CARR McCLELLAN
INGERSOLL THOMPSON & HORN

PERSPECTIVES ON LAW

FALL 2004

2 **No-Contest Clauses**
Take It or Leave It

4 **Real Estate**
Triple Net Leased Investments: Low Maintenance Real Estate

5 **Fiduciary Responsibility**
Some Trustees Must Now Register with the State

Exempt Organizations
Governor Signs Law Imposing New Requirements on Charities

6 **Equity Compensation**
Rewarding Company Founders: Part I - Restricted Stock

Commitment to Tradition While Moving Ever Forward

In addition to excellence in lawyering and client service, one of the hallmarks of our firm is our deep involvement in our business, civic and charitable communities. Although our lawyers and staff give back to the community without the expectation of accolades, we are pleased to have been recognized recently for our community contributions. Earlier this year, we received SAMCEDA's Award of Excellence in Community Service. This award is given to a business in San Mateo County that exemplifies good corporate citizenship and demonstrates a commitment to bettering the greater San Mateo Community. This past summer, we were also recognized for our contributions to the community by the San Mateo Area Chamber of Commerce and the City of San Mateo, which presented Carr McClellan with an Outstanding Business Award. We very much appreciate the acknowledgment of our contributions by our clients, business colleagues and friends in the communities to which our attorneys contribute their time and talent to make the Bay Area a great place to live, work and conduct business.

While our firm's commitment to giving back to our community is nothing new, what is new is the look of our firm's business systems; i.e., our letterhead, website, business cards and the like. We have updated our firm's website so that it is more navigable and full-featured. Our letterhead, business cards and other communication tools have a cleaner, more contemporary look, consistent with our redesigned firm brochure and *Perspectives*. Is there a message in the confluence of these events? I believe there is. While the firm has held on to its traditions of excellence and community involvement over the past 60 years, it nonetheless continues to move forward to meet the demands of a changing legal and business environment, and to provide those legal services necessary to solve our clients problems or assist them in taking advantage of opportunities. We are devoted to continuing to do so into the future.

Like past issues of *Perspectives*, this issue contains a sampling of articles ranging from Equity Compensation for Start-Ups by **Ed Willig** to Triple Net Leased Investments by **Carol Schwartz**. We welcome your comments on these topics and are open to your suggestions for future articles that you may find of interest and value.

Mark Cassanego is President of Carr McClellan.

Family Limited Partnerships: Safeguarding Your Partnership to Achieve Success

By Steven Anderson, Esq. and Marion Brown, Esq.

Many of our clients operate family business enterprises in the form of a limited partnership owned by parents, children and others. Certain recent estate tax law developments underscore the importance of proper planning in the family limited partnership arena.

The first development is that over the past twelve months the IRS has enjoyed considerable success in attacking partnerships that are not properly operated. The IRS has identified and pursued cases where the taxpayer who created the partnership and transferred partnership interests to other family members nevertheless continued to operate the transferred property as if it were still the taxpayer's own property.

In the most notorious of these cases, the IRS has been successful in convincing the courts to ignore the establishment of the partnership and the transfer of the partnership interests, and to treat all of the assets transferred to the partnership as part of the taxpayer's gross estate. This, of course, is a disastrous result. But this result can easily be avoided by operating the partnership properly and according to the terms of the partnership agreement. The partnership should (i) deposit all partnership receipts in a partnership account, (ii) pay partnership expenses from a partnership account, (iii) have its own tax identification number, (iv) file partnership tax returns, (v) make decisions in the manner specified in the partnership agreement, (vi) make distributions to partners as specified in the partnership agreement, and (vii) avoid random or special distributions to some partners and not others.

To assure that the partnership is being operated properly, we recommend that the general partner(s), the partnership's accountant and the partnership's legal counsel have annual meetings to review the operations and distributions and to assure that everything is being done properly.

The second development is the apparent deviation by the Tax Court in the *Strangi* case from some established theories (even though in a more recent decision, in the *Kimbell* case, the Federal Appellate Court for the Fifth Circuit overturned a lower court decision based on similar reasoning and handed the taxpayer's estate a victory).

see Safegaurding Your Partnership, *page 7*

TAKE IT OR LEAVE IT

By Daniel Morris, Esq.

More than 150 years ago, Charles Dickens wrote Bleak House, which opens with the case of Jarndyce vs. Jarndyce in the English High Court of Chancery - a family estate dispute, which has been going on for generations. In the end, the case was resolved, but all of the estate had been consumed with legal fees and court costs, leaving nothing for the heirs. Unfortunately, not much has changed since 1853. However, with careful planning, anyone executing a Trust or Will can greatly reduce the risk of exposing their estate to expensive post-death litigation.

Very few, if any, estate planning clients ever intend or desire that their family and estate be subjected to months or years of costly estate litigation. More often than not, at the end of the litigation, tens of thousands of estate dollars will have been spent on attorneys, expert witnesses and other legal expenses. More importantly, however, the estate litigation process will result in the permanent destruction of family relationships. It is not surprising, therefore, that many of our estate planning clients ask if there are ways to reduce the likelihood of a contest of their estate planning documents following their death.

As attorneys who prepare estate planning documents on a regular basis, usually consisting of Living Trusts and Wills, all efforts are made to reduce the likelihood of a successful dispute or contest following a client's death. Fortunately, there are several preventative measures estate planning attorneys and clients can take to discourage a contest from being filed. This article will summarize the most common grounds for estate contests and discuss the preventative measures that can be taken to avoid a successful estate contest.

Estate contests are most often brought on the grounds of undue influence or lack of testamentary capacity. Undue influence is established when it is shown that a testamentary instrument, such as a Trust or Will, was brought about by undue pressure, argument, entreaty, or other coercive acts that destroyed the testator's freedom of choice so that it can fairly be said that the person signing the testamentary instrument (for convenience sake referred to as “the testator”) was not a free agent when making his or her testamentary instrument. In general, the contestant has the burden of proof on the issue of undue influence. However, the contestant may be entitled to a presumption of undue influence if he or she can show: (1) there was a confidential relationship between the testator and the person alleged to have exerted undue influence; (2) the person alleged to have exerted undue influence actively participated in the actual preparation or execution of the testamentary instrument; and (3) the person alleged to have exerted undue influence received an undue benefit under the testamentary instrument.

“There are certain “red flags” or warning signs of undue influence that estate planning attorneys look for.”

In most cases, the analysis of mental capacity to execute a Trust or Will is the same. The testator must be at least 18 years of age and of sound mind. A person is not mentally competent to make a testamentary instrument if at the time of make the testamentary instrument he or she either: (1) does not have sufficient mental capacity to (a) understand the nature of the testamentary act, (b) understand and recollect the nature and situation of his or her property, or (c) remember and understand his relations to living descendants, spouse, parents, and others whose interests are affected by the will; or (2) suffers from a mental disorder with symptoms including delusions or hallucinations that result in his or her devising property in a way that, except for the delusion or hallucinations, he or she would not have done. The testator is presumed sane and competent and the contestant has the burden of proving by a preponderance of the evidence that the testator lacked testamentary capacity at the time the testamentary instrument was signed.

No estate planning attorney would knowingly permit a client to execute a testamentary instrument that was the product of undue influence or if the client lacked testamentary capacity. There are certain “red flags” or warning signs of undue influence that estate planning attorneys look for. These warning signs include: advanced age, fragile physical condition, physical dependency on others for care, requests for dramatic departures from past estate plans, and the involvement of others in setting up the appointment or transporting the client to the attorney's office. If there is any suspicion that a client may be the subject of undue influence, there are several measures that can be undertaken to protect the client's interest. First and foremost, it is important that the estate planning attorney meet privately with the testator before any documents are prepared to discuss the testator's desires and the reasons for the desires. This is particularly true when the testator is requesting a significant change in his or her existing estate plan. If the client expresses an intention of disinheriting a child or beneficiary under a prior Trust or Will or to treat children or other beneficiaries unequally, the reasons for such decisions need to be explored and thoroughly documented by the estate planning attorney. Another private meeting should occur after the documents are prepared and ready for execution. During this private meeting, the attorney should again review the testator's desires, as expressed in the testamentary instrument, and the reasons for the desires. It is important that the client's testamentary desires and the stated reasons for those desires remain generally consistent. Any changes expressed during the estate planning process needs to be explored and documented. Finally, no beneficiary should be permitted to be in the same room with the testator at the time he or she executes the testamentary instruments.

Several preventative measures can be taken by the estate planning attorney if there are any questions concerning a client's testamentary capacity. Like undue influence, the initial inquiry of a client's capacity begins with a private meeting with the client. It is important that the client be able to recite the names, relations and status of close family members, i.e. names of parents, siblings, children and grandchildren, whether any of the aforementioned relatives are deceased or alive, etc. The client should also be able to describe, at least generally, what property he or she owns. In most circumstances, the client should be able to identify the address of his or her residence and the location of all real property owned. The client should be able to generally identify what bank accounts, brokerage accounts and securities they own. The competent client may not need to know the exact balance on deposit in every bank account, but he or she should be able to at least recall what accounts exists at what banks. Finally, the client should be able to understand the general effect of the testamentary instrument he is considering. Again, recognizing the length and degree of legal formalities incorporated into a thirty or forty page trust, the client need not fully understand each and every finite detail of the testamentary instrument, but the client does need to indicate a general understanding of the effect of the document he or she is about to sign.

If there are still any uncertainties concerning a client's testamentary capacity, the attorney can ask the client to be evaluated by the client's own physician and that the physician certify the client's competency to execute a testamentary instrument.

Assuming a contest is anticipated, but a decision is made to proceed with the execution of a testamentary instrument in any event, an effective, but very rarely used, procedure for protecting the validity of the execution of the testamentary instrument is the videotaping of the client's execution. During such videotapes, the attorney interviews the client, asking the client to identify himself, his spouse, siblings and children. The client may be asked to state the date and location of the videotaping, as well as the name of the governor of California or the president of the United States. After the client demonstrates that he is alert and aware of family relations and current events, the client is then asked questions about why he or she is making the disposition under the document he or she is about to sign. The client then states in his or her own words the reasons for either disinheriting or treating beneficiaries unequally. Such videotapes are usually quite compelling evidence should a contest ever be brought.

However, because no attorney videotapes every execution of estate planning documents, videotaping of the execution of a Trust or Will is a two-edged sword. A contestant will no doubt argue that the videotaping of this particular execution of testamentary instruments was utilized in this rare instance because the estate planning attorney had doubts about his or her own client's competency or suspected undue influence.

"The beneficiary must decide whether to accept the amount provided, or risk losing everything."

Regardless of how many preventative measures the attorney and client take to reduce the likelihood of a post-death dispute, there simply is no guarantee that these measures will prevent an attempt to set aside the client's Trust or Will after he or she passes away. Upon hearing such advice, clients frequently ask what additional measures they can take to either discourage a contest of their estate planning documents altogether. This invariably leads to a discussion concerning the inclusion of a "No-Contest Clause" in the client's estate planning documents.

A No-Contest Clause imposes a penalty, usually a forfeiture, on anyone, including a beneficiary, who seeks to invalidate an estate planning document or who seeks to change the plan of asset distribution provided in an estate planning document. A fairly common No-Contest Clause provides:

> If any person, directly or indirectly, contests the validity of this will in whole or in part, or opposes, objects to, or seeks to invalidate any of its provisions, or seeks to succeed to any part of my estate otherwise than in the manner specified in this will, any gift or other interest given to that person under this will shall be revoked and shall be disposed of as if he or she had predeceased me without issue.

A beneficiary who is unhappy with the amount he or she is designated to receive under the terms of a Trust or Will is thus forced to make an election. The beneficiary must decide whether to accept the amount provided, albeit less than expected, or risk losing everything by challenging the validity of the Trust or Will and triggering the provisions of the No-Contest Clause.

This raises one of the weaknesses of No-Contest Clauses - they are effective deterrents only to persons who are already beneficiaries under the terms of the Trust or Will. A person who has been entirely disinherited under the terms of a Trust or Will is not effected by a No-Contest Clause, because the disinherited person has nothing to lose by filing a contest. For this reason, it is often suggested that clients consider making a gift to persons they would otherwise like to disinherit in an amount that would make the person think twice about filing a contest.

A No-Contest Clause does not, in and of itself, preclude litigation. The fact that a Trust or Will has a No-Contest Clause not does prevent the disgruntled beneficiary from filing a legal action to invalidate the Trust or Will. The No-Contest Clause simply imposes a penalty of forfeiture on the disgruntled beneficiary if the disgruntled beneficiary's legal action is unsuccessful and the basis of the contest does not fall within one of the several recognized exceptions to the application of a No-Contest Clause. This is an important point that bears clarification. If the disgruntled beneficiary is successful in convincing a court to invalidate the Trust or Will, the No-Contest Clause is not enforceable because the entire Trust and/or Will, including the No-Contest Clause, has been invalidated.

see NO-CONTEST CLAUSES, *page 8*

REAL ESTATE

TRIPLE NET LEASED INVESTMENTS: LOW MAINTENANCE REAL ESTATE

By Carol Schwartz, Esq.

Many of our clients own real estate as part of a diversified investment portfolio, and have been handsomely rewarded for their efforts. But actively managing real estate can also be real WORK! For those interested in trading in their overalls for a trip to the bank there are some opportunities available.

Taking advantage of the recent low interest rate climate and the opportunity to defer tax on capital gains, many real estate investors have opted to use the Section 1031 tax deferred exchange technique to acquire triple-net leased real estate constructed specifically for a so-called “credit tenant” such as Walgreens, CVS, Circuit City or Federal Express.

A Typical Walgreens Deal

• A real estate developer, usually one with an established relationship with Walgreens, finds a site and enters into a lease with Walgreens to construct a 14,000- to 15,000-sq.-ft. store with a drive-through pharmacy window and electronic reader board in a suburban shopping center.

• Walgreens leases the store for a 75-year term with a right to terminate at the end of the 25th year and every five years thereafter.

• Unlike most office or commercial/industrial leases, however, the rent is FIXED for the entire 75-year term of the lease! Typically, there will be additional rent if, over time, 2% of gross sales (except food and prescriptions) in a year exceeds the fixed rent for that year. Percentage rents are not likely to kick-in during the early years of the term, but over time as the price of goods sold inflates, the percentage rent could yield some additional income, thus providing a small hedge against inflation.

• Rent typically commences 60 days after the completed building is turned over to Walgreens.

• Except for an initial one-year construction warranty period (three years for latent defects) for which the owner is responsible, Walgreens is obligated to perform and pay for all maintenance, repair, utilities, operating expenses, taxes and other fees and charges imposed by the shopping center for common area maintenance. Walgreens insures the building and other improvements on the parcel.

The owner/investor simply collects a rent check each month, pays the mortgage payment and pockets the rest. In fact, the investor becomes more like a bond coupon-clipper than a traditional real estate investor.

“The owner/investor simply collects a rent check each month, pays the mortgage payment and pockets the rest.”

What about financing?

Financing opportunities have abounded using non-recourse debt that gets packaged and sold on Wall Street in the form of Collateralized Mortgage Backed Securities (CMBS for short). Until recently, interest rates were under 6% and money has been plentiful for this type of investment. Compared to bank loans, CMBS transaction fees are higher. Because the CMBS loans are non-recourse to the borrower, if there is a default the securities-holders will be looking solely to the value of the property as a source of recovery. In order to induce purchasers to buy the CMBS, the loan originator carries out a more thorough investigation of the physical condition of the property, thus incurring higher costs in an effort to understand and mitigate any property-related risks. Typically the lower interest rates compensate for the higher costs of the loan originator’s due diligence necessary to satisfy the purchaser of the CMBS. In addition to the fees incurred in satisfying the lender requirements, there are the standard real estate brokerage fees, mortgage brokerage fees and (yes) attorneys fees. With CMBS financing, the loan cannot be prepaid, although it can be assumed by a credit worthy purchaser meeting the lender’s qualifications. Most CMBS lenders require their borrower to form a “special purpose entity” such as a limited liability company to take title to the property and to be the borrower on the loan.

What are the downsides?

While the Walgreens type investment is relatively low-risk, there is little opportunity for appreciation.

How are Walgreens investments priced?

Capitalization rates of 7.3% or 7.4% were common a year or so ago; more recently, however, capitalization rates have dropped to between 6.6% to 7%. Thus, using a 6.6% cap rate, a Walgreens paying $24,000 a month in rent ($288,000/year) would fetch a bit more than $4.3 million.

Carol Schwartz is a member of the Real Estate Group.

Fiduciary Responsibility

Some Trustees Must Now Register with the State

By Terese Raddie, Esq.

Until recently the California Probate Code required only those persons serving as "private professional conservators," "private professional guardians" and "private professional trustees" to file declarations with a Statewide Registry maintained by the California Department of Justice. The Probate Code defines a "private professional trustee" as a nonprofit charitable corporation appointed as trustee.

The Probate Code has now been amended to require that "trustees", except those subject to one of the following conditions, register with the state by filing a declaration. The requirement to file a declaration will not apply to a trustee who is:

1. Related to the trustor or a vested beneficiary by blood, marriage, or adoption.
2. Administering less than six trusts at the same time.
3. A trust company.
4. An FDIC insured institution, its holding companies, subsidiaries or affiliates.
5. An employee of any entity of a trust company or FDIC insured institution, its holding companies, subsidiaries or affiliates while serving as a trustee in the scope of his or her duties.

While these exceptions are broad and apply to many who serve as trustees, if none of these exceptions applies, the trustee must file a declaration with the Statewide Registry on or before January 1, 2005. According to the amended Probate Code, a trustee required to register but who fails to do so by January 1, 2005, shall be removed as trustee by the court. In addition, the court may set and give notice of an order to show cause why a trustee should not be removed for failing to register.

The declaration to be filed with the Statewide Registry must contain the following information: (i) full name and professional name (if different from full name); (ii) business addressed and phone number; (iii) trustee's educational background and professional experience, including verification of any college or graduate degree claimed; (iv) names of the current trusts administered by the trustee; (v) the aggregate dollar value of all assets under the trustee's supervision; and (vi) whether the trustee has ever been removed as a trustee in a specific case, the circumstances of that removal or resignation, and the case names, court locations and case numbers. The registry information is available to a court for any purpose, but otherwise will be kept confidential (except that on request,

see Trustee Registration*, page 8*

"The court may set and give notice of an order to show cause why a trustee should not be removed for failing to register."

Exempt Organizations

Governor Signs Law Imposing New Requirements on Charities

By Penelope Greenberg, Esq.

In late September, Gov. Schwarzenegger signed into law SB 1262, which, beginning January 1, 2005, will require charities that receive or accrue $2 million or more gross revenues in any fiscal year (excluding certain government revenues) to prepare annual financial statements using generally accepted accounting principles (GAAP). The statements must be audited by an independent certified public accountant in conformity with generally accepted auditing standards and must be available to the California Attorney General and the public nine months after the charity's fiscal year end.

If the charity is a corporation, it must also have an audit committee (separate from the finance committee) that is appointed by the board and adheres to the following restrictions:

- The charity's CEO, CFO and staff members may not serve on the audit committee.
- The charity's finance committee members may serve on the audit committee, but not as the audit committee's chair and only so long as they constitute less than 50% of the committee.
- The audit committee may include non-board members but may not include anyone (board members or not) with a material financial interest in any entity doing business with the corporation.
- In general, members of the audit committee may not receive any compensation from the charity.
- The audit committee must confer with the auditor, review the audit and determine whether to accept it, and recommend to the board whether to retain or terminate the auditor. The audit committee may negotiate the auditor's compensation and is also responsible for certain nonaudit matters.

All charities (regardless of revenues) must have the board or a board committee review and approve the CEO and CFO's total compensation to be sure it is reasonable. This must happen upon hiring, upon renewal or extension of employment, and upon any modification of compensation.

SB 1262 also includes a number of provisions affecting commercial fundraisers and contracts between charities and commercial fundraisers. Increasingly charities and their finances are coming under the microscope of state and federal regulators as instances of poor practices continue to make the news. To read the full text of SB 1262 go to the Chaptered version on the Legislation page of State Senator Byron Sher, www.sen.ca.gov/sher.

Penny Greenberg is a member of the Exempt Organizations Group.

REWARDING COMPANY FOUNDERS:
PART 1 - RESTRICTED STOCK

By Ed Willig, Esq.

Entrepreneurs organizing start-up businesses - whether their first or their fourth - often ask the lawyer who represents the business "Who should own the business, and how should we compensate members of the founding team with equity?"

There are two general types of equity compensation that can be used: purchases of common stock (usually referred to in this context as "restricted stock"), and options to purchase common stock (usually referred to as "stock options"). For a variety of reasons, restricted stock is typically issued to the very first members of a start-up's team; stock options are often used later, when the business is more mature.

In thinking about restricted stock, it is helpful to start with an example: Sam Software is organizing a start-up (called Software Co.) to develop a new software product for the healthcare field. Sam (who will serve as the Chief Executive Officer) has assembled an initial team composed of an experienced software engineer, a programmer, and a recent college graduate who will assist with administrative responsibilities and may also do some programming.

To fund Software Co. initially, Sam has invested $10,000 in 1,000,000 shares of Software Co.'s common stock (at $0.01 per share). Software Co. can provide the rest of the founding team with an equity interest by issuing them restricted stock for $0.01 per share. These are shares of common stock which are issued subject to an agreement which provides that:

- All of the shares will vest in installments over a period of time (usually in monthly installments over three to five years after an initial "cliff" vesting period of six to twelve months).
- If an employee's employment terminates before the shares are fully vested, Software Co. will have an option to repurchase the unvested shares for their original purchase price. If Software Co. exercises this option, the employee will forfeit any appreciation in the unvested shares at the time of employment termination.
- If an employee's employment terminates after shares vest, either Software Co. will not have an option to repurchase the vested shares (which is typically the case), or Software Co. will have an option to purchase the vested shares for their fair market value at the time of termination.
- The shares cannot be transferred until they vest, and will be held in escrow until that time. This is why the shares are referred to as "restricted shares." After the shares vest, they generally cannot be transferred except after compliance with a right of first refusal held by Software Co.

"If the purchase price is less than fair market value, then the difference... will be taxable."

The amount that Software Co.'s employees pay for their restricted shares must equal or exceed the fair market value of the shares. If the purchase price is less than fair market value, then the difference between the fair market value and the purchase price will be taxable as ordinary income to the employees.

Equally important, the employees must file an election under Section 83(b) of the Internal Revenue Code with the Internal Revenue Service within 30 days of the purchase of their shares to avoid being taxed on the shares. If they do not file this election, then as their shares vest, the difference between the fair market value of the shares that vest and the purchase price paid for the shares will be taxable as ordinary income. If (as Sam expects) Software Co. is successful and appreciates rapidly but the employees do not file elections under Section 83(b), they could incur a huge tax burden as their shares vest.

Software Co. must comply with the state and federal securities laws in connection with each issuance of its shares - including its issuance of restricted stock. This should not be difficult for **a corporation whose employees reside in California**, but **it** is an important step.

If all of the applicable requirements are met, restricted stock will provide Software Co.'s employees with some significant benefits: they will become owners of Software Co. immediately, they will not incur any income tax in connection with the shares they acquire until they sell them, and when they sell their shares, the income they realize will be capital gain, which is currently taxed at a maximum marginal federal rate of 15% **and a maximum marginal California tax rate of 9.3%**.

In the next issue of Perspectives, Part 2 of this article will provide an overview of stock options.

Ed Willig is a member of the Corporate & Business Group.

Traditionally estate planning experts have believed – and the courts have confirmed – that when you transfer assets to a partnership and still retain some partnership interest at the time of your death, only the value of the retained partnership interest would be included in your gross estate; and that if your partnership interest is not a controlling interest, the value of the partnership interest in your estate will be adjusted ("discounted") for lack of control and lack of marketability.

In the *Strangi* case the Tax Court in effect said that if you transfer assets to a limited partnership and at the time of your death still own any general partner interest or any limited partner interest (whether or not a controlling interest), the existence of the partnership will be ignored and all of the transferred assets will be included in your gross estate at their date death values. Fortunately, the *Strangi* decision has been appealed, and many estate planning experts expect the decision will be reversed or modified by the appellate court. But no one can guarantee that result. The appeal process could take many months.

In the appellate court's *Kimbell* decision filed in May, 2004, the court respected the taxpayer's partnership planning (and in particular, the "bona fide sale" nature of the partnership transfers), basing its decision in part on the fact that each contributing family member partner received a partnership interest proportionate to his or her contribution, with similar treatment for the partners' capital accounts and rights on dissolution. Among the important factors were (i) the taxpayer's keeping sufficient assets outside the partnership for her own personal support (avoiding "commingling" of personal and business assets), (ii) the proper documentation of the asset transfers capitalizing the partnership; (iii) there was an "active management" element to the partnership assets (in that case, working interests in oil and gas properties); and (iii) the family members documented several non-tax business reasons for forming the partnership that could not be accomplished merely through the deceased taxpayer's revocable living trust.

The *Kimbell* court also very briefly addressed the most troublesome legal theory in the *Strangi* case, holding that the management powers possessed by the deceased taxpayer's son, and the fact that the deceased taxpayer owned only a 50% interest in the partnership general partner (and the fact that the son controlled the management of the general partner interest) meant that the deceased taxpayer did not retain the right to enjoy or designate who would enjoy the property owned by the general partner.

Even though the *Kimbell* decision upheld the validity of the family limited partnership planning at issue in that case, pending the appellate court decision in *Strangi*, anyone who has created a family partnership and transferred assets to it and still owns either a general partnership interest or a limited partnership interest should reflect on what action should be taken now, if any.

"...anyone who has created a family partnership and transferred assets to it and still owns either a general partnership interest or a limited partnership interest should reflect on what action should be taken now..."

One alternative is to do nothing now and wait for the appellate court's *Strangi* decision. The appellate court may reverse the Tax Court and reaffirm the traditional rules for dealing with partnership interests (as in *Kimbell*). But, as stated above, no one can guarantee this result. The appellate court may affirm the Tax Court's decision. Even in that event, the matter could be dealt with after the appellate court decision, provided the transferor has not died in the meanwhile.

Another alternative is to take steps now to avoid falling within the scope of the Tax Court decision in *Strangi*, and thereby avoid having all of the transferred assets "recaptured" in your gross estate. There are several possible "solutions", but all of them either are extremely complex or have potentially undesirable side consequences. These possible solutions include:

- Sell or give away **all** retained partnership interests (general partnership interests and limited partnership interests), so that you no longer own **any** interest in the partnership. This could give rise to a capital gain tax or a gift tax, and will result in a complete relinquishment of any level of control or voting power.
- Merge the partnership into a new partnership formed under Delaware law, which provides fewer voting rights to limited partners. This solution will not work if you retain a general partner interest. Also, because limited partners still have some (although minimal) voting rights under Delaware law, this solution may not work at all.
- Restructure the partnership so there are two classes of partnership interests, voting interests and non-voting interests, and arrange to have your interests classified as non-voting interests. This could generate a gift tax and will result in a complete relinquishment of any level of control or voting power.
- Create a special type of irrevocable trust and transfer your partnership interests to that trust. This involves a significant increase in complexity and could have some undesirable tax consequences depending on exactly how it is structured. Also, this is an untested solution, which may produce an IRS challenge.
- Dissolve the partnership and distribute the assets proportionately to all partners as tenants-in-common and then enter into an appropriate co-tenancy agreement. This normally will have no adverse tax consequences, but can result in a loss of control by the general partner and possibly a lowering of the valuation discount available to a co-tenant's estate.

The issuance of the *Kimbell* decision was a welcome endorsement of family limited partnerships as a planning technique. We believe there is a good chance the *Strangi* decision also will be modified on appeal, and we hope that will occur. We continue to believe that family limited partnerships formed for legitimate business purposes and operated in a business-like manner and in accordance with the partnership agreement should be respected by the IRS. But the future in this area is uncertain.

Steven Anderson and Marion Brown are members of the Estate Planning, Trusts & Wealth Transfer Group.

NO-CONTEST CLAUSES, *from page 3*

Alternatively, there are many exceptions to the application of a No-Contest Clause, mostly based on public policy considerations. For example, the following post-death legal actions will not trigger a No-Contest Clause as a matter of public policy, even if the legal action is expressly identified in the No-Contest Clause as a violation: (a) pleadings to modify or terminate a trust; (b) pleadings to establish or terminate a conservatorship; (c) pleadings challenging the exercise of a fiduciary power; (d) pleadings regarding the appointment or removal of a fiduciary, such as a trustee or executor; (e) pleadings regarding an accounting or report of a fiduciary; such as a trustee or executor; (f) pleadings regarding the interpretation of the instrument containing the No-Contest Clause; and (g) petitions to compel an accounting or report of a fiduciary. This is not an exhaustive list of public policy exceptions to a No-Contest Clause. The rules regarding the application of these exceptions can be complicated, and an attorney should be consulted.

With the inclusion of a No-Contest Clause, the disgruntled beneficiary must decide whether to accept what was provided under the subject Trust or Will or to challenge the Trust or Will and risk forfeiting everything. Recognizing the unfairness this election sometimes works on disgruntled beneficiaries in having to guess whether their contemplated legal action will trigger a No-Contest Clause, the California legislature has enacted a "safe-harbor" provision. The Probate Code provides a procedure for the disgruntled beneficiary to obtain a ruling from the probate court before filing a proposed action. If the probate court determines the proposed action will not trigger a No-Contest Clause, the disgruntled beneficiary is free to file the proposed action without fear of triggering the No-Contest Clause. Conversely, if the probate court determines the proposed action does trigger the No-Contest Clause, the disgruntled beneficiary knows in advance of filing the proposed legal action that he or she will be disinherited if the proposed action is filed and he or she is unsuccessful.

Although not perfect or all encompassing, the inclusion of a No-Contest Clause in an estate planning document can serve as an effective deterrent to post death litigation in many situations. Your estate planning attorney can provide you with additional information concerning the utilization of a No-Contest Clause in your estate planning documents, as well as other actions you can take now to avoid a disruptive, volatile and costly legal dispute in the future.

Daniel Morris is a member of the Trust, Estate & Fiduciary Litigation Group.

TRUSTEE REGISTRATION, *from page 5*

the registry may disclose to a member of the public the educational background and professional experience of a trustee registered with the Statewide Registry).

The cost of filing a declaration with the Statewide Registry is currently $385. Once registered, a trustee must re-register every three years. In addition, most counties also have county registries, and each trustee filing a declaration with the Statewide Registry must also file a declaration with the county registry having jurisdiction over the trust (usually the county where the principal place of administration of the trust is located).

To register with the Statewide Registry online you should visit the following website: http://caag.state.ca.us/conservator/index.htm. Although this website is entitled "Court-Appointed Conservators Statewide Registry of Private Conservators and Guardians" it is also applicable to trustees who are required to register.

The amended language of the Probate Code fails to clarify whether the definition of "trustees" is limited to court-appointed trustees or also includes non-court-appointed trustees (i.e. trustees of trusts currently not under court jurisdiction and supervision). Until claritive legislation is passed, we believe that any trustee who does not meet one of the stated exceptions should comply with the registration requirements. If you need assistance in determining whether or not it is necessary for you to register with the Statewide Registry please contact one of our attorneys in the Estate Planning, Trusts & Wealth Transfer Group.

Terese Raddie is a member of the Estate Planning, Trusts & Wealth Transfer Group.

CARR MCCLELLAN
216 PARK ROAD
BURLINGAME
CALIFORNIA 94010

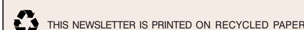
P 650.342.9600
F 650.342.7685

WWW.CARR-MCCLELLAN.COM

PERSPECTIVES ON LAW IS PUBLISHED BY CARR MCCLELLAN INGERSOLL THOMPSON & HORN PROFESSIONAL LAW CORPORATION. OUR GOAL IS TO PROVIDE CLIENTS AND FRIENDS OF THE FIRM WITH MORE THAN JUST UPDATES ON HOW THE LAW IS EVOLVING. WE HOPE TO SHARE OUR *PERSPECTIVES* SO THAT YOUR BUSINESSES AND FAMILIES CAN MAKE THE MOST OF THE OPPORTUNITIES BEFORE YOU.

CARR MCCLELLAN, FOUNDED IN 1945, IS LOCATED IN BURLINGAME. THE FIRM PROVIDES FULL-SERVICE LEGAL ADVICE TO MANY CLOSELY-HELD BUSINESSES AND MAJOR CORPORATIONS IN THE BAY AREA'S LEADING INDUSTRIES, AS WELL AS TO INVESTORS AND FAMILIES.

THIS NEWSLETTER IS FOR GENERAL INFORMATION PURPOSES ONLY AND IS NOT INTENDED TO OFFER LEGAL ADVICE ON SPECIFIC CASES. PLEASE CONTACT YOUR CARR MCCLELLAN ATTORNEY TO DETERMINE HOW THIS INFORMATION MIGHT AFFECT YOU.



THIS NEWSLETTER IS PRINTED ON RECYCLED PAPER.

CARR McCLELLAN
INGERSOLL THOMPSON & HORN
Professional Law Corporation