Income Act now requires that the fiduciary must make allocations based upon what is "fair and reasonable" to all beneficiaries, and further provides that (i) a determination in accordance with the Act is presumed to be "fair and reasonable," and (ii) if neither the terms of the governing instrument or the Act provide a rule for allocating a receipt or disbursement between principal and income, it is to be allocated to principal. Tex. Prop. Code § 116.004. The Texas Bar Commentary for this section states that the rule provides greater protection for fiduciaries by establishing a certain presumption for "fair and reasonable" allocations. A court may overturn a fiduciary's allocations only upon a showing of an abuse of discretion. Tex. Prop. Code § 116.006.

b. Specific Trust Code Provisions.

The Texas Trust Code provides considerable guidance on allocations, but despite its name, it isn't at all identical to the "uniform" act. In 2002, a special legislative committee of the Real Estate, Probate, and Trust Law Section of the Texas Bar began studying the 1997 Revised Uniform Principal and Income Act ("RUPIA"). The State Bar committee identified a number of concerns with RUPIA, and provided a number of recommended changes to RUPIA before its adoption by the Texas Legislature.

(1) Allocations in General.

Section 116.004 of the Texas Trust Code provides the outline for income and principal allocations, with detailed guidance on specific forms of property and activities being provided by Sections 116.151 through 116.206. Section 116.004 thus provides that the fiduciary shall administer the trust or estate in accordance with the terms of the trust or will, even if the statute provides some different provision. A fiduciary may administer a trust or estate by the exercise of a discretionary power of administration granted in the governing instrument, even if the exercise of that power produces results different from the results required or permitted under the Act. If the governing instrument does not contain a contrary provision or grant discretion to the fiduciary, the provisions of the Act must be followed, and if no provision of the Act controls, the receipt or disbursement must be allocated to principal. Finally, in exercising a "power to adjust" as outlined below, or a discretionary power of administration, whether granted under the governing instrument or the Act, the fiduciary "shall administer a trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries, except to the extent that the terms of the trust or will clearly manifest an intention that the fiduciary shall or may favor one or more of the beneficiaries." As noted above, a determination in accordance with the Act is presumed to be fair and reasonable to all of the beneficiaries. Tex. Prop. Code § 116.004.

(2) Accrued Income.

Items accrued on the day before the date of death, such as rent, interest and annuities, are treated as principal under the Texas Trust Code, even if those items are considered income (presumably, income in respect of a decedent) under the tax law. Tex. Prop. Code § 116.101(d). A trust which must distribute all of its "income" (i.e., fiduciary accounting income measured under the Texas Trust Code) would therefore be entitled to retain these items, since they are principal under local law. The effect of retaining these rights to taxable income may be to "trap" the taxable income in the trust. This trapping of income presents an opportunity to use an otherwise simple trust as a taxpayer in the year it is funded. Naturally, since the trusts reach the highest tax bracket at only $11,950 in income (using 2013 rates), the tax savings generated by this technique are limited. A simple trust with $12,250 in income ($300.00 of which would be excluded by the trust's allowance in lieu of personal exemption) would pay a tax of $3,090 instead of $5,315.5 if the entire $12,250 were taxed to a beneficiary in the top 43.4% bracket -- a savings of $2,226.50. Although income accrued *at the date of death* is principal, funds received by a trustee from an estate that constitute the estate's income under Section 378B of the Texas Probate Code is treated as trust income under Section 116.152 of the Texas Trust Code. Tex. Prob. Code § 378B(g). Accordingly, this post-death income passing from the estate to the trust will not be "trapped."

(3) Receipts from Entities.

The Act provides a uniform rule for distributions from any "entity" which includes a corporation, partnership, limited liability company, mutual fund, REIT, common trust fund, and any other entity except an estate, a trust, or a proprietorship. In general, distributions of money are allocated to income are treated similarly. A distribution is allocated to principal if it is (i) property other than money; (ii) money paid in a single or series of distributions in redemption of the trust's interest in the entity; (iii) money received in a total or partial liquidation of the entity; or (iv) money received from a mutual fund or REIT characterized as a capital gain dividend for federal income tax purposes. Money is received in partial liquidation if the entity so indicates, or if the total distribution is greater than 20% of the entity's gross assets. If the distributing entity provides the trustee with a statement at or near the time of the distribution setting forth information about the source or character of a distribution, the trustee is entitled to rely on that statement.

(4) Business and Farming Operations.

If a fiduciary operates a business or farming operation owned as a sole proprietorship, he or she may elect, if it is in the best interest of all beneficiaries, to account separately for the business or activity, instead of accounting for it as part of the trust's general assets. If a separate accounting is undertaken, the trustee may determine the extent to which its net cash needs to be retained for working capital, acquisition or replacement of fixed assets, or other reasonably foreseeable needs of the business, and the extent to which the remaining net cash receipts are to be allocated to principal or income. If the assets of the business are sold outside the ordinary course of business (and the sales proceeds are no longer required in the conduct of the business) the proceeds are allocated to principal. Tex. Prop. Code § 116.153. The activities to which this provision apply include retail, manufacturing, service and other traditional businesses; farming; raising and selling livestock; management of rental properties; mineral extraction; timber operations; and derivative operations..

(5) Interest and Rents.

Rents are treated as income, including amounts received for cancellation or renewal of a lease. Tex. Prop. Code § 116.161. Interest is also income, whether denominated as fixed, variable, or floating. If a fiduciary sells a note or other obligation to pay money more than one year after it is acquired, the sales proceeds must be allocated to principal, even if the obligation was acquired for less than its value at maturity. If the obligation is disposed of within one year after it is acquired, an amount received in excess of its purchase price or value when acquired must be allocated to income. Tex. Prop. Code § 116.163.

(6) Deferred Compensation, Annuities, and Similar Payments.

The Act, (revised in 2003 and amended in 2005, 2007 and 2009) now provides that (i) to the extent that the payer characterizes a payment as interest, a dividend, or equivalent payment, the payment is allocated to income; and (ii) if no part is so designated, *and if all or any part of the payment is require to be made*, an allocation is made to income to the extent of four percent of the "fair market value of the future payment asset," less the amount allocated to income for a previous payment in the same accounting period. Fair market value is measured on the day the asset first becomes subject to the trust, or after the first year, on the first day of the trust's year. Tex. Prop. Code Ann. § 116.172. The 2009 changes to the statute adopt a different rule for payments from a "separate fund" to a QTIP trust. For those accounts, income is based upon the internal income of the separate fund, as though the separate fund were a trust. It the trustee cannot determine the internal income of the fund, income is based upon four percent of the fund's value based upon the most recent available statement of value preceding the beginning of the accounting period. Tex. Prop. Code § 116.172 (h)-(k).

(7) Liquidating Assets.

Under former law, proceeds from depletable property other than minerals (for example, leaseholds, patents, copyrights and non-mineral royalties) acquired by a trust on or after September 1, 1993, constituted income to the extent of five percent of the inventory value, adjusted in the same manner as a promissory note bearing interest at five percent compounded annually. Former Tex. Prop. Code Ann. § 113.109 (Vernon Supp. 1995). All proceeds from depletable property acquired before September 1, 1993, constituted income unless the trustee had a duty to change the form of the investment. If the trustee was required, either under local law or under the terms of the trust instrument, to alter the form of the investment, up to 5% of the value of the asset disposed of is income, and the balance was allocable to principal. *Id.* For assets acquired on or after January 1, 2004, the trustee is to allocate ten percent of each receipt (*not ten percent of the inventory value*) to income, and the balance to principal. For assets on hand on January 1, 2004, the trustee may allocate receipts "in the manner provided by this chapter or in any lawful manner used by the trustee before January 1, 2004 to make the same allocation." Tex. Prop. Code § 116.173(c).

(8) Minerals, Water and Other Natural Resources.

The Texas Trust Code provides that nominal delay rentals are income, but production payments are principal except to the extent of any factor for interest provided for in the governing instrument. With respect to royalties, shut-in-well payments, take-or-pay payments, bonuses, or delay rentals that are more than nominal, the trustee must allocate receipts "equitably." Receipts from working interests or other amounts not expressly provided for must also be allocated "equitably." Amounts received for water are income if the water is renewable. If the water is not renewable, the proceeds must be allocated "equitably." Under former law, the trustee was required to maintain a reserve for most mineral royalties equal to the lesser of 27.5% of the gross proceeds or 50% of the net proceeds. Former Tex. Prop. Code Ann. § 113.107(d) (Vernon 1995). For assets on hand on January 1, 2004, the trustee may allocate receipts "in the manner provided by this chapter or in any lawful manner used by the trustee before January 1, 2004 to make the same allocation." Tex. Prop. Code § 116.174(d). So how does a fiduciary make sure that an allocation is being made "equitably"? The statute provides no specific guidance expect that an allocation of a receipt is presumed to be equitable if the amount allocated to principal is equal to the amount allowed by the Internal Revenue Code as a deduction for depletion (generally, 15%). *Id.* Under current tax rules, a depletion deduction is used by the trust or estate to the extent that the entity maintains a reserve, so all of the depletion deduction would be trapped in the trust. If the grantor or testator wants all royalty income to be paid to the income beneficiary, this provision should be altered by the terms of the will or trust. The effect of an alteration of this type is to cause the tax depletion to follow the trust income. *See* IRC § 611(b)(3); Treas. Reg. § 1.611-1(c)(4).

(9) Timber.

Fiduciaries are generally required to allocate net receipts: (i) to income to the extent the amount of timber removed does not exceed the rate of growth of timber during the accounting period in which a beneficiary has a mandatory income interest; (ii) to principal to the extent that the amount of timber removed exceeds the rate of growth of timber, or the net receipts are from the sale of standing timber; (iii) to or between income and principal if the net receipts are from the lease of timberland or from a contract to cut timber, applying the rules of (i) and (ii) above; and (iv) to principal to the extent that advance payments, bonuses and other payments are not allocated by the foregoing rules. However, for timber on hand on January 1, 2004, the trustee may allocate receipts "in the manner provided by this chapter or in any lawful manner used by the trustee before January 1, 2004 to make the same allocation." Tex. Prop. Code § 116.175(d). Former law provided simply that receipts from the disposition of timber were allocated "in accordance with what is reasonable and equitable to the income and remainder beneficiaries of the trust." No specific guidance was provided.

(10) Underproductive Property.

The Act eliminated a provision of prior law which required that some sales proceeds from underproductive property (property which did not produce an average return of at least 1%) be allocated to income. The former law credited to income the lesser of the profit on the sale of the property or the amount of the net sales proceeds sufficient to bring the return on the property up to 4% simple interest during the delay period. The current law provides instead only that if an estate tax marital deduction was allowed for property passing to a trust, and the property does not provide the spouse with sufficient income (and if the power to adjust discussed below does not cure the problem), the spouse may require the trustee to make the property productive of income, convert the property within a reasonable period of time, or exercise the power to adjust. The trustee can decide which of these steps to take. Tex. Prop. Code § 116.176.

(11) Other Sales Proceeds.

Proceeds from the sale of or other disposition of property not classified as underproductive are considered principal, and accordingly, capital gains are allocable as principal to the trust absent provisions of the trust instrument to the contrary. Tex. Prop. Code § 116.161.

(12) Depreciation.

Under the Act, the trustee may transfer to principal "a reasonable amount of the net cash receipts from a principal asset that is subject to depreciation," but may not transfer any amount for depreciation (i) for a residence and its contents available for use by a beneficiary; (ii) during the administration of a decedent's estate; or (iii) for proprietorship assets accounted for as a business activity. As with depletion, the effect of this provision is to establish a reserve for depreciation, which will trap the tax depreciation deduction within the trust to the extent of the reserve so maintained. If the testator wishes to have depreciation deductions follow income, a different allocation of depreciation must be provided for in the will or trust instrument. Tex. Prop. Code § 116.203.

c. The Power to Adjust.

The hallmark of the Uniform Principal and Income Act is the much-vaunted "power to adjust." Most comments criticizing various provision of the Act have been met with the simple reply, "But that's okay. If that doesn't work out fairly, the trustee always has the power to adjust." This simplistic response ignores the substantial limitations placed upon this power.

(1) Statement of the Power.

In its clearest form, Section 116.005(a) of the Texas Trust Code provides, "A trustee may adjust between principal and income to the extent that the trustee considers necessary if the trustee . . . determines, after applying the rules in Section 116.004(a) [requiring the trustee to administer the trust in accordance with the governing instrument and the Act], that the trustee is unable to comply with Section 116.004(b) [requiring the trustee to administer the trust or estate impartially, based on what is fair and reasonable to all of the beneficiaries].

(2) Availability of the Power.

The power to adjust arises only if the trustee invests and manages trust assets as a prudent investor, and the terms of the governing instrument describe the amount that may or must be distributed to a beneficiary by referring to the trust's income. Since the Uniform Prudent Investor Act now applies in Texas to all trusts unless the governing instrument otherwise so provides, the power to adjust should apply whenever the trust requires *or permits* the trustee to distribute trust income to a beneficiary. Thus, presumably, a trust that provides that the trustee "may distribute so much of the income as the trustee determines advisable, plus so much of the principal as the trustee determines necessary for health, education, maintenance and support" would seem to qualify.

(3) Limitations of the Power.

The power to adjust was initially designed to allow a trustee investing according to modern portfolio theory to adjust capital gains to the income account in a portfolio otherwise weighted toward growth assets. However, the power to adjust is not available in a number of circumstances. In particular, a trustee cannot make an adjustment:

(a) that diminishes the income interest in a trust that requires all of the income to be paid at least annually to a spouse and for which an estate tax or gift tax marital deduction would be allowed, in whole or in part, if the trustee did not have the power to make the adjustment;
(b) that reduces the actuarial value of the income interest in a trust to which a person transfers property with the intent to qualify for a gift tax exclusion;
(c) that changes the amount payable to a beneficiary as a fixed annuity or a fixed fraction of the value of the trust assets;
(d) from any amount that is permanently set aside for charitable purposes under a will or the terms of a trust unless both income and principal are so set aside;
(e) if possessing or exercising the power to make an adjustment causes an individual to be treated as the owner of all or part of the trust for income tax purposes, and the individual would not be treated as the owner if the trustee did not possess the power to make an adjustment;
(f) if possessing or exercising the power to make an adjustment causes all or part of the trust assets to be included for estate tax purposes in the estate of an individual who has the power to remove a trustee or appoint a trustee, or both, and the assets would not be included in the estate of the individual if the trustee did not possess the power to make an adjustment;
(g) if the trustee is a beneficiary of the trust; or
(h) if the trustee is not a beneficiary, but the adjustment would benefit the trustee directly or indirectly.

If items (e), (f), (g), or (h) applies to a trustee and there is more than one trustee, a co-trustee to whom the provision does not apply may make the adjustment unless the exercise of the power by the remaining trustee or trustees is not permitted by the terms of the trust.

(4) Comments on the Power.

Since most clients prefer to have their spouses or children serve as the trustee of the trusts created under their wills, and since the power does not apply if the trustee is a beneficiary of the trust, it seems unlikely that many trustees will be eligible to use the power unless a co-trustee who is not a close family member is willing to serve and make the adjustment.

VI. TYPES OF FORMULA GIFTS.

A. Use of Formula Clauses.

It is common practice for estate planners to structure Wills so that estate tax will be eliminated at the death of the first spouse, but that the optimal amount of property is placed into a trust for the benefit of the surviving spouse, which will not be subject to estate tax at the time of the surviving spouse's death (variously known as a "bypass trust," "credit shelter trust," "exemption trust," or "family trust"). For sake of simplicity, this outline uses the phrase "bypass trust" to describe this trust throughout. Of course, the estate planner cannot predict the exact size of the decedent's estate at the time of death, nor can one determine the amount of administration expenses, or whether those expenses will be deducted on the estate's income tax return or estate tax return. In addition, one cannot predict whether the decedent will make lifetime taxable gifts. Finally, changes made by Congress as part of the American Taxpayer Relief Act of 2012 will cause the amount of the federal estate tax exemption to change for inflation for each year following the year 2010. All of these factors come into play in evaluating the allocation of assets between the bypass and marital deduction gift. As a result, estate planners typically include formula clauses in their Wills which are designed to achieve an "optimal" marital deduction. If all estates were the same, one would expect that a single formula clause could be utilized as "standard." However, attorneys have developed a number of methods to express the "optimum" formula to achieve various tax and non-tax results. Unfortunately, as demonstrated below, the formula language itself will have an impact upon the income and estate tax consequences of the funding utilized. The use of these clauses varies with the size of the estate and the nature of the estate's assets, in order to match the advantages of the formula selected to the nature of the estate, while minimizing the negative features of each formula.

B. Goal of Formula Clauses.

Regardless of which formula method is utilized, the goal of the estate planner in drafting the formula is to achieve two objectives.

1. <u>"Optimum" Funding</u>.

The first objective is to place as much property as possible into the bypass trust, without generating any estate tax at the first death. The objective is to ensure that the full federal estate tax exemption available to the decedent in the year of his or her death is utilized to its fullest extent. This approach passes as much property as possible on to the next generation without incurring any estate tax at the death of either spouse. Broadly speaking this objective can be met by proceeding from one of two directions.

a. Bypass Formula Clause.

In the case of a formula gift describing the bypass amount, the formula is designed to produce a bequest exactly equal to the exemption equivalent available to the decedent. The "residue" of the estate then passes as the marital deduction gift. In its simplest form, this clause (in 2013) would say, "place $5,250,000 worth of property into the bypass trust. Give the rest of my estate to my spouse." Such a simple provision, however, fails to take into consideration changes in the amount of the decedent's exemption equivalent in the year of his death, other gifts (both probate and non-probate) passing at death which do not qualify for a marital or charitable deduction, the application of the credit for state death taxes, the deduction of administration expenses on the estate's income tax return (and the deduction of expenses of last illness on the decedent's final income tax return), adjusted taxable gifts, post-1976 gift taxes paid, and other relevant factors. Accordingly, more elaborate formulas taking these various factors into account have been devised. In the past, some commentators expressed concern that a formula bypass gift might jeopardize the marital deduction. This concern was based upon the fact that if the estate declined in value during administration, and date-of-distribution values were used to fund the bypass gift, all depreciation would fall upon the marital gift. The IRS has ruled, however, that this prospect does not cause a loss of the marital deduction. Rev. Rul. 90-3, 1990-1 CB 174.

b. Marital Deduction Formula Clauses.

Estate tax advisors may instead choose to use a formula that describes the otherwise-taxable portion of the estate, that is, the portion intended to qualify for the marital deduction. The "remainder" of the estate, which should equal the exemption equivalent amount (at least as of the date of death), then passes to the bypass trust. Again, formulae describing this gift must take into consideration other properties passing to the surviving spouse which qualify for the marital deduction (including both probate and non-probate assets), the amount of the unified credit and other credits available to the decedent's estate, adjusted taxable gifts, and other relevant factors.

2. <u>Minimization of Income Taxes</u>.

In addition to designing a formula which produces the optimum marital deduction, many estate planners are cognizant of trying to minimize the income tax consequences that will arise when a formula gift is funded. The income tax issue that presents the biggest problem relates to probate assets which have appreciated in value during the administration of the estate. When these appreciated assets are used to fund formula gifts, a taxable gain can result to the estate. As discussed above, the choice of which formula mechanism to use in computing the marital deduction bequest does not matter in terms of the amount of distributable net income carried out. Funding virtually any form of formula gift will carry the estate's distributable net income out to the marital and bypass gifts, since neither of these amounts can be computed with any certainty at the time of the decedent's death. The type of funding formula used to describe these gifts does, however, impact upon whether gain is recognized by the estate *as the result of using appreciated assets to fund those bequests*. In general, the funding of a pecuniary bequest using date-of-distribution values will cause gain to be recognized, while the funding of a residuary or fractional share gift will result in no gain being recognized to the trust or estate as a result of the funding. Note that in the context of a trust used as an estate surrogate, gains would be recognized, but losses would presumably be disallowed since the recipient of the pecuniary formula gift, whether an individual or another trust, is a beneficiary of the "living" trust, and thus a related party. *See* IRC § 267(b)(6). This issue can be avoided if the trustee and the executor (if any) elect to treat a "qualified revocable trust" as part of the estate for income tax purposes pursuant to Section 645 of the Code. In general, the estate recognizes gain only when it funds a "pecuniary" (specific dollar amount) gift, and not when funding the "residual" or remainder gift. *See* Rev. Rul. 55-117, 1955-1 CB 233. Therefore, capital gain exposure can best be minimized by using a formula to describe the smaller of the two gifts. Generally speaking then, to minimize gain on funding, a bypass formula would be most appropriate from an income tax standpoint for estates anticipated to be more than $10.5 million -- or more than $21 million for a community property estate (since the bypass amount is $5,250,000 under current law). For estates less than $10.5 million, a marital deduction formula would best minimize income tax exposure.

C. Types of Formulas.

Although there are a host of approaches to writing formula clauses in Wills, the various techniques utilized can be broadly described in two classes, with the first class taking one of three forms.

1. Pecuniary Formulas.

The first approach used in dividing the estate between the bypass share and the marital share involves the use of a formula designed to result in a pecuniary (that is, specific dollar) amount. In order for the pecuniary formula to result in a marital deduction to the estate, one of three formats must be utilized. *See* Rev. Proc. 64-19, 1964-1 CB 682.

a. True Worth (Date-of-Distribution) Formulas.

A "true worth" formula includes language specifying that assets distributed in satisfaction of the formula gift must be valued at the date or dates of their distribution. Under Texas law, unless the Will provides otherwise, pecuniary bequests are funded using date-of-distribution values. Tex. Prob. Code § 378A(b).

(1) Advantages.

One of the main advantages of a true worth formula is its relative simplicity in administration. The executor is required to revalue only the assets distributed in satisfaction of the gift. This formula also gives the executor maximum flexibility in selecting which assets will be distributed in satisfaction of the formula gift. Finally, this approach freezes the value of the formula bequest, shifting all gain or loss to the other (residuary) bequest.

(2) Disadvantages.

The main disadvantage of a true worth formula gift is that if the gift is funded with assets which have appreciated in value during the administration of the estate, the estate will recognize a taxable gain at the time the gift is funded with those assets. Treas. Reg. § 1.661(a)-2(f)(1). Of particular concern here is the use of assets which represent the right to "income in respect of a decedent" ("IRD"), including pension, IRA and similar accounts. If an IRD asset is used by an estate to fund a true worth pecuniary gift, the IRD will be accelerated to the estate. IRC § 691(a)(2).

b. Minimum Worth Formulas.

Formulae which provide for "minimum worth" funding stipulate that once the amount of the gift has been computed, assets to be distributed in satisfaction of the gift are valued at their estate tax values or their date-of-distribution values, whichever is lower.

(1) Advantages.

The main advantage of a minimum worth formula is that the distribution of appreciated assets presumably does not trigger any taxable income to the estate. The rationale for this conclusion is that, since post-death appreciation is not taken into consideration in funding, the estate derives no economic benefit from that appreciation, and should therefore not be required to recognize gain. While most commentators believe that this type of formula avoids capital gains, there is no statutory authority, treasury regulation or revenue ruling to support this position. Revenue Ruling 64-19, 1964-1 CB 682, specifically declines to rule on the income tax issues associated with funding formula gifts. *See* Featherston, The Funding of Formula Marital Deduction Gifts After the Economic Recovery Tax Act of 1981, 27 SOUTH TEX. L. REV. 99, 123 (1985). Some commentators suggest that, while avoiding capital gains, capital losses may nonetheless be recognized by the estate. *See* Pennell, Estate Tax Marital Deduction, (Tax Management Portfolio--Estate Tax Series) 843-1 T.M. A-75 (Bureau of National Affairs, 2004).

(2) Disadvantages.

While perhaps avoiding the income tax problem, minimum worth formulae place the burden of depreciating assets solely on the residuary estate. At the same time, this approach gives the executor the latitude to overfund the formula gift, which may give rise to disputes among beneficiaries.

c. "Fairly Representative" Formulas.

A "fairly representative" formula includes language requiring the assets distributed in satisfaction of the pecuniary gift to be valued at their estate tax values, but with a proviso that the executor must select assets which are "fairly representative" of the appreciation and depreciation in value of the probate estate from the date of death to the date or dates of distribution. Note that, if a Will specifies estate tax values be used to fund a pecuniary gift intended to qualify for the marital deduction, "fairly representative" language is engrafted under Texas law. Tex. Prob. Code § 378A(a).

(1) Advantages.

The main advantage of a fairly representative formula is that the distribution of assets will presumably not trigger any taxable income to the estate (subject, however, to the same cautionary note regarding lack of express authority or precedent mentioned above with respect to minimum worth formulas). In addition, this formula approach tends to result in a more balanced sharing of changes in the estate's value during administration, which may be especially important if the beneficiaries (or remainder beneficiaries) of the marital and bypass gifts differ.

(2) Disadvantages.

Funding a formula bequest on a fairly representative basis involves the administrative difficulty of revaluing all of the probate assets for purposes of determining what is "fairly representative" of appreciation and depreciation.

2. Fractional Share Formulas.

Under a fractional share formula, no pecuniary (specific dollar) amount is assigned to either the marital or bypass gift. Instead, the residuary estate is basically disposed of in two undivided portions. The potential income tax problem associated with pecuniary gifts is avoided, because neither gift is described as a fixed amount. Rather, each portion of the estate is described by a fractional share of the remainder. In the first portion, the numerator of the fraction describes the share defined under the applicable formula, whether the formula describes a bypass gift or the marital deduction gift. The denominator of the share generally consists of the estate tax value of the residuary estate. The second portion, then, is the compliment of the first fraction, so that the entire residuary estate is disposed of by the two fractions. Although this formula approach originally envisioned fractional shares of each and every asset of the estate being used to fund each bequest (and is sometimes still administered in that fashion), the Will now frequently includes language permitting the executor to make non-pro rata divisions of assets, once the appropriate fractions have been used to establish the date-of-distribution value of each bequest (a so-called "pick and choose" fractional formula).

a. Advantages.

Fractional share formulae have the advantage that no taxable gain is realized by the estate at the time the gifts are funded. In the case of fractional share gifts, there is express authority confirming this income tax result. *See* Rev. Rul. 55-117, 1955-1 CB 233; Rev. Rul. 60-87, 1960-1 CB 286; TAM 8145026. If a "pick and choose" fractional formula is used, the Will must expressly authorize non-pro rata distributions of assets to avoid gain recognition by the distributees. *See* Rev. Rul. 69-486, 1969-2 CB 159. As with fractional share funding, this formula approach balances sharing of appreciation and depreciation among all of the estate's beneficiaries.

b. Disadvantages.

The obstacle confronted when implementing a fractional share formula is the administrative inconvenience in computing and distributing assets in accordance with this fraction. In fact, every time there is a distribution, or every time income is accumulated or administration expenses paid by the estate, the applicable fraction must presumably be recomputed.

3. Combinations and Permutations.

As indicated above, there are three types of pecuniary formulas, and one fractional share formula, for a total of four approaches to express the desired amount of a formula bequest. The fraction or pecuniary amount formula can be used to describe the exemption equivalent, and thus fix the amount of the bypass gift, with the rest (or the complimentary fraction in a fractional share formula) passing to the marital share. Alternatively, the formula can be utilized to describe the marital gift, with the rest (or complimentary fraction) passing as the bypass share. Thus, there are eight combinations, using one of the four formulas to describe the bypass gift, or one of the four formulas to describe the marital gift.

4. Which Formula "Should" be Utilized.

As noted above, each of the eight alternative formula designs have advantages and disadvantages. The goal of this outline is not to identify which approach is "best," but rather to provide guidance on how best to fund gifts given the type of formula that you encounter in an estate. Any approach utilized can be criticized or praised, since each approach has disadvantages to accompany the advantages. In general, however, many estate planners have fallen into certain patterns, as identified in Donoghue, The Marital Deduction Five Years Later, State Bar of Texas 10th Annual Advanced Estate Planning and Probate Course (1986). The patterns were confirmed by survey in Quilliam, How Leading Texas Probate Attorneys are Handling Marital Deduction Problems (An Empirical Study), State Bar of Texas 11th Annual Advanced Estate Planning and Probate Court (1987). According to these sources:

a. Smaller Estates.

In situations where the estate is large enough to merit marital deduction/bypass trust planning, but small enough where one would expect the marital gift to be the smaller of the two portions, most estate planners utilize a pecuniary formula gift describing the marital share, using date-of-distribution funding. The residue of the estate, then, passes to the bypass trust. This approach is usually the simplest and most straightforward of all of the alternatives. Post-death appreciation passes to the bypass trust, thereby avoiding future estate tax. Also, there will normally be enough non-appreciating assets available to satisfy the smaller marital deduction amount to eliminate or substantially reduce taxable gain on funding.

b. Larger Estates.

In situations where the marital gift will be larger than the bypass amount, one is apt to encounter more variety. Nevertheless, it appears that most estate planners utilize a pecuniary formula to describe the bypass amount using date-of-distribution or minimum worth funding, with the residue passing to the marital share. Again, in larger estates, one would expect that there would be enough non-appreciating assets available to substantially fund the bypass trust, so that capital gain exposure is minimized. Utilization of the minimum worth approach has the advantage of enlarging the bypass share without significant capital gain exposure in case of an estate with assets which increase in value during the period of administration.

VII. FUNDING VARIOUS FORMULAS.

A. Identifying the Formula.

The foregoing material suggests that there are four general types of formula clauses which then can be used to identify either the marital portion (with the residue passing to the bypass trust) or the bypass portion (with the residue passing as the marital gift). Therefore, a total of eight combinations are possible, four describing the marital portion and four describing the bypass portion. It is critical to identify which of the eight formulae are at issue with respect to the Will being administered, because the funding strategy that best serves the estate depends to a large extent upon the formula chosen.

1. Pecuniary or Fractional Share.

The starting point for evaluating the formula at issue is determining whether the clause describes a fraction or a specific sum. This determination should be quite straight-forward, since a fractional share invariably instructs the executor to compute a fraction or ratio. The formula describes how the numerator and denominator of the fraction are to be computed, and provides for pro rata distribution of assets (or expressly permits non-pro rata "pick and choose" funding). Pecuniary share formulas, on the other hand, seek to describe a specific *amount* of property to be distributed for the marital or bypass gift, with the residue of the estate passing as the other gift.

a. Fractional Share.

Key to a true fractional share bequest is language that instructs the executor to transfer undivided interests in each and every asset in the residue based upon the fraction so computed. One should be careful with formulas which seem to utilize a percentage, but then apply the percentage to the federal taxable estate (as opposed to the estate on hand at the date of distribution). The IRS has held that this approach is actually a disguised pecuniary formula amount. *See* Rev. Rul. 60-87, 1960-1 CB 286; *Cf*. TAM 8145026. If a fractional share is being utilized, the analysis can end. It does not matter whether the fraction describes the bypass or marital amount, since the tax and funding results will not vary. All assets of the estate available for distribution must be revalued at the time of funding. The fraction must be recomputed each time a distribution is made until the estate is terminated by complete distribution.

b. True Worth, Minimum Worth, or Fairly Representative.

If the formula describes a pecuniary amount, the funding method must then be identified:

(1) "True Worth" Funding.

If the executor is instructed to fund the pecuniary gift in kind, with assets using ***date-of-distribution*** values, a "true worth" funding approach is being used. The assets to be distributed in satisfaction of the formula gift must be revalued to determine their true worth at the date or dates of distribution. Remember that if the Will is silent as to how to value assets used to fund the pecuniary amount, "true worth" funding is required by Texas law. Tex. Prob. Code § 378A(b).

(2) "Minimum Worth" Funding.

The formula uses "minimum worth" funding if the gift is to be funded with the ***lesser*** *of federal estate tax or date-of-distribution* values. The assets used to fund the gift must be revalued at the date of distribution, but the date-of-distribution value is considered only if it is less than the date-of-death value. Instead of using the phrase "federal estate tax" values, the draftsman may use equivalent phrases, such as "date-of-death" value or "cost basis in the hands of the estate." These phrases will generally refer to the same value, and are indicative of "minimum worth" formulas.

(3) "Fairly Representative" Funding.

If the formula requires funding using ***federal estate tax*** values, regardless of the value of the assets at date of distribution, the Will is almost certain to require the executor to ensure that the assets used are "fairly representative of appreciation or depreciation in the value of all assets available for distribution." If the Will does not contain this language, yet specifies estate tax values for a gift intended to qualify for the marital deduction, the "fairly representative" requirement is imposed by Texas law. *See* Tex. Prob. Code § 378A(a). This clause requires that *all* assets available for distribution be revalued, so that the assets selected are certain to be fairly representative of the appreciation and depreciation of all assets.

2. <u>Marital Formula or Bypass Formula</u>.

If a pecuniary formula is used, the next step in the process is to evaluate whether the formula seeks to describe the marital portion (with the residue passing to the bypass trust) or the bypass portion (with the residue passing as the marital gift). Again, this evaluation is usually straight forward. Some Wills seem to try to describe both gifts as a pecuniary amount, with no clear disposition of the "residue" of the estate. Under those circumstances, see if you can determine which of the two formulas will increase if the estate increases in value before funding, and if date-of-death values are used to fund the gifts. The amount that increases is probably the "residuary" gift, and the other is the pecuniary amount. If both amounts (or neither) change, you will probably need to get the input of the draftsman (or, in a worst-case scenario, a ruling from the probate court) to assist in the evaluation of the formulas.

3. <u>Changes in the Estate</u>.

Having identified the formula, we must now evaluate how the estate has changed during administration. When the executor is ready to make some actual funding decisions, it will be essential to identify which assets have appreciated, which have declined in value, and which have remained unchanged. In addition, some of the assets on hand at the date of death may have been disposed of, and new assets may have been purchased during the administration of the estate. Purchased assets will, of course, have a cost basis equal to their purchase price. Note also that if the estate owns assets that are used in a trade or business, or are otherwise depreciable for federal income tax purposes, any post-death depreciation allowable must be subtracted from basis. IRC § 167.

4. <u>Selecting a Funding Date</u>.

Although the available literature rarely speaks of the topic, selection of a funding date is a critical step in the funding process.

a. Practical Issues.

Anyone who has actually attempted to undertake the funding of an estate quickly makes two important discoveries. First, since asset values constantly change, many (or in some cases, all) of the assets need to be revalued as of the funding date. Second, it is virtually impossible to value the estate's assets and to actually fund the estate on the same date. For example, if marketable securities are owned by the estate, the executor must fund bequests based upon the value of those securities. Over the course of a given day, the value of the securities may change substantially. Nothing informs the executor which valuation to use, but if the executor decides to use securities' closing prices (or the average between their high and low--the method used for estate tax valuation), the executor must wait for the market to close before a valuation can be completed. Of course, once the market is closed, it is then too late to fund the trusts that day. Obviously, a practical solution must be used.

b. Selecting a "Funding" Date.

Most estate planning professionals recommend that the executor select a funding date (such as the last day of the month or calendar quarter). Over the next few days, assets are valued as of the selected date and funding decisions are made on that basis. Changes in value, income, dividends, stock splits and other post-valuation-date changes are then simply credited to the appropriate account, as though funding had actually occurred on the selected date. In times of volatile markets, some executors have sought to exploit the difference between valuation and actual funding in order to "shop" for a funding date that provides the best tax or economic result to the family. Using hindsight, they might, for example, seek to use an historically high funding date to maximize a residuary bypass gift, selecting assets to fund that gift that have had disproportionately less market decline. Revenue Ruling 64-19, which limits marital deduction formula clauses to those outlined above, had as one of its goals preventing executors from using this sort of wait-and-see approach. The Revenue Ruling does not, however, specifically address this issue. In fact, no rule currently in force seems to prevent it. Nevertheless, one might expect the IRS to argue, if funding is reviewed by them, that selecting arbitrary long-past funding dates violates the spirit and intent of the funding language of the Will and the Texas Probate Code. While short delays between valuation and funding are necessary and warranted, excessive delays will likely not hold up to IRS scrutiny if the funding is later reviewed.

5. Reviewing the Goals.

With the formula evaluated and a feel for the changes in estate assets at hand, the process of making some funding decisions can begin. At this point in time, it is helpful once again to review the goals of funding. In summary, our objectives are as follows:

a. Minimize Capital Gains.

Remember that the funding of a pecuniary gift using date-of-distribution values will result in the recognition by the estate of capital gains and losses. One funding goal is to minimize the recognized gains.

b. Maximize Capital Losses.

If an estate, and not a "living trust" is at issue, a second objective might be to maximize any capital loss recognized by the estate. Remember that a living trust used as an estate surrogate cannot recognize losses on funding since a trust and its beneficiaries are "related parties" under Section 267 of the Code, unless it has elected to be taxed as an estate under Section 645 of the Code. Even if the estate does not have recognized capital gains to offset the losses, unused losses are passed out to the beneficiaries of the estate in the year of its termination. IRC § 642(h). Thus, the recipient who bares the risk of a decline in the value of the estate can carry these recognized losses forward to be utilized in future years. Treas. Reg. § 1.642(h)-4.

c. Maximize the Bypass Trust.

Since the bypass trust passes estate tax free at both the death of the decedent under whose Will it is created, and at the death of the surviving spouse, it is in the best interest of the family to maximize the amount of property passing into the bypass trust. This goal is an ongoing one, so that under ideal circumstance, the bypass trust will be funded with the maximum initial amount, and the assets placed into the trust will be those expected to grow the most during the lifetime of the surviving spouse.

6. Doing the Math.

We now have the tools necessary to evaluate the effect of various funding options. The funding process now can begin in earnest. The ultimate funding options can now be evaluated, and a preferred approach selected. The steps in giving the executor the tools to make a final decision are as follows:

a. Group Assets by Changes in Value.

The assets on hand can be classified as appreciated, depreciated, and unchanged. Ultimately, the impact of disposing of appreciated and depreciated assets is the key to the funding analysis.

b. Evaluate the Capital Gain and Loss Effects.

The capital gains and losses can be analyzed by examining the tax effects of funding the various categories of assets into the marital or bypass gift. Remember that capital gains and losses will be recognized with "true worth" formulas but not fractional share formulas. Commentators *believe* that gains and loss are avoided by "fairly representative" funding, and the "minimum worth" formulas avoid gains (but perhaps not losses). Finally, remember that if a "living" trust is at issue instead of an estate, no losses will be recognized pursuant to 267(b)(6) of the Code unless the trust has made a Section 645 election to be treated as an estate.

c. Evaluate the Impact Upon the Bypass Trust.

For each funding approach, the executor should look at the amount ultimately passing to the bypass trust. In the best case, the bypass trust can be maximally funded without incurring excessive capital gains. In the worst case, the amount by which the bypass trust is underfunded can be minimized.

d. Evaluating Other Factors.

Ultimately, the executor must make the final determination of how to fund the gifts under the Will. Current tax and economic effects are only one consideration for the executor. The executor will also undoubtedly want to consider the administrative costs of funding the gifts, the costs of ownership of various assets, cash needs of the distributees, the likely future appreciation and depreciation potential for the assets, the wishes of the various beneficiaries as to who will ultimately own which assets, and other similar factors. The executor should remember that even a trust in which the trustee plans few if any distributions may have cash needs. For example, a bypass trust funded with raw land or a vacation home will still need cash to pay property taxes, insurance, maintenance costs, and the like. These practical issues must be thought through before making final funding decisions. Current tax and economic factors are important, however, and their evaluation is a key element in the decision making process.

7. A Case Study.

Attached to this outline as Appendix A is an example of how one might undertake the evaluations outlined above. The example looks at the tax and funding effects of each of the eight formulas, under a variety of assumptions about the changes in the assets of the estate. Thus, the funding and capital gain consequences of each type of formula is examined assuming (i) no change in the value of the assets, (ii) all assets appreciate in value by ten percent, (iii) all assets decline in value by ten percent, (iv) half of the assets decline in value by ten percent, while the other half appreciate by fifteen percent, and (v) half of the assets decline in value by fifteen percent while the other half appreciate by ten percent.

a. Some Caveats.

Please note that while the example is intended to cover a variety of situations, the generalizations made below must be taken with some caution. The example has several unique features that make generalizations a bit dangerous. These features include the fact that only two assets, each with the same initial value are shown. The proportionate changes in value, especially when half of the assets move in one direction and half in the other, is, to say the least, unlikely to occur in real life. Second, the size of the estate being divided between the marital and bypass share is $2,500,000 (and a death in 2002, with a $1,000,000 applicable exclusion amount is assumed). This size of estate has a marital gift which exceeds the bypass amount. As pointed out above, the goal of minimizing capital gains taxes and maximizing the bypass amount is commonly approached differently depending upon whether the marital amount is expected to exceed the bypass amount. Note finally that the example *presumes* that no tax, either gain or loss, will arise when funding minimum worth, fairly representative, and fractional share gifts. While the IRS has given us assurance of this result for fractional share gifts (*See* Rev. Rul. 55-117, 1955-1 CB 233), no certainty exists for this result as to the other formulas described. *See* Featherston, The Funding of Formula Marital Deduction Gifts After the Economic Recovery Tax Act of 1981, 27 SOUTH TEX. L. REV. 99, 123 (1985).

b. Some Generalizations from this Example.

Despite the caveats set forth above, some facets of this example are noteworthy. Applying these principles to the specific facts of your situation should be tested, however, before being relied upon as stating a universal set of truths.

(1) True Worth Formulas.

In each instance in the example involving "true worth" formulas, the executor would likely *fund the formula gift with depreciated (or the least appreciated) assets*, whether the formula describes the marital gift or the bypass amount. This approach generates a capital loss (or minimizes capital gain) without impacting upon the size of the bypass trust. Note that if the true worth formula describes the bypass amount, funding with depreciated assets may be short cited. If those assets continue to decline in value, while assets in the marital trust continue to appreciate, the income tax saved upon funding may be offset by higher estate taxes at the second death.

(2) Minimum Worth Formulas.

In each instance in the example involving "minimum worth" formulas, the executor would likely *fund the bypass gift with appreciated (or the least depreciated) assets*, regardless of which gift is described by the formula. If the conventional wisdom is correct, and no gains are recognized when minimum worth formulas are utilized, the use of appreciated assets to fund the bypass trust will ensure that the maximum amount of property will pass to the next generation tax-free upon the death of the surviving spouse.

(3) Fairly Representative and Fractional Share Formulas.

In each instance in this example involving "fairly representative" or "fractional share" formulas, the executor would likely be *indifferent as to which specific assets went to fund which gift*, since no tax is presumable generated, and any truly "fairly representative" funding will result in funding amounts indistinguishable from fractional share funding.

VIII. VALUATION ISSUES RELATING TO FUNDING.

A. Discounts (and Premiums) at Funding.

Frequently, whether because of the funding formula employed or because of the decisions of the executor, the recipients of estate assets receive undivided fractional interests in assets owned by the estate at death. One should be mindful that when distributing fractional or minority interests, the date-of-distribution values of the asset received by a given beneficiary may be very different than the value of the asset in the hands of the estate. For example, in *Estate of Chenoweth*, 88 TC 1577 (1987), the Tax Court held that a bequest of 51% of the stock of a family corporation to the surviving spouse entitled the estate to an increased marital deduction associated with a "control premium" attributable to the stock. The IRS has applied this analysis to their advantage, however, reasoning that a minority discount should be applied if the marital gift is funded with less than a controlling interest. *See* TAM 9050004 (minority interest discount applied to bequest of 49% of stock of closely held business passing to QTIP where other 51% bequeathed to son). For a more detailed discussion of the valuation problems associated with funding marital bequests, see Moore, Honey, Who Shrank My Deduction, 11 PROB & PROP. 8 (1997). *See also*, Akers, Postmortem Planning Considerations, a Review of Income, Gift, and Estate Tax Planning Issues, ALI-ABA Estate Planning for the Family Business Owner, 2007.

B. Fractional Interest Discounts at Second Death.

While fractional or minority interest funding may be problematic at the time of funding, it may prove advantageous to the family at the death of the second spouse if the recipient is a QTIP trust (or surviving spouse). For example, in *Estate of Pillsbury*, 1992 TC Memo 367, the marital trust received an undivided 77% interest in property, with the other 23% passing to a trust for the decedent's children. Upon the death of the second spouse, the Tax Court ruled that a fractional interest discount was available in valuing the marital trust's 77% interest, despite the fact that the same person was the trustee of both trusts, and the fact that the marital trust terminated in favor of the children's trust upon the spouse's death.

C. Minority Interest Discounts Associated with Community Property.

A related issue arises when the decedent's community property one-half interest in an asset is funded entirely into the marital trust. The IRS has taken the position that upon the death of the second spouse, no minority or factional interest discount is available, since the two halves of the community are effectively re-combined in the spouse's estate. See, e.g., TAM 9608001; 9550002; 9140002. Fortunately, the Fifth Circuit, however, has held to the contrary. In *Estate of Bonner*, 84 F.3d 196 (5th Cir. 1996) the husband died owning undivided interests in various assets, the remaining interests in which were owned by a QTIP trust established under his wife's Will. The husband's executors took discounts on the various properties in the range of 45% based upon minority interests, etc. The Court declined to follow the IRS's view that Section 2044(c) of the Code, which treats the QTIP property as passing from the decedent, acts to re-combine the interests for valuation purposes. Instead, the Court applied the rationale of *Estate of Bright*, 658 F.2d 999 (5th Cir. 1981), which held that no family attribution applies in valuing undivided community property interests in property. A similar result was reached by the Tax Court in *Estate of Mellinger*, 112 TC 26 (1999).

IX. INCOME TAX ISSUES ASSOCIATED WITH TRUSTS OWNING PASS-THROUGH ASSETS

A. Special Problems with S corporation stock.

1. Eligibility Issues - Estates.

A decedent's estate qualifies as an S corporation shareholder for the entire period of administration. IRC § 1361(b)(1)(B). For purposes of ensuring that the corporation has no more than 100 shareholders, the estate counts as only one shareholder. Treas. Reg. § 1.1361-1(e)(1). In addition, the fact that an estate has one or more beneficiaries who are not eligible to be S corporation shareholders does not disqualify the S election so long as the estate retains the stock and does not distribute it to the ineligible shareholder. These rules give an executor time to analyze the consequences of a distribution of stock, and to take necessary actions to ensure that the beneficiaries who receive the stock are eligible shareholders. These actions might include reforming a recipient trust to ensure that it is eligible to hold S corporation stock. Note, however, that an estate cannot be prolonged beyond the period necessary for its administration. If an estate is unduly prolonged, the IRS might assert that the estate has in effect become a trust, and therefore is no longer an eligible shareholder. *See Old Virginia Brick Co.*, 367 F2d 276, 66-2 USTC ¶ 9708 (4th Cir. 1966); *see also* Tenney and Belkap, "Postmortem Planning for Interests in Pass-Through Entities," 27 EST. PLAN. J.,No. 6, p. 250 (July 2000).

2. Eligibility Issues - Trusts.

In general, only certain trusts are eligible to serve as S corporation shareholders. IRC § 1361(c)(2). In particular, a grantor trust may hold stock for up to two years after the death of the grantor. In addition, a trust to which stock is transferred pursuant to the terms of a Will may hold the stock, but only for a period of two years beginning on the date that the stock is transferred to the trust. Thereafter, trusts are not eligible to hold S corporation stock unless they are Qualified Subchapter S trusts or Electing Small Business Trusts. If any other trust receives stock in the S corporation, the S election will be deemed to be terminated. IRC § 1362(b)(3)(C).

a. Qualified Subchapter S Trusts.

A qualified subchapter S trust ("QSST") is one that has only one income beneficiary during whose life, all income must be distributed to that beneficiary. In addition, no distributions of principal may be made to anyone other than the income beneficiary. If the trust terminates during the life of the income beneficiary, all of the trust assets must pass to that beneficiary. IRC § 1361(d)(3). The *beneficiary* of the trust (not the trustee), must consent to the S election and agree to be taxed on the S corporation income. IRC § 1361(d)(2).

b. Electing Small Business Trusts.

Unlike qualified subchapter S trusts, an electing small business trusts ("ESBT") may have more than one shareholder. To be eligible as an electing small business trust, the trust must not have any shareholders other than individuals, estates, and certain qualified charities. In addition, none of the stock in the electing small business trust may be acquired by purchase. IRC § 1361(e). In the case of an electing small business trust, each potential current beneficiary of the trust is counted as a shareholder for purposes of the 100 shareholder limit. If a trustee makes the election to be treated as an electing small business trust, all S corporation income is taxed to the trust at the highest marginal income tax rate, and the trust is not entitled to a distribution deduction the income that passes through from the S corporation.

A. Pass-Through Entities and Simple Trusts.

1. Distributions of All "Income".

As noted above, a simple trust is one which must distribute all of its "income" annually. "Income" for this purpose means *fiduciary accounting income* determined under local law–not taxable income. IRC § 643(b). In most states, "fiduciary accounting income" is determined under some version of the Uniform Principal and Income Act or the Revised Uniform Principal and Income Act and the relevant provisions of the governing instrument. The trust need not distribute all of its taxable or distributable net income. Naturally, in the context of stocks, bonds and most other assets, the trustee can look to the governing instrument or local law to determine which items constitute principal or income.

2. Trapping Distributions.

a. Trapping Distributions Described.

A "trapping distribution" may arise when one fiduciary (e.g., an estate) distributes property to a trust (e.g., a marital deduction trust), if the distribution carries with it taxable income in the form of the distributing entity's distributable net income. If the transferee fiduciary considers the receipt corpus under principles of local law or the governing instrument, the recipient will not distribute that amount as "income" to the beneficiary. As a result, the DNI carried out by the distributing entity is "trapped" inside the transferee entity. This trapping of income presents an opportunity to use an otherwise simple trust as a taxpayer in the year it is funded. As noted above, since trusts reach the top tax rates at only $11,950 in income (the 2013 inflation-adjusted threshold), the tax savings generated by this technique are limited. Under UPIA and the Texas Trust Code, income accrued at the date of death is principal, but funds received by a trustee from an estate that constitute the estate's income is treated as trust income. Accordingly, this post-death income passing from the estate to the trust will not be "trapped." Although trapping distributions may arise without regard to whether the estate owns an interest in a pass-through entity, their application in the trust context can be more insidious.

b. Example.

Assume an estate's only asset is a limited partnership interest worth $7,875,000 at the date of death, and the Will makes a formula bequest of $2,625,000 (33-1/3% of the estate) to a QTIP trust, with the residue (66-2/3% of the estate) passing to a bypass trust. Suppose the estate funds these bequests on November 30, 2013. Upon funding, the partnership closes its books and determines that the estate's share of partnership taxable income is $240,000. No distributions are made by the partnership to the estate. The estate would report taxable income and DNI of $240,000, and increase its basis in the partnership by this amount. The estate would then distribute one-third of its limited partnership interest to the marital trust, and two-thirds of its interest to the bypass trust. These distributions would entitle the estate to a distribution deduction of $240,000 (since all of the estate's taxable DNI was distributed) and the estate's taxable income would be zero. The estate would issue K-1s to the QTIP trust showing $80,000 of income, and to the bypass trust showing $160,000 of income. The trusts would also receives a K-1 from the partnership for income earned by the partnership from December 1 to December 31, 2013. Assume for this example that partnership expenses offset income for the month of December and so no amounts are reportable on the K-1s issued by the partnership to the trusts. The QTIP trust, which has a mandatory income distribution requirement, calculates its fiduciary accounting income to be zero. (Even though post-death taxable income has been attributed to the estate, presumably no post-death fiduciary accounting income has been received by the estate or distributed to the trust.) The trust's only asset is a limited partnership interest which it held for one month during 2013. The partnership made no distributions to the trust in 2013. Therefore, the QTIP trust is not required to make any income distributions to the surviving spouse beneficiary in 2013. However, the marital trust has taxable income of $80,000 on which it must pay tax at fiduciary rates. The income is "trapped" in the trust (unless the trust agreement allows for, and the fiduciary actually makes, corpus distributions during December 2013 or within 65 days after the QTIP trust's year end under the 65 day rule of Section 663(b) of the Code).

3. <u>Cash Flow Difficulties</u>.

a. If the Entity Makes No Distributions.

Note that in the above example, the QTIP trust and bypass trust both have serious liquidity problems. Their only assets are limited partnership interests from which they cannot demand a cash distribution. Perhaps the trusts could carve out and distribute partnership interests with a basis or value equal to their DNI (if the distributions are deemed to be necessary under the standards set forth in the trusts, and if the partnership agreement permits such an assignment). The effect of those distributions would be to shift the tax liability (and the liquidity problem) to the beneficiaries receiving the distributions. Query whether the trustee's fiduciary duty to the beneficiaries is violated by making in-kind distributions which carry out taxable income, without distributing sufficient cash to pay the resulting tax. If the trusts do not make any distributions, they are each faced with a significant federal income tax liability and no cash with which to pay it. Although the IRS now accepts credit card payments, it has not yet approved payment by way of partnership interests. Presumably, the trustees will be required to sell sufficient limited partnership interests to raise the required cash, or to borrow funds to pay taxes.

b. If the Entity Distributes "Enough to Pay Taxes".

(1) Partnerships.

If a partnership owned by a simple trust makes a distribution during the year, but doesn't distribute all of its taxable income, a new cash flow problem arises. Suppose that a QTIP trust owns a 25% interest in a partnership which earns $1,000,000 in income. The managing partner decides to distribute $440,000 to the partners ($110,000 of which passes to the QTIP trust), so that the partners have funds with which to pay any resulting tax liability. The partnership sends the trust a K-1 for $250,000. For fiduciary accounting purposes, though, the income of the trust (if income is based upon receipts) is only $100,000. Tex. Prop. Code §116.151. As a result, the trust distributes $100,000, leaving taxable income of $150,000 in the trust. The trust owes tax on that income of about $57,750 (using 2013 rates). Under the original version of Section 505 of the Uniform Principal and Income Act (codified in Texas as Section 116.205 of the Texas Property Code), a tax required to be paid by a trustee on the trust's share of an entity's taxable income was required to be paid *proportionally* (i) from income to the extent that receipts from the entity are allocated to income; and (ii) from principal to the extent that receipts from the entity are allocated to principal, or the trust's share of the entity's taxable income exceeds receipts from the entity. For this purpose, receipts were reduced by the amount distributed to a beneficiary which generates a distribution deduction. Since on these facts, the trust's share of taxable income exceeds the receipts from the entity, the tax was charged to principal, leaving the trust with a $57,750 cash shortfall. In 2011, the Texas Legislature amended Section 116.205(c) to provide that tax is to be paid from income to the extent that the receipts are allocated to income. It also added Section 116.205(d), which provides that the amount of the trust's "income" is adjusted to reflect the reduction in taxes arising from any distribution. The result is that the distributable amount is reduced by taxes, which reduces that distribution (and the distribution deduction). This reduced deduction further increases taxes, etc. until the tax bill on nearly the entire $250,000 is owed by the trust, generating a tax of $83,954.97, leaving $26,046.03 of income to be distributed by the trust (using 2013 tax rates). In other words, for tax purposes, the trust would have $250,000 of K-1 income, less a distribution deduction of $26,046.03, leaving taxable income of $223,953.97, yielding a tax of $89,953.97. From a fiduciary account income point of view (ignoring UPIA), the trust would have $110,000 of gross accounting income, less $89,953.97 in taxes, for net accounting income of $26,046.03 (equal to the imputed distribution deduction).

(2) Electing Small Business Trusts.

A similar issue arises if the entity involved is an S corporation and the trust has made an ESBT election. The trust will receive a K-1 from the S corporation showing taxable income of $250,000. Even if we ignore the 3.8% Medicare tax on net investment income and possible state income taxes, the trust will owe tax of $99,000 ($250,000 x 39.6%). As with the preceding example, actual *proceeds* of $110,000 have been received by the trust, which should be characterized as income. Section 116.205 of the Trust Code allocates taxes to the income account to the extent receipts are treated as income. That Section provides that receipts allocated to income are reduced only for distributions yielding a distribution deduction, but an ESBT receives no distribution deduction. Therefore, the tax, to the extent it relates to income, should reduce fiduciary accounting income. If the trustee reduces fiduciary accounting income by the taxes attributable to income, the fiduciary accounting income will be $110,000, less the tax on that income ($43,560) or $66,440. The trust has only $110,000 of cash, but must write a check for $99,000 in tax, and make a distribution of $66,440. Thus, the trust will have a cash shortfall of $55,400 ($110,000-$99,000-$66,450) when it comes time to make its required distribution.

(3) Qualified Subchapter S Trusts.

If S corporation stock is held in a QSST, the S corporation should send the K-1 to the trust beneficiary, and not the trust. IRC § 1361(d)(1)(B); Treas. Reg. § 1.1361-1(j)(7). In that event, the $110,000 received by the trust is all fiduciary accounting income distributable to the beneficiary, who then has the cash flow with which to pay the tax.

(4) Power to Adjust Taxes.

Section 116.206 of the Texas Property Code (506 of UPIA) grants a fiduciary a power to adjust between principal and income to offset the shifting of economic interests or tax benefits between income and remainder beneficiaries which arise from tax elections, and distributions or ownership of interests in flow-through entities. This section is essentially a codification of the doctrine of equitable adjustment. The commentary on Section 505 of UPIA notes that the power to adjust, together with the more general power to adjust between principal and income in Section 104 of UPIA (when available) "are probably sufficient to enable a trustee to correct inequities that may arise because of technical problems." This Pollyannaish view of the complex issues presented does little to solve the cash flow problems encountered by the trust. For example, for an ESBT to pay its taxes when the S corporation distributes only enough to pay taxes, the commissioners must expect the trustee to ignore UPIA Section 401, allocate all ESBT distributions to principal, and make no distributions to the income beneficiary, so that corporate dividends may be used to pay the trust's tax. Perhaps this is the best result one can hope for under the current state of the law, but it is probably contrary to the expectation of most income beneficiaries.

X. OTHER TAX EFFECTS OF FUNDING.

A. Terminating Distributions.

Typically, the funding of formula gifts is undertaken at the conclusion of the estate administration process. As a result, it is important to consider the income tax consequences of estate terminations when funding those bequests.

1. Effect of Termination.

All income of an estate, including capital gains, is considered to have been distributed by the estate, and is therefore reportable by the beneficiaries, in the year of the estate's termination. The allowance in lieu of personal exemption is lost to the estate in its final year. If the estate has excess deductions for its final year, other than the allowance in lieu of personal exemption and any charitable deduction, the excess is allowed to the beneficiaries succeeding to the property of the estate. IRC § 642(h). *O'Brien v. Commissioner*, 75 TC 304 (1980). The deduction is a deduction to taxable income, and may be deducted by the beneficiary in his or her year in which the estate terminates. Net operating loss carryovers and long-term capital loss carryovers may be utilized by the beneficiary, and the character of those items remain the same in the hands of the beneficiary. Treas. Reg. § 1.642(h)-1(b). In determining the number of years in which a loss may be carried over by a beneficiary, the last year of the estate and the first year the beneficiary to which the loss is carried are considered separate years. Treas. Reg. § 1.642(h)-1(b). (*But see Dorfman v. Commissioner*, 394 F.2d 651 (2d Cir. 1968) holding this portion of the Regulations invalid). Of course, if the beneficiary succeeding to an estate is a trust, and it has deductions in excess of gross income as a result of the excess deductions, its beneficiaries may not deduct the excess expenses unless the trust also terminates in the same year. Rev. Rul. 57-31, 1957-1 CB 201.

2. "Living" Trusts Contrasted.

Trusts used as estate surrogates face issues similar to estates in the context of making distributions and funding the successor trusts. In the words of one author,

> A postmortem successor trust does not spring, Minerva-like, full-blown from the Jovian brow of the grantor trust *eo instante* upon the grantor's death. In most instances, and unless the governing instrument provides otherwise, the postmortem successor trusts (marital deduction, credit shelter or other) will be treated as separate trusts for income tax purposes only when funded. Funding occurs only when the trustee has assigned assets to the trust after careful exploration and prudent exercise of post-mortem tax options and elections available under the Internal Revenue Code of 1986. In the interim, the grantor trust normally functions like an estate pending distribution to its beneficiaries (including successor trusts) and, as such, in a separate taxable entity for income tax purposes.

Becker, Wills vs. Revocable Trusts - Tax Inequality Persists, 3 PROBATE & PROPERTY NO. 4 at 17, 18 (1989). Trust termination rules are governed by paragraph (b) of Treasury Regulation Section 1.641(b)-3, as opposed to paragraph (a). The rules, however, are similar and should give rise to no real substantive difference in timing or treatment. Historically, post-death revocable trusts suffered several minor disadvantages when contrasted with an estate for income tax purposes. These included, for example, fiscal year-end selection, holding periods for S stock, waiver of active participation for passive losses, use of the $600 allowance in lieu of personal exemption, income tax deductions for charitable set asides, Section 194 amortization of reforestation expenditures, avoidance of estimated tax payment requirements for two years, etc. For decedents dying after August 5, 1997, however, the trustee and the executor (if any) may irrevocably elect to treat a "qualified revocable trust" as part of the estate for income tax purposes. A "qualified revocable trust" is a trust that, during the life of the grantor, was treated as a grantor trust because of his or her right of revocation under Section 676 of the Code. The election must be made on the estate's first timely filed income tax return (including extensions), and applies until "the date which is 6 months after the date of the final determination of the liability for tax imposed by chapter 11," or if no estate tax return is due, two years after the date of death. It is unclear whether the "final determination" of estate tax liability arises at the time the estate tax closing letter is received, or at the time of the running of the statute of limitations on the 706.

B. Deduction of Interest Paid on Pecuniary Bequests.

As discussed above, Section 116.051(3) of the Texas Trust Code provides that the devisee of a pecuniary bequest is entitled to interest on the bequest beginning one year after the date of death, at the legal rate on open accounts (currently, six percent). This is a change from former Section 378B(b), under which interest accrued beginning one year after letters testamentary were issued. (The new rule became effective January 1, 2004, and presumably applies to persons dying on or after that date.) Payment of this interest is treated for tax purposes not as a distribution of income, but as an interest expense to the estate and interest income to the beneficiary. Rev. Rul. 73-322, 1973-2 CB 44. Under Section 163(h) of the Code, interest is non-deductible "personal interest" unless it comes within an exception, none of which expressly relates to interest on a pecuniary bequest. Section 163(d)(3) of the Code defines "investment interest" as interest paid or accrued on indebtedness properly allocable to property held for investment. Property held for investment is described by reference to Section 469(e)(1) of the Code, and includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. No case or ruling addresses the allocation of interest expense when an estate incurs an expense as a result of a delay in funding a pecuniary bequest. However, IRS Notice 89-35, 1989-13 I.R.B. 4, provides temporary guidance on allocating interest expense on a debt incurred with respect to certain pass-through entities. Under that Notice, the debt and associated interest expense must be allocated among the assets of the entity using a reasonable method. Reasonable methods of allocating debt among assets ordinarily include pro rata allocation based upon fair market value, book value, or adjusted basis of the assets. Although this Notice does not apply by its terms to indebtedness incurred by an estate in funding a bequest, perhaps these principles can be applied by analogy to estates. This analysis would probably require the executor to examine the activities of the estate. One could argue that a "debt" was incurred because the estate failed to distribute its assets to fund the pecuniary bequest within one year after the decedent's date of death. As a result, the estate was able to retain assets, including assets that generate portfolio income, as a result of its delay in funding the bequest. In effect, the estate could be said to have "borrowed" these assets from the beneficiary during the period that the distribution was delayed, and it is as a result of this borrowing that the interest is owed under the provisions of the Texas Probate Code. This analysis would mean that to the extent that the assets ultimately distributed to the beneficiary (or sold to pay the beneficiary) were assets of a nature that produced interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business, the interest expense would be deductible to the estate as "investment interest." It should be noted, however, that in an example contained in the Treasury Regulations issued regarding the separate share rules, the IRS states (without explanation) that interest paid on a spouse's elective share that is entitled to no estate income, but only statutory interest, is income to the spouse under Section 61 of the Code, but non-deductible to the estate under Section 163(h). Treas. Reg. § 1.663(c)-5, Ex. 7. The focus of this regulation is on the amount of DNI that will be carried out by the distribution; it properly rules that no DNI is carried out. Its characterization of the interest expense as nondeductible under Section 163(h) is gratuitous, and in this author's view, erroneous.

C. Non-Pro Rata Divisions of Community Property.

Can an executor and the surviving spouse make tax free non-pro rata divisions of community property, so that the beneficiaries own 100% of a community property asset while the spouse succeeds to 100% of other community property assets of equal value? Two 1980 technical advice memoranda suggest that a tax-free division is permissible in these circumstances. Both rely on Revenue Ruling 76-83, 1976-1 CB 213, a ruling involving similar issues in the divorce context, which has since been rendered obsolete by the enactment of Section 1041 of the Code which expressly provides for non-recognition in a divorce context. Tech. Adv. Mem. 8016050; Tech. Adv. Mem. 8037124. A more recent ruling seems to confirm this analysis, so long as the division is if permitted by the governing instrument or by local law. Tech. Adv. Mem. 9422052. Does Texas law permit a non-pro rata division of community property? Remember that under Section 177(b) of the Texas Probate Code, the executor of an estate takes possession of both halves of the community property of the decedent and the decedent's spouse. Section 385 of the Texas Probate Code provides that when a husband or wife dies leaving community property, the surviving spouse may, at any time after the grant of letters testamentary and the filing of an inventory, make application to the court for a "partition" of the community property into "two equal moieties, one to be delivered to the survivor and the other to the executor or administrator id the deceased. The provisions of this Code respecting the partition and distribution of estates shall apply to such partition so far as the same are applicable." Tex. Prob Code § 385. At least one court has described equal moieties in this circumstance to be either two groups alike in magnitude, quantity, number or degree, or two groups alike in value or quality. *Estate of Furr*, 553 S.W.2d 676, 679 (Tex. Civ. App.–Amarillo, 1977, writ ref'd n.r.e.). Section 373 of the Probate Code deals with partitions and distributions of estate assets generally. This section does not require the court to make a pro rata partition of each and every asset of the estate, but permits the court to allocate assets among beneficiaries to achieve a "fair, just and impartial" distribution of estate assets. Similar powers perhaps apply to independent executors acting without court supervision. For example, in the context of a community administrator, there appears to be no requirement to account for specific assets upon the conclusion of the administration. Rather, the responsibility of the survivor is only in the aggregate. *See Leatherwood v. Arnold*, 66 Tex. 414, 416, 1 S.W. 173, 174 (1886). *Cf. Gonzalez v. Gonzalez*, 469 S.W.2d 624, 630 (Tex. Civ. App.–Corpus Christi 1971, writ ref'd n.r.e.) (power of an executor to distribute an estate does not include the right to partition undivided interests, absent express grant of authority in the Will). As to partitions generally, Texas courts in establishing the rights of co-owners of property subject to partition have adopted the concept of "owelty." The classic definition of "owelty" is an amount paid or secured by one co-tenant to another for the purpose of equalizing a partition. Although originally designed to address minor variations in value, the concept has been expanded to the situation where one co-tenant acquires all of the commonly owned property, and the other takes only cash. See, e.g., *McGoodwin v. McGoodwin*, 671 S.W. 2d 880 (Tex. 1984). For an excellent discussion of partition issues in general, see Jenkins, Drafting Real Estate Documents for the Estate Planning and Probate Practitioner, State Bar of Texas Advanced Drafting: Estate Planning and Probate Court (1993).

XI. NON-TAX ISSUES WHEN FUNDING.

A. Consideration of Non-Tax Issues.

When funding testamentary trusts, the executor should give consideration to a number of practical issues that the trustee may encounter after the trust is funded. Unfortunately, the executor is not always presented with a mix of assets well suited to fund trusts in the most advantageous manner. It is often the case that the executor is also named to serve as trustee. The Will frequently grants the executor the powers of trustees, and it is sometimes difficult to discern the role in which the fiduciary is acting. Nevertheless, it is the executor who ultimately must determine which assets go where, taking a wide variety of factors into consideration.

B. Some Caveats.

Generally speaking, it is not the province of the executor to change the mix of estate assets. An executor has been held to be primarily a liquidator and conservator of assets, not an investor. As a result, for example, investing in a new business has been held to be inappropriate absent authority to do so under the decedent's will. *Lovenskiold v. Nueces Hotel Co.*, 208 S.W. 759 (Tex. App.-San Antonio 1919, no writ). The executor may take some comfort in the fact that the Texas Trust Code places the burden on the trustee to evaluate the suitability of the assets of the trust. Specifically, within a reasonable time after accepting the trusteeship or receiving trust assets, the trustee must review trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust and of the Texas Prudent Investor Act. Tex. Prop. Code § 117.006.

C. Non-Tax Issues.

With the foregoing limitations in mind, there are a number of non-tax factors that an executor might wish to consider when funding bequests.

1. Economic Viability.

Will distributing a given mix of trust assets give the trustee sufficient cash flow to maintain the assets on hand? For example, if the vacation home that is the family icon is conveyed to the bypass trust as its only asset, how will the trustee pay for property taxes, insurance, maintenance and upkeep for the property once it is owned by the trust? If the property is not rented out, it is unlikely that the trustee will be in a position to borrow sufficient funds to satisfy the trust's cash-flow obligations. As a result, the trustee might be required to sell the property.

2. Benefits for Specific Owners.

Some assets obtain tax and non-tax benefits if held by certain owners that are not available if other persons or entities own the property. For example, if a parent owns the residence occupied by a child, and that residence is conveyed to a trust for the child's benefit, instead of conveying it to the child directly, it is unlikely that the child will be able to claim a property tax homestead exemption for the property. *See* Tex. Tax Code § 11.13(j)(3) (which effectively limits the homestead exemption for residential property owned by trusts to trusts created by court order or trusts for the benefit of the grantor or the grantor's spouse). If a principal residence is owned by a trust, and is later sold, it is unlikely that the exclusion of gain on the sale of a principal residence offered by Section 121 of the Code will be available.

3. Family Preferences.

When the executor has the discretion to fund assets among beneficiaries or among trusts with different beneficiaries, the preferences of the beneficiaries are often taken into account to the extent possible. While it is often impossible to satisfy all of the beneficiaries all of the time, clearly articulated preferences by a beneficiary to which no other beneficiaries object are often honored. Remember that absent express authority in the governing instrument, it is uncertain whether an executor may have the authority to make non pro rata distributions of estate assets. *Gonzalez v. Gonzalez*, 469 S.W.2d 624 (Tex. Civ. App.-Corpus Christi 1971, writ ref'd n.r.e.). *See also McDonough v. Cross*, 40 Tex. 251 (1874).

4. Partnerships to Facilitate Conveyances.

Frequently, when an estate is distributable to multiple beneficiaries, the division of assets into undivided interests can become unwieldy. The ownership of assets in the form of undivided interests requires joinder of all parties for the management of the property, and can make the payment of property taxes and other expenses associated with the ownership of the property quite cumbersome. Therefore, in lieu of distributing undivided interests in assets which are not readily capable of division, the executor and the beneficiaries may want to consider the establishment of a partnership or limited liability company to own estate assets. As noted above, specific authorization in the Will permitting the executor to form this sort of entity may be required under Texas law. If permitted, however, conveying assets into a partnership and distributing partnership interests may avoid the problems associated with owning property in undivided interests. Of course, if the Will does not permit the executor to form a business, the beneficiaries may do so themselves if they are amenable.

XII. DOCUMENTING THE FUNDING.

A. Importance of Documentation.

After the foregoing process has been completed, the executor is ready to convey assets to the appropriate beneficiary. It seems self-evident that the executor should undertake steps to *document* the funding decisions that have been made, but it is surprising how often this crucial step is omitted. For a discussion of many of the important issues to consider in documenting the closure of an estate, see Donaho, Pitfalls for Fiduciaries in Closing Estates, State Board of Texas Advanced Estate Planning and Probate Course (1997). In documenting funding, many attorneys take a three-step approach. First, an agreement that documents exactly which assets pass to whom is often prepared. Second, detailed instructions for funding are typically provided to the executor. Finally, any necessary instruments of conveyance are prepared, executed and delivered.

B. Agreement Regarding Distribution of Estate.

A written agreement often serves as the basis of funding. A funding agreement is especially useful to document non-pro rata funding of testamentary gifts, or to document non-pro rata divisions of community property. Although this instrument does not itself serve as a conveyance, it may prove helpful at the death of the surviving spouse to establish to the IRS that the marital and bypass trusts were properly funded, and that post-death changes in value were considered and appropriately allocated. Our firm typically documents this agreement in the form of an instrument that can be recorded in the probate proceedings of the first decedent's estate, although it is our current practice not to record this instrument. This same agreement may be used to document the receipt of assets by the recipient and the release of the executor from further liability. A sample "Agreement Regarding Distribution of Estate Assets" is attached as Exhibit "A".

C. Detailed Funding Instructions.

Depending upon the executor's sophistication and experience in retitling assets, he or she may need detailed instructions regarding the steps to be taken in funding testamentary gifts. These instructions may take the form of one or more meetings between the executor and counsel (or a qualified legal assistant) or may take the form of a detailed letter or memo of instruction. A sample memo to the executor outlining the steps to be taken is attached as Exhibit "B".

D. Transferring Title to Assets.

Finally, the conveyance instruments themselves should be prepared and filed. Conveyance instruments may take the form of deeds; mineral deeds or division orders; stock powers (or endorsement of stock certificates); writing checks on the decedent's or the estate's accounts; instruments to transfer title to vehicles, boats, or other certificated assets; etc.

1. Real Estate.

As mentioned earlier, under Section 37 of the Texas Probate Code, title to real property vests immediately upon the death of the owner. As a result, some authorities argue that there is no need for a formal conveyance of real property. As a practical matter, however, a typical formula marital deduction Will gives no guidance as to which beneficiary or trust is entitled to receive which piece of real property. As a result, a formal conveyance that specifically identifies the distributee is recommended.

a. Distribution Deeds.

A distribution deed ensures that the proper recipient is identified in the real property records. Recording this deed thus adds an important link in the chain of title. It serves to establish ownership, fixes liability for future property taxes, and relieves the executor from having to join in any future conveyance of the property.

b. General vs. Special Warranty.

Most attorneys caution executors that they should execute only special warranty deeds (or even deeds without warranty). An executor may be unaware of claims made or issues arising with respect to title before the decedent's death. Granting a warranty covering facts unknown to the executor could theoretically subject the estate to potential unnecessary liability. On the other hand, some title companies reportedly argue that execution of a special warranty deed does not transfer insurance protections in the decedent's policy of title insurance, since it warrants only actions by the executor, and not the decedent. One possible approach is a deed with only a special warranty (or without any warranty) which also conveys to the grantee any rights of the estate in the decedent's policy of title insurance. A sample deed conveying the estate's interest in real estate (and limiting the title warranty of the executor) is attached as Exhibit "C".[1]

[1] The author gratefully acknowledges the assistance of Stephanie Donaho for her thoughts on this matter, and her assistance in providing sample language which has been incorporated into the attached deed addressing the title insurance question.

c. Oil and Gas Interests.

Oil and gas interests constitute interests in real property. When the decedent owned the underlying minerals, those minerals are generally transferred by mineral deed. Where a retained royalty is at issue, the royalty is typically transferred by execution of new division orders (or issuance of letters in lieu of division orders) provided to the payor of the royalty.

2. Mortgages, Notes and Cash.

Transfers of cash are generally undertaken by issuing checks from the decedent's or the estate's accounts. As to mortgages and notes payable to the estate, however, the original instruments representing those notes should be transferred. Promissory notes are typically assigned by endorsement. As with the discussion regarding warranty deeds, an executor typically assigns a note by endorsing it "Payable to the order of [beneficiary], without recourse to the executor or the estate." This endorsement prevents the estate from being subjected to liability in case of future non-payment by the maker of the note. If the note is secured by real estate, then in addition to the endorsement of the note, an assignment of the lien should be recorded in the deed records where the real property is located. In any event, the executor should notify the maker of the note to ensure that future payments are made directly to the recipient.

3. Stocks and Bonds.

We frequently recommend that executors transfer stocks and bonds held by the decedent into a brokerage account held in "street name" or "book entry." Subsequent transfers of stocks and bonds registered in the street name are substantially simpler than the process required if original stock certificates are owned by the decedent, reissued to the estate, and then reissued to the beneficiary. Frequently, beneficiaries are requested to create their own accounts at the same brokerage firm or financial institution so that a simple journal entry can be utilized to transfer securities. They can thereafter transfer stocks to their own financial institution if they so desire. If the stock issued is not publicly traded, the executor should determine what steps are necessary to transfer the shares. In the case of a closely held business in which the decedent was the controlling shareholder, the decedent (or perhaps his counsel or accountant) likely has possession of the corporate minute book and stock transfer ledger. Old stock certificates in the decedent's name should be cancelled, and new stock certificates should be issued in the name of the appropriate beneficiaries. The stock transfer ledger contained within the corporation's minute book should be appropriately updated. If the corporation at issue is an S corporation, the executor should ensure that the beneficiaries understand the general income tax consequences associated with ownership of S corporation stock.

4. Insurance on the Life of the Decedent.

Since insurance is a non-probate asset (unless payable to the estate), the transfer of life insurance proceeds is generally undertaken directly by the beneficiaries. If the insurance is payable to the estate, the executor can collect the insurance directly by providing the insurance company with the original insurance policy, a copy of the death certificate, and claim forms provided by the insurer. Cash received as a result of a collection of these proceeds is then distributed as provided in the Will, or if no specific guidance is given, as a part of the other cash belonging to the estate.

5. Miscellaneous Assets.

Miscellaneous assets frequently include tangible personal property, the ownership of which is typically controlled by possession. Therefore, these assets are typically distributed by delivering possession of the assets directly to the beneficiaries. Ownership of some tangible property is evidenced by a certificate of title. Therefore, vehicles, boats, airplanes, and other similar assets will require endorsement of appropriate title certificates and execution of title transfer applications in order to convey title to the property.

6. Partnerships to Facilitate Conveyance.

As noted above, dividing estate assets into undivided interests among multiple beneficiaries can become unwieldy, since the ownership of assets in undivided interests requires joinder of all parties for the management of the property. Therefore, in lieu of distributing undivided interests in assets which are not readily capable of division, the executor and the beneficiaries may want to consider the establishment of a partnership or LLC to own estate assets. Under Texas law, express authorization in the Will may be required for the executor to form a partnership prior to distribution. If no such authority exists, the beneficiaries themselves may agree to the formation of the partnership if they are all amenable. By conveying assets into a partnership and distributing partnership interests, the problems associated with owning property in undivided interests can be avoided. A simple partnership agreement designed to avoid fractionalization of ownership is attached as Exhibit "D".

7. Receipts for Distributed Property.

In most cases, the executor of the estate will want to obtain a receipt from the various beneficiaries of the estate. In the context of the typical marital deduction Will, the recipient signing the receipt is the trustee of the bypass and marital trusts, who is often the same person as the executor of the estate (usually, the surviving spouse). As noted above, the funding agreement used by our firm frequently serves the multiple purposes of blueprint, record, agreement, receipt and release. (See Exhibit "A"). When other distributions are provided for, the executor is entitled to obtain a receipt. Although a release is typically also requested, an executor may not require a waiver or release from the distributee as a condition of delivery of property to the distributee. Tex. Prob. Code § 151(d). A sample receipt and release is attached as Exhibit "E".

XIII. "FUNDING" AFTER THE SECOND DEATH.

What is one to do if the estate at hand is that of the second spouse, and the trusts called for under the Will of the first spouse to die were never funded? There is surprisingly little authority to date on this topic–an observation which in part serves to justify the fact that the following discussion asks more questions than it answers. I am hopeful, however, that asking these questions might at least help point the way.[2]

Illustration: Suppose that you now represent the executor of Hugh's estate. Hugh's wife Wilma died several years ago with a Will that contained a pecuniary bypass trust, with a residuary outright marital bequest. Hugh was named to serve as the executor of Wilma's estate and as trustee of the bypass trust. The estate tax return for Wilma's estate shows that the bypass trust was to receive $600,000. Total assets on hand at Hugh's death are $6,000,000, with no indication that a bypass trust was every funded. If the bypass trust cannot somehow be "reconstructed," the children will owe approximately $300,000 in estate tax. Is it possible to argue that the assets now held in Hugh's name that should have gone to the bypass trust may be deducted or excluded from Hugh's estate?

A. Theories of Recovery.

Broadly speaking, there seem to be two plausible approaches to the problem of the missing bypass trust. On the one hand, it might be argued that Hugh is not the true owner of the assets that should have been funded into the bypass trust. Instead, the assets are actually held by Hugh as trustee (either of the bypass trust, a "constructive" trust, or perhaps a "resulting" trust). On the other hand, it may be argued that Hugh died owing a "debt" to the bypass trust, measured by the amount that would now be held by the trust if the funding amount had not been wrongfully withheld. In other words, although Hugh may be said to hold legal title to all of the property, bare legal title alone does not necessarily give rise to estate tax inclusion. In order to flesh out these theories, the question of the exact nature of Hugh's property interests must be viewed under local law.

1. Applicability of State Law.

Although federal law determines which of the decedent's property interests are subject to estate tax, state law determines the nature and extent of those interests. *Morgan v. Comm'r*, 309 U.S. 78, 80, 23 AFTR 1046 (1940). As discussed below, if under state law, title to the property at issue is vested not in the decedent, but in a trust created by the will of a prior decedent, then the second decedent owns no interest in the property in question, and it is not subject to estate tax. *Est. of Richard v. Comm'r*, 103 TCM 1924 (2012). Likewise, if the property in question is impressed with a constructive trust, then the beneficial interest in that property belongs not to the decedent, but to the beneficiary for whom the constructive trust is held. If the decedent died owing debt to a third party that is allowable by the laws of the jurisdiction under which the estate is being administered, that debt may be deducted for federal estate tax purposes. But note that in a federal estate tax controversy, the IRS (or a federal court) is not bound by a state court determination of property interests where the United States was not a party to the proceeding. *Estate of Bosch*, 387 U.S. 456, 19 AFTR 2d 189, 87 S.Ct. 1776 (1967). The *Bosch* Court held that (i) when a state law property right has been decided by the highest court of the state, the decision should be followed and respected as the best authority for that state's law; but (ii) when a state law property right has not been decided by the highest court of the state, federal authorities "must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." *Id.* at 465. *See, also, Lake Shore National Bank v. Coyle*, 296 F.Supp. 412, 22 AFTR 2d 6102 (N.D. Ill. 1968). Therefore, in order for the IRS or a court to permit assets to be deducted or excluded from an estate, relevant state law rulings concerning property rights must be examined. The deference that

[2] The author gratefully acknowledges the assistance of Eileen W. Allan for permission to incorporate in this section portions of her outline "The Unfunded Bypass Trust at the Death of a Surviving Spouse" which she presented to the December 1995 meeting of the Houston Estate Planning Study Group.

the IRS is required to provide to these rulings is discussed in more detail below in Section XI.G. below, beginning at page 46.

2. Impact of State Law.

Given our facts, would a Texas court permit Hugh to keep the property in violation of the terms of Wilma's Will? If the property at issue remained in Wilma's name, and Hugh took no actions inconsistent with the ownership of the assets by Wilma's estate or the bypass trust, it can be persuasively argued that the title to the property is vested in the trustee of the bypass trust pursuant to Section 37 of the Texas Probate Code, which provides that title to property vests immediately in the devisee or legatee of the property under the decedent's Will. *See, Est. of Richard v. Comm'r*, 103 TCM 1924 (2012). If the property has been retitled into Hugh's name individually, since Hugh was named as both executor of Wilma's estate and trustee of the bypass trust, it appears that Hugh's failure to fund the bypass trust constitutes a serious breach of his fiduciary duties. In 2005, the Texas Legislature added Section 114.008 to the Texas Trust Code. Effective January 1, 2006, the new statute provides that to remedy a breach of trust that has occurred or might occur, the court may, among other remedies, "impose a lien or a constructive trust on trust property, or trace trust property of which the trustee wrongfully disposed and recover the property or the proceeds from the property." Tex. Prop. Code § 114.008(a)(9). Alternatively, the court may "compel the trustee to redress the breach of trust, including compelling the trustee to pay money or to restore trust property." Tex. Prop. Code § 114.008(a)(3). In addition, the court may compel the trustee to render a proper account of the trust. Tex. Prop. Code § 114.008(a)(4). Even before the enactment of that statute, however, these same remedies were available at common law. For example, the Restatement (2d) of Trusts provides that when a trustee by wrongful disposition of trust property acquires other property, the beneficiary is entitled, at his or her option, either: (1) to enforce a constructive trust of the property so acquired; or (2) to enforce an equitable lien upon it to secure his or her claim for breach of trust, so long as the product of the trust property can be traced. If the property can't be traced, the beneficiary retains a claim against the trustee as a general creditor. RESTATEMENT (2D) OF TRUSTS § 202 (1959).

B. The "Vested in the Bypass Trust" Approach.

As noted above, if the property at issue remained in Wilma's name, and Hugh took no actions inconsistent with the ownership of the assets by Wilma's estate or the bypass trust, it can be persuasively argued that title to the property is vested in the trustee of the bypass trust pursuant to Section 37 of the Texas Probate Code. Hugh simply owns no interest in the property. For example, in , *Est. of Richard v. Comm'r*, 103 TCM 1924 (2012), Victoria Richards passed away in 1997 owning 140 shares of preferred stock in a family business. Her will, which wasn't admitted to probate, left the stock to a bypass trust for her husband Alfred. Alfred died in 2004, and the estate tax return filed for his estate in March, 2006 listed the 140 shares among his assets, valued at $140,000. Just before the running of the statute of limitations in March, 2009, the IRS issued a notice of deficiency valuing the 140 shares at just over $27 million. Albert's children found Victoria's will in September, 2010, and had it admitted to probate in November of that year. The IRS argued that Florida state court proceedings establishing Victoria's bypass trust as the owner of the stock were not controlling, because Alfred effectively became the owner of the stock after Victoria's death, despite lack of formal transfer of ownership to him. In ruling for the taxpayer, the Tax Court noted that title to the shares remained in Victoria's name until after Alfred's death, and Alfred never took any overt actions (such as voting the shares or receiving dividends) to indicate that he was the owner of those shares. The court found that the decedent's children didn't take steps to enforce the rights of the bypass trust only because they did not know of its existence until more than thirteen years after their mother's death. The court noted that the admission of Victoria's will to probate in 2010 caused the bypass trust's ownership of the 140 shares of stock to date back to the date of Victoria's death, and therefore, the shares were not properly included in Alfred's estate.

C. The "Constructive Trust" Approach.

If Hugh wrongfully holds the bypass trust property, or the proceeds therefrom, in his individual name, then pursuant to Section 114.008(a)(9) of the Texas Property Code, a proper remedy would be to subject the property or proceeds to a constructive trust. If the property or proceeds are subject to a constructive trust, may they be excluded from Hugh's estate? In *Stansbury v. United States*, 543 F. Supp. 154, 50 AFTR 2d 82-6134 (N.D. Ill. 1982), *aff'd* 735 F.2d 1367 (7th Cir. 1984), the court found that a decedent held property in a constructive trust for the benefit of another, and the court permitted the trust property to be excluded from the estate of the decedent. This result was based on the argument that the decedent held the property merely as a naked title holder. Thus, under state law, the decedent did not own an interest in the property at her death or possess a power of appointment over the trust property. The *Stansbury* decision did not involve a bypass trust. Rather, the court was valuing the holdings of a revocable trust included in the decedent's estate. Among the assets of the revocable trust were a farm and stock that has been inherited by the decedent's husband and his sister. The husband fraudulently induced the sister to transfer her half interest in the assets to him, promising to transfer all of the farm and stock to her upon his and his wife's death. He later transferred the assets to his wife to avoid the claims of his creditors. After the wife's death, the sister filed suit to recover the property based upon various theories, including a breach by the husband of his contract to make a will. The state court ruled that the sister's contract claim was barred by the statute of limitations, but nevertheless imposed a constructive trust on the farm and the stock for the sister's benefit. The executor of the wife's estate sought to exclude the property subject to the constructive trust from the wife's estate. The IRS sought to include all of the property. The District Court, after citing *Bosch*, held that the state court finding of a constructive trust was entitled to great weight, and ruled that the farm and stock subject to the constructive trust should be excluded from the wife's estate. *Id*. at 158. Under Texas law, a constructive trustee may be ordered to convey to the rightful owner either the property originally impressed with the trust, or other property purchased with the proceeds of the sale of the original property. *See Home Inv. Co. v. Strange*, 109 Tex. 342, 195 S.W.2d 849 (1917) *modified on other grounds*, 109 Tex. 342, 204 S.W.2d 314 (1918); *Spencer v. Pettit*, 17 S.W.2d 1102 (Tex. Civ. App.–Amarillo 1929), *aff'd* 34 S.W.2d 798 (Tex. Comm'r App. 1931); *Smith v. Green*, 243 S.W. 1006 (Tex. Civ. App.–Amarillo 1922, writ ref'd). Applying the *Stansbury* rationale to our facts would suggest that some of the assets on hand at Hugh's death do not legally belong to Hugh. Instead, the assets should be subject to a constructive trust pursuant to Section 114.008(a)(9) of the Texas Trust Code. As a result, the assets should be excluded from Hugh's estate.

1. <u>What was Consumed?</u>

As noted above, it is unlikely that all of the assets on hand at the time of Wilma's death will still be on hand at the time Hugh's estate is being administered. Upon which assets would the constructive trust be imposed? Which assets did Hugh consume after Wilma's death–his own assets or those of the bypass trust? Under Texas law, a trustee is charged with a fiduciary duty not to commingle trust property with the trustee's own property. *Boettcher v. Means*, 201 S.W.2d 255, 256 (Tex. Civ. App.–Galveston 1947). If the trustee commingles trust property with his own property, the rights of the trust beneficiaries are not destroyed. *Pierce v. Sheldon Petroleum Co.*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo 1979). In fact, as discussed in more detail below, if a trustee commingles trust property with his own, there is a presumption that all of the commingled property is trust property. The trust beneficiaries have the right to recover trust property held by the trustee that can be identified as the original trust property or that can be traced as the mutations (i.e., proceeds or products) of the original trust property. *Batmanis v. Batmanis*, 600 S.W.2d 887 (Tex. Civ. App.–Houston [14th Dist] 1980, writ ref'd n.r.e.); *Pierce v. Sheldon Petroleum Company*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo, 1979). In addition, to the extent that the trustee draws on commingled funds, the trustee is presumed to have withdrawn his own money first. *Batmanis v. Batmanis*, 600 S.W.2d 887 (Tex. Civ. App.–Houston [14th Dist] 1980, writ ref'd n.r.e.); *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App.–Dallas 1955, writ dism'd). Applying these favorable presumptions can work to maximize the amount treated as held by the bypass trust.

2. <u>What Can Be "Identified as the Original Trust Property"?</u>

The court in *Batmanis* held that the trust beneficiaries have the right to recover trust property held by the trustee that can be identified as the original trust property or that can be traced as a mutation of that property. *Id.* at 890. Identifying assets as the original trust property can sometimes be done, especially with respect to real estate, stock in a closely held business, or other unique assets. Often, if deaths are in fairly quick succession and assets were not actively traded, a number of assets on hand at the second death can be identified as having been included in the first spouse's estate. If the trustee disposes of the trust property, the beneficiary can nevertheless recover that property if it is not held by a bona fide purchaser. *Meadows v. Buerschwatle*, 516 S.W.2d 125 (Tex. 1974); *Pierce v. Sheldon Petroleum Company*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo 1979). If the property has been conveyed to a bona fide purchaser for value, the property itself may not be reachable, but the proceeds or "mutations" thereof may be recovered on behalf of the trust. The proceeds of a wrongful sale of trust property, together with the profits on the sale, rightfully belong to the trust. *Meadows v. Buerschwatle*, 516 S.W.2d 125 (Tex. 1974).

3. <u>Tracing "Mutations"</u>.

Tracing "mutations" of property is permitted, but may be problematic, especially if substantial time has elapsed between the dates of death. One would expect that tracing principles similar to those used to identify separate and community property in a divorce context may be employed, but most likely at considerable expense. The law is clear that the proceeds of a wrongful sale of trust property, together with the profits on the sale, rightfully belong to the trust. *Meadows v. Buerschwatle*, 516 S.W.2d 125 (Tex. 1974). The courts in equity may follow the trust property through its mutations into its changed form. *Continental Nat'l Bank v. Weems*, 69 Tex. 489, 6 S.W. 802 (1888); *Pierce v. Sheldon Petroleum Company*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo 1979). Although the right to follow the trust property itself ends when it passes to a bona fide purchaser, the proceeds of the sale nevertheless belong to the trust. *Smith v. Green*, 243 S.W. 1006 (Tex. Civ. App.–Amarillo 1922, writ ref'd).

4. Effects of Commingling.

If the exact property cannot be traced because it has been commingled with the trustee's property, can the trust nevertheless maintain a claim for the commingled property? Under Texas law, the burden is on the trustee to distinguish his or her own funds from those of the trust, and if the trustee cannot do so, the *entire commingled fund* becomes subject to a trust in favor of the beneficiary. *See, e.g.,, Eaton v. Husted*, 141 Tex. 349, 172 S.W.2d 493, 498-499 (1943); *Logan v. Logan*, 138 Tex. 40, 156 S.W.2d 507 (1941); *General Association of Davidian Seventh Day Adventists, Inc. v. General Association of Davidian Seventh Day Adventists*, 410 S.W.2d 256, 259 (Tex. Civ. App.–Waco 1966, writ ref'd n.r.e.); *Pierce v. Sheldon Petroleum Company*, 589 S.W.2d 849 (Tex. Civ. App.–Amarillo 1979). This principle may serve to protect a substantial amount of funds for the benefit of the remainder beneficiaries of the bypass trust. One may wonder, however, if the IRS would be willing to apply this principle of state law as a general proposition, since its effect would be to "reward" the estate of a wrongdoer with a substantial decrease in estate tax liability.

5. Did the Surviving Spouse Effectively "Distribute" All of the Assets?

If Hugh were still alive, he might be expected to argue that he didn't improperly fail to fund the trust. Rather, he might assert that he simply "distributed" the assets of the trust to himself as a beneficiary of the trust, based upon his need for the funds. Frequently, the bypass trust is drafted to permit distributions of both principal and income to the surviving spouse/trustee. Presumably, however, distributions to the spouse under the governing instrument are limited pursuant to a so-called ascertainable standard related to "health, education, support or maintenance" of the spouse. Treas. Reg § 20.2041-1(c)(2). If the spouse is the trustee, and distributions are not so limited, then the trust at issue will not avoid estate taxation at the spouse's death. Treas. Reg § 20.2041-1. Therefore, in evaluating a claim that the bypass trust assets were simply distributed to Hugh, one would be required to ascertain whether he had enough property in his own right (i.e., in excess of the bypass trust amount) to provide for his health, education, maintenance, and support. Although the IRS deems this language to give rise to an "ascertainable" standard, in practice it is difficult to quantify how the discretion granted to the trustee might have been exercised. Just how much, if any, was Hugh permitted (or required) to distribute for his health, education, maintenance and support? In that regard, remember that even though it might not have been the case were the bypass trust properly funded, where the trustee draws on a fund in which trust funds are *commingled* with those of the trustee, the trustee is presumed to have withdrawn his own money first. *Batmanis v. Batmanis*, 600 S.W.2d 887 (Tex. Civ. App.–Houston [14th Dist] 1980, writ ref'd n.r.e.); *Sibley v. Sibley*, 286 S.W.2d 657 (Tex. Civ. App.–Dallas 1955, writ dism'd).

6. What About Income Taxes?

If the bypass trust had been properly funded, the trustee would have been required to file income tax returns, reporting the trust's income, and taking a distribution deduction for amounts properly distributed to Hugh. If the constructive trust theory is applied, should Form 1041s be filed for the "constructive trust" for prior years? There appears to be no authority for this proposition. Presumably, since all assets were titled in Hugh's name, income from stocks, bonds, bank accounts, etc. were reported by Hugh on his own tax return, and payors of that income used Hugh's social security number to report the income. As a result, it is likely that Hugh reported income from the assets properly passing to the bypass trust, either on an estate income tax return, or by adding it to his own income on his Form 1040. If late Form 1041s are filed for the bypass trust, perhaps these returns should (or at least could) reflect a distribution to Hugh of all income from the bypass trust so that no income tax, interest, or penalties would be due. Of course, this result is mandated for items of ordinary income if Wilma's Will requires all income to be distributed to Hugh annually. IRC §§ 651, 661. On the other hand, if the bypass trust does not require the distribution of income, treating the income as having been distributed to Hugh will have the effect of decreasing the balance that "should" be in the bypass trust at the time of Hugh's death. This treatment thus has the effect of decreasing the amount that passes estate tax free at the second death. Reporting all income as having been distributed is also contrary to the helpful "own money first" presumption in *Batmanis*. In any event, capital gains would be taxable to the trust, since they are virtually always excluded from distributable net income. IRC § 643(a)(3). Income tax issues associated with actually funding the bypass trust are discussed in Section IV.B. above, beginning at page 6.

D. The "Claim Against the Estate" Approach.

If Hugh was the executor of Wilma's estate, in lieu of the constructive trust approach, an equally compelling argument can be made that Hugh actually owned all of the assets on hand at the time of his death, but that he owed a "debt" to the unfunded assets to the bypass. This analysis uses the remedy of requiring the trustee to pay money to remedy the breach of trust as mandated by Section 114.008(a)(3) of the Texas Trust Code. *See also* RESTATEMENT (2D) OF TRUSTS § 202 (1959). If the debt approach is used, then all of the assets on hand at the time of Hugh's death would be included in his estate, but the amount that is determined to be owed by Hugh to the bypass trust would be reported as a debt to be deducted on Hugh's estate tax return as provided in Section 2053 of the Code.

1. Is There a "Debt"?–*Estate of Bailey*.

Section 2053(a)(3) of the Code provides that for purposes of the tax imposed by Section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts for claims against the estate as are allowable by the laws of the jurisdiction under which the estate is being administered. In this regard, the case of *Estate of Bailey v. Comm'r*, 741 F.2d 801, 54 AFTR 2d 84-6527 (5th Cir. 1984) is instructive.

a. Factual Background.

Joseph Bailey, Jr. died intestate in Texas in 1943. As a result, under the law then in effect, his one-half of the community property estate he held with his wife Roberta passed to his son, Joseph III, who was then a minor. Roberta acted as community administrator of the estate, and no formal letters of administration were issued. At the time of his death, Joseph Jr.'s share of the community property was worth $73,396.68. Roberta never informed Joseph III that he was entitled to his father's estate, although she did file an heirship affidavit in 1949 listing him as Joseph Jr.'s sole heir, and asked Joseph III at that time to sign a deed for the sale of her house. Roberta did not set up a separate account for Joseph III's benefit and did not separately track or account for the inherited funds. Instead, she treated all of the assets as her own. When Roberta died in 1976, her estate was worth nearly $1.6 million. While administering his mother's estate, Joseph III first became aware of his inheritance rights in his father's estate. He included the full value of all of the assets on Roberta's estate tax return, but took a deduction under Section 2053 of the Code in the amount of $765,282.50 as a claim against his mother's estate. Joseph III contended that the amount of this claim was the current value of the property he should have inherited from his father's estate, and that on these facts, the Texas courts would impress a "constructive trust" in his favor.

b. The Tax Court's View.

The Tax Court, citing the fact that Roberta had reported taxable gifts given to Joseph III of over $939,500 during her lifetime, found for the government. The Tax Court noted that the gifts made by Roberta to Joseph III amounted to many times over the amount of the wrongfully withheld inheritance, and held that since Joseph III's claims were equitable in nature, the gifts completely undercut any constructive trust or other equitable claim that Joseph III might have had against his mother. *Estate of Bailey v. Comm'r,* 79 TC 441 (1982) at 452.

c. The Fifth Circuit Holding.

The 5th Circuit Court of Appeals reversed the Tax Court. After reviewing the elements of constructive trust claims in Texas, the Court found that the mother-son relationship constitutes a "long-standing fiduciary or confidential, trusting relationship unrelated to the subject transaction." *Estate of Bailey v. Comm'r*, 741 F.2d 801 (5th Cir. 1984) at 803. In addition, Roberta's role as community administrator gave rise to fiduciary obligations. Second, the Court reviewed the facts to determine whether "the court's failure to intervene must cause unjust enrichment." *Id.* The Court noted that at first blush, the unjust enrichment element seemed troubling. Viewed after Roberta's death, when not only her generous gifts, but her entire estate passed to Joseph III, her unjust enrichment (and Joseph III's damages) were obscured. The Court went on to note, however, that "we cannot be misled by [these facts] to conclude that he was never in the past injured." *Estate of Bailey v. Comm'r*, 741 F.2d 801, 804, 54 AFTR 2d 84-6527 (5th Cir. 1984). The court found the fact that Roberta used Joseph III's inheritance for thirty years gave rise to a constructive trust. Quoting *Grebe v. First State Bank of Bishop*, 136 Tex. 226, 150 S.W.2d 64, 67 (1941), the Court noted that although the surviving spouse might use community funds to pay community debts, "the survivor is not entitled to use the funds or community assets for [her] own private use, but holds same in trust for the benefit of the true owners thereof." *Id.* The Court thus found that the Tax Court erred in finding that Texas courts would not impose a constructive trust. Regarding Roberta's generous gifts, the Court pointed out that they were all reported by her as gifts of her own property, and not as any sort of settlement of Joseph III's claims. *Id.* Therefore, the Court allowed the Section 2053 deduction, remanding the case for a determination of the current value of the son's inheritance from his father. Applying this rationale suggests that Hugh's estate would be entitled to a Section 2053 deduction for amounts owed to the bypass trust.

2. How Much is the Debt?

Quantifying the debt can be problematic. It would seem that an analysis much like the constructive trust tracing-consumption-distribution approach would be required here as well.

a. The Tax Court On Remand.

On remand, Joseph III and the IRS both put on expert testimony to quantify the amount owed to Joseph III. The IRS expert began with the amount of Joseph Jr.'s estate and excluded the stock of two companies that Roberta subsequently gave Joseph III in kind. As to the rest, the IRS expert applied a present value factor based upon averages of the prime rate of interest as it existed over the life of the trust. Joseph III's expert instead divided the assets into two classes: (1) traceable assets, and (2) non-traceable assets. As to the traceable assets (stock), the expert looked at the actual stock splits, stock dividends and dividends paid in the 33-year period. With respect to the non-traceable assets, the expert compared the weighted average of long-term yields of the bond and stock market, and assumed a 50/50 mix of assets. (Roberta's investments were actually 65% stock and 35% bonds.) The Tax Court rejected the IRS expert's testimony as unrealistic. It first noted that the traceable stock could not be excluded, since it constituted a gift from Roberta of her property, and not a distribution from Joseph Jr.'s estate. As to non-traceable assets, the Tax Court ruled that applying the prime rate of interest was improper since it represents only a short-term rate of return. It sided with Joseph III's expert and allowed the deduction in full. *Estate of Bailey*, TC Memo 1985-274.

b. Alternative Approaches.

Where trust property has been wrongfully disposed of, the beneficiary may recover either the price obtained by the trustee, or the value of the property at the time of trial. *Boothe v. Feist*, 80 Tex. 141, 15 S.W. 799 (1891); *Moseley v. Fikes*, 126 S.W.2d 589 (Tex. Civ. App.–Fort Worth 1939), *aff'd* 136 Tex. 386, 151 S.W.2d 202 (Comm'r App. 1941). Alternatively, as the court in *Batmanis* reminds us: "It is clearly the law in Texas that interest is allowed as damages for the failure to pay a sum due. . . . [I]nterest should be at the rate of 6% from the date due until the date of judgment." 600 S.W.2d 877, 890. For decedents dying before January 1, 2004, former Section 378B of the Texas Probate Code mandated the payment of interest on a pecuniary bequest at the statutory rate of six percent beginning one year after letters testamentary were issued. For decedents dying on or after January 1, 2004, interest accrues one year from the date of death (or in the case of a bequest from a trust, one year after a preceding income interest ends). Tex. Prop. Code § 116.051(3). In addition to interest, exemplary damages may be assessed if the court finds the breach by the trustee to be willful, malicious, or grossly negligent. *First City Nat'l Bank of Paris v. Haynes*, 614 S.W.2d 605 (Tex. Civ. App.–Texarkana 1981).

E. The "Resulting Trust" Approach.

What if the bypass trust was funded in whole or in part, but does not appear to be around at the time of Hugh's death? If the disappearance of the trust cannot be attributed to proper distributions to its beneficiaries, a theory similar to the "constructive trust" approach may be applied. In PLR 9338001, a trust provided for payment of all income to an individual during her lifetime, and upon her death, the principal was to be paid to her issue. According to the ruling, the trustee (who apparently was not the income beneficiary) grew "weary" of administering the trust, and on her own initiative, transferred the securities in the trust's brokerage account to the decedent's brokerage account at the same firm. The decedent was aware of the transfer, but continued to spend only the income from the securities. After some time, the securities were transferred to a separate account, still in the decedent's name. The IRS held that a valid trust had been created, but as a result of the trustee breaching her fiduciary duty, the express trust failed. Under these facts, the IRS determined that a court in Tennessee would find that a "resulting trust" had been created for the benefit of the decedent during her lifetime with the remainder passing to her issue. *See also*, RESTATEMENT (3D) OF TRUSTS § 8 (2001). Consequently, since the assets were held not by the decedent but by the resulting trust, the assets were not includable in the decedent's estate under Section 2033 of the Code.

F. Has the Statute of Limitations Run?

If substantial time has lapsed since the time of Wilma's death, the IRS might argue that the statute of limitations has run, so no claim survives at the time of Hugh's death. It would appear that under Texas law, the residual limitations period of four years would apply to this type of claim. Tex Civ. Prac. & Rem. Code Ann. § 16.051. But when does the cause of action accrue? In cases involving constructive trusts, the statute does not begin to run until the beneficiary knew, or should have known, that he or she had a cause of action. *Kelley v. Kelley*, 575 S.W.2d 612, 618 (Tex. Civ. App.– San Antonio 1978, writ ref'd n.r.e.); *Andretta v. West*, 415 S.W.2d 638,642 (Tex. 1967).

Fraud prevents the statute of limitations from running until the fraud is discovered or should have been discovered. *Cartwright v. Minton*, 318 S.W.2d 449, 454 (Tex. Civ. App.– Eastland 1958, writ ref'd n.r.e.). The beneficiary of an estate has the right to presume that the executor will carry out the provisions of the Will, and in due time will pay the bequest. Therefore, the statute of limitations will not begin to run until the executor has definitely and finally notified the beneficiary that no payment will be forthcoming under the Will. *Savage v. Delagado*, 93 S.W.2d 480 (Tex. Civ. App.–San Antonio 1936, writ dism'd). For a discussion of these issues as well as issues relevant to the potential gift tax aspects of failure to fund, see Tracy, Implementation of Estate Planning Strategies–Mechanics of Pecuniary Formula Bequests, State Bar of Texas Advanced Strategies Course (1999).

G. Other Hard Questions.

Before deciding between the constructive trust or the claim approach, a number of other factors need to be considered.

1. What About Basis?

If the assets traceable to the bypass trust are really *excludable* from Hugh's estate as belonging to the (constructive) bypass trust, they are treated as having passed from Wilma. Basis depends upon the fair market value at Wilma's date of death. IRC § 1014. Since the bypass assets are not included in Hugh's estate, no second step-up (or down) in basis applies. If the executor of Hugh's estate is now funding a pecuniary bypass bequest with appreciated assets based upon their date-of-distribution value, however, a substantial capital gain (measured by the difference in value from Wilma's death to the date of funding) could result. Treas. Reg. § 1.661(a)-2(f)(1). (The income tax consequences of funding the bequest are discussed in detail in Section IV.B. above beginning at page 6.) On the other hand, the approach of including the property in Hugh's gross estate and taking a Section 2053 deduction would presumably permit a step-up in basis for all of the assets held in Hugh's name. However, if the bypass trust is funded with property that has appreciated after Hugh's date of death, his estate will be satisfying a claim against the estate with appreciated property which will be a recognition event for capital gains purposes (measured, however, only by the difference in value from Hugh's death to the date of funding). Rev. Rul. 74-178, 1974-1 CB 196. Moreover, if the amount of the debt owed to the bypass trust includes accrued interest, that interest, when paid, will constitute ordinary income to the trust. Rev. Rul. 73-322, 1973-2 CB 44. As to whether Hugh's estate is entitled to receive an offsetting interest deduction, see the discussion in Section X.B. above, beginning at page 33.

2. Is a 706 Required?

In our example, the total value of Hugh's estate is $6,000,000, but arguably, at least $600,000 of that amount belongs to the bypass trust, so that Hugh's actual estate is only $5,400,000. Since the bypass trust claim is based not on its value at Wilma's death, but at Hugh's, it is certainly conceivable that the computed value of the bypass trust may well exceed $750,000. If the constructive or resulting trust approach is employed, Hugh's estate may well be below the filing threshold. If no federal estate tax return is filed, but the IRS somehow later is successful in asserting that a return was due and tax was owed, the executor of Hugh's estate would be personally liable for estate tax, penalties, and interest until discharged from liability. IRC §§ 2002, 2204. The statute of limitations for estate and gift tax is three years from the date the return is filed. IRC § 6501(a). In addition, if there is an omission on an estate tax return that exceeds 25% of the gross estate, the statute of limitations is extended to six years from the date of filing of the return. IRC § 6501(e)(2). However, there is an exception (i.e., there is no statute of limitations) if no return is filed. Thus, if Wilma's bypass trust is funded after Hugh's death, and Form 706 is never filed for Hugh's estate, the statute of limitations never begins to run; exposure, theoretically, never ends. There appears to be nothing to prevent an executor from filing a Form 706 even if it appears that Hugh's estate is less than the filing requirement. The IRS could hardly take the inconsistent position thereafter that tax is somehow due, but the statute failed to run because the return as filed wasn't required. If the IRS asserts that tax is due, then of course a return was required to have been filed, and was in fact filed.

3. Is it Cost Effective?

If Hugh's estate exceeds the filing threshold only because the bypass assets are treated as owned by Hugh, the estate should not have to bear the expense of filing a Form 706. Ironically, however, the expense of "tracing" the bypass trust's assets may be more than the cost of filing the return. But is the marginal cost of "tracing" excessive when compared to the cost involved in filing the return, quantifying the "debt," and proving its amount and validity to the satisfaction of the IRS?

4. What Gets Disclosed?

If Hugh's estate exceeds the filing threshold, even if the assets traced to the bypass trust are excluded from his estate, (or if the executor simply decides to file a return anyway), should information about the late funding of the "constructive" bypass trust be disclosed on the Form 706? The Form 706 instructions request attachment of all instruments creating a trust for the benefit of the surviving spouse. Therefore, Wilma's Will or revocable trust agreement creating the bypass trust should be attached. The Form 706 instructions do not currently request information regarding the *funding* of the bypass trust, or even the value of the predeceased spouse's bypass trust at the date of the second spouse's death. Obviously, if the debt approach is utilized and Hugh's assets exceed the filing threshold, the amount of the debt must be listed. Full disclosure of how the "debt" is computed may be warranted, especially in view of the fact that debts owed to related parties are on the "hit" list of IRS examining attorneys. *See* IRS Estate Tax Examiner's Handbook § (16)33(3), (4).

H. Making the Funding Binding on the IRS.

Is the resolution of a dispute between Hugh's estate and the remainder beneficiaries of Wilma's trust binding on the IRS if the government is not a party to the settlement? As noted above, the seminal case addressing this issue is *Estate of Bosch*, 387 U.S. 456 (1967). In *Bosch*, the United States Supreme Court first affirmed its longstanding holding that property rights are determined by state law. *Id*. at 467 ("it was incumbent upon federal courts to take state law from state court decisions when federal tax consequences turn on state law"). The Court held, however, that when federal estate tax liability is contingent on the character of a property interest held and transferred by a decedent under state law, the Internal Revenue Service is not "conclusively bound" by a state court ruling as to a property interest. Rather, the Court formulated a new test which provides: (i) when a state law property right has been decided by the highest court of the state, the decision should be followed and respected as the best authority for that state's law; (ii) when a state law property right has not been decided by the highest court of the state, federal authorities "must apply what they find to be the state law after giving 'proper regard' to relevant rulings of other courts of the State." *Id.* at 465. The Supreme Court acknowledged that its ruling requires the deciding authority (whether the IRS, the Tax Court, or another federal court) to sit "as a state court." As a result, in order for a settlement of property rights to be respected for estate tax purposes, it must meet state law requirements and be based on valid rights of the parties under state law.

1. Fundamental Tax Considerations.

In general, the shifting of valuable property rights in compromise of a bona fide dispute between adverse parties will not give rise to adverse tax consequences and will be recognized for federal tax purposes. A settlement agreement will be recognized by the IRS if the settlement agreement resolves a bona fide dispute and the participants are bona fide claimants. Conversely, if there is no actual dispute, a settlement agreement that is a voluntary rearrangement of property interests will not be recognized by the IRS. *Reed's Estate v. Commissioner*, 171 F.2d 685 (8th Cir. 1948); *Centerre Trust Co. of St. Louis v. United States*, 676 F. Supp. 928 (E.D. Missouri 1988); *Commissioner v. Vease*, 314 F.2d 79 (9th Cir. 1963). Amounts received in settlement of a bona fide claim are generally characterized for tax purposes by looking to the nature of the underlying claim. Thus, for example, amounts received in settlement of a Will contest are generally treated as amounts received in the nature of an inheritance, and as a result, are not subject to income tax. *See Lyeth v. Hoey*, 305 U.S. 188 (1938). In addition, the transfer of property in settlement of property rights does not generally give rise to the imposition of gift tax. Treas. Reg. § 25.2512-8. *See also*, Priv. Ltr. Rul. 8902045 (Oct. 21, 1988) (bona fide settlement does not result in gift tax under IRC Section 2501). Thus, the effect of a settlement on estate taxation of the property at issue depends on the existence of a bona fide dispute, the transfers involved, and the existence of an enforceable right as between the settling parties. *See Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981); Priv. Ltr. Rul. 8902045.

2. Bona Fide Disputes.

Family settlement agreements may be given effect for tax purposes only if there is a bona fide dispute among the beneficiaries. The Internal Revenue Service will not consider a family settlement agreement to be a bona fide compromise agreement unless the parties' claims are (i) bona fide and (ii) satisfied on an economically fair basis. *See* Priv. Ltr. Rul. 8902045. While truly adverse positions must be settled, the courts have held that a settlement among the parties may be honored even in those situations where the disagreement is short of a "full scale war." *See Citizens and Southern Nat'l Bank v. United States*, 451 F.2d 221 (5th Cir. 1971); *see also Estate of Hubert v. Comm'r*, 101 TC 314 (1993), aff'd, 63 F.3d 1083 (11th Cir. 1995) (marital deduction allowed for payments to spouse in settlement of bona fide will contest); *Estate of Dutcher v. Comm'r*, 34 TC 918 (1960), *acq*., 1961-1 CB 4; *Ducan v. U. S.*, 236 F. Supp. 747 (D. Md. 1965); *First Nat'l Bank v. U. S.*, 328 F. Supp. 1339 (N.D. Ala. 1971); *Estate of Barrett v. Comm'r*, 22 TC 606 (1954).

3. Enforceable Rights Under State Law.

A party to a settlement should not assume that the property and proceeds received or paid in settlement will automatically be deemed to have passed from the decedent to a person pursuant to a settlement agreement. The IRS may well argue that the property passed not from the decedent, but among the heirs as a settlement of their disputes. If the claim results in the passage of property among the heirs, and not from the decedent, the result may be that the property will nevertheless be subjected to estate tax in the decedent's estate. Whether the constructive trust or debt claim is one against the decedent is a matter of state law. As the Supreme Court noted in *Bosch* in the context of a marital deduction bequest, the "test of 'passing' for estate tax purposes should be whether the interest reaches the spouse pursuant to state law, correctly interpreted [by the federal court]—not whether it reached the spouse as a result of a good faith adversary confrontation." *See Estate of Brandon v. Comm'r*, 828 F.2d 493, 497 (8th Cir. 1987) (citing *Bosch* at 774). Thus, the availability of deductibility depends on whether the settlement payment is made pursuant to an enforceable right. The constructive (or resulting) trust and debt rationales articulated in Article III above constitute the substantive basis for arguing that these are rights enforceable under state law.

4. Does a Law Suit Need to Be Filed?

While state property rights control, a judicial determination is not necessarily required in order to establish those rights. In fact, it is the policy of the State of Texas to encourage resolution of disputes and the "early settlement of pending litigation through voluntary settlement procedures." TEX. CIV. PRAC. & REM. CODE ANN. § 154.002 (Vernon 1997). *See also Shepherd v. Ledford*, 962 S.W.2d 28 (Tex. 1998); *In Re Estate of Hodges*, 725 S.W.2d 265, 267 (Tex. App. – Amarillo 1986, writ ref'd n.r.e.); *Estate of Morris*, 577 S.W.2d 748, 755-56 (Tex. Civ. App. –Amarillo, 1979, writ ref'd n.r.e.). Encouraging settlement and compromise is in the public interest. *See Bass v. Phoenix Seadrill/78, Ltd*., 749, F.2d 1154, 1164 (5th Cir. 1985); *Knutson v. Morton Foods, Inc.*, 603 S.W.2d 805, 808 (Tex. 1980); *Gilliam v. Alford*, 69 Tex. 267, 6 S.W. 757, 759 (Tex. 1887). From a tax standpoint, the settlement of a bona fide dispute should be accorded the same effect as a judgment. *Estate of Barrett v. Comm'r*, 22 TC 606 (1954). According to the court:

> In *Lyeth v. Hoey*, the Supreme Court found too formal for substance the distinction between a payment made to an heir pursuant to judgment in a proceeding contesting a will and a payment made in compromise, in advance of trial, of the claims made in the proceeding. We think, similarly, that the distinction pressed by the respondent, on the basis of his regulations, between a payment made pursuant to an order of a local court after a fully litigated proceeding and a payment made in settlement of claims that avoids a will contest is without merit. A will contest can exist without full blown legal proceedings and we have no doubt that the executor in this case recognized the threat made on his sister's will. If the proceeding had ever come to issue and trial, the executor may well have opposed Barrett's claim, though recognizing as a danger that there was a possibility that Barrett might succeed and be awarded a substantial sum of money. If Barrett had litigated his claim and been awarded a judgment, the amount received by him would qualify as a marital deduction as an interest passing by inheritance. We find nothing in the statute or in logic that would deny similar treatment to a settlement payment made in advance of the contest where there is sufficient basis for a reasonable belief that only such payment would avoid a serious and substantial threat to the testamentary plan provided by the decedent.

Id. at 610. For a discussion of the extent to which the IRS is apt to give effect to family settlement agreements, see Gerstner, <u>The Case is Settled–Who Pays the Taxes? Tax Considerations in Probate and Trust Litigation</u>, Southwest Legal Foundation 37th Annual Wills and Probate Institute, 1998. *See also* Patel Pacheco and Davis, <u>Peace Treaties: Considerations When Negotiating, Drafting and Enforcing Settlements Agreements</u>, Houston Bar Association Probate Section Meeting (Sept. 2012); Kelly, <u>Tax Aspects of Family Settlement Agreements</u>, State Bar of Texas Advanced Estate Planning and Probate Course (1998).

5. The Relationship of the Parties.

Where the remainder beneficiaries of the bypass trust are the same as the beneficiaries of the surviving spouse's estate, can a bona fide dispute still exist? It was the relationship of the son as both a donee and beneficiary of his mother's estate that caused the Tax Court to initially deny the deduction of Joseph III's claim in *Estate of Bailey v. Comm'r*, 741 F.2d 801, 54 AFTR 2d 84-6527 (5th Cir. 1984), discussed above beginning on page 43. Even though the son was the ultimate beneficiary of the surviving spouse's estate, however, the Fifth Circuit nevertheless held that the surviving spouse's use of the inherited funds (for over 30 years) gave rise to a legitimate damage claim by the beneficiary. Of course, if Hugh remarried and the new spouse benefits from assets in Hugh's estate at the time of his death, a bona fide dispute is easier to find (but a family settlement is all the more unlikely). A similar result arises where Wilma's children of her first marriage (Hugh's step-children) are named as the remainder beneficiaries of the bypass trust.

XIV. CONCLUSION.

Funding formula bequests in Wills is a complex process. The executor is often faced with choosing between unpleasant alternatives, in the form of "underfunding" the bypass trust or incurring excessive capital gains. Although recent changes to the Texas Probate Code and Texas Trust Code offer considerable guidance, there are still several areas where computing and allocating estate income can be difficult. Unless the executor carefully reviews receipts and disbursements applying fiduciary accounting rules, and unless the executor is armed with an analysis of the capital gain impact of funding pecuniary gifts, these "unpleasant alternatives" may come as a rude surprise to the executor and the beneficiaries only after the estate has been terminated. Interpreting the formulas set forth in the governing instrument may be considered a legal matter, requiring the input of the estate's attorney. Many attorneys, however, view the analytical process of evaluating funding options as being within the exclusive province of the accounting profession. If a corporate executor is involved, the attorney and accountant may assume that the trust officer is responsible for undertaking this analysis. Obviously, a collaborative effort is required. Your ability to guide the executor through this process so that informed decisions are made is an essential part of the estate administrative process. It is hoped that the steps outlined above will prove helpful in undertaking this important analysis.

EXHIBIT A

NO. _______

ESTATE OF	§	IN THE PROBATE COURT NO. ___
	§	
[DECEASED SPOUSE],	§	OF
	§	
DECEASED	§	HARRIS COUNTY, T E X A S

AGREEMENT REGARDING DISTRIBUTION OF ESTATE ASSETS

RECITALS

The following facts form the basis for this agreement:

XV. [DECEASED SPOUSE] (the "Decedent") died in Houston, Harris County, Texas, on _________, 20___.

XVI. The Decedent was survived by his wife, [SURVIVING SPOUSE] (the "Surviving Wife"), and his son, ____________________. (the "Decedent's son").

XVII. The Last Will and Testament of the Decedent dated the __th day of _________, 20__ (the "Will") was admitted to Probate in Cause No. _______ in the Probate Court No. ___ of Harris County, Texas, and Letters Testamentary were issued to [SURVIVING SPOUSE] as Independent Executrix (the "Executrix") of the Estate of [DECEASED SPOUSE], Deceased (the "Estate").

XVIII. Pursuant to the Will and certain beneficiary designations for non-probate assets, the Decedent's former one-half community property passed from the Estate to the Surviving Wife, the Decedent's friend [SPECIFIC LEGATEE], the ____________ Family Trust, the ____________ Exempt Marital Deduction Trust, and the ____________ Non-Exempt Marital Deduction Trust.

XIX. The Surviving Wife has paid certain expenses of the Estate from her personal funds, and the Estate has received certain items of community property belonging to the Surviving Wife. The Estate has paid certain community property expenses from its funds, and the Surviving Wife has received certain items of community property belonging to the Estate, all of which events require a reconciliation of accounts due and owing to or from the Surviving Wife or the Estate.

XX. Following the foregoing adjustment, the community property of the Estate and the Surviving Wife is to be equally divided, with certain assets assigned to the Estate, and certain other assets of approximately equal value assigned to the Surviving Wife, in a nontaxable exchange as provided in Revenue Ruling 76-83, 1976-1 C.B. 213.

XXI. The Executrix and the Surviving Wife desire to evidence of record the transfer of all the property, both real and personal, of the Estate in accordance with the terms of the Will and the beneficiary designations for non-probate assets, effective as of ________ ___, 20___.

AGREEMENT

NOW, THEREFORE:

I. The Executrix has distributed, transferred, and conveyed the property listed on the attached Schedule A to the Surviving Wife.

II. The Executrix has distributed, transferred, and conveyed the property listed on the attached Schedule B to [SPECIFIC LEGATEE].

III. The Executrix has distributed, transferred, and conveyed the property listed on the attached Schedule C to the ____________ Exempt Marital Deduction Trust for the primary benefit of the Surviving Wife, such property having a net fair market value as of ________ ___, 20___equal to $______________, plus interest as provided by Section 378B(f) of the Texas Probate Code.

IV. The Executrix has distributed, transferred, and conveyed the property listed on the attached Schedule D to the ____________ Non-Exempt Marital Deduction Trust for the primary benefit of the Surviving Wife, such property having a net fair market value as of ________ ___, 20___equal to $_____________, plus interest as provided by Section 378B(f) of the Texas Probate Code.

V. The Executrix has distributed, transferred, and conveyed the property listed on the attached Schedule E to the ____________ Family Trust for the primary benefit of the Surviving Wife, such property having a net fair market value as of ________ ___, 20___equal to the value of the residue of the Estate.

VI. The assets are conveyed effective as of the close of business on ________ ___, 20___, and any income earned and any change in value or in form of any asset after that date shall inure to the benefit of the transferee of the asset as set forth herein.

VII. [SURVIVING SPOUSE], as Trustee of the ____________ Family Trust, the ____________ Exempt Marital Deduction Trust, and the ____________ Non-Exempt Marital Deduction Trust (the "Trustee") hereby agrees to indemnify and hold harmless the Surviving Wife, the Executrix, and their respective successors and assigns against all claims (including taxes of every kind and character), demands, suits, judgments, costs, expenses, accountant's fees, attorneys' fees, and to all losses and damages of every kind and character arising or to arise by reason of the distributions made herein.

VIII. The Executrix, the Surviving Wife, and the Trustee, at the request of any other party, shall execute where necessary from time to time such other documents as may be reasonably necessary to more fully and effectively consummate the transfers contemplated by this agreement.

IN WITNESS WHEREOF, the parties have executed this agreement as of the dates of the acknowledgments set forth below.

____
[SURVIVING SPOUSE], Individually, in her capacity as Independent Executrix of the Estate of [DECEASED SPOUSE], Deceased, and in her capacity as Trustee of the ____________ Family Trust, the ____________ Exempt Marital Deduction Trust, and the ____________ Non-Exempt Marital Deduction Trust

THE STATE OF TEXAS §
§
COUNTY OF HARRIS §

This instrument was acknowledged before me on the _____ day of ______________, 20___, by [SURVIVING SPOUSE], Individually, in her capacity as Independent Executrix of the Estate of [DECEASED SPOUSE], Deceased, and in her capacity as Trustee of the ____________ Family Trust, the ____________ Exempt Marital Deduction Trust, and the ____________ Non-Exempt Marital Deduction Trust.

____
Notary Public in and for the State of Texas

SCHEDULE A

The Executrix has distributed, transferred, and conveyed the following property to [SURVIVING SPOUSE], the Surviving Wife:

Item No.	Description	Value
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		
11.		
12.		
13.		
14.		
15.		
16.		
17.		
18.		
19.		
20.		
		$ ________

SCHEDULE B

The Executrix has distributed, transferred, and conveyed to [SPECIFIC LEGATEE] the following property:

Item No.	Description	Value
1.	$_________ cash	$
		_________

SCHEDULE C

The Executrix has distributed, transferred, and conveyed the following property to the ________________ EXEMPT MARITAL DEDUCTION TRUST:

Item No.	Description	Value
1.		
2.		
3.		
4.		
		$ __________

SCHEDULE D

The Executrix has distributed, transferred, and conveyed the following property to the ________________ NON-EXEMPT MARITAL DEDUCTION TRUST:

Item No.	Description	Value
1.		
2.		
3.		
4.		
5.		
6.		
7.		
8.		
9.		
10.		
11.		
12.		
13.		
14.		
15.		
		$____________

SCHEDULE E

The Executrix has distributed, transferred, and conveyed the following property to the ________________ FAMILY TRUST:

Item No.	Description	Value
1.		
2.		
3.		
4.		
5.		
		$ _________

EXHIBIT B

DAVIS & WILLMS, PLLC
3555 TIMMONS LN., SUITE 1250
HOUSTON, TEXAS 77027
(281) 786-45000900

MEMORANDUM

TO: [Executor]

DATE: March 14, 2013

FROM: Mickey R. Davis

RE: Steps to Fund Trusts and Distribute Estate

As we discussed, this memorandum is intended as a "step-by-step" checklist for your use in implementing the Agreement Regarding Distribution of Estate Assets for Mr. _________'s estate. As you know, that instrument documents the asset allocations made between you, the Exempt Marital Deduction Trust, the Non-Exempt Marital Deduction Trust, and the Family Trust. The allocation of these assets is made effective as of June 30, 2012. As a result, any asset sold, dividend paid, or other change in any asset made since that date will need to be reviewed so that we can ensure that the division of assets is made effective as of June 30th.

Specifically, the following steps should be taken:

[Surviving Spouse's] Assets:

9. All but ______ shares of [Exxon] stock (along with any dividends paid after 6/30/12) should be transferred into your brokerage account.

10. The stock certificate from [Closely held Business, Inc.] should be located and endorsed on the back by you as "[Surviving Spouse], Independent Executrix of the Estate of [Deceased Spouse]." A new certificate for _________ shares should then be issued in your name. The balance of these shares pass to the __________ Family Trust as described below.

11. The Note Receivable from ___________ should be endorsed on the back, as you would endorse a check: "Pay to the order of [Surviving Spouse]. It should then be signed by you as "[Surviving Spouse], Independent Executrix of the Estate of [Deceased Spouse]." [Maker] should be notified that all future note payments should be made out to you. Any note payments made after 6/30/12 not now in your personal account should be transferred to you.

12. It is my understanding that you have already collected and deposited into your personal account the proceeds from

Group Life and Health Insurance Co. Policy No. _______________.

13. The title to the [car/boat/travel trailer] should be located and retitled in your name. If any of these assets have been sold, you should insure that the sales proceeds are deposited into you account.

14. There is nothing for you to do to retitle the [household goods and personal effects]. They are transferred to you by your taking possession of them. Again, however, if any of these items has been sold, the sales proceeds should be transferred to you.

15. The balance in [Deceased Spouse's] Profit Sharing Plan belongs to you, as does IRA Account No. ___________, IRA Account No. ___________ and IRA Account No. ___________. You can leave these funds where they are and begin distributions to yourself at any time. You are *required* to begin taking distributions in the year that [Deceased Spouse] would have turned 70½. Alternatively, you may transfer these accounts into an IRA in your name. In that event, you cannot begin taking distributions until you turn 59½ (unless you pay a 10% penalty), but you can defer taking any required distributions until you turn 70½. I would suggest that you discuss your options with respect to these accounts further with [your accountant] or me.

16. You should review the beneficiary designation for *your* Profit Sharing Plan to ensure that it is payable to "The Trustee named in the Last Will and Testament of [Surviving Spouse]. The same beneficiary should be designated for any IRA accounts held in your name. This designation ensures that [your children] will receive these funds in trust at the time of your death.

17. It is my understanding that you already have deposited into your account the Wages Receivable from [Deceased Spouse's employer].

18. $__________ should be transferred from [Estate Checking Account No. ___________] to one of your bank accounts. This transfer equalizes the values that are distributed in accordance with the Agreement Regarding Distribution of Estate Assets.

19. Exempt Marital Deduction Trust Assets:

20. The Exempt Marital Deduction Trust should receive cash from [Estate Checking Account No. __________] or another estate account in the amount of $__________. A bank or brokerage account to hold these funds should be opened in the name of the ____________ Exempt Marital Deduction Trust using Taxpayer I.D. No. 76-______1.

21. Non-Exempt Marital Deduction Trust Assets:

22. We are preparing deeds for your signature to transfer the [__________] property and the [________] County real estate and minerals to the Non-Exempt Marital Deduction Trust.

23. A new brokerage account should be established in the name of the ____________ Non-Exempt Marital Deduction Trust using Taxpayer I.D. No. 76-______2. The following assets (along with any dividends paid after 6/30/12) should be transferred into that account:

(24. a) ________ shares of [Exxon] stock
(25. b) ________ shares of [IBM] stock
(26. c) ________ shares of [Compaq] stock
(27. d) ________ shares of [General Electric] stock

28. The general partner of [________] Properties, Ltd. should be notified that the new owner of this partnership interest is the____________ Non-Exempt Marital Deduction Trust, using Taxpayer I.D. No. 76-______2.

29. [Brokerage] Account No. ___-_____-_____ (mutual fund) should be transferred into the trust's brokerage account.

30. Cash in the total amount of $__________ should be transferred from the [Estate Checking Account No. __________] into the trust's brokerage account. This amount includes $_______ from the sales proceeds of the [___________] property. It also equalizes the values that are distruibuted in accordance with the Agreement Regarding Distribution of Estate Assets.

31. Family Trust Assets:

32. A bank or brokerage account should be opened in the name of the ____________ Family Trust using Taxpayer I.D. No. 76-_______3. Cash in the total amount of $__________ should be transferred from the [Estate Checking Account No. __________] into the trust's brokerage account. This amount includes $_______ from the sales proceeds of the [___________] property. It also equalizes the values that are distributed in accordance with the Agreement Regarding Distribution of Estate Assets.

33. As indicated above, the stock certificate from [Closely held Business, Inc.] should be located and endorsed on the back by you as "[Surviving Spouse], Independent Executrix of the Estate of [Deceased Spouse]." A new certificate for __________ shares should then be issued to the ___________ Family Trust. The balance of these shares pass to you as described above.

34. [Specific Legatee]:

35. $25,000 should be distributed to [Specific Legatee]. Mr. [Specific Legatee] should be asked to sign a Receipt and Release in the form attached to this memo.

36. I hope that you find this memorandum helpful in outlining the steps that you need to take to complete the funding of the trusts and distribution of the estate. As always, if you have any questions regarding this matter, please feel free to give me a call.

EXHIBIT C

[SPECIAL] WARRANTY DEED

Date:

Grantor:

Grantor's Address:

Grantee:

Grantee's Address:

Consideration: As a distribution from the Estate of [DECEASED SPOUSE], Deceased

Property (including any improvements):

Reservations from and Exceptions to Conveyance and Warranty:

> This conveyance is expressly made subject to all [easements, rights-of-way, and prescriptive rights, whether of record or not; all] presently recorded [easements,] restrictions, reservations, covenants, conditions, oil and gas leases, mineral severances, [conveyances,] and other instruments that affect the property; and taxes for 20_____, the payment of which Grantee assumes.

Grantor, for the consideration and subject to the reservations from and exceptions to conveyance and warranty, grants, sells, and conveys to Grantee the property, together with all and singular the rights and appurtenances thereto in any wise belonging, to have and hold it to Grantee, Grantee's heirs, executors, administrators, successors, or assigns forever. Grantor binds Grantor and Grantor's heirs, executors, administrators, and successors to warrant and forever defend all and singular the property to Grantee and Grantee's heirs, executors, administrators, successors, and assigns against every person whomsoever lawfully claiming or to claim the same or any part thereof, except as to the reservations from and exceptions to conveyance and warranty**[, when the claim is by, through, or under the Grantor but not otherwise][; provided, however, that the Grantee's remedies for breach of any warranty granted hereby shall be limited to remedies or amounts recoverable against any policy of title insurance issued to [DECEASED SPOUSE], or any remedies or amounts recoverable against any predecessor in interest to [DECEASED SPOUSE] with respect to such title]**.

For the same consideration stated above, Grantor does hereby grant and convey to Grantee, [in equal undivided interests as described above,] all of Grantor's rights to any land situated in any adjacent street or other right-of-way, and all other rights, privileges, and appurtenances owned by Grantor and in any way related to the Property (all such rights being referred to herein as the "Additional Interests"); provided, however, that the conveyance of the Additional Interests by Grantor is made without warranty of title of any nature whatsoever and Grantor hereby expressly excludes and disclaims any warranty of title as to the Additional Interests.

Grantor is acting herein in her capacity as Independent Executrix of the Estate of [DECEASED SPOUSE], Deceased under the Will admitted to probate in Cause No. __________ in the Probate Court No. _____ of Harris County, Texas. The foregoing covenants and agreements made by Grantor are made solely in her fiduciary capacity as Executrix of the Estate of [DECEASED SPOUSE], and in no other capacity whatsoever, and the liability of said Grantor under those covenants and agreements is limited to the Grantor acting in that fiduciary capacity and is limited to the assets of the estate held by the Grantor at the time any such liability may be conclusively established.

When the context requires, singular nouns and pronouns include the plural.

____
[SURVIVING SPOUSE], in her capacity as Independent Executrix of the Estate of [DECEASED SPOUSE], Deceased, and not otherwise

THE STATE OF TEXAS §
§
COUNTY OF ________________ §

This instrument was acknowledged before me on the _____ day of ________________, 20_____, by [SURVIVING SPOUSE], in her capacity as Independent Executrix of the Estate of [DECEASED SPOUSE], Deceased, and not otherwise.

____
Notary Public, State of Texas

EXHIBIT D

PARTNERSHIP AGREEMENT

FOR

THE SMITH FAMILY PARTNERSHIP

This Partnership Agreement (the "Agreement") is effective as of ____________________, and is entered into by and among the following persons (individually, a "Partner" and collectively, the "Partners"): JOHN SMITH of Harris County, Texas ("Jack"); MARY SMITH of Harris County, Texas ("Mary"); ALICE SMITH-JOHNSON of Pocahontas County, Iowa ("Alice"); and BARNEY SMITH of Travis County, Texas ("Barney").

RECITALS

The Partners desire to create a limited purpose general partnership (the "Partnership") in order to: own, manage, operate, and lease or sell certain mineral properties (the "Oil and Gas Properties"); manage, operate, and lease or sell certain real properties (herein, the "Real Properties"); and provide for the division and reinvestment of the resulting profits, losses, gains and credits, and other relevant matters.

A description of the Oil and Gas Properties is attached to and made a part of this Agreement as Exhibit "A". Legal descriptions of the real Properties are attached to and made a part of this Agreement as Exhibit "B". The Oil and Gas Properties and the Real Properties, and all proceeds and reinvestments, are sometimes collectively referred to as the "Property."

The Partners desire to form a general partnership for the limited purposes described above.

AGREEMENT

NOW, THEREFORE, for and in consideration of the mutual covenants and agreements below and other valuable considerations, the receipt and sufficiency of which are acknowledged by each of the parties, the parties agree as follows:

A.. Formation of General Partnership. The parties form a general partnership, pursuant to the laws of the State of Texas, as presently enacted and in force, effective as of the date of this agreement.

B.. Name and Place of Business.

1.. The business of the Partnership shall be conducted under the firm name of "THE SMITH FAMILY PARTNERSHIP." The Partnership's principal place of business shall be

____
Houston, Texas 77___
(713) ___-____

unless changed by the Manager (appointed below).

2.. Each Partner, except the Manager, expressly authorizes the Manager or his appointee to execute, with full power and authority, one or more assumed name certificates for the Partnership as may be required by the laws of the State of Texas or any other governmental authority.

C.. Character of Business and Title to the Property.

1.. The general character of the business of the Partnership is and shall be to own, manage, operate, and lease or sell the Property and all other property, if any, reasonably required in connection with partnership operations, and to do all things reasonably incident thereto, including, but not limited to, borrowing money for Partnership purposes and securing such borrowings by mortgages, pledges, or other liens upon the Property, any improvements thereon and such personalty at any time.

2.. Promptly following the formation of the Partnership:

a.. the Partners shall each deliver their initial capital contributions set forth below; and

b.. the Partners shall take such steps, if any, as may be necessary to cooperate with the executors of the Estate of Joseph Smith, Deceased, to effectuate the transfer of their respective interests in the Property to into the name of the Partnership.

3.. Term. The term of the Partnership shall commence on the date of this Agreement and shall expire on December 31, 2018, unless sooner terminated by agreement of all the Partners or otherwise pursuant to the provisions hereof. However, unless the Partners agree to the contrary by majority vote prior to any termination, the term of the Partnership shall automatically extent for successive five year periods.

D.. Capital.

1.. Initial Capital. The initial capital of the Partnership shall be the sum of One Hundred Dollars ($100) in cash, as indicated below, which shall be contributed in the following amounts:

Partner	Initial Capital
Jack	$ 25.00
Mary	25.00
Alice	25.00
Barney	25.00
TOTAL	$100.00

2.. Additional Capital. Upon request of the Manager, any further additional capital reasonably necessary for the operation of the business of the Partnership shall be contributed by each Partner in proportion to the Partnership Interest of each as set forth in 5.6 below. Each Partner shall be personally liable for any additional capital contributions deemed necessary by the Manager for the conduct of the business of the Partnership.

3.. Capital Account. A “Capital Account” shall be established for each Partner and shall be credited with the amount of his or her initial contribution and the amount of any subsequent contributions by him or her to the Partnership, and each

Capital Account shall be further adjusted as specified in Articles 7 and 8 below. A Partner shall not be entitled to withdraw any part of his or her Capital Account or to receive any distribution from the Partnership, except as otherwise specifically provided in this Agreement.

4.. Interest. No interest shall be paid on any capital contributed to the Partnership except as otherwise specifically provided in this Agreement.

5.. Capital Account Deficits. The Partners anticipate that no Capital Account deficits shall ever exist. If any Partner's Capital does have a negative balance, it shall be deemed to create an obligation of the Partner to pay such deficit to the Partnership upon liquidation of the Partnership or that Partner's withdrawal from the Partnership.

6.. Ownership and Liability. The Partners' respective fractional ownership interests in the Partnership (the "Partnership Interests") shall be as follows:

Partner	Initial Capital
Jack	25.00%
Mary	25.00%
Alice	25.00%
Barney	25.00%
TOTAL	100.00%

All debts, obligations and liabilities of the Partnership shall be borne by the Partners in accordance with their respective Partnership Interests, except as otherwise specifically provided in this Agreement.

E.. Accounting.

1.. Books of Account. The Manager shall maintain or cause to be maintained, at the expense of the Partnership, full and accurate books of account of the Partnership at the Partnership's principal place of business in Houston, Texas, or any other location specified by the Partners jointly, showing all receipts and disbursements, assets and liabilities, profits and losses and all other records necessary for the accurate recording of the Partnership's business affairs, including those sufficient to record the allocations and distributions provided for in this Agreement. The books of the Partnership shall be open to inspection and examination by each Partner in person or by his or her duly authorized representative at all times during reasonable business hours on any day other than Saturdays, Sundays or holidays observed by state-chartered banks in Houston, Texas.

2.. Fiscal Year, Accounting Method. The fiscal year of the Partnership shall be from January 1 to December 31 of each year and the books of the Partnership shall be maintained on the cash basis.

3.. Special Reports. The Manager shall, at the expense of the Partnership, furnish the other Partners reports covering the status of the Property upon any significant change in the status of the Property and at the time of any capital call.

4.. Quarterly Statements. Within ninety (90) days after the end of each fiscal quarter, a quarterly statement showing the taxable income and expenses of the Partnership as of the end of such fiscal quarter, shall be prepared at the expense of the Partnership and distributed, together with the corresponding Balance Sheet as of the end of the fiscal quarter, to all Partners.

5.. Checking and Savings Accounts. All funds of the Partnership shall be deposited in its name in such checking and savings accounts or time deposits in Harris County, Texas, or such other reasonable locations, as shall be designated by the Manager from time to time.

6.. Accounting Matters. All decisions as to accounting matters shall be made in accordance with applicable accounting principles consistently applied.

7.. Tax Returns. The Manager of the Partnership at the expense of the Partnership shall prepare and file in timely fashion all required tax returns of the Partnership and shall furnish all Partners with copies of the returns and a form K-1 reflecting his or her individual status for such fiscal year.

8.. Tax Election. Upon a transfer of all or any part of a Partnership Interest by a Partner or in the event of a distribution of all or a part of the Property, the Partnership shall elect, pursuant to Section 754 of the Internal Revenue Code, as amended, to adjust the basis of the Property as allowed by Code Sections 734(b) and 743(b), unless the Partners and the personal representative of any deceased Partner shall unanimously agree to a contrary election.

F.. Profits and Losses. The profits, losses, gains and credits of the Partnership shall be determined for each fiscal year in accordance with accounting methods followed for federal income tax purposes. For the purpose of determining which Partners shall receive items of income, which Partners shall bear items of expense, which Partners' Capital Accounts shall be appropriately adjusted, and which Partners shall take certain items into account for tax purposes, the following allocations are made (all of which shall be reflected by appropriate adjustments to the Capital Accounts according to the provisions of Section 5.3 above except as otherwise specifically provided in this Agreement):

1.. Except as otherwise specifically provided below, all items of Partnership income, gain, loss, deduction and credit, and all other similar items shall be allocated to the Partners in accordance with their respective Partnership Interests.

2.. Any income from the sale of the Property shall be allocated to the respective Partners in such manner as shall ensure the elimination of any positive or negative Capital Account balances upon the final distribution in liquidation of the Partnership, but shall otherwise be allocated in the same manner as provided in Section 7.1. The intent of this allocation is to insure that upon distribution of the proceeds of the sale of the Partnership Property, each Partner's Capital Account shall be reduced to zero.

3.. If any Partner shall have made a capital contribution to the Partnership of property having an adjusted basis for federal income tax purposes different from the fair market value of such property as of the date of such contribution as shall be agreed upon among the Partners, (i.e., the amount credited to such Partner's Capital Account by virtue of his or her having contributed such property to the Partnership), then, upon the sale of that property, the contributing Partner shall be specially allocated an amount of gain or loss equal to the unrealized pre-contribution appreciation or depreciation, respectively, so as to ensure that the Partner shall bear the pre-contribution tax consequences appurtenant to such property. Allocations made pursuant to this Section 7.3 shall not be charged or credited to the Partner's book (as opposed to tax) Capital Account.

G.. Distributions.

1.. General Distributions. Cash receipts available for distribution shall be distributed to the Partners as frequently as the Manager may, in his sole discretion, choose. The term "cash receipts available for distribution" shall mean all cash in the accounts of the Partnership less a "reserve fund". The "reserve fund" shall be the amount determined by the Manager to be reasonably necessary to pay principal and/or interest payments on debts of the Partnership and/or other costs and expenses incident to the ownership or operation of the Property that shall become due and payable within the succeeding calendar quarter and for which cash to make the payment(s) may not be generated during the quarter, plus a reasonable reserve for replacement or repair of capital items. The Manager of the Partnership shall be responsible for determining the amount of the "reserve fund" and calculating the cash receipts available to the Partnership. At all times, distributions shall be in proportion to the Partners' respective Partnership Interests.

2.. Distribution in Kind. Unless distributed in partial or complete liquidation of the Partnership Interest of one or more Partners, any assets of the Partnership distributed in kind, shall be distributed to the Partners as tenants-in-common in the same proportions in which the Partners would have been entitled to cash distributions.

3.. Distributions Charged. All distributions to the Partners (other than repayment of loans, payment of management fees, and/or guaranteed payments, if any) shall be charged to their respective Capital Accounts.

4.. Limitations. Except as otherwise expressly provided in this Agreement, no Partner shall be entitled to a partition of the Property or any other property or assets of the Partnership, or to demand or receive property other than cash in return for his or her capital contributions to the Partnership, or to withdraw any part of his or her capital contribution except for the distributions of cash flow expressly provided for in this Agreement.

5.. Loans by a Partner. Any Partner may lend money to the Partnership if the Manager shall determine that the Partnership requires the funds and the majority of the other Partners shall approve of the loan. Partner loans shall not increase the capital contributions of the Partner or entitle him or her to any increase in his or her share of the distributions of the Partnership. Unless otherwise specifically provided in the documents evidencing the loan: (i) each loan shall be an unsecured obligation of the Partnership; (ii) the Partners shall not be personally obligated to repay the loans, and the loans shall be payable only to the extent and collectible out of the assets of the Partnership; and (iii) all loans shall bear interest at an annual rate of one percent over the “prime” rate of banks in the Houston area as published in the Wall Street Journal (or banks nationally if Houston information is not published) (but never more than the maximum permitted by applicable law and never less than the amount needed to have "sufficient stated interest" for purposes of Internal Revenue Code section 7872), and shall be repaid in full before any distributions to the Partners shall be made.

6.. Order of Payment and Distribution Priority. The Partnership shall, to the extent of its available cash, pay expenses and make distributions in the following priority: First; all payments to any lender and other third parties shall be made. Second, amounts owing to Partners other than in their capacities as Partners (e.g. loans, management fees, guaranteed payments, etc.), shall be paid. Lastly, distributions to the Partners in their capacities as Partners may be made.

H.. Management.

1.. Appointment, Rights and Duties of Manager. Mary Thompson is appointed "Manager" of the Partnership. If she is unable to act for any reason, the other Partners may appoint a successor or interim Manager by majority vote. The Manager shall be in general charge of all day-to-day activities of the Partnership. The Manager shall receive reimbursement for all his out-of-pocket expenses and shall receive compensation for services as Manager in the amount as the Partners may agree from time to time.

2.. Specific Management Decisions. Except for the day-to-day activities of the Partnership granted to the Manager by Section 9.1, the business and affairs of the Partnership shall be governed by the vote of Partners owning in the aggregate, a combined Partnership Interest greater than fifty percent (50%). By way of illustration, majority approval shall be required to:

a.. Amend the provisions of this Agreement;

b.. Sell or otherwise dispose of all or any substantial part of the Property;

c.. Create, alter, extend, refund or renew any indebtedness of the Partnership in excess of $10,000 in the aggregate outstanding at any one time or take any action (subject to Section 9.3) that will create any liability of the Partnership for indebtedness in excess of an aggregate of $10,000;

d.. Make contracts or commitments for capital improvements to the Property in excess of $10,000 during any six (6) months' period;

e.. Perform any act not in the ordinary course of Partnership business; or

f.. Remove the Manager and appoint a new Manager.

3.. Competitive Business. Any Partner may engage in or possess an interest in other business ventures of any nature or description, independently or with others, including, but not limited to, the oil and gas and real estate businesses in all their phases, which shall include, without limitation, purchase, ownership, operation, management, syndication, development and sale of real and mineral properties; and neither the Partnership nor any other Partner shall have any rights in or to these independent ventures or the income or profits derived from them.

4.. Limitation on Authority. Except as otherwise expressly provided in this Agreement, without the prior written consent of the other Partners, no Partner shall:

a.. Do any act in contravention of this Agreement;

b.. Do any act which would make it impossible to carry on the business of the Partnership; or

c.. Possess the Property or assign the rights of the Partnership in the Property or any other property or assets of the Partnership.

5.. Suspension of Voting Rights. Any Partner who shall be in default, as specified in Article 13, shall have no voting rights during the term of the default; and his or her voting rights shall, during the term of the default, be proportionately allocated to the other Partners.

I.. Representations and Warranties. Each Partner represents and warrants unto the Partnership and the other Partners that he or she has fully investigated all aspects of the Property; that he or she has been furnished full information concerning the Partnership and its purposes; that he or she has requested no additional or further information that has not been furnished; that he or she is familiar with the risks involved, can afford to take such risks and willingly accepts them; that he or she has been advised by his or her own tax counsel with respect to the applicable tax law and the probable effect thereof upon his or her own tax situation, and is in no way relying on any advice or statement of any other Partner with respect to his or her investment in the Partnership; and that he or she has no view to selling or otherwise disposing of his or her Interest in the Partnership, all with full knowledge that the Partnership has not been registered for public offering or sale either with the federal Securities and Exchange Commission or with the Securities Board of the State of Texas or any other state, and that each of the other Partners is acting in full reliance upon these representations and warranties.

J.. Assignment of Interests of Partners.

1.. Limitation on Assignment. Unless the prior unanimous written consent of the other Partner's shall have been obtained, a Partner's Partnership Interest may be sold, assigned and/or transferred only as permitted by the provisions of this Article 11 and, even if so permitted, neither the Partnership nor the Partners shall be bound by any assignment until a counterpart of the instrument of assignment, manually executed and acknowledged by the parties to it, shall be delivered to the Manager.

2.. Limitation on Encumbrances. No Partner may mortgage, pledge or otherwise encumber his or her Partnership Interest without the written consent of the other Partners.

3.. Permitted Assignments. Any Partner shall have the right to sell, assign or transfer all or any part of his or her Partnership Interest to any of the following without restriction, but only on condition that all parties to whom the Partnership shall be obligated, if any, (i) shall consent to the transfer or (ii) shall, in the Manager's reasonable opinion, have no right to accelerate any indebtedness of the Partnership or declare a default by the Partnership as a result of the transfer:

a.. any other Partner or Partners,

b.. any spouse, companion in life or descendant of any individual Partner, c.. any trust for the primary benefit of any Partner or any spouse, companion in life or descendant of any individual Partner.

d.. any corporation, limited liability company, or general or limited partnership which is controlled by and all the ownership interests of which are held by Partners, or the spouses, companions in life or descendants of Partners, or

e.. any charitable institution.

4.. Right of First Refusal. In the event any Partner ("Selling Partner") shall desire to sell or otherwise dispose of his or her Partnership Interest, he or she shall notify all of the other Partners ("Other Partners") in writing, specifying the price at which, and the terms and conditions upon which, the proposed sale shall be effected; which terms shall provide, *inter alia*, that the purchase price shall be wholly payable in cash and by a promissory note (which may be secured by such Partnership Interest) only. Each of the Other Partners shall have a period of thirty (30) days within which to elect to purchase the Partnership Interest, in the proportion that the Partnership Interest of each of the Other Partners shall bear to the total Partnership Interests of all Partners electing to participate in the purchase, and if they shall not have notified the Selling Partner in writing of their election prior to the expiration of the thirty-day period, it shall be conclusively deemed that they do not desire to exercise the purchase election. The electing Partners shall be required to purchase all of the Partnership Interest being offered for sale, and in the event the entire interest being offered for sale shall not be purchased, then all electing Partners shall be conclusively deemed to have elected not to purchase. If the Other Partners shall not have notified the Selling Partner of their desire to purchase within the thirty (30) day period the Selling Partner shall have the right for a period of ninety (90) days to sell the Partnership Interest to any third party at the same or a higher price and upon identical terms and conditions as were offered to the Other Partners, but if the sale shall not be fully consummated within such ninety-day period, this first right of refusal shall revive as though no notice had been given in the first instance. If the Other Partners shall have elected to purchase all of the Partnership Interest being offered by the Selling Partner, then the Other Partners shall purchase it for the price and upon the terms as shall have been offered to the Other Partners and the closing shall be held at the time mutually agree upon, but in any event within thirty (30) days after the date of the last to occur of such elections.

5.. Liability Remains. Notwithstanding any transfer or assignment, partial or complete, each Partner shall be and remain responsible and liable for all of his or her obligations hereunder unless a novation shall be effected by which any Selling Partner shall be released of such liability.

6.. Procedures for Assignment. No assignee or transferee of all or part of the Interest of any Partner shall have the right to become a substitute Partner unless:

a.. His or her assignor shall have stated such intention in the instrument of assignment and same shall have been approved in writing by the remaining Partners;

b.. The assignee shall have executed an instrument reasonably satisfactory to the non-assigning Partners and their respective counsel accepting, adopting and agreeing to be bound by, the terms and provisions of this Agreement; and

c.. The assignor or assignee shall have paid any reasonable expenses of the Partnership in connection with the admission of the assignee as a Partner.

K.. Termination. The Partnership shall be dissolved and terminated upon the happening of any of the following events:

1.. The approval of Partners owning aggregate Partnership Interests in excess of fifty percent (50%) of the total Partnership Interests;

2.. The sale or other disposition of all or substantially all of the Property and other assets of the Partnership and distribution of the proceeds to the Partners; or

3.. The expiration of the Partnership term.

L.. Partnership Liquidation Procedures. Upon the dissolution of the Partnership pursuant to the terms of this Agreement, the Manager shall wind up the business and affairs of the Partnership. The Manager may cause the miscellaneous property and assets of the Partnership to be sold upon the terms and conditions as in his reasonable judgment may be appropriate. In the event of a sale of the Property, any income (or loss) shall be allocated to the respective Partner's Capital Accounts as provided in Section 7.2 and the proceeds shall be used to the extent necessary to pay or provide for the debts and obligations of the Partnership and the debts to which his or her assets may be subject; and the remainder shall be distributed to the Partners in accordance with their respective Capital Account balances. Each of the Partners shall be furnished a statement prepared by the Partnership's accountants which shall set forth the assets and liabilities of the Partnership as of the date of complete liquidation.

M.. Default.

1.. A Partner shall be in default if the Partner shall do any of the following (and if any Partner shall be in default, the Manager shall immediately notify all other Partners):

a.. fail to make any capital contribution when required by the Manager or fail to deliver to the Partnership or any other party monetary sums required to be delivered by the terms of this Agreement for a period of ten (10) days following the delivery of written notice of the failure to the Partner by the Manager, another Partner, or any other party;

b.. fail to perform any other duty or to fulfill any other covenant under this Agreement for a period of thirty (30) days following the delivery of written notice of the failure to the Partner by the Manager or another Partner;

c.. admit in writing his or her inability to pay his or her debts as they mature, institute proceedings of any nature under the Federal Bankruptcy Act or other debtor relief laws by which the Partner shall seek relief as a debtor, or make a general assignment for the benefit of his or her creditors; or d.. fail to discharge or dissolve within sixty (60) days after commencement or creation any proceeding instituted against him or her under the Federal Bankruptcy Act or any receivership created to take possession of any of his or her assets.

2.. If any Partner shall be in default, the other Partners may sue for specific performance, dissolve the Partnership, or exercise any other remedies provided in this Agreement, under law, or at equity.

N.. Notices. All notices or other instruments or communications provided for in this Agreement shall be in writing and signed by the party giving it and shall be deemed properly given and received when deposited in the United States mail, postage prepaid, return receipt requested, as registered or certified material, addressed as follows:

If to:	Addressed as follows:
Jack	_________________________ Houston, Texas 77____
Mary	_________________________ Houston, Texas 77___
Alice	Rt. 2, Box 127 Fonda, Iowa 50540
Barney	_________________________ Austin Texas 787__

and if sent otherwise then on the date received. Each Partner may, by notice to the others change his or her address.

O.. Governing Law. This Agreement shall be governed by and construed in accordance with the laws of the State of Texas.

P.. Binding Effect. Except as otherwise provided herein, this Agreement shall be binding upon, and shall inure to the benefit of, the parties hereto and their respective successors, heirs, representatives and assigns.

Q.. Counterparts. This Agreement may be executed in multiple counterparts, all of which, taken together, shall be deemed an original.

R.. Merger Agreement. This Agreement contains the entire understanding between the parties and supersedes any prior understandings and agreements between them respecting its subject matter.

S.. Interpretation. The paragraph headings in this agreement have been inserted for convenient reference only and shall not have the effect of modifying or amending the express terms and provisions of this Agreement. All pronouns and the like shall be deemed to refer to the masculine, feminine, neuter, singular or plural as the context may require.

T.. Acknowledgment. Each Partner acknowledges that he or she has read this Agreement and that he or she understands its terms and his or her relative rights and obligations under it.

U.. Execution Pages. It shall not be necessary for each Partner to execute the same execution page; execution pages with respect to each Partner may be attached with the same effect as though each Partner had physically executed the same page.

V.. Separability. In case any one or more of the provisions of this Agreement or any application of it shall be invalid, illegal or unenforceable in any respect, the validity, legality and enforceability of the remaining provisions and any other application of it shall in no way be affected or impaired.

W.. Tax Shelter Registration. The Manager shall make a timely determination whether the Partnership is required to be registered under the Federal Tax Shelter Registration requirements. If the Manager shall not register the Partnership and the Partnership is later penalized for failure to do so, the Manager agrees to indemnify and hold the other Partners harmless from all resulting damages and penalties.

EXECUTED to be effective as of the date first above written, although not necessarily signed on that date.

JOHN SMITH ALICE SMITH-JOHNSON

MARY SMITH BARNEY SMITH

STATE OF TEXAS §
§
COUNTY OF HARRIS §

Subscribed and Acknowledged before me by John Smith on this ____ Day of _________________, 20__.

(SEAL)

Notary Public, State of Texas

STATE OF TEXAS §
§
COUNTY OF HARRIS §

Subscribed and Acknowledged before me by Mary Smith on this ______ day of ______________, 20__.

(SEAL)

Notary Public, State of Texas

STATE OF ________ §
§
COUNTY OF _____________ §

Subscribed and Acknowledged before me by Alice Smith-Johnson on this _____ day of ____________, 20__.

(SEAL)

Notary Public in and for said State

STATE OF TEXAS §
§
COUNTY OF ____________ §

Subscribed and Acknowledged before me by Barney Smith on this _____ day of ________________________, 20__.

(SEAL)

Notary Public, State of Texas

EXHIBIT E

NO. _______

ESTATE OF	§	IN THE PROBATE COURT NO. ___
	§	
________________,	§	OF
	§	
DECEASED	§	HARRIS COUNTY, T E X A S

RECEIPT AND RELEASE

I, the undersigned, being one of the Beneficiaries under the Last Will and Testament of ________________, Deceased, hereby acknowledge receipt of a cash bequest in the amount of ____________________, which has been delivered to me pursuant to the provisions of such Will, and I hereby grant to _______________ and to said Estate a full and final release of any and all of my claims and causes of action of every kind with respect to the Estate of ________________.

IN TESTIMONY WHEREOF, witness my hand this ____ day of ____________, 20___

____
_________, Beneficiary

THE STATE OF TEXAS	§
	§
COUNTY OF _________	§

BEFORE ME, the undersigned authority, on this day personally appeared _________, known to me to be the person whose name is subscribed to the foregoing instrument, and acknowledged to me that she executed the same for the purposes and consideration therein expressed.

GIVEN under my hand and seal of office this ___________ day of , 20___ .

____

____

Notary Public in and for the State of Texas

"True Worth" Funding of Pecuniary Marital - Residuary Bypass Gifts

	Date of Death	Both Increase	Both Decrease	Net Increase	Net Decrease
A Corp	$750,000.00	$825,000.00	$675,000.00	$862,500.00	$637,500.00
B Corp	$750,000.00	$825,000.00	$675,000.00	$675,000.00	$825,000.00
Total	$1,500,000.00	$1,650,000.00	$1,350,000.00	$1,537,500.00	$1,462,500.00
Fund Marital with A Corp					
Marital	$900,000.00	$900,000.00	$900,000.00	$900,000.00	$900,000.00
Bypass	$600,000.00	$750,000.00	$450,000.00	$637,500.00	$562,500.00
Gain (Loss)	$0.00	$81,818.18	($100,000.00)	$108,333.33	($112,500.00)
Appreciation (Depreciation) passes to:	None	Bypass	(Bypass)	Bypass (Marital)	(Bypass)
Fund Marital with B Corp					
Marital	$900,000.00	$900,000.00	$900,000.00	$900,000.00	$900,000.00

Bypass	$600,000.00	$750,000.00	$450,000.00	$637,500.00	$562,500.00
Gain (Loss)	$0.00	$81,818.18	($100,000.00)	($45,652.17)	$61,764.71
Appreciation (Depreciation) passes to:	None	Bypass	(Bypass)	Bypass	(Bypass)

"Minimum Worth" Funding of Pecuniary Marital - Residuary Bypass Gifts

	Date of Death	Both Increase	Both Decrease	Net Increase	Net Decrease
A Corp	$750,000.00	$825,000.00	$675,000.00	$862,500.00	$637,500.00
B Corp	$750,000.00	$825,000.00	$675,000.00	$675,000.00	$825,000.00
Total	$1,500,000.00	$1,650,000.00	$1,350,000.00	$1,537,500.00	$1,462,500.00
Fund Marital with A Corp					
Marital	$900,000.00	$990,000.00	$900,000.00	$1,012,500.00	$900,000.00
Bypass	$600,000.00	$660,000.00	$450,000.00	$525,000.00	$562,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	(Bypass)	Marital (By-pass)	(Bypass)
Fund Marital with B Corp					
Marital	$900,000.00	$990,000.00	$900,000.00	$900,000.00	$975,000.00

Bypass	$600,000.00	$660,000.00	$450,000.00	$637,500.00	$487,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	(Bypass)	Bypass	Marital (By-pass)

*PRESUMABLY NO GAIN OR LOSS RECOGNIZED--SEE TEXT

"True Worth" Funding of Pecuniary Bypass - Residuary Marital Gifts

	Date of Death	Both Increase	Both Decrease	Net Increase	Net Decrease
A Corp	$750,000.00	$825,000.00	$675,000.00	$862,500.00	$637,500.00
B Corp	$750,000.00	$825,000.00	$675,000.00	$675,000.00	$825,000.00
Total	$1,500,000.00	$1,650,000.00	$1,350,000.00	$1,537,500.00	$1,462,500.00
Fund Bypass with A Corp					
Bypass	$600,000.00	$600,000.00	$600,000.00	$600,000.00	$600,000.00
Marital	$900,000.00	$1,050,000.00	$750,000.00	$937,500.00	$862,500.00

Gain (Loss)	$0.00	$54,545.45	($66,666.67)	$78,260.87	($105,882.35)
Appreciation (Depreciation) passes to:	None	Marital	(Marital)	Marital	(Marital)
Fund Bypass with B Corp					
Bypass	$600,000.00	$600,000.00	$600,000.00	$600,000.00	$600,000.00
Marital	$900,000.00	$1,050,000.00	$750,000.00	$937,500.00	$862,500.00
Gain (Loss)	$0.00	$54,545.45	($66,666.67)	($66,666.67)	$54,545.45
Appreciation (Depreciation) passes to:	None	Marital	(Marital)	Marital	(Marital)

"Minimum Worth" Funding of Pecuniary Bypass - Residuary Marital Gifts

	Date of Death	Both Increase	Both Decrease	Net Increase	Net Decrease
A Corp	$750,000.00	$825,000.00	$675,000.00	$862,500.00	$637,500.00
B Corp	$750,000.00	$825,000.00	$675,000.00	$675,000.00	$825,000.00
Total	$1,500,000.00	$1,650,000.00	$1,350,000.00	$1,537,500.00	$1,462,500.00
Fund Bypass with A Corp					
Bypass	$600,000.00	$660,000.00	$600,000.00	$690,000.00	$600,000.00
Marital	$900,000.00	$990,000.00	$750,000.00	$847,500.00	$862,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	(Marital)	Bypass (Marital)	(Marital)
Fund Bypass with B Corp					
Bypass	$600,000.00	$660,000.00	$600,000.00	$600,000.00	$660,000.00

Marital	$900,000.00	$990,000.00	$750,000.00	$937,500.00	$802,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	(Marital)	Marital	(Marital)

*PRESUMABLY NO GAIN OR LOSS RECOGNIZED--SEE TEXT

"Fairly Representative" and "Fractional Share Funding

	Date of Death	Both Increase	Both Decrease	Net Increase	Net Decrease
A Corp	$750,000.00	$825,000.00	$675,000.00	$862,500.00	$637,500.00
B Corp	$750,000.00	$825,000.00	$675,000.00	$675,000.00	$825,000.00
Total	$1,500,000.00	$1,650,000.00	$1,350,000.00	$1,537,500.00	$1,462,500.00
Fairly Representative					
Bypass	$600,000.00	$660,000.00	$540,000.00	$615,000.00	$585,000.00
Marital	$900,000.00	$990,000.00	$810,000.00	$922,500.00	$877,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	Split	Split	Split
Fractional Share					
Bypass	$600,000.00	$660,000.00	$540,000.00	$615,000.00	$585,000.00

Marital	$900,000.00	$990,000.00	$810,000.00	$922,500.00	$877,500.00
Gain (Loss)	$0.00	None*	None*	None*	None*
Appreciation (Depreciation) passes to:	None	Split	Split	Split	Split

*PRESUMABLY NO GAIN OR LOSS RECOGNIZED--SEE TEXT