

Welcome to the inaugural edition of **Legal News: Estate and Trust Litigation**, a publication of Foley & Lardner's Tax, Valuation and Fiduciary Litigation group. This E-newsletter will provide trust officers, estate and trust attorneys, and other readers with periodic updates on important state and federal law developments and offer risk management tips. We hope you find it beneficial, and we welcome your comments.

FLORIDA ADOPTS NEW UNIFORM PRINCIPAL AND INCOME ACT

On April 16, 2002, Governor Bush signed into law the new Uniform Principal and Income Act ("New Act"), which repeals and replaces in its entirety the current act. The effective date is January 1, 2003, which should allow professional fiduciaries ample time to make necessary adjustments to current practices and procedures. The New Act operates by default unless the instrument in question provides to the contrary. This column highlights a few of the noteworthy changes.

Background

The New Act is modeled after the 1997 Uniform Principal and Income Act ("Uniform Act") adopted by 24 states and pending before the legislature in 6 others, but makes a number of substantive changes. The New Act emphasizes the "total return" concept, which should enable fiduciaries genuinely to follow the prudent investor rule. It provides for investment modalities that were not in existence in 1962 when the current act was promulgated, including derivatives, options, deferred payment obligations, and synthetic financial assets. It also considers the problem of disbursements made due to environmental laws, introduces "unincorporated entity" concepts, and addresses imbalances and inequities caused by tax elections or peculiarities in the way fiduciary income tax rules apply. In short, the New Act significantly modernizes a key component of Florida estates and trusts law.

Noteworthy Provisions in the New Act

Perhaps the most noteworthy aspect of the New Act is the power to adjust the amounts distributable as income "to the extent the trustee considers necessary" to produce an impartial result. This power may be exercised either by supplementing

FIDUCIARY RISK MANAGEMENT TIP

CONVERSIONS TO COMMON MUTUAL FUNDS

In the past few years, many plaintiffs' lawyers have filed class-action lawsuits alleging wrongdoing by trustees for having converted trust assets from common trust funds to mutual funds. Common mutual funds may indeed be a proper investment vehicle; the question is whether the trustee complied with its fiduciary duties in making the investment decision. To improve the defense of such claims, we recommend that corporate trustees:

- (1) Develop a written policy articulating the rationale for a conversion, *i.e.* under what circumstances investments in common mutual funds better meet the objectives and best interests of beneficiaries than other alternative investments, and update internal investment guidelines and manuals to reflect the policy.
- (2) Document the decision-making considerations for any particular conversion.
- (3) Disclose all fees to be received through the mutual funds, as well as the formula used to determine the fees.
- (4) Promptly respond in writing to beneficiary inquiries and complaints.

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traditional trust income with transfers from principal, or by reducing trust income with a transfer to principal. For example, a trustee may now adjust principal and income to the extent made necessary by prudent investment even though a trust provides a fixed income interest. Before making an adjustment, however, the trustee must consider factors delineated in the New Act. Adjustments are restricted in certain circumstances, such as when they diminish the income interest in a trust that requires all of the income to be paid at least annually to a surviving spouse and for which an estate tax or gift tax marital deduction would be allowed, or when the trustee is a beneficiary of the trust. The adjustment power is available to all trusts created after the effective date of the New Act, and to trusts which already exist but do not become irrevocable until after the effective date.

In addition to the power to adjust, the New Act allows a trustee to convert an income trust to a total return unitrust without first seeking court approval. (The terms "total return unitrust" and "unitrust amounts" are not defined in the New Act, but in general terms, a "unitrust" is a trust from which a fixed percentage of the net fair market value of the trust's assets, valued annually, is paid each year to the beneficiary, while a total return trust is a trust that directs or allows the trustee to distribute net income to one or more persons, either in fixed proportions or in amounts or proportions determined by the trustee.) The New Act also allows a trustee to convert a total return unitrust to an income trust, change the percentage used to calculate the unitrust amount, or change the method used to determine the fair market value of trust assets. This power, however, may only be exercised by a trustee who does not have the power to adjust discussed above. Like the power to adjust, the power to convert is subject to certain limitations.

Once the fiduciary exercises the discretion to adjust or convert, the court may not change the trustee's decision to exercise the power or not, unless it finds the decision was an abuse of discretion. Even if the court finds an abuse of discretion, the remedy is to readjust the interests to return the beneficiaries to the positions they would have occupied but for the abuse of discretion. The trustee is not personally liable unless it is impossible to restore the beneficiaries to their prior positions. If the trustee successfully defends itself, the trustee's attorneys' fees and costs are paid from trust assets.

Also noteworthy is the New Act's express grant of authority to the trustee to make adjustments between principal and income for tax purposes. Imbalances in the tax treatment of different classes of beneficiaries can now be properly remedied by the trustee pursuant to this express power.

Key Differences Between the New Act and the Uniform Act

The New Act includes a number of provisions not found in the Uniform Act, including the following:

- A method by which a supermajority of the beneficiaries may elect, under certain circumstances, to opt out of the new provisions for adjustment between principal and income.
- The value of assets is determined on an asset-by-asset basis. The valuation is conclusive if reasonable and performed in good faith. An appraisal less than two years old is presumed correct. A valuation challenge must be commenced within six months of the date the interested party is notified of the valuation.

- Existing Florida estate tax apportionment law controls over any conflicting apportionment provisions in the New Act.
- Payments the trustee receives in the nature of interest or dividends must be allocated to interest even if they are characterized otherwise by the payor.
- The amount of depreciation taken for tax purposes is presumptively correct in allocating between principal and income.
- A formula for apportioning expenses between the life tenant and the remainder interests.

The New Act will bring about significant changes for professional fiduciaries. Attention should be given now to updating systems and policies to ensure a smooth transition.

FEDERAL DECISIONS

Federal Tax Liens; Tenants by the Entirety. Reversing the Sixth Circuit Court of Appeals, the U.S. Supreme Court recently held that a tenant by the entirety (TBE) possesses "property" or "rights to property" to which a federal tax lien may attach pursuant to I.R.C. § 6321. Tenancy by the entirety is a form of concurrent ownership limited to married couples; each spouse is vested with the entire title, but neither has individual rights. In this case, the husband failed to pay federal income tax liabilities, and the issue was whether a resulting tax lien attached to real property he and his wife owned as tenants by the entirety. The Court looked to state law (Michigan) to determine the scope of the husband's rights with respect to the entireties property, which included the right to use the property, to receive income produced by it, and to exclude others from it. The Court then decided as a federal question that those rights qualified as "property" to which a federal tax lien could attach under § 6321, notwithstanding state law to the effect that a TBE possesses no separate interest in the property and that one spouse's interest in TBE property is not subject to claims of the other spouse's creditors. [United States v. Craft](#), 122 S. Ct. 1414 (2002).

Other jurisdictions - including the District of Columbia, Florida, Illinois, Maryland, and Virginia - have TBE provisions similar to the Michigan law at issue in *Craft*. Entireties property in those jurisdictions also may be vulnerable to federal tax liens arising from a spouse's tax liability.

IRS Summons; Attorney-Client Privilege. A recent federal district court case examines the scope of the attorney-client privilege as applied to documents relating to an estate tax return. In [Bria v. United States](#), 89 A.F.T.R.2d 2002-2141 (D. Conn. 2002), plaintiffs, the co-executors of their mother's estate, retained counsel to prepare a Form 706 but terminated the law firm's services before the return was filed. The IRS issued a summons to the attorneys as part of its investigation into whether the plaintiffs understated the value of the estate in the return eventually filed. The attorneys objected on privilege grounds to the disclosure of information regarding assets not disclosed on the tax return and the reasons the plaintiffs terminated the attorneys' services. The court ordered the attorneys to answer questions and produce documents regarding contributions to unreported joint accounts, ruling that the information was provided to the attorneys for the purpose of preparing the tax return and therefore was not intended to be confidential. The court also ordered the attorneys to answer questions about

plaintiffs' statements concerning the value of property in the estate. The IRS was not entitled to ask the attorneys about legal advice plaintiffs requested regarding how to treat the joint bank accounts, however; the court rejected the IRS' argument that the crime-fraud exception to the attorney-client privilege should apply because the IRS had failed to satisfy its burden of showing probable cause that a crime or fraud had been committed and that the communications were in furtherance of the crime or fraud. Similarly, the court denied the IRS' request to question the attorneys about the circumstances of their termination, ruling that the termination and resulting fee dispute could involve privileged information about legal advice and strategy.

No Minority Discount in Valuing 50% Partnership Interest. In [Estate of Godley v. Commissioner](#), 286 F.3d 210 (4th Cir. 2002), the Fourth Circuit Court of Appeals affirmed the Tax Court's valuation of the decedent's 50% interest in five general partnerships that owned and operated housing projects for elderly tenants under contracts with the Department of Housing and Urban Development. The remaining 50% interest was owned by the decedent's son. The Tax Court applied a 20% lack of marketability discount but no minority discount. The Fourth Circuit affirmed. In doing so, it held that whether to apply a minority discount is a question of fact, not of law, and depends on the facts and circumstances. Here, there was little benefit to holding a controlling interest in the partnerships, and little risk to holding a minority interest, because the HUD contracts guaranteed the partnerships a long-term, steady income stream, and the partnership agreements required annual distributions of net cash flow. Accordingly, it was not clearly erroneous for the Tax Court to decline to apply a minority discount.

CALIFORNIA

Palimony. In 1976, in [Marvin v. Marvin](#), 18 Cal. 3d 660 (1976), the California Supreme Court decided the time had come to recognize the "prevalence of nonmarital relationships in modern society and the social acceptance of them." In addition, the court believed that "the mores of society have indeed changed so radically in regard to cohabitation that we cannot impose a standard based on alleged moral considerations that have apparently been rejected by so many." In the years following [Marvin](#), California courts have struggled with what has become known as the "palimony" claim.

In the recent case of [Cochran v. Cochran](#), 89 Cal. App. 4th 283 (2001), the appeals court, following review of a series of cases where a decedent's former non-marital partner sought to enforce oral property and support agreements, liberalized the concept of "cohabitation" to include situations where the parties do not live together full-time. The court began its analysis with the [Marvin](#) holding that adults who voluntarily live together and engage in sexual relations are competent to contract respecting their earnings and property rights. So long as the agreement does not depend on meretricious sexual relations for its consideration, or so long as that portion of the consideration may be severed from the proper forms of consideration, such agreements are enforceable. On the question whether full-time cohabitation is required for a palimony claim, the court found persuasive cases involving criminal convictions for inflicting injury to a cohabitant. Those cases define cohabitation to include "off and on" relationships, and the [Cochran](#) court extended that rationale to the palimony context. The court reasoned that to require full-time cohabitation before enforcing an agreement would defeat the

reasonable expectations of those who may clearly enjoy a significant and stable relationship arising from cohabitation, albeit less than a full time living arrangement.

The question following Cochran is, what is the significance of Marvin? Recall that Marvin addressed the situation of people who lived together in the same manner as married couples. The assumption has been that this required close to full time cohabitation. If Cochran is adopted by the other appeals courts, it will be increasingly difficult for estates to defend palimony claims. The shorter the duration of time the potential plaintiff must have resided with the decedent to establish cohabitation, the more difficult it will be to prove that cohabitation did not occur. Given that the decedent is not available to deny the existence of the alleged oral promise or the living arrangements, one might expect more plaintiffs' verdicts against estates.

DISTRICT OF COLUMBIA

Heir Hunter Has Probate Claim. Appellant, an "heir hunter," located four potential heirs to an estate and obtained an assignment of 25% of the value of any property to which they were entitled. Three of these located persons were recognized by the probate court as heirs. When a distribution was made, Appellant received no payment. Appellant's complaint was rejected by the probate court, ruling that the Estate was not a party to the assignment and that Appellant's remedy was to file a civil complaint against the assignors. The Court of Appeals reversed, holding that the Appellant, as assignee, attained status as an "interested person" in the probate proceeding and stood in the shoes of the heirs; it therefore was entitled to receive payment from the Estate. [Brandenburger & Davis, Inc. v. Estate of Lewis](#), D.C. App. No. 00-PR-31 (April 5, 2001), 129 D.W.L.W.R. 885 (May 9, 2001).

ILLINOIS

Powers of Attorney. The First District Appellate Court recently decided two cases illustrative of the ever-increasing litigation over the use of powers of attorney. The first case discusses the history of the battle of presumptions in joint tenancy situations, with the presumption of fraud clearly displacing the presumption of donative intent. The second employs a more contractual analysis and makes for interesting reading.

[In re Estate of Teall](#), Nos. 1-00-3727, 1-00-3728, 2002 WL 480607 (Ill. App. Ct. 1st Dist. Mar. 29, 2002). Plaintiff, the decedent's neighbor and volunteer caregiver, was entitled to over \$200,000 on her claim for personal services. The court held that, where services rendered by one person for another are knowingly and voluntarily accepted, the law presumes that such services are given and received with the expectation of payment and implies a promise to pay the reasonable value of the services. However, the court only allowed the plaintiff to recover for services rendered during the five years preceding the filing of her claim due to the statute of limitations.

At the same time, the court found that joint bank accounts that passed to the plaintiff upon the decedent's death were actually "convenience accounts," and thus were property of the estate. In so finding, the court relied on the presumption of fraud that attaches to a transfer by a fiduciary.

Documents showing that the accounts were opened after the commencement of the fiduciary relationship pursuant to a power of attorney created the presumption of fraud.

[In re Estate of Romanowski](#), No. 1-00-3376, 2002 WL 480648 (Ill. App. Ct. 1st Dist. Mar. 29, 2002). In this case, the appellate court upheld the finding that an agent exceeded the scope of her authority under a power of attorney by naming herself and her daughter as contingent beneficiaries of a decedent's trust after deeding a parcel of commercial property into such trust. The court ruled that the decedent's statutory form power of attorney for property was clear and unambiguous with no additions to the form, and if the principal had wished to grant the agent the power to name a beneficiary, such power should have been specifically added in the space provided on the statutory form. Without such an addition, the limitations recited in the statutory form controlled. The court also held that, pursuant to the parol evidence rule, the trial court erred in admitting oral testimony as to the decedent's intent regarding the designation of the trust's contingent beneficiaries where the power of attorney was unambiguous as to this issue.

Illinois Slayer Statute. [In re Estate of Malbrough](#), No. 1-00-2765, 2002 WL 480603 (Ill. App. Ct. 1st Dist. Mar. 29, 2002), involves a novel theory of neglect as a cause of death under the so-called Slayer Statute contained in Section 2-6 of the Illinois Probate Act. Petitioner (the decedent's brother) claimed that the decedent's wife killed the decedent by depriving him of necessary care that amounted to neglect, and thus, she should be disqualified from inheriting under the decedent's will. The appellate court reversed the trial court's dismissal for failure to state a claim, relying on several affidavits from the decedent's health care providers opining about the decedent's lack of proper care. Because these statements were incorporated into the complaint and set out with the requisite specificity, the court found that the requirements to state a cause of action were fulfilled. The court also held that a death certificate is not conclusive as to cause of death.

WISCONSIN

Dead Man's Statute. Two recent Wisconsin Court of Appeals decisions illustrate the narrow construction courts apply to Wisconsin's "dead man statute." In an effort to prevent living persons from gaining an undue advantage over decedents, the dead man's statute prohibits interested parties from testifying about transactions or communications with the decedent if those transactions or communications are the basis for the interest of the opposite party. For testimony to be barred under the dead man's statute, (1) the witness must have an interest and be testifying on the witness' behalf; (2) the testimony must relate to a transaction or communication with the deceased; and (3) the opposing party must derive her interest through the deceased person. As reflected in the following decisions, the dead man's statute is disfavored, and courts are amenable to admitting relevant evidence obtained from a decedent provided the witness does not testify to actual conversations or transactions with the decedent.

In [Belisle v. Belisle](#), 2001 WI App 280, 248 Wis. 2d 984, 638 N.W.2d 395, Shirley Belisle filed a foreclosure action against her son, Paul, for failure to make the required payments on a land contract among Paul and the decedent and Shirley. At trial, Paul contended that he understood, through

conversations with the decedent, that the payment obligation under the land contract was satisfied in full through the assignment of rents and other interests. Shirley objected to Paul's testimony regarding conversations with the decedent. While the Court agreed that Paul's testimony concerning his actual conversations with the decedent violated the dead man's statute, it nevertheless permitted him to testify as to his "understanding" of the repayment terms.

In re Estate of Erickson, 2002 WI App 56, 640 N.W.2d 565, the personal representative, one of the decedent's nieces, initially offered for probate a 1988 will that left the residue of the estate to the Calvary Covenant Church. Upon reviewing the contents of the decedent's safe deposit box, the personal representative found a 1992 will that left all of the estate to the decedent's trust, which in turn left the residue to the decedent's nieces, including the personal representative. The church objected to admitting the latter will to probate, claiming the decedent was not competent at the time she signed the second will. Over the church's objections, the court allowed the personal representative to testify as to the decedent's competence at the time the will was executed, so long as she did not testify about any communications or transactions between herself and the decedent.

Legal News: Estate and Trust Litigation

This publication is one of several newsletters published by Foley & Lardner's Tax, Valuation & Fiduciary Litigation [TVFL] team. TVFL provides a unique blend of skilled litigators along with tax and estates and trusts attorneys to successfully represent clients in risk management, dispute resolution and litigation services. Specialties include Federal Tax Controversy, State Tax Controversy, Valuation Litigation, Insurance Tax Controversy and Estate and Trust Litigation.

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