



California

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CLU, CFA

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Trusts and Estates Section

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From the Chair

by Warren Sinsheimer, Esq.*

This will be my final From the Chair column for the Trusts and Estates Quarterly. By the time you are reading this, the State Bar of California will have held its annual meeting in Monterey, the Executive Committee of the Trusts and Estates Section will have held its final meeting of the 2001-2002 year, and Marshal Oldman will be your new chair. It has been an honor and a delight for me to serve as your chair during this year. It is always fun to meet the variety of committed and caring people from throughout California who have chosen to practice in this most human of areas of the law.

As the Section embarks on the 2002-2003 year, we are in the capable hands of Marshal Oldman of Encino. Marshal is a frequent writer on trusts and estates matters and a frequent speaker at continuing education programs. From what I hear, he largely practices in the area of trusts and estates litigation, one of the fastest growing areas of sub-speciality practice in this field. Marshal has chaired our Section's litigation and incapacity subcommittees during his tenure on EXCOMM. He has been a wise and able Vice Chair, and we all look forward to a solid year as chair. Good luck, Marshal.

With the annual transition, comes the time to say farewell to many beloved and conscientious volunteers who will transition off EXCOMM. Generally, these attorneys have served three years as a member and another three years as an advisor of the executive committee. One of the most common statements I hear from veterans of EXCOMM is how difficult it is to figure out where the time came from to do all the things we do. The other most common refrain is how much people miss the camaraderie and stimulation of the EXCOMM experience.

Lyn Hinojosa from Los Angeles will wrap up his time on EXCOMM with the annual meeting this year. Lyn is a widely respected Trusts and Estates litigator, and during his time on the executive committee he has brought that background to bear on many important projects. He has worked with the Litigation Committee, which he chaired, and he has been involved in helping to develop our own legislation and to criticize and improve the legislation proposals of others. Lyn is a veteran CLE speaker who always draws a crowd. Surprisingly enough for a litigator, Lyn is a good friend and wonderful company.

Sandy Price from San Francisco has been a stalwart, filling many tough jobs for our section during her time on EXCOMM. She chaired the Education Committee, which is always a demanding undertaking. She recruited speakers, then coddled and

shepherded them along the way, all the while publicizing our programs and making certain that we did a good job of educating the bar while not losing money. That is a tall order, and she handled it with aplomb. More recently, Sandy took the reins of our Ethics Committee. This has been and will continue to be a "hot" area for our area of the law. The challenges posed to us as T&E lawyers are qualitatively different from what many of our colleagues face. Most recently Sandy has agreed to continue her involvement as our section's liaison to the State Bar's Commission to revise the ethics rules. That means we will still be in touch with Sandy, and for that we are thankful.

Tom Worth of Walnut Creek and San Francisco is well known to readers of the Quarterly. After rotating through a good assortment of EXCOMM duties, Tom agreed to be part of the editorial team for the Quarterly. He handled that with consummate skill and patience. He suffered through the difficulties imposed by changing State Bar procurement rules and disappearing printers. Tom never stopped smiling, and he never stopped producing the best periodical which crosses our desks. Along the way, Tom has been a fixture in our CLE efforts, covering recent developments every year. Although we will miss Tom and his wisdom, we hope he will have more Saturdays free to watch resurgent Golden Bear football.

Randy Godshall would have been more prominently featured here but for the fact that he succumbed to the entreaties of his friends on the Nominating Committee and EXCOMM in general. Randy will transition from the status of departing advisor to incoming vice chair. Randy is a most wise and experienced practitioner from Newport Beach who will be a great team member along with Marshal next year.

Finally, it is with sadness and disbelief that we contemplate the departure of our beloved Susan House. Susan's tenure on EXCOMM stretched beyond memory and her service exceeds imagination. Susan has time and again been the "go to" member of EXCOMM. A partner with Hahn & Hahn in Pasadena, Susan has done everything while a member of EXCOMM. Every successful project we have attempted has her fingerprints on it. She was editor of the Quarterly, a task to which she brought not only her considerable legal talents but also insightful and rigorous journalistic talent. She served as Chair of our Section during the tumultuous "Bar Crisis" when the future of the Section was not always clear. She served as co-editor of our California Ethics Guide, which is an indispensable item on all our bookshelves. We will all miss Susan more than we can even yet imagine. She is one of the real superstars.

No doubt Marshal will give thorough welcome to our new members who join us in Monterey. They are Neil Horton of Oakland, Catherine Lawson of Cameron Park, Ruth Phelps of Pasadena, Jim MacDonald of Costa Mesa and Richard Burger of Petaluma. We welcome all of them to what will be one of the signal experiences of their careers. We had a large and talented

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From the Editor

by *George F. Montgomery II, Esq.**

In selecting material to publish in the Quarterly, we aim for a mix between short “how to” pieces and more substantive articles that may require closer review. Our lead article by Patrick Collins clearly falls in the latter category. Patrick takes on a difficult subject: how to educate lawyers about principles of risk analysis in evaluating investment alternatives. We judge Patrick to have succeeded, but be forewarned: you will need to concentrate, and you may find yourself rereading Patrick’s article more than once before it all sinks in.

We hear about changes in the trust law in other states relaxing the rules about grantor spendthrift trusts or repealing the rules against perpetuities. But what are practitioners there doing? Dave Shaftel reports from Anchorage, Alaska, on the first 5 years of experience with Alaska’s changes to the traditional rules governing trusts.

Although we hope it is rare, from time to time we may represent a client who has filed a tax return late. If the client was otherwise entitled to a refund, we and our clients would have been challenged by the muddy state of the law in the Ninth Circuit. But this recently has changed, and Jim Chisholm reports on the Ninth Circuit’s recent pro-taxpayer decision in *Omohundro v. United States*.

We had a slight production problem with the Summer issue of the Quarterly. Some of you received an issue that was missing pages 17-24 and 41-48. If you did receive an incomplete issue, you should request a replacement copy by email to Sonny Ramos of the State Bar at rosano.amos@calbar.ca.gov (or, if you do not use email, by telephone at 415-538-2091).

* *Friedman, McCubbin, Spalding, Bilter, Roosevelt & Montgomery, San Francisco, California*

* * * * *

[The following is the text of a blast email distributed recently to Section members from Warren A. Sinsheimer, Chair of the Trusts and Estates Section.]

Red Cross Funds for 9/11 Victims

Dear Colleagues,

The Trusts and Estates Section has been notified by the American Red Cross in New York that the Red Cross is preparing to issue flat gift payments of \$45,000 to each of the estates of

those killed as a result of the September 11 attacks. If you are involved in the administration of an estate of one of the victims, you can contact the American Red Cross directly with specific information about such an estate. The person to contact is Daniel Zellman, Coordinator, Financial Assistance, September 11 Recovery Program. Mr. Zellman’s contact information is as follows:

Via Mail: Financial Assistance Program
American Red Cross
100 Varick Street
New York, NY 10013.

Via e-mail: zellmand@usa.redcross.org

Via phone: 212-875-2019.

If you are not involved yourself, but know of someone who is, whether in California or elsewhere, please pass along this information.

Thank you.

Warren A. Sinsheimer
Chair, Trusts and Estates Section
State Bar of California

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A RISK PRIMER FOR INVESTMENT FIDUCIARIES — WITH SPECIAL ATTENTION TO MANAGEMENT OF ENDOWMENT FUNDS

By Patrick J. Collins, Ph.D., CLU, CFA*

Introduction: A Risk Compass

The concept of investment risk, for many investment fiduciaries, is often merely an ill-defined notion of future uncertainty. Risk, when it remains unmeasured, makes effective decision-making difficult and impedes the ability to design and execute optimal investment strategies. In some cases, uncertainty about the future results in an extreme and unproductive conservatism. The fiduciary seeks not to manage risk but to avoid it altogether with the unfortunate result of avoiding returns (above the risk-free rate) as well. Conversely, ignoring risk because of unwarranted optimism may expose a trust or endowment portfolio to the possibility of catastrophic loss.

Although § 227 of the Restatement of Trusts Third directs the fiduciary to exercise reasonable care, skill, and caution in constructing “an overall investment strategy which should incorporate risk and return objectives reasonably suitable to the trust,” the inability to appraise and define risk quantitatively can frustrate attempts both to measure and manage it to best advantage. However, despite the fact that there are many ways to define risk, not all definitions have equal import with respect to the “purposes, terms, distribution requirements, and other circumstances of the trust.” Consider, for example, some questions that may confront the investment fiduciary:

- What is the risk that, during the next year, the trust portfolio will suffer an x% decline in value?
- What is the risk that, at any time over the next y years, the trust portfolio will suffer a decline of x%?
- What is the risk that, at any time over the next y years, the trust portfolio will drop below x% of its current value?
- What is the risk that, at the end of y years, the trust will have x% less than its current value?

These questions sound similar because they all concern the probability of a loss of x% of portfolio value. They are, however, quite different and, as we shall see, have very different answers. In fact, the set of answers to the above questions forms a “risk compass.” The first two questions point North and South: what’s the chance of a decline of x% or more in the next year; and what’s the chance of a decline of x% or more from year t_1 , through year

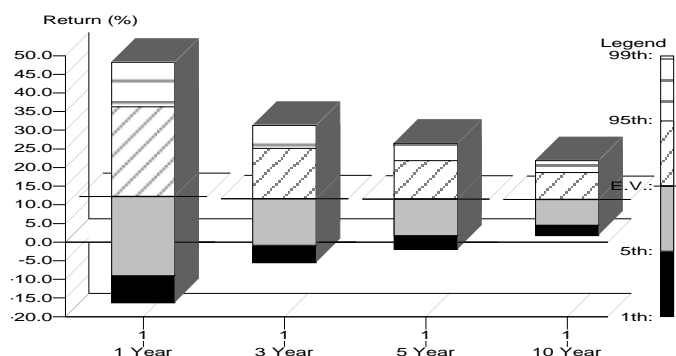
t_1+i , where ‘i’ represents any year within the planned investment horizon. The last two questions point East and West: what’s the chance that the trust will sink below a designated floor value at any time during the planning horizon; and what’s the chance that at the end of the planning horizon it will have less than the designated floor value.

Investment fiduciaries find it somewhat easy to orient themselves within the single-dimensional landscape of returns. Risk, however, constitutes a second dimension because it includes both return and the possible range of dispersion (i.e. magnitude of uncertainty) regarding future returns. This essay discusses how investment fiduciaries can effectively measure and manage risk to assure that the trust portfolio is well suited to its purposes, terms, distribution requirements, and other circumstances.

I. A FIRST APPROACH: EVALUATING RISK BY CONSIDERING RETURNS

We start in the landscape of investment returns. Prior to the meltdown of the NASDAQ market (brought about by the precipitous decline in value of the “new economy” telecommunications, computer and internet stocks), many investors defined risk as the risk of missing the wealth-creating (i.e. return) opportunities of stocks. Investors considered conservative investments risky because they incurred tremendous opportunity costs: investing in a T-Bill at 5% missed the opportunity to earn 40%, 60%, 80% or more by investing in a high-tech company. Throughout the bull market of the late 1990s fiduciaries sometimes approached investment decisions primarily from the perspective of potential return. Indeed, it is easy and natural to orient ourselves within a returns-based financial landscape. For example, we present a returns-based chart of possible investment results over time.¹ In this case, we model a portfolio of 70% stocks (S&P 500 Stock Index) and 30% bonds (Long Term US Bond Market Index) over a ten-year planning horizon:

Chart 1 — Portfolio Returns

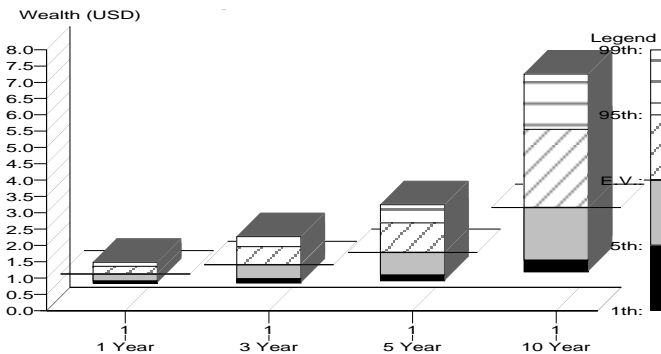


The chart, based on unadjusted historical data, projects a range of probable future returns for a 70% stock / 30% bond portfolio. It depicts not only how returns can vary significantly over a one year planning horizon; but also, how bad years and good years tend to



offset each other with the result that, ultimately, returns tend to converge to a more narrow (i.e. more certain) range of positive results over time. This phenomenon is known as “time-diversification” and implies that time reduces investment risk. The next chart, however, implies the reverse. It is not a chart of returns, but rather a chart of wealth and illustrates an important concept. There is, over time, a tug of war between rates of return, which converge, and dispersion of ending wealth, which intensifies. Small differences in return, compounded over time, create large differences in ending wealth:

Chart 2 — Dispersion of Wealth



This is a critical concept because beneficiaries spend wealth, not returns. Taken together, the two charts provide helpful information to fiduciaries wishing to make portfolio allocation decisions. But they are not easy to interpret. For example, with respect to the far right hand column in Chart 2:

- Why is the area representing the best five percent of results much larger than the area representing the worst five percent of results?
- Why does the horizontal plane representing average outcome (E.V. = expected or average value) cut across the column approximately one-third of the distance from the bottom instead of exactly one-half the distance?
- Is the chart intended to have predictive force for an actual portfolio?
- Finally, if you compare the right hand column of the Dispersion of Wealth chart with the right hand column of the Portfolio Returns chart, why are the areas proportionally different?

II. RETURNS ARE MULTIPLICATIVE; OR, YOU'RE ONLY AS SMART AS YOUR WORST MISTAKE

Fortunately, most of the complex mathematics underlying the charts is also manifest in the following examples. Consider, first, how money compounds. If you invest a dollar at ten percent return (compounded annually) your wealth at the beginning of year two equals \$1.10; and, at the beginning of year three, equals \$1.21. The total gain realized over the period equals \$0.21. However, if you

lose ten percent each year, wealth at the beginning of year two equals \$0.90; and, at the beginning of year three, equals \$0.81. The total loss equals \$0.19. A sequence of positive returns generates more wealth than a proportional sequence of negative returns subtracts. Furthermore, if the total account value drops to \$0.20 and you lose an additional 10%, the absolute monetary loss is only 2 cents; however, if your account grows to \$10 and you lose 10%, your absolute loss equals 100 cents. When investing in stocks, the downside loss is bounded (in most investments, you cannot lose more than the invested capital) while the upside is, theoretically, unbounded (the sky is the limit). The wealth generating process is positively skewed because results are multiplicative (wealth is the *product* of the period by period returns) rather than additive (the *sum* of period by period returns). When investing, because final results are multiplicative, a large loss at any point in a return series adversely impacts total ending wealth. You are only as smart as your worst mistake; therefore, it behooves the prudent fiduciary to think about risk as well as return.

Consider, secondly, how wealth grows under conditions of uncertainty. In this case we proxy uncertainty by conditioning the growth of \$1.00 on the results of tossing a single fair coin where we double wealth with heads and half wealth with tails. Given a 50% probability of either heads or tails, the positive expected mathematical value of each toss equals 50% x \$2.00 plus 50% x \$0.50 = \$1.25, or 25% average gain. After ten tosses, we have the expectation of growing an initial investment of \$1.00 into a tidy nest egg of \$9.31 [(1.25)¹⁰ = 9.31]. However, the typical coin toss participant will flip five heads and five tails over the ten tosses. This means that the average participant in the game will win five times and lose five times for an ending wealth equal to the starting wealth of \$1.00. The order of the five heads and five tails has no influence on the final result. The reason for this outcome is that each coin flipper wins or losses the *actual* dollar values not the *average* dollar values. Furthermore, it means that approximately half of the coin-flipping participants will end up with \$1.00 or less. This is particularly sad because it means that most of us will be unable to earn a living by tossing coins. Equally important, however, is the fact that the variability in results (what statisticians term “variance”) drains away our prospects for wealth accumulation in a coin-flipping career. Variability of results means that each of the actual outcomes differs from the average outcome. Under the above conditions of uncertainty, an investment with a positive mathematical expectation of a 25% gain per period results in approximately half of the investors making nothing or losing money.

III. IT IS MATHEMATICALLY IMPOSSIBLE FOR THE AVERAGE INVESTOR TO ACHIEVE THE AVERAGE GAIN

Before returning to the charts to address the interpretive questions, let's explore the coin-tossing example for a bit longer. In the example, expected gain equals the average gain per toss — i.e.



25%. But the average coin flipper will not achieve the average gain! Rather, the average coin flipper achieves far less than the expected value of the game. Armed with this information, how much would you be willing to pay for the chance to flip the coin ten times? If your answer is less than \$1.00, you are a risk averse investor; if your answer is exactly \$1.00, you are a risk-neutral investor; if your answer is \$9.31, please contact us immediately.

This example provides an intuitive understanding of the important investment principle that expected value is a value never to be expected. In this case, there is no combination of coin toss results that will generate winnings of \$9.31 with a starting stake of \$1.00. Undoubtedly, there will be a few coin flippers who toss ten consecutive heads and walk away with \$1,024 ($2^{10} = 1,024$). You will know the identity of these participants because they will author books and appear on TV shows to discuss “how to get rich by investing in coin flip games,” “secrets of coin flipping expertise” “the courage to flip” “rich coin / poor coin” and related topics. Rather than discussing the mental discipline required to “think heads and grow rich,” or “the seven habits of successful coin flippers,” however, we seek to understand the nature of the return generating process that prevents the average investor from realizing the expected gain.

The examples demonstrate that:

- Variability in the actual results is a drain on expected future gain; and,
- Variability of results means that actual outcomes may differ considerably from the average (or expected) outcome.

This is critical information because it provides insight into measuring risk. Once risk is measured, the investment fiduciary can use the “risk compass” to check whether the portfolio is in a suitable location in the risk/return landscape.

IV. STATISTICS, CALCULUS AND WEALTH

In the coin flip example, we know the average result: \$1.25. We also know the actual results at 50/50 odds: either \$2.00 or \$0.50. Therefore, we can measure risk in terms of the variance of actual results from the average result. There are (at least) two academic formulas for determining the variance value. Mean absolute difference is the absolute value of the differences divided by the number of possibilities (the coin flip has only two possibilities: heads or tails). Thus the mean absolute risk measure is:

$$[(2 - 1.25) + (1.25 - .50)] / 2 = .75$$

Intuitively, this sounds correct because we are \$0.75 cents away from expected value either by winning or by losing. A more complicated, but ultimately more useful, measure of risk is a variance measure that eliminates negative numbers by squaring the difference between the actual and average results:

$$[(2 - 1.25)^2 + (.50 - 1.25)^2] / 2 = .5625$$

Intuitively, we cannot easily understand variance because it expresses values in terms of squared units of risk. What does it mean, for example, to tell a coin flip participant that he or she will experience .5625 squared units of variability in the actual results? But in this case, .5625 will serve us well for at least two reasons. First, it helps approximate what the average participant in the coin flipping game will earn; and second, it enables us to make an accurate risk compass by locating the position of any investment outcome on a probability graph [i.e. draw the cumulative probability density function to determine the location of specific outcomes on a graph like the “bell curve.”]. The first task requires some calculus (a Taylor series expansion of the return generating function around its mean) that leads to a handy approximation formula:

$$\text{Compound Return} = \text{Expected Return} - 1/2(\text{Variance})$$

It is important to focus on compound return (as opposed to expected return) because compound return is the engine that drives future wealth. Thus, if expected return from each coin flip is 25%, and $1/2(56.25\%)$ is the amount that is drained away by variance, then actual ending wealth (which is the product of compounding) equals $25\% - 28.13\% = -3.13\%$. Informing a participant that he or she is more likely to lose 3% per toss than to gain 25% per toss provides a more realistic perspective on the game. The astute reader will note that we now have two averages. The first average (called the mean) tells us the expected gain per coin flip (25%); the second average (called the median) tells us the expected gain per coin flipper (-3% according to the approximation formula). As we shall shortly see, the actual median is 0%; but -3% is closer to zero than + 25%; and the approximation formula is a great improvement.

The second task requires some statistics. Variance is used to calculate what statisticians term a “Z score” which indicates the probability that any actual future result will deviate from the expected average. If the distribution is shaped like a bell curve, the Z score indicates how close a specific outcome is to the center of the curve. But now there are two averages; and so, we are not sure what to do. It would be simpler if we only had one average so that the risk compass could deliver unambiguous results. The clue for solving this problem lies in the example of how money compounds. Compounding means that a series of percentage gains produces more wealth than a comparable series of percentage losses subtracts. We want a mechanism to translate different absolute wealth changes produced by multiplications into equal relative changes produced by additions (or, in the language of mathematics, we want a monotonic transformation that assures that the function remains invariant over its domain). But we learned about this function in grammar school: $3^2 \times 3^2 = 81$. We can solve this equation either by multiplying each of the terms ($9 \times 9 = 81$) or by adding each of the exponents ($3^4 = 81$). Later, in high school, we learned that the log of 9 to the base 3 equals 2 which simply means that 2 is the power that 3 must be raised to in order to



generate 9. By using a logarithmic function, we eliminate the multiplicative interactions that cause results to be skewed. We need only use addition. In other words, we eliminate the mean average (this is okay because we said that expected value was a value never to be expected) and are left only with the median average (this is okay because fiduciaries are more interested in what may actually happen as opposed to an abstract mathematical expectation that can never be realized).

Here's how it works for the 50/50 coin flip game (where \ln = the logarithmic function):

$$[\ln(\$2.00) \times .50] + [\ln(\$0.50) \times .50] = \text{value of return from the game}$$

$$.3466 + (-.3466) = \$0.00$$

In this case, the expected return (\$0.00) is *both* the median return (50% of coin flippers will exceed this return and 50% of coin flippers will fail to achieve this return) *and* the mean return (the average impact of the game on our wealth). The logarithmic function brings seemingly dissimilar averages into perfect alignment. Fortunately, there is a well-known probability distribution that is completely described by its average and variance—the normal bell curve. Fortunately, as well, the Central Limit Theorem assures us that additive returns sampled randomly are distributed normally despite the fact that individual or period-by-period returns may not be generated in a normal distribution.

Returning to Chart 2, we reiterate that the portion of the bar representing the top 5% of results is larger than the portion representing the bottom 5% despite the fact that the sections represent best case / worst case results at the same probability level. The positive skew in the compound wealth generating process means that the outlier results of positive return multiplications (top 5%) increase absolute wealth more than negative return multiplications (bottom 5%) subtract. Or, on average, positive results will generate more money than negative results will lose. Large positive results increase the mean average of expected total wealth; but, although the magnitude of these gains is substantial, the probability of achieving them is small (in this case, 5% or less).

The above facts also indicate why the horizontal plane representing expected value (E.V.) intersects the bar not at the halfway point (the mean), but at, roughly, the one-third point (the median). It shows not what to expect on average but rather what the average investor can expect. In the language of mathematics (i.e. Jensen's Inequality for concave functions), it measures the mean value of the wealth creating function rather than the value of the function at its expectation or average $[E(f(x)) \text{ rather than } f(E(x))]$, where $E(f(x)) < f(E(x))$. Intuitively this makes sense because the majority of coin flippers will make less than \$9.31 after they have flipped ten times.

V. PREDICTION AND THE SHAPE OF RISK

At this point we may recall Mark Twain's aphorism that

prediction is very difficult, especially when it concerns the future. Do the charts have predictive force for any particular investment program? We know with absolute certainty the underlying return generation process associated with coin flipping. Unless something is seriously wrong with the coin, there is a fifty percent probability of heads and a fifty percent probability of tails. Therefore, it is possible to apply rules of mathematics and probability to make good predictions about the range of future outcomes. It is not possible to predict the outcome for any single participant. By chance, a small number of participants will win \$1,024 but we cannot say who they will be or when they will have incredibly good fortune. We can predict that the average investor will come close to breaking even (note, however, at the limit, the chances of breaking even by flipping an infinite amount of times approaches zero. If you flip a coin 1,000 times, you break even only with *exactly* 500 heads and *exactly* 500 tails which, given the number of flips, is an extremely improbable result).

Investment prediction is very different than coin flip prediction. Rather than fixed probabilities we must input relative frequencies into a returns-based model. This means that the charts indicate only a range of probable results for similarly constructed portfolios over many ten year planning horizons. They contain only limited predictive information for any particular trust or endowment portfolio over the next ten years.

Let's develop the implications of this last statement. Academics state that future return is a "random variable." This is a jargon term: a random variable is a number the value of which we don't yet know. The value of the Dow Jones average in the year 2042 is a random variable because we will not know it until several decades have passed. We do know, however, that the value of any number that we don't yet know can be expressed as a shape. For example, if we wanted to create a shape (i.e. plot a graph) for the Dow Jones value 20 years hence, we could create a lower bound of zero (a doomsday scenario), a projected average based on the average growth rate over the past 20 or 50 or 80 years, and a reasonable upper bound by increasing average results by a factor determined by the degree of variance. For example, if we graphed the shape of the Dow Jones random variable, the graph would exclude values of -3 thousand or + 10 billion. Investors cannot control future return. They can, however, control risk — i.e. the shape of the range of possible future results. A trust portfolio consisting of 80% Bonds / 20% Stock will have a much different shape than a portfolio consisting of 20% Bonds / 80% Stock despite the fact that we do not know the actual future dollar value of either portfolio.

VI. THE "SECRET FORMULA" FOR CONTROLLING RISK

In the investment world, how does the investment fiduciary control risk (i.e. align the shape to fit the trust's goals and economic circumstances)? If portfolio goals are ambitious, the investment



landscape better have some steep mountains and valleys. If portfolio goals are modest, a flatter landscape is more appropriate. This is common sense; but, some trustees forget that moving to a flatter landscape (i.e. avoiding variance) may have a significant opportunity cost, while other trustees forget that moving to a mountainous landscape (i.e. increasing variance) may drain ending wealth if the portfolio is not carefully constructed.

How does the fiduciary control risk? The answer is diversification. Investments can be combined in an infinite number of ways in order to fine tune the shape of risk. If, for example, the coin flipper diversifies by splitting his or her initial capital of \$1.00 between two coins instead of one, then the following results are possible:

1. Win with coin one, Win with coin two = \$2 - \$1 = \$1 gain;
2. Win with coin one, Lose with coin two or, Lose with coin one, Win with coin two = \$1.25 - \$1 = \$0.25 gain;
3. Lose with coin one, Lose with coin two = \$0.50 - \$1 = -\$0.50 loss.

Furthermore,

- The probability of outcome one is 50% x 50% or 25%
- The probability of outcome two is 25% x 2 or 50%
- The probability of outcome three is 50% x 50% or 25%

The expected value of the coin flip game's return is $(25\% \times \$1) + (50\% \times \$0.25) + (25\% \times -\$0.50) = \0.25 or 25% which is exactly the same mathematical expectation of the single coin game.

However, the two-coin game decreases variance:

$$\text{Variance} = [(\$1 - \$0.25)^2(.25) + (\$0.25 - \$0.25)^2(.50) + (-\$0.50 - \$0.25)^2(.25)] = .2813$$

Compound Return is approximated by the formula:

$$\text{Compound Return} = \text{Expected or Average Return} - 1/2 (\text{Variance})$$

or,

$$\text{Compound Return} = \$0.25 - 1/2(\$0.28) = \$0.11$$

Using the logarithmic function to calculate return, the actual, as opposed to approximated, compound return equals \$0.125. Thus, after ten flips, the median investor in the one-coin game starts with \$1.00 and ends with \$1.00. The median investor in the two-coin game starts with \$1.00 and ends up with $(\$1.125)^{10} = \3.25 . Paradoxically, diversification reduces the chance of getting the best payoff from one out of two to one out of four. However, diversification gives us the expectation of seeing our ending wealth increase by 225%!

The prudent investment fiduciary has two reasons to diversify:

1. to control the shape of risk; and,
2. to assure the most favorable trade off between compound growth and variance drain.

Paying attention to variance drain (i.e. scientifically diversifying), for many trusts and endowments, will add more to future wealth than eschewing diversification to maximize period-to-period investment return. Avoiding risk means avoiding return; ignoring risk means courting disaster; managing risk means increasing the probability of achieving reasonable wealth accumulation targets. In many respects, it is more important for fiduciaries to orient themselves with respect to risk than with respect to return.

Such orientation is, however, difficult. The investment landscape, for example, appears strange because counterintuitive forces shape it. For example, adding an investment with a *negative* expected return to an existing portfolio may actually result in higher overall future wealth. This result occurs if the negative return asset has a low correlation with the other assets. Portfolio *composition* rather than security *selection* is key to long-term wealth accumulation. Fiduciaries who merely go treasure hunting in the stock market rarely emerge unscathed.

VII. THE RISK COMPASS: A CASE STUDY

A risk compass is a useful tool for those charged with managing portfolios under Prudent Investor standards. (The compass consists of statistical formulae for analyzing lognormal distributions.) The following example shows how a risk compass enables the fiduciary to make informed judgments regarding the suitability of investment portfolios. Specifically, we consider two hypothetical, globally diversified \$1 million portfolios. Portfolio One contains 60% stocks and 40% bonds, while Portfolio Two contains 85% stocks and 15% bonds. The 60/40 portfolio has an expected compound return (based on unadjusted historical data) of 10.36%. Over a ten year horizon, each dollar currently in the portfolio (and remaining in the portfolio throughout the period) is expected to grow to $(1.1036)^{10} = \$2.68$. The 85/15 portfolio has an expected compound return of 13.66%. Over a ten year horizon, each dollar currently in the portfolio is expected to grow to $(1.1366)^{10} = \$3.60$. Thus the opportunity cost over ten years of selecting the more conservative portfolio amounts to $(\$3.60 - \$2.68) = \$0.92 / \$2.68 = 34\%$ less ending wealth for the trust or endowment. However, the risk, as measured by the standard deviation (square root of variance) statistic, of Portfolio One is approximately half the risk of Portfolio Two: .0912 vs. .1899. Although the risk/return tradeoff is "better" for the 60/40 portfolio (a 50% reduction in risk leads to only a 34% reduction in wealth), lower risk means higher opportunity costs. In the investment landscape, the risk/reward tradeoff is always operative and always multidimensional.

The risk compass provides information on the comparative risks of these portfolios. Assuming a 10-year planning horizon, we calibrate the compass so that it calculates the probability of a 10% loss. The first question is what is the probability of a 10% or greater loss in portfolio value during the next year:

- Portfolio One: 1.27%



- Portfolio Two: 3.53%

The next question is what is the probability, over the next 10 years, of a decline of 10% or more (year over year):

- Portfolio One: 11.98%
- Portfolio Two: 30.19%

The next question is what is the probability, at any time over the next 10 years, of a 10% or greater drop below the initial portfolio value of \$1 million:

- Portfolio One: 8.24%
- Portfolio Two: 19.82%

The final question is what is the probability of ending up after 10 years with a loss in portfolio value equal to or greater than 10%:

- Portfolio One: 0.01%
- Portfolio Two: 0.03%

The risk compass indicates that Portfolio Two's risk is uniformly higher than Portfolio One's. This is, of course, to be expected because stocks are generally more volatile than bonds. However, when measuring the risk of a 10% or greater loss, the risk compass returned answers for Portfolio One that range from 11.98% to 0.01%; and, for Portfolio Two that range from 30.19% to 0.03%. Trustees expecting that their asset allocation decisions have only a 0.03% chance of producing an adverse long-term outcome may not be pleased to discover that, in fact, the probability for such an outcome in any year is greater than 30%. These results suggest that trustees should be clear about the risk (i.e. adverse results) that might flow from their asset allocation decisions. Trustees and boards of directors may be unable to stay the course (i.e. invest for the long term) if they judge portfolio success based on short-term results. In fact, the risk compass suggests that expectation of long-term wealth in excess of the risk free rate comes only with the expectation of short-term investment reversals.

The risk compass helps the investment fiduciary by clarifying the relationship between time and risk:

- Question One refers to the next time period. For each portfolio there is a chance, in excess of one out of a hundred, of incurring a substantial drop (10%+) in value over the forthcoming year.
- Question Two calculates the probability of encountering a drop of 10% or more during the course of any year (i.e. a portfolio valued at \$1,300,000 loses \$130,000 or more in the following year). According to the risk compass, such an event is very probable; for the 85/15 Portfolio, there is a one in three chance of such a percentage decline during a twelve-month period during the forthcoming decade. If the prospect of a \$130,000 roller coaster swing is unacceptable to trustees or

beneficiaries, Portfolio Two is probably not suitable to the needs and objectives of the trust.

- Question Three asks the likelihood that, at some time during the next ten years, the portfolio will penetrate a floor value of \$900,000. Even for the conservative 60/40 portfolio, there is more than a negligible chance that the portfolio owner will sink below \$900,000. If such a result causes the trustees and beneficiaries to recoil, then portfolio risk should be ratcheted back. Interestingly, however, reducing portfolio risk may cause even great recoil when trustees and beneficiaries see the opportunity costs as measured by the decrease in projected compound returns. This iterative process, however, is at the heart of the risk/return tradeoff that all fiduciaries must confront.
- Question Four is of critical importance to investment fiduciaries primarily concerned with long-term results. It quantifies the likelihood that the portfolio's value, the end of ten years, will be \$900,000 or less. The risk compass indicates that such a result is improbable for either portfolio.

The risk compass helps fiduciaries understand the nature of short and long-term risk. It allows fiduciaries to assess accurately a trust's tolerance for risk without resorting to ill-defined labels (e.g. "safe," "aggressive," etc.). Additionally, it permits fiduciaries to gauge the risk of specified asset allocations. Although the risk compass considerably improves the management of the trust portfolio, what fiduciaries would prefer is a tool that enables them to implement the asset allocation best suited to the designated level of risk. In terms of the above example, this task amounts to finding the optimal portfolio given that the trustee(s) wish to incur no greater than an x% risk of penetrating a floor value. This, however, is a considerably more difficult task.

VIII. RESTATEMENT THIRD: AN OVERALL INVESTMENT STRATEGY SHOULD INCORPORATE RISK AND RETURN OBJECTIVES REASONABLY SUITABLE TO THE TRUST

Once again, consider the coin toss game where a win doubles your money and a loss cuts it in half. Let's say that you have a dollar in your pocket and that you do not object to a little wagering excitement. Assuming that fractional bets are permitted, how much of the dollar should you bet in order to maximize the probability that you will have a good outcome over a series of bets? We noted, previously, that some participants who bet their entire wealth on each coin toss may amass \$1,024 after ten trials. These are the participants who ignore risk and follow a strategy designed to maximize the maximum results (max/max strategy). However, it is clear that continuing this strategy results in bankruptcy with a 100% probability. Likewise, some participants may wager only a penny; and, upon each winning toss, withdraw their profits. These participants pursue a minimize-the-minimum (min/min) strategy,



designed to maximize safety, with the result that changes in wealth are negligible. Neither strategy appears to be the optimal “asset allocation.”

How does the fiduciary move from risk tolerance to asset allocation? This question does not have an easy answer, but the coin toss illustrates some relevant mathematical principles. The coin toss is a special case of a general set of return distributions known as Bernoulli trials.² The coin toss is a Bernoulli trial with 50/50 odds. We determine the optimal asset allocation in this game by reference to an algebraic approximation formula developed in 1956 at Bell Laboratories in New Jersey:

Optimal Allocation =

$$[(1 + \text{win/loss dollar ratio})(\text{probability of winning}) - 1] \div \text{win/loss dollar ratio}$$

In the case where you can win \$1 or lose \$0.50 (win/loss ratio = $1 \div 0.5 = 2$):

$$[(1 + 2) \cdot 0.5 - 1] \div 2 = .25 \text{ or } 25 \text{ cents}$$

The optimal asset allocation to the game is 25% of wealth invested in the risky asset (i.e. the coin toss) and 75% invested in a risk-free reserve. If your allocation is different, you will, on average, pay a penalty. For example, under this return generating process and series of potential future payoffs, any series of investments (i.e. bets) in the risky asset that is greater than 50% of wealth, will lead, over time, to bankruptcy with absolute certainty.

If the coin toss payout is changed to, say, \$2 profit for heads and \$0.50 loss for tails (win/loss dollar ratio equals $2 \div 0.5 = 4$), then the optimal allocation is to invest 75% of wealth in the risky venture and 25% in a risk free account. If the payout ratio is sufficiently high, the formula directs you to borrow funds (i.e. commit more than your personal wealth) to the venture. Leveraging an investment program makes sense if you are confident that the future payout will be considerably greater than your borrowing costs. Leverage, however, increases variance; and, therefore, you should be *very* confident regarding the future payout if you decide to borrow money to fund an investment position.

There is another, very different, concept of leverage that we should note. Assuming that \$800,000 is the designated floor value, if you manage a \$1,000,000 portfolio by investing \$600,000 in stocks and \$400,000 in a risk free account, you have leveraged the trust’s required reserve by 100%. That is to say, if you want a portfolio that maximizes safety, the allocation must be 20% to stocks and 80% (or \$800,000) to the risk free asset. Clearly, however, the opportunity cost of such an allocation is high. In developing a target asset allocation, the decision regarding how much to “borrow” from the trust’s required reserve is of great importance.

Ultimately, the fiduciary would like to match the trust’s risk tolerances to an asset allocation that maximizes the probability of investment success over the applicable planning horizon. For a trust portfolio, however, the fiduciary might seek to maximize

several competing objectives (what economists term “objective functions”), such as ongoing income to the current beneficiary and future wealth for the remainderman. However, the fiduciary maximizes the objectives taking into account several constraints. A trust’s current beneficiaries might be highly risk averse regarding, for example, depletion of portfolio values prior to their death. In such a case, the use of investment leverage must be constrained. Matching a portfolio’s investment allocations to economic objectives is easy. TV advice shows or newsstand periodicals never lack for recommendations on how to do this. Matching a portfolio’s investment allocation to economic objectives in a way that maximizes the probability of a successful outcome for differing beneficiary classes, however, is somewhat more challenging.

IX. DOES TIME REDUCE RISK?

Coin flipping is not investing and the classical laws of probability that apply to coin toss games cannot be comfortably generalized to investment portfolios. Although in the coin toss game we rely on a physical object (the coin), we cannot characterize a stock as a physical object. A stock is as much an economic and legal abstraction as it is a pro-rata ownership share in the tangible and financial assets of a company. In the coin toss game, we set the odds so that the return generation process is fully determined and, therefore, fully known in advance. We do not know the exact return series that individual players will realize over time, but we can make accurate predictive statements regarding the general population of coin toss participants. Recognizing the significant differences between investing and coin-toss games we can, nevertheless, use the coin toss model to explore a question that has critical importance for investment fiduciaries: does time reduce risk?

The risk compass suggests an affirmative answer in that the risk of a loss in excess of a designated floor value decreases with time. The time vs. risk question, however, has produced a small library of academic articles that argue for both sides of the proposition. The trustee’s perspective on this topic will profoundly influence asset allocation decisions, portfolio management decisions (e.g. rebalancing strategies) and many other components of ongoing investment strategy. If the game is set to a 50% chance of winning \$1.00 and a 50% chance of losing \$1.00, the odds present a 0% return expectation. Despite the fact that coin toss participants have a mathematical expectation that they will leave the game with zero profit, the possibility of leaving the game with wealth significantly different than zero *grows* with time (i.e. with the number of tosses or Bernoulli trials). The distribution of final results for this game, having a mean of \$0 and a variance of \$1, is a normal or bell curve distribution given a sufficiently large number of trials [the Binomial or Bernoulli distribution approximates, at the limit, the bell curve distribution]. The variance term will push the actual results for any single player away from the mean of the distribution, which is \$0.00. If the



variance term pushes the player towards the left side of the bell curve, the player is in negative (loss) territory; if it pushes the player to the right hand side, he or she is in positive (profit) territory. If the game is limited to a few tosses, many players will break even. However, after a sufficiently large number of tosses, it becomes virtually unthinkable that any player will break even (expected value is a value never to be expected). Fortunately, although the risk of deviating from expectation increases with time, there are two mitigating factors in this game:

1. Half of the deviations will put the player into positive territory; and so, it is unlikely that the player will mind; and,
2. Risk increases not directly with time, but in proportion to the square root of time.

Thus, for a game of 100 tosses, there is a 5% probability that the player will either win or lose \$20 [(\$1 variance) x (2 standard deviations on the bell curve) x (100)^{1/2}]; for a game of 1 million trials, there is a 5% probability that the player will either win or lose \$2,000. The longer you play the game, the greater the odds that you will be far away from the expected value. It seems that time increases risk.

Another way of expressing this concept is that for any two contestants playing against each other in the game, it is more likely that one will experience losses while the counterparty delights in his or her profits than it is that both sides will break even. In a 50/50 game of chance, the odds are great that you will spend a considerable time either above or below the game's expected value. Given the statistical propensity for wealth to drift away from expected value for extended periods of time, what is the likelihood of spending time either in positive (profit) or negative (loss) territory in a coin toss game? This probability is given by a trigonometric formula known as the first arc sine law.³ If the x axis is the vector of expected value and the y coordinate measures the amount of profit or loss, then the expected value of the game is a horizontal line on the x axis. If the y value is positive, the player will plot above the x axis; if the y value is negative, the player will plot below. Thus the sine of expected value should equal zero for any number of trials. The first arc sine law gives the probability of being either above or below the x-axis given an equal payout for a win or a loss and given the odds set for the game:

$$\text{Probability} = 2 \div \text{Arcsine}(\text{Odds}^{1/2})$$

Thus, if the game is rigged against you and the odds of tossing heads are only 10%, you can expect to spend approximately 97% of the time on one side of the x axis (our guess is that this would be the side where y values are negative). One would think that, with a fair coin (i.e. 50-50 odds), the average participant would hop back and forth across the axis and therefore divide his or her time approximately 50% in positive territory and 50% in negative territory. What is counterintuitive, however, is that the participant

can expect to spend approximately 80% of his or her time on one side or the other of the x axis. Even portfolios that are, eventually, successful can expect to have long periods of underperformance. Conversely, getting off to a fast start may not guarantee ultimate success.

X. RISK EVALUATION AND HISTORICAL RETURNS

Moving from games to portfolios is not a straightforward task. Let's begin, however, by returning to Chart 1 depicting portfolio returns over a ten year time period. The allocation of the portfolio is 70% to stocks (S&P 500) and 30% to bonds (Long-Term US Government/Corporate Bond Index). The chart calculates the median return and variance of the portfolio using historical data over the 1973 through October 2001 time period. The software program uses these parameters to project an unbiased estimate of the range of possible future results. It cannot foretell actual numerical results; but assuming that the distribution of future results has parameters comparable to the historical sample, it can generate a picture (shape) of future risk. The first year shows a range of results, at a 99% confidence interval, ranging from -16% to +48%. By year five, the portfolio's annual compound return range falls within a more narrow band: -2% to +26%; and, by the end of year ten, the range narrows to +2% to +21% at a 99% confidence interval. The median of the distribution, unadjusted for expenses, taxes or other portfolio frictions) at the end of ten years is approximately 11%.

To review, all investors in this portfolio will, over the next ten years, achieve the same result (assuming no cash flows). We do not know what this result will be. The best guess is that the average investor should expect something close to 11% but the realized return could be as high as 21% or as low as 2%. This is different from predicting that an investor will earn 11% in any given ten-year period. The Law of Large Numbers works over many ten year planning horizons, not over a single ten-year period. The probability that the realized return is 2% or lower is very small (roughly 1/2 of 1%); but the possibility exists and, given enough ten-year periods, it will manifest itself with a probability approaching certainty. The best we can do is to measure risk probabilistically so that decision making is based on the soundest possible footing. The measurement parameters become more accurate as time unfolds and the number of historical returns becomes larger. However, we continue to sample from only a single set of data (in this case, the historical returns of U.S. capital markets), and have no guarantee that the sample is "representative" of the future return generating process. Investing is not coin flipping. Although many commentators suggest that time reduces risk by offering empirical "proof" that U.S. stocks have always outperformed U.S. bonds over long time horizons, there is no mathematical necessity in this conclusion.

One noteworthy observation about the returns chart is that the "worst case" line moves from well below 0% return in year one, to



approximately 2% by year ten. Thus, if we define risk not merely as the statistical value of return variance but as the risk of ending up with less money than we had at the start, time seems to decrease risk. Earlier, we noted that investors could control the shape of risk through diversification. Scientific diversification is not selecting a bunch of “good stocks” but is a solution to the portfolio composition problem that demands stocks with differing characteristics and return patterns. At this point, we encounter time as a second dimension to diversification. Assuming that returns from investments are independent from period to period (academic studies of stock returns suggest that this is reasonable), holding a single stock over multiple periods of time is like holding a portfolio of many assets during a single point in time. Thus, holding a portfolio of many assets over many time periods greatly increases the benefits of diversification. This is the intuitive justification for the theory that time reduces risk.

However, Chart 2 provides a different point of view on the time and risk controversy. This chart illustrates that as percentage returns converge over time, the absolute level of future dollar wealth becomes more uncertain. At a 99% confidence interval the bottom of each column moves steadily upwards. By the end of year one, wealth might be below the portfolio’s starting value. However, by the end of year ten, the bottom of the column has moved above negative territory. This confirms the finding of the risk compass that the risk of losing the initial value of the portfolio decreases over time. However, the risk of ending up with a substantial shortfall in expected value increases dramatically during the ten-year period. The distance between expected and worst case value in year one is only a fraction of the distance in year ten. If you start with a portfolio of \$1 million dollars, it’s nice that the risk of ending up with less than that at the end of ten years is miniscule. However, if you count on having \$3 million and end with only \$1.5 million, this result might be cold comfort. Time increases the dispersion of possible results. This is the intuitive justification for the theory that time increases risk.

XI. INVESTOR UTILITY AND RISK AVERSION

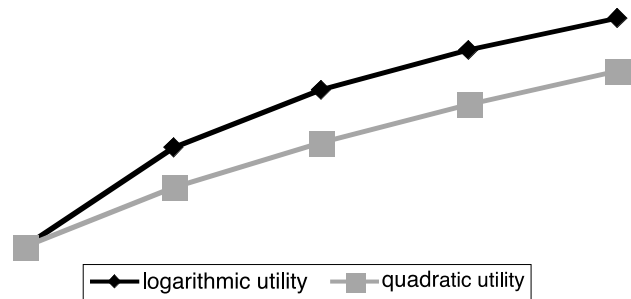
As we continue the time-traveling journey through the landscape of risk and return, there is an important stop that must be made before arriving at “Alignmentville.” Alignmentville is the place where the portfolio is well suited to the trust’s economic objectives, time horizon, and risk tolerance. It is the golden city on the hill that is the quest of every investment pilgrim. The name of the interim stop is “Utility Junction.”

Asset allocation targets are difficult to sustain if they are poorly aligned with a trust’s risk tolerance. Most investors prefer more wealth to less wealth (the “non-satiation principle”) but have a decreasing marginal rate of satisfaction. Earning an additional dollar produces slightly less satisfaction than losing a dollar produces dissatisfaction. An economist might state that most investors are sensitive to absolute changes in their dollar wealth

(they exhibit “absolute risk aversion”) while a mathematician might state that investors exhibit increasing utility of wealth curves that have positive first derivatives and negative second derivatives (head upwards but at a constantly decreasing rate). Both sets of jargon mean the same thing: the joy of a \$1.00 gain is not as great as the pain of a \$1.00 loss.

The following chart illustrates two curves that fit nicely into the von Neumann-Morgenstern family:⁴ a logarithmic curve (Utility = logarithm of wealth) and a quadratic curve (Utility = square root of wealth):

Chart 3 — Investor Utility Curves



The investor with the logarithmic utility curve is said to be more sensitive to changes in wealth because the curvature produced by the function is greater. Thus, the logarithmic investor is more risk averse. The quadratic utility investor is less sensitive (the line exhibits less curvature) and is therefore said to be more risk tolerant. Chances are that the asset allocation that will best satisfy the log of wealth investor will not be the allocation that will best satisfy the quadratic utility investor. The reason for this preliminary conclusion lies in the fact that these investors have very different views about risk. Investors with utility functions that have curvature greater than the log of wealth will tend to want “safer” portfolios; investors with utility function curves that are flatter than quadratic will tend to be comfortable with more aggressive portfolios. In the coin toss game, the lucky few investors who ignored risk and walked away with \$1,024 after ten flips, have utility curves that are straight line (linear with respect to wealth), or that are “gamblers’ curves” that monotonically decrease instead of increase. For gamblers, the thrill of the wager often has greater utility than the level of wealth attained by the wager.

XII. BUYERS OF LIFE INSURANCE AND LOTTERY TICKETS

Mathematically, risk averse investors have utility curves that are concave up (negative second derivatives). Alternately, a decision maker with a von Neumann-Morgenstern utility function is said to be risk averse if he or she is unwilling to accept every actuarially fair and immediately resolved lottery. A lottery provides an opportunity to win or lose money. An actuarially fair

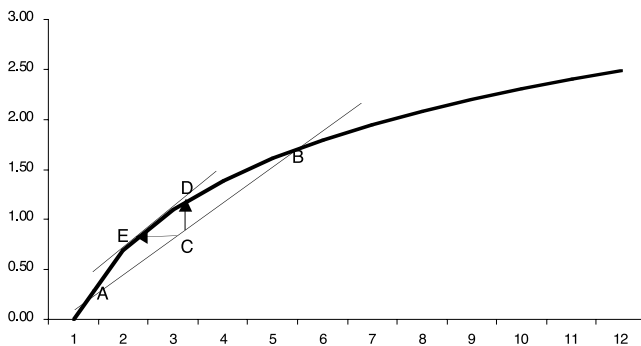


lottery is one in which the expected value of the wins and losses is exactly equal to cost of entry into the game where expected value is the average of the amounts that can be won or lost in the gamble. In function notation the expected value of the lottery is $E(\text{£}) = \text{the risk free rate}$, where £ is the average of lottery payouts. For the risk averse investor, his or her satisfaction (utility) with a risk free investment is greater than his or her utility with the prospect of entering an actuarially fair lottery that has the same expected ending wealth values:

$$U(W) > E[U(W+\text{£})]$$

The following chart illustrates some of these concepts for an investor with a logarithmic utility function:

Chart 4 — Logarithmic Utility of Wealth Curve



The investor is offered the opportunity to participate in a lottery where he can win or lose a sum of money. The chart plots wealth on the x axis and the utility of wealth (units of investor satisfaction) on the y axis. Under the model, the rational investor will choose the investment strategy that maximizes the utility of wealth. Note that the phrase “maximize the utility of wealth” is not the same as “maximize wealth,” or “maximize expected wealth.” The investor’s current level of risk-free wealth is at point D (wealth of approximately 3.3 with a utility of approximately 1.25). He is offered a lottery that will either increase his wealth to point B or 5.5 (utility 1.75) or decrease wealth to point A or 1.5 (utility .25). The expected value of the lottery is point C. Point C is also the 3.3 wealth level. If the investor merely considers expected value, he should be indifferent as to whether he enters the lottery or leaves the funds in the risk free investment. However, point C clearly plots below the investor’s utility curve. In fact, entering the lottery proposition is equivalent to the investor moving from point D to point E which, according to the mean value theorem (i.e. secant and tangent lines have equal slope), is the certainty equivalent of the lottery. Although this is an actuarially fair lottery, the investor will decline to participate in it. The concept of “variance drain”, discussed earlier, has a parallel notion of “utility drain.” Point C has the same expected value as point D but exhibits a utility shortfall: the distance from D to C is the measure of this shortfall or drain. If variance decreases (i.e. points A and B move closer to point D and the secant line becomes shorter), the amount of utility

drain decreases. Conversely, if the best case/worst case outcomes of the lottery become more pronounced (i.e. the secant line becomes longer), the distance from D to C increases.

To induce a risk averse individual to participate in a lottery (i.e. enter an investment that has the possibility of a gain or loss), he or she must expect to receive a compensatory risk premium. Thus, the lottery must be actuarially favorable—the participant might not win, but the odds of winning and payout amounts must be attractive. Parenthetically, a risk averse investor is also inclined to pay money to avoid a gamble. We call such a bargain an insurance contract. In this situation, however, the actuarially expected profit from the bargain accrues to the insurance carrier not to the policyholder.

XIII. UTILITY FUNCTIONS: IS YOUR CURVE KINKED?

The particular set of utility functions used to model risk aversion depends on the investor’s unique risk tolerance profile. For example, an investor might have a relatively flat curve above a threshold account value, but a great degree of curvature below that value. Such a “kinked” curve might characterize an endowment fund that cannot afford to dip below a certain level without incurring donor or board of director wrath. Constant relative risk aversion⁵ assumes that the investor is equally averse to a constant percentage loss irrespective of his or her absolute level of wealth. Thus, it assumes that a millionaire is willing to commit no greater percentage of investible assets to the stock market than an individual with only a fraction of the millionaire’s absolute wealth. Constant relative risk aversion is an important characteristic for many mathematical models because it enables their conclusions to be more readily generalized to a broad spectrum of investors. Finally, the log utility function is particularly handy because it is the inverse of the geometric wealth compounding function (the exponential growth function) that is key to investment success. Thus, most utility models incorporate the logarithmic function, if not exclusively, then as a major part of their calculation algorithms.

Some commentators argue that even if the investor’s risk aversion curve is not logarithmic, it should be logarithmic because this type of curvature is best suited to make decisions that maximize long term geometric growth rates. This logical extension is made by assuming that all rational investors will want to maximize their chances of success; therefore, all investors will align their preferences accordingly (i.e. it would be irrational to act otherwise). Investors with little curvature in their utility functions will ignore risk and, because their capital suffers occasional catastrophic losses, will command, on average, less economic presence in the marketplace. Investors with too much curvature incur substantial opportunity costs and end up leaving so much money on the table that they short-change themselves by accumulating far less wealth than investors with the optimal allocation. The log function, as the mirror image of the compound



return function, is, in fact, *the function* towards which *all* rational investors will converge. Investors who do not converge towards this function are systematically marginalized by the very operation of the marketplace. Thus, in the limit, it does not matter if each investor has a log of wealth utility function so long as all rational investors exhibit logarithmic risk aversion. Stated otherwise, it does not matter that there exist many stock investors who operate as if they believed that the market is not efficient (i.e. irrational) because, at the end of the day, their actions cannot change the fact of market efficiency. Rational, profit seeking, investors will always delight in taking advantage of opportunities for arbitrage profits.

XIV. PAUL SAMUELSON'S FAMOUS UTILITY OF WEALTH ARGUMENT

This is a powerful, elegant, and sometimes controversial argument that lies at the heart of much capital market theory and that has critical importance for investment fiduciaries.⁶ Nobel Prize winning economist Paul Samuelson uses utility theory to make the argument that investors should have the same allocation of risky and risk-free assets irrespective of their planning horizon. In Samuelson's view, investors should not assume that a lengthy planning horizon makes it safer to commit a larger portion of discretionary wealth to risky investments. He makes this argument based on the theory of investor utility outlined above. Here is a sketch of his position.

Assume that an investor has the opportunity to keep \$100 in a risk free account that earns 1% per year. After one year, the account will grow to \$101; and the log of 101 equals 4.615. This is simply another way of saying that the investor enjoys 4.615 'units of satisfaction' at an expected level of wealth of \$101. Compare the risk free investment strategy to a risky investment strategy. In this case, the investor has the opportunity to purchase a stock that, with equal probability, will either increase in value by 30% or decrease in value by 23.1% during the next year. In this case, the fact that only two ending values are possible makes the model similar to the heads/tails coin toss game. Starting with \$100, the investor has an expected value of $\$100(1+.30)(.5) + \$100(1-.231)(.5) = \$103.45$ which is greater than \$101. However, despite the higher expected value of the risky investment, the investor will reject it because it provides lower utility (satisfaction). The following table outlines the possible results over a one-year period:

Investment Outcome	Probability	Utility of Wealth
\$130.00	50%	$\ln(130) = 4.8675$
\$76.90	50%	$\ln(76.9) = 4.3425$
Expected Investment Wealth: \$103.45		
Utility of Investment Wealth: $2.434 + 2.171 = 4.605$		

Samuelson demonstrates that given the above return generating process, an investor with a log of wealth utility function will reject the risky investment over a one-year horizon despite the fact that it has a higher expected return. The utility of the risky investment strategy equals 4.605, which is less than the utility of the risk-free strategy (4.615).

In the following year (year 2), the risk free investment grows to \$102.01 with a utility of wealth value equal to 4.6215. The following table outlines the possible results in year two for the risky investment:

Investment Outcome	Probability	Utility of Wealth
\$169.00	25%	$\ln(169) = 5.1299$
\$100.00	50%	$\ln(100) = 4.6052$
\$59.14	25%	$\ln(59.14) = 4.0800$
Expected Investment Wealth: \$107.03		
Utility of Investment Wealth: $1.282 + 2.303 + 1.020 = 4.605$		

The expected utility of wealth of the risky investment remains at 4.605 despite the fact that the expected value of the risky investment outpaces the expected value of the risk-free investment by a margin that increases year after year. Conversely, the utility of the risk free investment increases yearly and thus outpaces the utility of the risky investment by an ever-widening margin. Samuelson's main point is that the utility of wealth is invariant to one's planning horizon given a logarithmic utility function. This leads to the conclusion that one should invest for the long term exactly as one invests for the short term. As Samuelson observes, the probability of loss decreases with the square root of time but the magnitude of the possible loss increases. Long periods of time mean greater opportunities to experience catastrophic losses and, therefore, one cannot conclude that long investment horizons decrease risk for investors who attempt to maximize the utility of wealth. Furthermore, Samuelson demonstrates that this conclusion holds not only for investors with logarithmic utility functions but for investors with any utility function that exhibits constant relative risk aversion so long as returns are independent from period to period.

Samuelson's argument runs squarely up against conventional wisdom that cautions investors to decrease exposure to risky assets as the length of their planning horizon shortens. The entire concept of life-cycle funds, for example, is built on the notion that investors close to retirement (or currently in retirement) should have decreasing commitments to equities. The equity allocations depend, all or in part, on the chronological age of the investor. Samuelson's argument suggests that, all else equal, an investor with a log of wealth utility function will remain indifferent between a risky asset and a risk free asset of equal expected utility. This indifference will persist over planning horizons of any length



provided that future returns are independent and normally distributed. Furthermore, for any utility function that exhibits constant relative risk aversion and decreasing absolute relative risk aversion, the expected utility of a risky investment never changes despite the fact that the investment's expected value constantly increases. The increase in the utility of high levels of expected wealth is exactly offset by the decrease in utility brought about by the dispersion (variance) in ending wealth. Thus, there is a tug of war between dispersion of wealth and convergence of returns (or, between opportunity cost and risk aversion). Investors will prefer to have a constant allocation between risky and risk-free investments despite the length of their planning horizon.

What if returns are not independent and identically distributed from period to period? If returns are mean reverting (good results are more likely to follow periods of bad results and visa-versa), then investors with logarithmic utility continue to experience constant utility from the risky investment. However, investors with utility functions that exhibit greater curvature will experience an increase in the value of utility over time; investors with flatter curves experience a decrease in the value of utility because wealth is dispersing too slowly in a mean reversionary process.

XV. DOES TIME INCREASE RISK?

Although we continue to explore some of the implications of assuming a logarithmic utility function, we should note that there are at least two schools of thought that advance the hypothesis that time increases risk. One school, based on options theory, contends that the price of a put option increases with time; this therefore constitutes a proof that time *increases* risk. A put option is comparable to an insurance contract because it insures the portfolio against a loss greater than a designated threshold value. The holder of a put option has the right to sell assets at a specified price irrespective of their actual price in the market. All else equal, a long-term put costs more than a short-term put; if the cost of insuring against the risk of portfolio loss increases over time, then this reflects the fact that the peril of loss also increases.

In counterpoint, the costs of a put are preference dependent. That is to say, the cost is a function of the portfolio floor level below which you do not wish to penetrate. If, for example, you define the floor value of the portfolio as a return equal to the risk free rate, the strike price of the put will continuously increase through time due to compounding of wealth at the risk free rate. It is not surprising that the put price also increases because the put insures a constantly increasing floor value. If, however, you wish to protect against penetrating a fixed nominal floor value, the cost of the put may well decrease as the holding period increases. Thus, option theory does not produce definitive answers to the question of whether time reduces risk.

Another school of thought uses mean-variance utility analysis as opposed to expected utility of wealth analysis. The argument parallels, in certain respects, the convergence of returns / dispersion

of wealth phenomenon discussed above. Despite the fact that the variance parameter (assuming a stable lognormal distribution) remains constant and despite the fact that, over time, the standard deviation of annual returns decreases (i.e. lognormal distributions have finite variance), the cumulative variance increases with time. The more time that passes, the greater the likelihood that the investor's wealth will differ from its expected terminal value. Just as there is an approximation formula for compound return [compound return = expected return - 1/2(variance)], there is also a generalized mean-variance utility function:

$$U(W_t) = E[R_{pt}] - (A/2)(s_{pt})^\beta$$

Where:

- $U(W_t)$ is the utility of wealth at time t ;
- $E[R_{pt}]$ is the expected return of the portfolio at time t ; and
- $(A/2)(s_{pt})^\beta$ is the "utility drain" with s equal to the square root of variance (or, standard deviation), A is a risk-aversion parameter, and β is the exponent that determines the curvature of the risk aversion function line.⁷

In the above utility of wealth equation, for example, assuming a 4% risk free rate of return, a risky asset with an expected return of 8% and a variance of 4% and values for A and β of 2, the optimal commitment to equity equals 50% for a one-year planning horizon, 32% for a five-year horizon, and 18% for a ten-year horizon. At this point, it appears as if we are getting close to the goal of understanding and measuring risk in order to arrive at asset allocations that provide us with the best chance of maximum satisfaction or utility.

Unfortunately, we are working with a mean-variance utility function that presents us with two problems. First, under certain conditions, maximizing the utility of such a function will lead to bankruptcy. For example, if the optimized portfolio allows for even a small percentage chance of a 100% loss in each period, then, given a sufficiently long planning horizon, the strategy produces certain ruin. This might be the case for leveraged portfolios.

Secondly, if the fiduciary wishes to maximize the probability of long-term financial success within the framework of the trust's economic objectives and risk tolerance, the parameters of the mean-variance function must be specified. Additionally, assumptions regarding the return generating process, the risk free rate and the complex interactions between all variables will have profound consequences for the asset allocation decision. In the above case, flattening the utility of wealth curve by selecting parameter values of 0.88 for A and 1.04 for β , results in an optimal commitment to risky assets of 0% for a one year planning horizon and 100% for a ten year horizon!



XVI. UTILITY AND FINANCIAL CATASTROPHE

Let's return, therefore to the log of wealth utility function. The reader will remember that the mathematical properties of the logarithmic function (namely maximizing compound growth requires summing the log of period-by-period returns) make it attractive for calculation purposes. We can use the normal or bell curve in the model and, therefore, make straightforward statistical estimates; we can readily obtain terminal dollar wealth by applying the compound growth factor (exponential or 'e') to the logarithmic values. Maximizing logarithmic utility also maximizes compound growth.

The problem with restricting the discussion exclusively to the logarithmic function is that it does not allow for either more conservative or more risk tolerant investors. One way to overcome this difficulty, however, is to merge the concept of risk aversion with respect to discretionary wealth with the concept of a required reserve. A required reserve is a floor value below which the fiduciary does not wish to penetrate. It is each investor's unique definition of financial catastrophe in the sense that minimum economic objectives cannot be funded should wealth decrease below the reserve's floor value. The more risk averse the investor, the higher the floor value. The advantage of this approach is that it is easier for investors to specify floor values than it is to derive mathematical equations to describe the curvature of their utility functions.

The path from risk tolerance to asset allocation is straightforward. Assume that your floor value is 90% of initial wealth and that you are considering investing in the hypothetical, globally diversified 60/40 portfolio that was plugged into the risk compass. The expected return of the portfolio is 10.36% and the Standard Deviation (square root of variance) is 9.12%. Further, assume that expected inflation over the applicable planning horizon is 4% so that the portfolio's real return equals 6.36% (10.36 - 4.00). Trustees could keep 90% of funds in a money market and invest the remaining 10% into the risky asset portfolio. The opportunity cost of such a strategy, however, would rapidly dissuade most trustees from pursuing this allocation.

To the extent that trustees shift money to the investment portfolio, however, they are leveraging the required reserve. For example, if they decided to invest 60% of the trust into the portfolio, they have leveraged the required reserves by 125% (10% discretionary wealth + 40% remaining in money market + 50% of reserve committed to portfolio = total wealth. $50\% \div 40\% = 1.25$). The critical issue is the extent to which reserves should be leveraged in order to participate in the investment while at the same time maximizing utility of wealth. Incorporating leverage into the compound growth function,⁸ this calculation suggests that the trustee should keep 13% of wealth in the money market reserve and commit 77% [$7.66 \times$ (discretionary wealth percentage of 0.10) = 76.60%] to the 60/40 investment portfolio. Alternately, the trustee

could move slightly down the risk/reward continuum and commit most funds to a 55/45 portfolio. Note that if the required reserve equals 80% of initial wealth (i.e. the discretionary wealth percentage is 0.20), the 60/40 portfolio is too conservative. The calculation formula suggests that the optimal allocation would require not only a 100% commitment of wealth but also securing a margin loan to increase investment exposure. Whereas such a strategy may not be available to many trustees, this suggests that an alternative strategy that makes a greater allocation to equity will produce a more satisfactory portfolio.

XVII. CAN WE USE UTILITY THEORY TO ALIGN ASSET ALLOCATION WITH RISK TOLERANCE?

It appears that we are now very close to having the capability to calibrate asset allocation decisions to a trust or endowment's level of risk tolerance. However, in order for the formula to work, we had to make a variety of assumptions regarding both inflation and the nature of the return distribution (i.e. shape of risk). One of the problems with deriving asset allocation decisions from utility of wealth functions is that changes in the model's specifications of the return generating distribution may dramatically change the asset allocation decision. For risky assets to be attractive, they must provide the investor with increasing utility over time. That is, the utility of wealth produced by the distribution of a risky asset such as a stock must exceed the utility of wealth produced by a risk free alternative. Assume an investment of \$100 (log utility of \$100 = 4.605) into return generating process that has a 90% chance of producing a 50% profit and a 10% chance of producing a 20% loss. The results after one year are as follows:

Investment Outcome	Probability	Utility of Wealth
\$150.00	90%	$\ln(150) = 5.0106$
\$80.00	10%	$\ln(80) = 4.3820$
Expected Investment Wealth: \$143.00		
Utility of Investment Wealth: $4.510 + 0.438 = 4.948$		

Assuming a risk free return of 1%, the utility of the risk free alternative after one year amounts to $U(\$101) = 4.6151$. The risky asset is preferred ($4.948 > 4.6151$). The preference for the risky asset continues into all future years with the utility of wealth generated by the risky asset's return distribution increasing in its attractiveness relative to the risk free alternative. Additionally, this return distribution also diminishes the likelihood that the portfolio will generate a return less than the risk-free rate. During year one, the risk of a shortfall (< risk free rate) equals ten percent. By year two, the risk decreases to $(.10 \times .10)$ one percent. Although the dispersion of wealth becomes great over time, this distribution has little risk of underperforming the risk free alternative over a long



planning horizon. The utility of wealth is dependent on how fast the distribution of final wealth diverges and on the interim up/down values along the binomial paths. With respect to the hypothetical 60/40 portfolio, if the single-value point estimates regarding expected return, variance and inflation are not accurate, the calculation results could be misleading.

It is also incorrect to assume that, for any specific planning horizon, the compound return of the risky asset will exceed the compound return of the risk free asset despite the fact that, averaged over all previous periods, this has been the case. Model inputs are often sample estimates only; the true parameter values remain unknown. This problem is especially acute with mean-variance optimization because the calculation algorithms systematically select for assets with overestimated returns and underestimated risks; but this problem also plagues other approaches including modeling comparative return distributions using a stochastic dominance approach. In this approach, the investigator compares the cumulative distribution of estimated returns for various investment strategies to determine if all investors, regardless of their risk preferences, prefer a particular strategy.⁹

Most trustees defer present spending (trust distributions) if they wish to accumulate wealth for future objectives (economists call this “elasticity of intertemporal substitution”). However, the moment that we introduce the concept of cash flows (portfolio contributions and withdrawals) into the return generating process, the nature of the game changes completely. Cash flows create what economists term “path dependency.” Earlier, we noted that the ending value of a portfolio was the result of the multiplication of a series of returns. Multiplication is commutative and the order of the returns does not change the final result ($3 \times 2 \times 1 = 1 \times 2 \times 3 = 2 \times 1 \times 3 = 6$). The ending value of six is not path dependent. However, periodic distributions from a portfolio experiencing a series of positive and negative returns create path dependency. Assume, for example, a \$5.00 periodic distribution from a portfolio with an initial value of \$100. If the periodic return series is +10%, -6%, and +3% the ending value is \$91.51. However, simply changing the order of returns to -6%, +10%, and +3%, changes the final value to \$90.69.

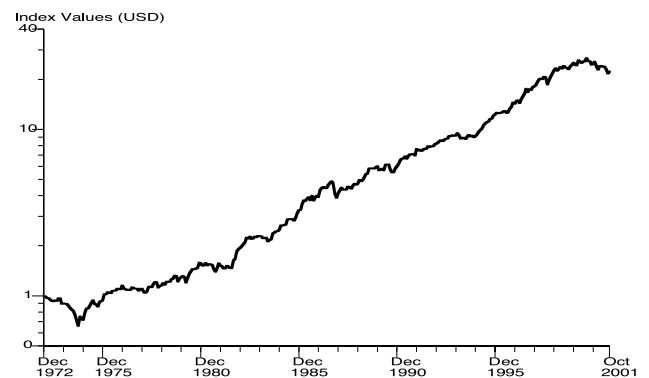
Given dynamic portfolios unfolding over time, it seems as if Utility Junction is actually the Slough of Despond. We stopped to investigate utility theory in the hope that it would allow us to find a formula for asset allocation. Initially, efforts in this direction seemed promising. However, we learned that objective formulae for aligning the portfolio with risk tolerance, economic objectives and planning horizons are elusive. Results are preference dependent: selecting one shortfall target vs. an alternative alters the preference for risky assets. Asset allocation choices are also highly sensitive to the nature of the return generating process (i.e. the shape of risk), to the available risk free rate, and to the differential between the risk-free rate and the risky asset’s expected return.

Most models assume constant values for variance, correlations, risk-free rates, inflation, etc., over the applicable planning horizon. Despite simplified inputs, however, it is difficult, if not impossible, to generalize conclusions regarding any single utility function into rules for making allocation decisions. Furthermore, even if these obstacles are overcome, we still face the formidable task of defining the precise form of utility function that best fits the trust’s tolerance regarding risk and specifying the relevant parameters (risk aversion and curvature) of the function. This is a challenging assignment even for skilled economists and statisticians. Although investors have differing risk aversion functions, we could “default” to a log of wealth utility function. But as soon as cash flows are introduced, the results of the return generation process become path dependent. This means that not only are closed form analytical solutions (i.e. formulae) for the asset allocation decision difficult to implement, they are also difficult to find.

XVIII. CASH FLOWS, HISTORY AND THE FLAW OF AVERAGES

Let’s return to the data set underlying Charts 1 and 2. The projections of each chart for a portfolio consisting of 70% S&P 500 stock index and 30% long-term U.S. government/corporate bond index are based on the monthly time series of returns beginning in January 1973. The historical path of the portfolio is as follows:

Chart 5 — 70-30 Returns



A \$1,000 investment into the portfolio grew to an ending value of approximately \$22,200. Therefore, simply by looking at the beginning and ending points of the function, we note that the historical rate of return amounts to 11.36%. This return was not consistently generated each year. Along the way, the function exhibited a wide range of behaviors. When it was good, it was very good (+20.98% per year in 1997-1999); but when it was bad.... (-15.43% per year in 1973-74). The convergence of return (good years/bad years) and dispersion of wealth charts both reflect parameter values extracted from the historical return series. We do not claim that history will repeat itself, but we are relatively confident that the sample contains a sufficiently diverse representation of both favorable and unfavorable economic regimes so that it is reasonably representative of likely future behaviors. In this case, the sample contains exogenous world-wide



economic shocks (OPEC oil crisis), presidential impeachments and resignations, market crashes, international banking and liquidity crises, wars, periods of high inflation, low inflation and economic stagflation, etc.

But the parameters that we extract from the historical return series are averages. Expected returns, as we have noted, are based on average results. Variance is an *average* of squared differences between actual and mean results. Thus, the wealth projection chart represents our best guess regarding the end point of the wealth accumulation function during the next time period, and the projection is based on parameterized values extracted from a single pass through history. Even working with averages, however, we are forced to admit that the end point of the function during its next pass through history (i.e. the forthcoming ten years) may be very different. Even projections derived from averaged (smoothed) inputs suggest that the true return of the function may be anywhere from 2% to 21%.

Likewise, the projections and risk assessments rely on the simplifying assumption that there are no portfolio cash flows or other “frictions” (taxes, expenses, or other charges). If this assumption is relaxed, however, results become path dependent and final wealth is a function of *actual* rather than *average* results. Path dependency means that both the magnitude of returns and the order of the sequence of returns govern final results. It is the unique pattern of unfolding events rather than statistical averages over the period that is of importance. Average results no longer suffice as model inputs.

Investment averages are highly sensitive to:

- the period of time that is under evaluation;
- outlier results during the period; and,
- survivorship bias.

Furthermore, parameter (average) values reflect behaviors that are revealed under a single economic history (i.e. a sequence from high inflation to stagflation to low inflation). The fickleness of history makes it highly unlikely that such a sequence will repeat in the near term future. Finally, parameterized projections must assume a statistical distribution. The mean-variance parameters, for example, fully describe several distributions including the Poisson and the Normal distributions. But the probability density functions underlying these distributions (i.e. the shape of risk) are very different. The moment that a distributional shape is assumed, the model cannot allow for magnitudes and probabilities that “violate” the characteristics of the distribution. However, this is no guarantee that any distribution selected a-priori will accurately reflect the path of future investment results. Indeed, the most commonly assumed distribution for investment returns (lognormal) does not allow for the leptokurtic (“fat-tailed”) behavior that is a hallmark of investment experience. The lognormal distribution is too neat not only because it assumes the stability of the parameters,

but also because it may not reflect realistic probabilities for extreme results. Parameterized projections are fragile models upon which to base future economic decisions.

XIX. THE ARCHITECT V. THE SYSTEMS ENGINEER

The goal of the investment fiduciary remains straightforward. The task is to construct a trust or endowment portfolio that aligns return expectations sufficient to discharge reasonable economic objectives with risk tolerances that allow interested parties to sustain an optimal investment strategy through bull and bear markets. Traditional measures of risk, as we have seen, assume static parameters that operate either according to simplistic algebraic algorithms or within a pre-set probability distribution. The static nature of this type of modeling argues for a static model of portfolio construction. In such a model, investment results are a function of the asset allocation of the portfolio and the investment fiduciary assumes the role of the portfolio “architect.”

Trustees, however, must manage portfolios of assets in a dynamic rather than static environment. As time unfolds, not only do asset management decisions generate geometric (compounded) financial consequences, but the relevant variables also exhibit complex, non-linear patterns of interaction. It is not sufficient to decompose the determinates of future wealth into segregated factors reflecting investment returns, inflation, distribution/contribution policy, rebalancing strategies, tax effects, expenses of asset management strategies, etc. with the hope that realistic risk measurements are achievable simply by reaggregating such separable components in a kind of “what if” scenario analysis. Set-in-stone, parameterized formulas fail because actual results are conditioned on behaviors of stochastic variables operating within an interactive and tightly coupled system. The portfolio architect model is dangerously irrelevant in such an environment. The investment task is more suited to a systems engineering approach.

XX. SIMULATION TECHNOLOGY AND RISK MODELING

Superior risk measurement and management demands a modeling methodology that generates realistic future possibilities without a slavish adherence to the single sample of historical results. Economic forces are constantly changing capital markets with the result that models based on averaged historical data are suboptimal. Path dependency created by a multitude of asset management decisions that impact taxes, fees, distributions, contributions, and so forth, results in vastly differing results when historical return sequences are reshuffled. Simple resequencing shows that historically successful investment strategies may, in the future, drive the trust portfolio into oblivion and that naïve reliance on past results is not a viable (or defensible) asset management philosophy.

The methodology best suited for modeling the shape of risk is a computer-driven simulation methodology that allows each



variable to exhibit a range of plausible behaviors. Additionally, simulation modeling allows for plausible patterns of linkage between variables despite the fact that certain linkage patterns have yet to be observed in historical economic environments. They have yet to be observed not because the linkages are impossible, but simply because the sample of history is not exhaustive.

Although a comprehensive discussion of simulation modeling is beyond the scope of this essay, it is relatively easy to grasp the benefits of a well-designed simulation model. The greatest advantage is that it describes the evolution of thousands of potential vectors of portfolio performance as each vector emerges from economic conditions (e.g., inflation) which shape a unique pattern of:

- investment results;
- discretionary or mandated distributional stresses; and,
- mortality (in the case of certain irrevocable family trusts).

The investment fiduciary gains a comprehensive picture of portfolio performance over a broad range of future economic conditions. Furthermore, simulation modeling allows performance results to emerge directly from the data rather than forcing the data to conform to the statistical characteristics of a pre-selected distribution. This difference, although subtle, is important for trustees wishing to base asset management decisions on credible information.

Simulation modeling is especially appropriate when the investment fiduciary confronts competing economic objectives. This might be the case for the endowment plan seeking to increase current expenditures while simultaneously growing the portfolio to fund future projects, or for the trustee of a testamentary trust with an obligation to provide funds sufficient for the income beneficiary while maintaining the value of the corpus for the benefit of the remaindermen.

XXI. CASE STUDY: AN ENDOWMENT PORTFOLIO

In order to motivate a discussion of how simulation modeling provides the investment fiduciary with the proper tools for risk measurement and risk management, we discuss some investment challenges faced by an endowment plan. In this example, trustees intend to utilize the current \$10,000,000 investment corpus to provide a yearly income to the institution in the amount of \$500,000 indexed to inflation. Additionally, the trustees would like to preserve the purchasing power of the portfolio so that the fund can withstand the stress of future inflation-adjusted distributions as well as attendant fees and expenses of investment management. For illustration simplicity, the hypothetical example assumes no future donor contributions (i.e. all cash inflows are the results of investment earnings), although simulation analysis is a good vehicle for incorporating a random variable for future cash flows from charitable gifting.

A list of trustee concerns includes:

- How well is the current asset allocation suited to the needs, terms and purposes of the endowment?
- How can trustees evaluate alternative asset allocation elections?
- What are the tradeoffs of various asset management strategies (active vs. passive management, rebalancing strategies, etc.)?

In essence, the trustees are concerned about the financial effects of their current investment and asset management decisions. Specifically, they must measure the consequences of these decisions on the future dollar value of the portfolio. The set of decisions that evidences the greatest likelihood of achieving future success is optimal. This likelihood is easily measured in terms of failure rates. All else equal, decision sets that generate low failure rates are preferred over decision sets that generate higher failure rates. In this case, the board of trustees defines failure rates in terms of income streams (i.e. how likely is it that the dollar value of the portfolio will, at some future date, be inadequate to fund the inflation-adjusted income targets); and, in terms of inflation-adjusted floor values for the portfolio (required reserve equal to \$8 million).

It is important to note that the risk/reward tradeoff that trustees must consider has a unique definition in the context of fiduciary asset management. The trustees are not necessarily asked to select the decision set that generates the highest return (max/max strategy) or even the highest expected (mean) return. Rather, they are charged with using the requisite degree of care, skill, and caution to maximize the probability of a successful outcome in terms of competing economic objectives. Attention is best focused on median results of asset management decisions as well as the risk that such decisions will produce results outside of acceptable boundaries. Thus, the tradeoff might be expressed in terms like: "if you elect this allocation, the median value of the endowment fund increases by 4%. However, the likelihood that the investment corpus will sink below the required reserve increases by 6%." The asset allocation decision (as well as other asset management elections) often becomes a trade off between upside growth and downside failure rates. Simulation makes it easy for trustees to operate a very sophisticated risk compass.

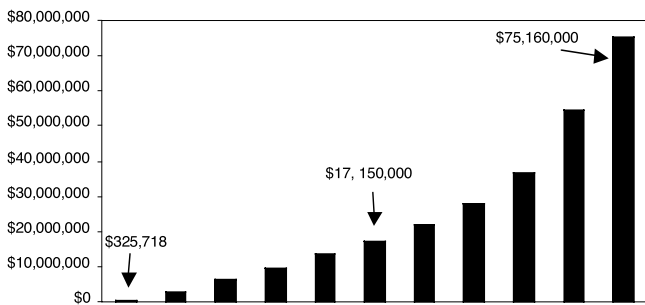
The board of trustees confronts the issue of investment utility not from a formulaic point of view; but, rather, from a perspective that is more concrete (i.e. expressed in dollar values), intuitive (easy to understand), and specific (data is particular to the investment issues at hand). In summary, the critical challenge of risk measurement reduces itself to failure rate analysis (downside risk vs. future portfolio wealth), while the formidable task of risk management reduces itself to ongoing monitoring of the portfolio in terms of its dollar value sufficiency to discharge future



objectives. If we originally defined the goal in structural terms (i.e., building a portfolio that aligns the asset allocation with the risk tolerance and economic objectives of the trust), it is now defined as a process (i.e., selecting an optimal set of decision variables and monitoring the interconnected system on an ongoing basis to determine that it remains within the failure rate guidelines established by trustees). The conceptual model of the investment fiduciary as portfolio architect gives way to the model of the investment fiduciary as systems engineer.

The following charts depict how simulation analysis illuminates the future consequences of current portfolio and asset management decisions. Simulations incorporate historical data for asset classes during the period 1973 through 2000. The first chart shows the distribution of 20-year portfolio values assuming an initial value of \$10 million, a 70% S&P 500 stock index and 30% Long-term U.S. bond index allocation. The portfolio reflects a yearly inflation-indexed distribution of \$500,000:

**Chart 6 — 20th Year Endowment Fund Values:
90% Confidence Interval**



The chart depicts a 1000 trial simulation of the endowment fund's future values (expressed in constant dollars). Specifically, by maintaining a 70% S&P / 30% Long-Term Bond allocation, the trustees can expect the investment performance to generate a 20th year purchasing power value equal to \$325,718 *or worse* at a 5% probability; or, at the other extreme, to generate a 20th year purchasing power value equal of \$75,160,000 *or better* at a 5% probability (rounded to the nearest \$10 thousand). The average value (not shown) over 1000 trials equals \$25,000,000 in inflation-adjusted purchasing power. However, this average value is misleading because it suggests that the endowment portfolio can withstand the stress of a \$500,000 constant dollar distribution; and, will grow to 250% of its initial value. It is misleading for two reasons:

1. It represents a point-estimate when, in fact, future results may take values over a wide range; and,
2. It skews future results and does not indicate the median, which is the more appropriate measure of likely investment performance.

Half of simulation trials produce values below the median of

\$17,150,000 while half of the trials produce results in excess of this amount. Thus, the median is the result, on average, that the trustees can expect to realize rather than the average portfolio value (mean or expected value) over all trials.

Despite the fact that, on average, the portfolio succeeds, the chart suggests that there is considerable risk of failure. Indeed, there is a 5% chance of driving the fund's purchasing power from \$10,000,000 to \$325,000 *or worse*. The trustees wish both to avoid running out of funds with which to support ongoing distributions in support of the institution's spending policy and to avoid depleting the future purchasing power of the endowment so that it is unable to support projects for future generations. In terms of these competing objectives, is the two-asset class macro-allocation optimal for the endowment portfolio? In this case, it is helpful to track three critical failure rate variables so that trustees can assess the risk/reward tradeoffs of their investment decisions. Specifically, the 1000 trial simulation indicates the following failure rates for the allocation under evaluation:

1. 20th Year Portfolio Bankruptcy rate: 4.1%
2. Values below \$800,000 floor (nominal dollars) during the 20 year period: 20.0%
3. Values less than 5 years projected distribution requirements during the 20 year period: 10.8%

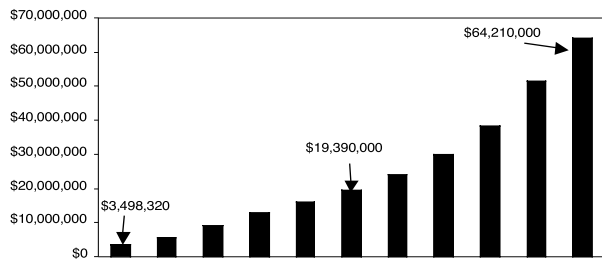
To what extent, if any, can the trustees improve the portfolio's risk/return posture? If the earlier observations of this essay are true, the best strategy for increasing median compound wealth while improving the shape of risk is a strategy of scientific diversification. The following chart depicts the results of diversifying the \$7 million equity position from a single asset class to multiple asset classes:

- U.S. Large Company Stocks: \$1.5 million
- U.S. Large Company Value Stocks: \$1.5 million
- U.S. Small Company Stocks: \$750 thousand
- U.S. Small Company Value Stocks: \$750 thousand
- Large Company International Stocks: \$1.5 million
- Small Company International Stocks: \$1 million

Likewise, the revised allocation shifts the \$ 3 million U.S. long-term bond portion of the portfolio to the aggregate index of U.S. government and corporate bonds (i.e. an index consisting of short, intermediate and long-term bonds).



**Chart 7 — 20th Year Endowment Fund Values:
90% Confidence Interval With Increased Diversification**



The dispersion of results becomes much tighter. The magnitude of the big, albeit improbable, payoff reduces from \$75 million to \$64 million. Floor values, at the 5% probability level increase approximately ten fold from \$325,718 to \$3.5 million. Finally, median results show a \$2 million plus improvement. Not surprisingly, improvements in critical failure rates also demonstrate the benefits of diversification:

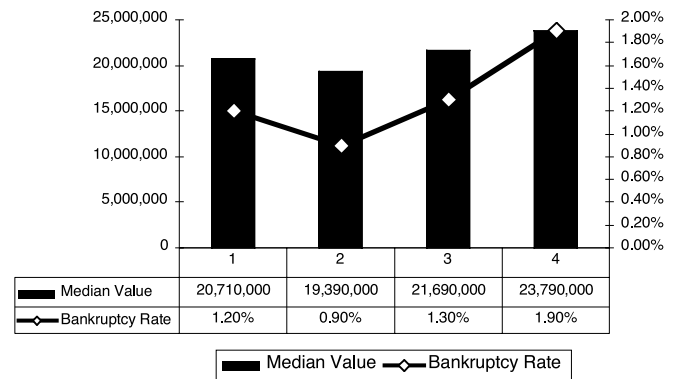
	Two Asset Class Portfolio	Diversified Portfolio
Bankruptcy Rate	4.1%	0.9%
Trials < floor value	20.0%	7.9%
Trials < 5 yrs distribution requirements	10.8%	4.0%

For example, the poorly diversified portfolio experiences bankruptcy (portfolio value equal to \$0.00 in year 20) in 41 out of the 1,000 trials. The diversified portfolio, however, experiences bankruptcy in only 9 of the 1,000 trials. These results suggest that the treasure-hunting investment fiduciary, who eschews diversification in favor of seeking big paydays, increases the risk of a fiduciary surcharge for imprudent asset management unless all interested parties have flat utility curves.

The following chart provides insight into the risk/return tradeoff of four well diversified portfolios with differing asset allocations:

- Portfolio 1: 65% Equity / 35% Bonds.
- Portfolio 2: 70% Equity / 30% Bonds.
- Portfolio 3: 75% Equity / 25% Bonds.
- Portfolio 4: 80% Equity / 20% Bonds.

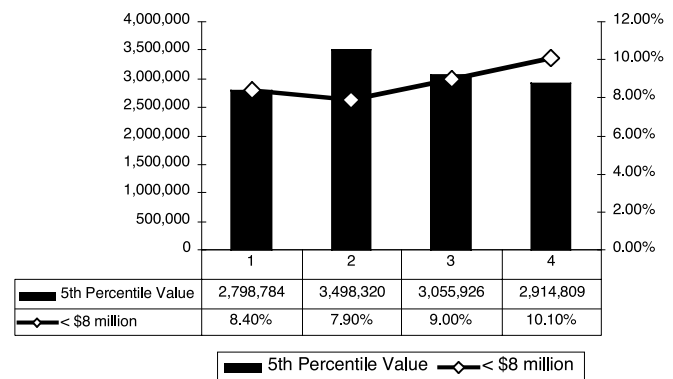
Chart 8 — Risk Return Tradeoff: Median Values



Each portfolio rebalances to its target allocation annually.

Although the relationships between the percentage commitment to equity and median values / bankruptcy risks are not strictly linear, nevertheless, there appears to be a positive association between high median values and bankruptcy risk (within the interval of 65% to 80% equity exposure). This result may appear counterintuitive in that more money usually suggests a lower chance of bankruptcy. However, the median value merely provides information regarding the 50th percentile of the distribution of simulation results. The 5th percentile provides useful information regarding the lower boundary of results (results of the fifty worst outcomes out of 1,000 trials). The 5th percentile results are, therefore, the results that are equal to or worse than results expected at a 5% level of probability. The next chart is a graphic depiction of the relationship between lower bound portfolio levels and the risk of the nominal value of the portfolio dropping below the designated floor value of \$8 million (in any month within the 20 year period) for each of the four asset allocations:

Chart 9 — Risk Return Tradeoff: 5th Percentile Values



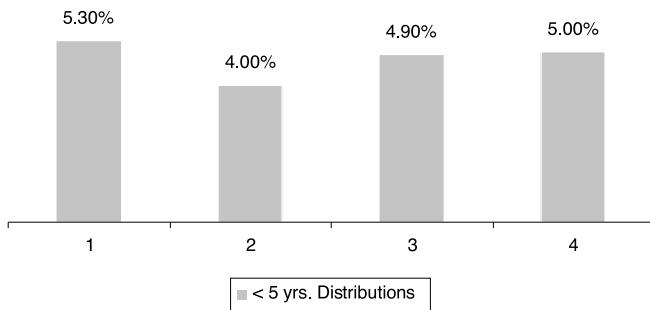
The chart indicates that the 70% equity allocation is close to the minimum value of the failure rate function when the function is defined as wealth below an acceptable floor value. Moving either direction (towards a lower or a higher commitment to equity) does not produce improvement in either the risk or the return posture of the portfolio from the perspective of lower bound results. Although lower bound portfolio values are substantially below the designated



floor in every allocation, the 70-30 diversified portfolio produces the “least worst” results. As the chart indicates, during the 20 year period only 79 of the 1,000 trials (7.90%) exhibited portfolio values less than \$8,000,000 for the 70-30 portfolio. When equity exposure increases to 80%, the failure rate increases to double digits (10.10%). Although, from this perspective, the 70-30 diversified portfolio dominates the other allocation alternatives, its dominance is preference dependent and should not be generalized into a rule of thumb for asset management. Selection of other floor values and enhanced diversification into other equity and fixed income asset classes such as real estate, global bonds, etc. may change relative preference rankings.

The final definition of the failure rate function is the number of trials that produce values insufficient to fund projected expenses over any forthcoming five-year period. The next chart depicts the relationship between equity commitment and portfolio sufficiency:

Chart 10 — Asset Allocation and Portfolio Sufficiency Risk



In terms of failure rates measured along the portfolio sufficiency variable, the 70-30 allocation of portfolio 2 also generates favorable relative results. These results, however, are not a free lunch because the median value of the 70-30 allocation is approximately \$4.5 million below that of the 80-20 portfolio (see Chart 8). Thus, the trustees must decide between trading decreased downside risk for diminishing average values. Such decisions carry significant financial consequences, and it is therefore important to base them on good data rather than on hunches, speculations, rules of thumb, or other methods lacking academic credibility or legal defensibility.

XXII. CONCLUSION: CRITICAL VARIABLES FOR PRUDENT ASSET MANAGEMENT

Programs may fail not because they have funds inadequate in terms of their objectives, but rather because the stewardship of the trustees is deficient — i.e. they lack a reasonable decision making process. One variable that is critical to long-term success is the yearly costs of asset management. When investing in capital markets that are, for the most part, relatively efficient, investment costs are the greatest determinate of variation in the risk-adjusted performance of investment managers. Although the Third Restatement allows for both passive (low cost) investment management as well as active (higher cost) management, it

cautions investment fiduciaries to make an informed determination that active management is suitable for the trust. Faced with the expectation of higher investment management costs, the fiduciary must judge that gains from the course of action in question can reasonably be expected to compensate for its additional costs and risks.

What is the value of 50 basis points? The temptation is simply to say that the value is a very small amount (one half of 1%), which is only a modest decrement to a portfolio’s rate of investment return. However, the failure rate profile for the \$10 million sample endowment fund changes considerably if we relax the assumption that investment returns are not subject to portfolio frictions (fees, expenses, professional services, commissions, and other trading and management costs).

For illustration purposes, we compare the failure rates for three portfolios:

1. The 70/30 diversified portfolio without investment expenses (as illustrated in the above examples);
2. A 70/30 diversified portfolio with total investment expenses of 75 basis points (minimum yearly expenses equal \$10,000); and,
3. A 70/30 diversified portfolio with total investment expenses of 125 basis points (minimum yearly expenses equal \$10,000).

The following charts compare 20-year median values, and 5th percentile values, as well as bankruptcy, floor value and portfolio sufficiency failure rates.

Chart 11 — 20 Year Median Values in Constant Dollars

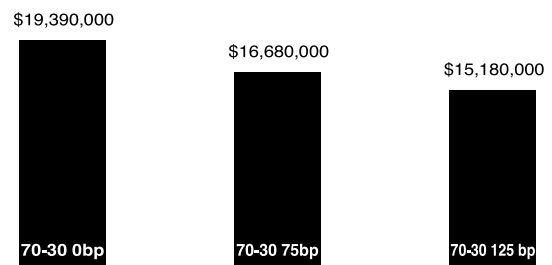


Chart 12 — 20 Year 5th Percentile Values in Constant Dollars

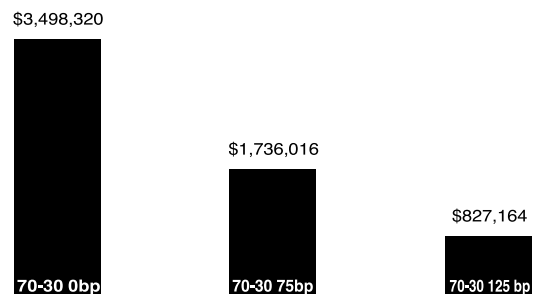
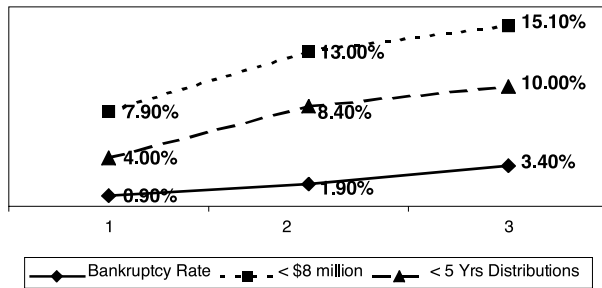




Chart 13 — Failure Rate Analysis



The above sequence of graphs shows that small decrements to return, compounded over a sufficiently lengthy horizon, result in large decreases in value as well as significant increases in failure rates. This is particularly striking with respect to portfolio bankruptcy rates where a 50 basis points increase in portfolio costs (75 to 125 basis points) generates an approximately 80% increase in the failure rate, 50% less value at the 5th percentile of the distribution of simulation results, and 14% less in terms of the purchasing power of the median portfolio results.

Finally, what decisions will trustees face one year from now if the value of the endowment fund plunges by 10%? Is it prudent to continue the targeted distribution rate under these circumstances? How will failure rates and projected dollar values change? What adjustments to spending policy are required to maintain risk/return targets? Effective asset management, through surveillance and monitoring program, benefits from the ability to provide accurate answers to these questions.

Simulation analysis helps the investment fiduciary to achieve insights into risk and return that, in many respects, are superior to those generated through utility analysis or through parameterizations of historical data either fitted to a specific return distribution or to a distribution selected a-priori. Not only does it resolve many methodological conundrums, but also enables critical examination of complex sets of decision variables. Fee schedules, investment management costs, expected alphas of active management strategies, asset allocations, rebalancing schedules, tax apportionment, mortality concerns, cash flows and other dynamic operators are readily evaluated in terms of their future consequences for current decisions. The decision sets that promote the risk/return objectives of the trust are both identifiable and quantifiable, while decision sets that are detrimental to future objectives can be avoided, mitigated or eliminated.

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Endnotes

- 1 Data based on S & P 500 US Stock Index Returns and Lehman Long Term US Corporate / Government Bond Index Returns for the period 1973 through October of 2001. Return series unadjusted for estimated expenses. Software program copyright Ibbotson & Associates, Inc.
- 2 A Bernoulli trial is an outcome that only admits two possibilities: the coin is heads or tails; the test for anthrax is positive or negative; the student will pass the course or fail. In a Bernoulli trial, a specific probability is assigned to each outcome and the outcome can be measured [where a success/failure trial is measured in terms of 1 (for success) or 0 (for failure)].
- 3 An arc sine is the measure in radians of an angle within a circle of 2 Pi radians. It is the inverse of the sine function which gives the ratio of the y coordinate to the hypotenuse of the circumscribed triangle when the angle at the origin is known.
- 4 There are a variety of different types of curves that can fit into the generalized mathematical model known as von Neumann-Morgenstern utility functions (named after two Princeton University mathematicians who developed comprehensive game theory models that underlie much U.S. defense department battle doctrine including the theory of nuclear deterrence: mutual assured destruction or MAD).
- 5 Power Utility functions [U(W) — (W to the gamma power) divided by gamma] exhibit decreasing absolute risk aversion for certain values of g; and functions like the logarithmic and negative exponential [U(W) = -e to the -aW power] exhibit a property called constant relative risk aversion.
- 6 It may be inappropriate to apply general "maxims" such as the superiority of "optimal growth" portfolios to any specific investor. There is a rich set of literature exploring such topics as the optimal portfolio choice for individuals in the face of labor income risk, and the optimal portfolio for endowments faced with positive correlation between stock market performance and donor gifts. We can say with

some confidence, however, that, if you have quit your day job to become a full time stock trader on the Internet, you should consider optimal growth portfolio mathematics very seriously. On the other side of the coin exists the "interior decorator fallacy" that suggests that investment portfolios should mirror the fashions of the day and the subjective tastes of the portfolio owner. Advertisements from the stockbroker community often use vocabulary that promotes this fallacy.

- 7 The reader can note that the earlier Taylor Series expansion for approximation of compound return has a value of A equal to 1 and a value of the exponent equal to 2 (the square of standard deviation equals variance); or, compound return = $E[Rt] - (1/2)(st)^2$.
- 8 The logarithmic function is the inverse of the compound growth function which was approximated by:

$$\text{Compound Growth} = \text{Expected Return} - 1/2(\text{Variance})$$

where variance is the square of standard deviation. The addition of leverage (Lev) to the right hand side of the equation produces:

$$\text{Lev}(\text{Expected Return}) - 1/2(\text{Variance})(\text{Lev}^2)$$

Recalling, from calculus, that the maximum value of a function is found when its first derivative is set to zero, we take the first derivative with respect to leverage:

$$E - \text{Lev}(V) \text{ or,} \\ \text{Optimal Leverage} = E/V$$

In terms of the 60/40 portfolio, Optimal Leverage = Expected Return [E] ÷ Variance [V], or $.0636 / (.0912^2) = 7.66$.

- 9 However, stochastic dominance approaches provide powerful evidence to suggest that switching or "market timing" strategies between risky and risk free investments are suboptimal.

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ALASKA'S FIVE-YEAR EXPERIENCE WITH SELF-SETTLED DISCRETIONARY SPENDTHRIFT TRUSTS

By David G. Shaftel, Esq.*

[Editor's Note: An earlier version of this article was published in the October 2002 issue of Estate Planning magazine. This revised version is reproduced here for the convenience of the readers of the California Trusts & Estates Quarterly.]

Five years ago, Alaska approved the creation of self-settled discretionary spendthrift trusts. This article examines how these trusts have been used in Alaska and analyzes planning for these trusts in light of existing authority.

In 1997, Alaska was the first state to enact a usable statute authorizing self-settled discretionary spendthrift trusts ("SSDS Trusts").¹ In this article, an "SSDS Trust" means an irrevocable trust which authorizes an independent trustee, in such trustee's absolute discretion, to make distributions to a class of beneficiaries which includes the settlor. In addition, Alaska made its first attempt to abolish the rule against perpetuities, so as to allow the formation of Alaska perpetual trusts.² Five years have elapsed. Many non-Alaska practitioners have inquired about Alaska's experience with SSDS Trusts. For the period from 1997 to the present, the following experience has been reported.³

In a survey conducted by the author, Alaska trustees report that approximately 870 trusts have been formed under Alaska law by nonresidents of Alaska.⁴ Of these, approximately 310 are SSDS Trusts, and the balance are perpetual trusts. Most of the SSDS Trusts also used a perpetual trust plan. Approximately 110 attorneys provided the legal services for the creation of these trusts.

Alaska estate planning attorneys report that approximately 125 SSDS Trusts have been formed for Alaska residents. In addition, 200 to 300 perpetual trusts have been created for Alaskans. Several lawyers report that their standard "default plan" for medium and large estates now is based on a perpetual trust dispositive plan. Approximately 60% of both the resident and nonresident SSDS Trusts have involved contributions of assets which were completed gifts for federal gift tax purposes.

Preliminary inquiries of several trust companies and attorneys in the three other states that have recently enacted statutes authorizing SSDS Trusts have produced the following

data.⁵ Delaware contacts report that approximately 300 SSDS Trusts have been formed by nonresidents. These Delaware trusts are funded with approximately \$2 billion of assets. Most of these trusts involve incomplete gifts. Inquiries of Nevada and Rhode Island attorneys indicate that so far there is little activity involving nonresidents forming SSDS Trusts under their laws.

When the Alaska Legislature enacted statutes authorizing the creation of SSDS Trusts in 1997, the initial focus was on asset protection. Gifts to such pure asset protection trusts would often be structured to be "incomplete" for gift tax purposes.⁶ This would allow substantial funding without the payment of gift tax. Advocates of foreign trusts correctly pointed out that persons seeking maximum asset protection should look offshore. As a result, in the five years since passage of the Alaska statutes, the primary focus of Alaska SSDS Trusts has changed from asset protection to transfer tax reduction. The use of SSDS Trusts for such tax reduction is also the focus of this article.

The following example of a "planning dilemma" illustrates the use of SSDS Trusts for transfer tax reduction planning. The balance of this article discusses (1) how such trusts have been structured and implemented in Alaska, (2) the use of SSDS Trusts by nonresidents of Alaska, (3) how an SSDS Trust could fail, and (4) planning analysis in view of the existing authority. Tax and asset protection issues are identified, and their merit is discussed. However, an in-depth analysis of these issues is not the goal of this article. Such analysis has been accomplished in the articles cited in the footnotes.

I. THE PLANNING DILEMMA: EARLY GIFTING VERSUS FUTURE POSSIBLE NEEDS

Consider this planning situation: your clients are a couple in their fifties. One or both is a small business owner, executive, or professional. Their net worth is in the range of \$3 to \$10 million. Substantial estate taxes could be saved if your clients made annual exclusion and applicable credit gifts to irrevocable trusts for their children and/or grandchildren. These gifts will not render the clients insolvent, nor will they be transfers made with an intent to evade existing creditors. The gifts could be structured so that they qualify for valuation discounts, and the growth of the gift assets would be excluded from your clients' estates.⁸ Based on your clients' net worth, and anticipated future earnings, it appears that these gifted amounts would not be needed by them. Nevertheless, your clients are reluctant to give away significant assets at this point in their lives. They tell you that they might need these assets in the future if they have an unexpected financial reversal.

Your clients ask if they can be added as discretionary beneficiaries of the trust. Then the trustee can make distributions to them if needed. You respond that if they were added as



discretionary beneficiaries, the IRS could successfully argue that the trust assets should be included in their gross estates at death and be taxed under the federal estate tax.

The reason is that your state has a statutory or case law policy that provides that if the settlors are discretionary beneficiaries of the trust, the settlors' creditors can reach the maximum amount that the trustee could distribute to the settlors and, in many instances, this would be all the assets in the trust.⁹ Therefore, the settlors could “run up” debts and the settlors' creditors could reach the trust assets to satisfy these obligations. Another way of looking at the situation is that the settlors, indirectly, have retained the ability to reach the trust assets through incurring debts.

This indirect retention of the use of the trust assets prevents the settlors' transfers to the trust from being completed gifts for gift tax purposes.¹⁰ Moreover, such indirect retention would result in the trust assets being included in the settlors' gross estates under IRC §§ 2036 and 2038.¹¹

II. ALASKA'S STATUTORY CHANGE PROVIDES A SOLUTION

In 1997, the Alaska Legislature changed Alaska law to authorize the use of SSDS Trusts. The new legislation provided, in effect, that under Alaska law a settlor may create an irrevocable trust, transfer assets to it, be a discretionary beneficiary of such trust, and yet, the settlor's creditors cannot reach the assets in such a trust.¹²

From a transfer tax standpoint, because the settlor's creditors cannot reach the assets in the trust, the settlor's ability to incur debt does not give the settlor “dominion and control” over the trust assets.¹³ Accordingly, the settlor's transfers to a SSDS Trust are completed gifts. The IRS has agreed.¹⁴ In addition, proponents of SSDS Trusts contend that none of the inclusion provisions of the federal estate tax apply to the assets in an Alaska SSDS Trust. The proponents' position is that the settlor has not retained the enjoyment or income from the assets (I.R.C. § 2036), nor does the settlor possess at death the power to alter, amend, revoke, or terminate the transfer (I.R.C. § 2038). Hence, the trust assets should be excluded from the settlor's gross estate. In the application for Private Letter Ruling 9837007, the Alaska settlor stated her position that the trust not be includible in her estate. In response, the Service declined to rule.

As a result, the clients in our example (above) may create an Alaska SSDS Trust, make annual exclusion and applicable exclusion amount gifts to the trust,¹⁶ and be included in the class of discretionary beneficiaries to whom an independent trustee may make distributions. A strong position exists that such assets will not be included in their gross estates at their deaths. If the clients need funds in the future, due to an unexpected financial

downturn, the trust assets are available.

III. HOW A SSDS TRUST IS STRUCTURED AND FUNDED

Often, settlors first form a family limited partnership (“FLP”) or family limited liability company (“FLLC”).¹⁷ These entities are funded with investment assets such as interests in closely held businesses, real estate, and marketable securities. The clients may desire that they, or family members, be the general partners or managers. Then, the clients give to the SSDS Trust the limited partnership or non-managerial interests. In this way, clients – or their family members – retain the ability to manage the assets and to decide when distributions will be made to the trust. Giving gifts of the non-managerial interests qualifies for valuation discounts.

A “rule of thumb” has developed concerning the portion of a client's assets which should be transferred to an SSDS Trust. This “rule” limits such assets to no more than one-third (conservative) to one-half (aggressive) of the client's net worth. The rationale for this “rule” is that a settlor would not give away assets which the settlor knew with some certainty that he or she would need in the future, unless the settlor also knew that he or she could get the assets back. Thus, the transfer of too large a proportion of the settlor's assets to an SSDS Trust invites a court finding that an

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agreement exists between the settlor and the trustee.¹⁸

A. Trust-Owned Life Insurance

SSDS Trusts have also become a vehicle for the ownership of life insurance on the settlors' lives. For example, suppose the clients wish to purchase a second-to-die life insurance policy that will develop substantial cash value and will benefit from income tax-free inside buildup. However, the clients want the ability to reach the value of the policy if they have a financial reversal.

If the policy is owned by an SSDS Trust, the independent trustee may borrow from the insurance company, or even cash in the policy, in order to make discretionary distributions that are needed by the settlors. The fact that the settlors are discretionary beneficiaries of the trust does not appear to be enough to conclude that they have retained "incidents of ownership" in the policy.¹⁹ Nevertheless, careful choices of trustees and drafting are necessary in order to ensure that such incidents of ownership are not attributable to the clients.

B. The Dispositive Plan

A typical SSDS Trust will provide that the independent trustee has absolute discretion to make distributions to a class of beneficiaries that includes the settlors and their descendants. This absolute discretion is provided in order to avoid an exception to the Alaska spendthrift rule for any portion of a trust's income or principal which must be distributed to the settlor.²⁰ Further, absolute discretion avoids contentions that a beneficiary (or the beneficiary's creditors) can force a trustee to make distributions pursuant to an ascertainable standard stated in the trust instrument.²¹ For instance, a creditor could argue that maintenance or support includes the payment of the beneficiary's creditors. Alternatively, a creditor could argue that a trustee is required, pursuant to an ascertainable standard, to distribute assets to an insolvent beneficiary. Then, the creditor could attempt to attach the distributions.

Often, an SSDS Trust will contain a perpetual trust dispositive plan to be implemented after the deaths of the settlors.²² A perpetual trust dispositive plan is designed to provide the following advantages for the non-settlor beneficiaries: (1) asset protection for descendants; (2) elimination of transfer tax upon the portion of the assets held in a generation-skipping transfer ("GST") tax-exempt trust; (3) management; (4) an "estate plan" that is already in place; and (5) probate avoidance.²³

C. Choice of Trustee

At least one trustee of an SSDS Trust should be an independent trustee. This independent trustee has all trust distribution powers under the absolute discretion standard. In

order to preserve the independence of the trustee, there must not be any agreement between the independent trustee and the settlor regarding distributions. The existence of such an agreement would allow the settlor's creditors to reach the trust assets because the settlor would have a right to the distribution of the assets. The result would be inclusion of the assets in the settlor's gross estate. Such an agreement could be written, oral, or implied through a pattern of distributions.²⁶ It would be more likely that a court might imply an agreement between the trustee and settlor if the independent trustee had a relationship with the settlor. Such relationships would include being a close relative, close friend, or employee. Because the transfer tax advantages depend on the premise that the settlor's creditors cannot reach the assets in the trust, it is very important to choose a trustee who will minimize the risk that an implied agreement will be found.

In addition to an independent trustee, some clients wish to appoint a family trustee who will have some or all of the administrative responsibilities for the trust. These are not tax-sensitive duties²⁷ and should not affect the creditor protection of the trust. However, if the trust owns insurance policies insuring the life of a family trustee, the managerial duties relating to such policies must be reserved for the independent trustee to avoid inclusion of the insurance proceeds in the family trustee's gross estate.

The state where a potential trustee resides must be considered. A creditor can obtain jurisdiction over the trust in that state. Then, that state's courts will first decide conflict of laws issues, and a judgment from such state's courts will be entitled to full faith and credit in Alaska. Moreover, if the trustee resides in a state that has an income tax, that state may assert its tax against the trust.²⁸

D. Future Amendments

The newness of SSDS Trusts and the ambiguous state of the law has encouraged drafters to build flexibility into the trust instrument. The independent trustee, or an independent trust protector, is often given the authority to amend the trust instrument in order to adjust for future changes in the tax law.²⁹ A trust protector may be given the power to eliminate the settlor as a discretionary beneficiary of the trust³⁰ and to change the choices of trustees. The goal of such provisions is to allow future adjustments so that the trust assets will not be included in the settlor's gross estate if the tax law is interpreted or changed in a manner indicating that such inclusion is likely.

E. Use of SSDS Trusts by Nonresidents of Alaska

The framers of the Alaska SSDS and perpetual statutory trust provisions considered that persons located outside Alaska might well be interested in using such trusts. Consequently, they enacted statutory provisions which the framers thought would



establish a sufficient Alaska nexus so that Alaska law would apply to nonresident trusts.

These provisions require that some or all of the trust assets be deposited in Alaska and administered by a “qualified person,” who is either an individual who is an Alaska resident or an Alaska trust company or bank.³¹ The powers of the Alaska trustee include, or are limited to, maintaining records for the trust on an exclusive or nonexclusive basis and preparing or arranging for the preparation of, on an exclusive or nonexclusive basis, an income tax return that must be filed by the trust. Part or all of the trust administration is to occur in Alaska, including physically maintaining trust records in this state.³²

In order for nonresidents to achieve the transfer tax benefits of an SSDS Trust, they must qualify for the underlying asset protection provided by the Alaska statute. Additional issues have been raised questioning such qualification. These issues are discussed below in the section entitled, “How Could a SSDS Trust Fail?”

F. Subsequent Alaska Legislation Facilitating SSDS Trusts

In addition to the 1997 legislation which reversed the general rule concerning SSDS Trusts and abolished the rule against perpetuities, the Alaska Legislature subsequently enacted a number of other provisions that facilitate the use of these trusts and trust administration in the state.³³

III. HOW COULD A SSDS TRUST FAIL?

As discussed above, this type of transfer tax planning first depends on the asset protection foundation. Once an adequate asset protection foundation exists, then the inquiry shifts to analysis of two federal estate tax provisions (IRC §§ 2036 and 2038) and contention regarding the Contract Clause.

Residents of states that have enacted SSDS statutes have a strong position concerning the asset protection foundation.³⁴ Nonresidents who establish SSDS Trusts have additional issues relating to whether they have an adequate asset protection foundation: the Full Faith and Credit Clause and the bankruptcy court scenarios.

If the transfer tax issue is contested, the asset protection foundation will be hypothetical. There will not be a creditor trying to reach the assets of the trust. The court will need to decide if an “adequate” asset protection foundation exists for the settlor in question. Such a foundation may well not need to be perfect and without any theoretical weaknesses.

A. Application of Sections 2036 and 2038

With the above analytical approach in mind, first consider

the provisions of the estate tax. If applicable state law prevents the settlor's creditors from reaching the trust assets, then § 2038 does not apply because, as of the date of the settlor's death, the settlor does not have the power to revoke the trust by relegating creditors to the trust assets. The remaining estate tax issue is whether, pursuant to I.R.C. § 2036(a)(1), the settlor has retained enjoyment of, or the right to income from, the trust assets. Initially, the plain language of the statute which requires “retention” does not seem to apply to a settlor-beneficiary who may receive distributions only pursuant to the absolute discretion of an independent trustee.

There are a number of authorities that support the conclusion that retention within the meaning of § 2036(a)(1) does not exist with respect to the rights of a discretionary settlor-beneficiary.³⁵ Shortly after the Alaska statute was enacted, a primary journal commented:

If the grantor's retained interest is discretionary, his creditors cannot reach the trust property, except as provided in the statute. Thus, under existing estate tax authority, the trust property would not be includible in the grantor's gross estate. Transfers to the trust without taxable gifts could be made by a grantor through annual exclusion gifts using powers of withdrawal.³⁶

Another analyst, Professor Dodge, states that “[t]he better rationale for the exclusionary rule here is that the grantor has not ‘retained’ the income from the transferred property.”³⁷ Professors Stephens, Maxfield, Lind and Calfee state in their treatise:

If he has no legal right to income, the “income” phrase would not support inclusion under Section 2036. Perhaps it may be said he has retained “enjoyment”. However, if some meaning is to be accorded the word “retained,” some showing of an arrangement, more than the fact that income was paid to the decedent, should be required.

* * *

Since such transfers are treated as complete when made for gift tax purposes (see Rev. Rul. 77-378, 1977-2 C.B. 347), . . . there is even less reason for the imposition of estate tax liability under Section 2036.³⁸

One critical analyst of these authorities, Professor Pennell, finds some to be indirect or not on point but concedes there is supporting authority for the conclusion that the trust assets will not be included in the settlor's gross estate.³⁹

Finding “retention” under the existing language of I.R.C. § 2036, based only on the settlor's status as a discretionary beneficiary, is a significant stretch. In a similar situation



involving questionable coverage by § 2036 of joint purchases of property, the Treasury Department found the need for a statutory change.⁴⁰ One analyst concluded, “[i]t was sufficiently unclear whether § 2036(a)(1) would apply to such a case that § 2702(c)(2) specifically addresses this form of transaction.”⁴¹ If § 2036 is amended to expressly include SSDS Trusts, and if such amendment is stated to be a change in the law, then its effect should be prospective. Existing SSDS Trusts should be grandfathered. If the amendment is stated to be only a clarification of the law, this issue of statutory interpretation will continue for existing SSDS Trusts. Nevertheless, as a practical matter, the Service may take a much less aggressive position in regard to trusts formed prior to the amendment.

Interestingly, if there were a statutory change in § 2036 with regard to SSDS Trusts, there is no certainty that the change would be designed to produce inclusion of the trust assets in the settlor's gross estate. Congress' recent legislative changes in the transfer tax area have gone in the other direction.⁴² A reasonable argument can be made that § 2036 should be amended to expressly allow a settlor to create an SSDS Trust in any jurisdiction in order to solve the “planning dilemma” described earlier. Such an accommodation might help alleviate the tension between complete repeal of the estate tax and the “sunset” that exists under the Economic Growth and Tax Relief Reconciliation Act of 2001 (“2001 Tax Act”).

Alternatively, faulty implementation of the trust could result in estate tax inclusion. The specific choices of trustees, documentation, and pattern of distributions may justify a court finding that an agreement existed between the settlor and the trustee to make certain distributions. This would constitute the retention of an income interest, and I.R.C. § 2036 would apply.⁴³ The result would be inclusion of trust assets in the settlor's gross estate.⁴⁴

B. The Contract Clause

Next, consider the Contract Clause⁴⁵ contention, which applies to both residents and nonresidents of SSDS states. To violate the Contract Clause, an SSDS statute must substantially impair the obligations of parties to existing contracts or make them unreasonably difficult to enforce.⁴⁶ The violation of the Contract Clause occurs because of the retroactive effect of the statute upon contracts that exist on the date of enactment of the statute.⁴⁷ Creative arguments have been made in support of a Contract Clause violation by the new SSDS statutes.⁴⁸ The settlor's response would be that a contract creditor still has adequate remedies under the state's fraudulent conveyance statute. The contract creditor would then contend that if the transfer does not constitute a fraudulent conveyance, then the settlor has successfully protected assets which the contract creditor could otherwise have reached.⁴⁹

The relevance of this Contract Clause contention to transfer tax planning involves the completed gift issue.⁵⁰ If a settlor has existing contract creditors when the SSDS statute was passed (1997), the settlor could refuse to pay these creditors. They could then attack the transfer pursuant to the Contract Clause theory. If the contract creditors are successful, the settlor will arguably have relegated creditors to the trust's assets. The tax issue is whether in such a scenario the settlor has retained such “dominion and control” as to prevent the gift from being completed. Because this Contract Clause contention applies only to contract creditors who existed on the date of enactment of the statute (1997), as time expires this argument will become factually irrelevant to settlors forming new SSDS Trusts.⁵¹

C. The Full Faith and Credit Scenario

Now consider the full faith and credit scenario involving a nonresident settlor. Assume that a hypothetical creditor sues the settlor in the settlor's domiciliary state and obtains a judgment. Next, assume that as part of that suit, or in a separate action in the domiciliary state, the creditor proceeds against the trustee of the SSDS Trust in order to enforce the judgment against the trust's assets. The first issue is one of choice of law. Which state's spendthrift trust rules apply — Alaska's or the rules of the settlor's state of domicile? A sub-issue is whether this question is one of administration or validity of the trust.⁵² Depending on how this sub-issue is resolved, ultimate resolution of this conflict of laws issue may be factually dependent.⁵³ The public policy of the domiciliary state may need to be determined.⁵⁴

Assume that the domiciliary court chooses its spendthrift trust rules and enters a judgment against the trustee. The hypothetical creditor then proceeds to Alaska and asks the Alaska court to enforce the judgment against the trustee based upon the Full Faith and Credit Clause.⁵⁵ A basic requirement for full faith and credit is that the judgment be valid.⁵⁶ One requisite for validity is that the forum court possessed jurisdiction.⁵⁷ Assume that the Alaska trustee did not participate in the domiciliary court action and had few, if any, contacts with that state.⁵⁸ Then, the domiciliary state's jurisdiction over the Alaska trustee and the assets such trustee holds will be highly questionable.⁵⁹ Consequently, full faith and credit may well be denied.⁶⁰

D. The Bankruptcy Court Scenario

The bankruptcy court scenario must also be considered when analyzing the asset protection foundation of a nonresident settlor. This scenario includes both statutory interpretation and choice of law issues. First, assume that a creditor has forced the settlor into involuntary bankruptcy. However, § 541(c)(2) of the Bankruptcy Code expressly exempts spendthrift trusts. Therefore, in order to include the trust assets in the bankruptcy estate, the creditor must persuade the court to narrowly construe this provision to exclude



the recent Alaska, Delaware, Nevada, and Rhode Island SSDS Trust statutes. Only with such a narrow construction would the Supremacy Clause give § 541(c)(2) precedence over conflicting state SSDS provisions. Then, the trust assets would be included in the bankruptcy estate.⁶³

If the creditor fails to convince the bankruptcy court to so construe the bankruptcy code, then alternatively the creditor can argue the choice of law issue. This assumes that the creditor forces the settlor into involuntary bankruptcy in the settlor's state of domicile. The bankruptcy court will have personal jurisdiction over the Alaska trustee based on the court's national jurisdiction. The court will need to resolve the choice of law issue.⁶⁴ If (1) the bankruptcy court applies the domiciliary state's choice of law rules, (2) those rules follow the *Restatement (Second) Conflict of Laws*,⁶⁵ and (3) the court determines the issue is one of validity of the trust, then the bankruptcy court may determine that the Alaska SSDS statute violates a strong public policy of the domiciliary state.⁶⁶ As a result, the trust assets will be included in the bankruptcy estate.

This choice of law bankruptcy scenario involves a number of obstacles. First, all of the legal assumptions described above must fall into place. Next, it assumes the creditor is successful in forcing the settlor into involuntary bankruptcy. More importantly, if the settlor anticipates this scenario, the settlor may voluntarily declare bankruptcy in Alaska. This may lead the bankruptcy court to apply Alaska's SSDS rules.⁶⁸

E. Summary For Nonresidents

First, it is important to consider the difference between pure asset protection cases and transfer tax litigation. The highly publicized recent asset protection cases involved extreme facts and equities that would influence most courts to sympathize with the plaintiff-creditor.⁶⁹ The situation is quite different when the asset protection issue is hypothetical and needs resolution only so that the transfer tax issue may be determined.

The above analysis establishes that the asset protection foundation for a nonresident settlor using an Alaska SSDS Trust is not absolute. The interesting question is whether such a foundation needs to be perfect for transfer tax purposes. The above analysis describes theoretical approaches for a creditor to reach the SSDS Trust assets, if the facts are right and if a court follows a specific decision-tree. Are these approaches certain enough to undermine the asset protection foundation, for transfer tax purposes, of a carefully implemented Alaska SSDS Trust created by a nonresident? This is the crucial issue for nonresident settlors.

V. WHY DON'T WE HAVE MORE AUTHORITY?

Five years have elapsed since the enactment of Alaska's

SSDS Trust statutes. However, authority and review remain sparse. The IRS has refused to rule further on such trusts.⁷⁰ Despite the formation of numerous SSDS Trusts, practitioners in Alaska and Delaware report that as yet there is no audit experience. Consequently, there has been no administrative or judicial review of such trusts.

With respect to residents of states that have enacted SSDS statutes, the Service's estate tax statutory position appears weak. The Contract Clause contention becomes factually irrelevant as time expires. Therefore, a challenge may occur only if there is faulty implementation of the trust. Resolution of such a fact-dependent case will not be helpful for the resolution of other cases involving properly implemented trusts.

With respect to nonresidents, the additional issues revolve around whether the asset protection foundation exists. The discussion of the full faith and credit argument and the bankruptcy court scenario demonstrates that most of these issues are both highly fact-specific and depend on unpredictable decisions of domiciliary, Alaska and bankruptcy courts. When cases are decided in the future, the decisions may be narrow and limited to the specific situation involved.⁷¹

A legislative resolution of the effectiveness of transfer tax planning with SSDS Trusts is also unpredictable. At some point before 2010, Congress will likely "rethink" the transfer tax changes enacted by the 2001 Tax Act. Section 2036 could be amended to resolve this area. But which way?

In view of the above-described limited arguments available to the Service with respect to residents of an SSDS state, and the fact-specific character of the issues involving nonresident settlors, there may continue to be a lack of significant judicial authority in this area.⁷² If the tax question does arise, the Service and the estate's representative often may find a negotiable resolution.

VI. WHAT SHOULD THE PLANNER DO? EVALUATE YOUR CLIENT'S TOLERANCE FOR AMBIGUITY, AND THE DOWNSIDE

Clients considering the use of an SSDS Trust for transfer tax reduction purposes should be fully advised of the present lack of significant authority. Planners and their clients need to be aware that such authority in this area may continue to be slow in coming. Those uncomfortable with this ambiguity should not use an SSDS Trust. For clients who are still interested, an analysis should be made of the downside risk.

If the SSDS Trust approach were to fail because of one of the issues discussed above, then the following transfer tax consequences would occur. The trust assets and their appreciation will be included in the settlor's gross estate and be



subject to estate tax.⁷³ Further, the settlor has lost the benefit of the annual exclusion gifting that was made to the trust. The settlor's estate retains the use of the applicable credit amount that was originally allocated to the completed gift to the trust.⁷⁴ The settlor has lost the cost of creating and maintaining the trust.

What if the settlor made attempted completed gifts that were larger than the settlor's annual exclusion and applicable credit amounts and, as a result, paid out-of-pocket gift tax? In addition to the above consequences, the settlor would have lost the use of the out-of-pocket tax amount during the settlor's lifetime. Moreover, if the federal estate tax is permanently repealed, the payment of the gift tax would have been unnecessary.

The main downside risk appears to be that the settlor has lost the opportunity to do some different planning with the settlor's annual exclusion gifts and with the portion of the settlor's applicable credit amount used for the SSDS Trust. Would the settlor have done such different planning? How do the risks and rewards of such different planning compare to the SSDS approach? These are the key questions that the estate planner and interested clients need to resolve.

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Endnotes

- 1 Alaska's statute was passed in April 1997. Delaware immediately followed suit and enacted its version in July 1997. In 1999, both Nevada and Rhode Island passed statutes designed to implement SSDS Trusts.
- 2 In this article, a "perpetual trust" means an irrevocable trust created in a jurisdiction which has abolished the rule against perpetuities, and therefore the trust can continue as long as it has assets. Many SSDS Trusts are also designed as perpetual trusts.
- 3 The general factual information stated above and elsewhere in this article concerning Alaska SSDS and perpetual trusts is based on anecdotal, as opposed to scientific, research by the author. The author surveyed institutions and individuals who had indicated an interest in acting as a trustee for nonresident trusts. Also contacted were Alaska estate planning attorneys likely to be involved in creating SSDS Trusts for Alaska residents or in helping non-Alaska attorneys form such trusts.
- 4 The numerical counts stated in this article refer to the number of trust instruments. Each trust instrument may create one or more separate subtrusts.
- 5 See note 3 supra.
- 6 Alaska Statute 34.40.110(b)(2) allows the settlor to retain a power to veto a distribution from the trust or a testamentary special power of appointment. These approaches were authorized so that a settlor would make incomplete gifts to the SSDS Trust. However, the retention of a testamentary power may not make gifts incomplete if the trustee has discretion to make distributions to beneficiaries other than the settlor.

- 7 Giordani and Osborne, "Alaska Asset Protection Trusts: Will They Work?," included in Osborne and Schurig, *Asset Protection: Domestic and International Law and Tactics*, Special Pamphlet to 1997-4 Supplement (Clark Boardman Callaghan, 1995); Osborne, *Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches*, 33 U. of Miami Heckerling Inst. on Est. Plan. (1999); Hogan, *Once More Unto The Breach: Planning for a Conflict of Laws With Alaska and Delaware Self-Settled Spendthrift Trusts*, 14 Probate & Property (Mar./Apr. 2000).
- 8 For example, assume that your clients give gifts totaling \$1 million and that they are both 50 years of age. Further assume that these assets grow at a net rate of 5% per year and that the second to die of your clients lives to age 84. The gift assets will grow to \$5,454,648. Subtracting the \$1 million initially given to the SSDS Trust leaves growth of \$4,454,648. Assume this growth is taxed at a federal estate tax rate of 45%. This would produce taxes of \$2,454,592. This is the tax amount that would have occurred 34 years from now if your clients had not given the \$1 million to the SSDS Trust. Using the same 5% rate, avoiding this tax produces a present value savings of approximately \$449,000.
- 9 Prior to 1997, almost all states had such a policy.
- 10 Reg. § 25.2511-2(b) provides that a gift is complete if the donor "has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another" The above reasoning illustrates that this test is not satisfied by SSDS Trusts in most states.
- 11 I.R.C. § 2036 would probably apply because the settlors have retained the enjoyment of, and income from, the property by their ability to incur debt which their creditors may satisfy from trust assets. I.R.C. § 2038 would apply because the above-described ability to relegate creditors to the trust assets allows the settlors to revoke the transfer of assets to the trust. Rev. Rul. 76-103, 1976-1 C.B. 293; Rev. Rul. 77-378, 1977-2 C.B. 347; *Paolozzi v. Comm'r*, 23 T.C. 182 (1954), acq. 1962-1 C.B. 4.
- 12 Alaska Statutes 34.40.110; 13.36.310.
- 13 PLR 9332006; PLR 8037116; *Estate of German v. United States*, 85-1 USTC ¶ 13,610 (Ct. Cl. 1985); cf., *Estate of Uhl v. United States*, 241 F.2d 867 (7th Cir. 1957). See also *Estate of Wells*, T.C. Memo 1981-574 (1981).
- 14 PLR 9837007, which involved an Alaska resident and an SSDS Trust; Rev. Rul. 77-378, 1977-2 C.B. 347.
- 15 For a comprehensive discussion of these issues, including the relevant authorities, see Blattmachr and Zaritsky, *North to Alaska – Estate Planning Under the New Alaska Trust Act*, 32 U. of Miami Heckerling Inst. on Est. Plan. (1998); Pennell, 2 Estate Planning, § 7.3.4.2 (Aspen, 6th ed.); Manley, *Estate Planning and Asset Protection Using Self-Settled Alaska Trusts*, 33 U. of Miami Heckerling Inst. on Est. Plan. (1999), Spec. Sess.; and Shaftel, *Newest Developments in Alaska Law Encourage Use of Alaska Trusts*, 26 ETPL (Feb. 1999).
- 16 Gifts to a fully discretionary trust cannot be "split," under I.R.C. § 2513, with a spouse who is a discretionary beneficiary. See Handler and Chen, *Fresh*



- Thinking About Gift Splitting*, 14 Tr.&Est. 36 (Jan. 2002); Benjamin, *When Should the Option to Split Gifts be Chosen?* ETPL 24 (Jan./Feb. 1995).
- 17 Alaska's limited partnership and limited liability company statutes have both been amended so as to maximize qualification for valuation discounts. See Alaska Statutes 32.11.110, et seq., and 10.050.010, et seq.
- 18 The consequences of such an agreement are discussed below in the material on "Choice of Trustee."
- 19 See PLR 9434028; Reg. § 20.2042-1(c).
- 20 Alaska Statute 34.40.110(b)(3).
- 21 Restatement (Second) of Trusts § 155, comment b (1959); Rothschild, *Protecting the Estate From In-Laws and Other Predators*, 35 U. of Miami Heckerling Inst. on Est. Plan., pp. 17-21 through 17-23 (2001).
- 22 In 1997, Alaska took a first step abolishing its rule against perpetuities. This abolishment was perfected in 2000 by amendments designed to avoid the "Delaware Tax Trap." Alaska Statute 34.27.051-.100. See Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28ETPL 68 (Feb. 2001). Alaska is one of only several states that (1) have successfully abolished the rule against perpetuities in a manner that avoids this tax trap, and (2) also do not have a state income tax.
- 23 These planning concepts have been thoroughly analyzed and discussed by Frederick R. Keydel and Harvey B. Wallace II in "Trust Drafting for the Unforeseeable," presented at a workshop and later incorporated by Ronald D. Aucutt into *Structuring Trust Arrangements for Flexibility*, 35 U. of Miami Heckerling Inst. on Est. Plan. (2001).
- 24 Alaska Statute 34.40.110(b)(3).
- 25 See Reg. § 20.2036-1(a), which finds "retention" under § 2036 if such an agreement exists.
- 26 Cases involving I.R.C. § 2036 and an implied understanding of grantor access are discussed in Boxx, *Gray's Ghost – A Conversation About the Onshore Trust*, 85 Iowa L.R. 1195, at 1244-51 (2000).
- 27 Pennell, 2 Estate Planning, note 15 supra, at § 7.3.3, p. 320.
- 28 Coleman, *State Fiduciary Income Tax Issues*, ALI-ABA Advanced Estate Planning Techniques (2002); Gutierrez, *The State Income Taxation of Multi-Jurisdictional Trusts—The New Playing Field*, 36 U. of Miami Heckerling Inst. on Est. Plan. (2002).
- 29 Such flexibility and suggested provisions are discussed in McBryde and Keydel, *Back to the Future for the Estate Planner: Building Flexibility in Estate Planning Documents*, 30 U. of Miami Heckerling Inst. on Est. Plan. (1996).
- 30 See Dodge, 50-5th T.M. (BNA), *Transfers With Retained Interests and Powers*, p. A-78.
- 31 Alaska Statute 13.36.390(2).
- 32 Alaska Statute 13.36.035(c).
- 33 These changes are discussed in Greer and Shaftel, *Alaska Enacts Additional Estate Planning Legislation*, 27 ETPL 376 (Oct. 2000), and Shaftel, *Newest Developments in Alaska Law Encourage Use of Alaska Trusts*, note 15 supra.
- 34 This article and its hypotheticals assume that a fraudulent transfer has not been made. Both residents and nonresidents will be vulnerable to a creditor challenge if the settlors were found to have transferred assets to the SSDS Trust with an intent to evade existing creditors. Alaska Statute 34.40.110(b)(1). See Osborne, *Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches*, note 7 supra, at 13-28.
- 35 See the authorities cited in note 13 supra and in the articles listed in note 15 supra.
- 36 Practical Drafting, (published by U.S. Trust Co. of N.Y.), July 1997, at 4891.
- 37 Dodge, 50-5th T.M. (BNA), *Transfers With Retained Interests and Powers*, p. A-23.
- 38 Stephens, Maxfield, Lind & Calfee, *Federal Estate and Gift Taxation* (7th ed., Warren, Gorham & Lamont 1996), ¶ 4.08[4][c], p. 4-154.
- 39 Pennell, 2 Estate Planning, supra note 15, at § 7.3.4.2. This commentator concludes, "[t]he answer to that question has not adequately been provided by case law or rulings." *Id.*, p. 7.345.
- 40 I.R.C. § 2702(c)(2), enacted in 1990.
- 41 Pennell, 2 Estate Planning, note 15 supra, at § 7.3.4.1, p. 7.334.
- 42 The best example is the Economic Growth and Tax Relief Reconciliation Act of 2001 ("2001 Tax Act" or "EGTRRA"), which has as its ultimate goal the repeal of the estate tax.
- 43 See note 25 supra and the text to which it relates.
- 44 If the settlor's interest applied to all the trust's assets, the assets would all be included in the settlor's gross estate. On the other hand, if the settlor desired an interest in only part of the trust's assets, then only the proportion "retained" would be included in the settlor's gross estate. Reg. § 20.2036-1(a). See *Mahoney*, 831 F.2d 641, 60 AFTR2d 87-6152 (CA-6, 1987); *Estate of Tomac*, 40 T.C. 134 (1963); Rev. Rul. 79-109, 1979-1 C.B. 297. This provides a hedge for the more conservative settlor and planner.
- 45 U.S. Const. art. I, § 10, cl. 1.
- 46 Osborne, *Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches*, note 7 supra, at 14-26.
- 47 *Id.*
- 48 *Id.* See also Boxx, *Gray's Ghost*, note 26 supra, at 1230.
- 49 Osborne, *Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches*, note 7 supra, at 14-26. Boxx, *Gray's Ghost*, note 26 supra, at 1240.
- 50 See this article's section entitled "The Planning Dilemma: Early Gifting Versus Future Possible Needs" above.
- 51 Boxx, *Gray's Ghost*, supra note 26, at 1240, n.295.
- 52 If the question is one of administration, the settlor's choice of law in the trust



instrument controls. Restatement (Second) Conflict of Laws § 273(b). If the question is one of validity, then again, the settlor's choice will prevail, "provided that this state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which, as to the matter at issue, the trust has its most significant relationship under the principles stated in § 6" (*Id.*, § 270.)

53 For example, factual determinations may need to be made concerning whether Alaska has a substantial relation to the trust, and which state has the most significant relationship to the trust.

54 Further analysis of this conflict of laws issue may be found in Blattmachr and Zaritsky, *North to Alaska—Estate Planning Under the New Alaska Trust Act*, note 15 *supra*; Hogan, *Once More Unto the Breach: Planning for a Conflict of Laws With Alaska and Delaware Self-Settled Spendthrift Trusts*, note 7 *supra*; and, generally, in Moore, *Choice of Law in Trusts: How Broad is the Possible Spectrum?* 36 U. of Miami Heckerling Inst. on Est. Plan. (2002).

55 U.S. Const. art. IV, § 1.

56 18 Moore's Federal Practice § 130.04[3] (Matthew Bender 3rd ed.).

57 *Id.* Restatement (Second) of Conflict of Laws § 92, comment e.

58 Jurisdictional issues may be very fact dependent. For example, there may be arguments that long-arm jurisdiction is appropriate due to a corporate trustee's activities in the domiciliary state, which may include advertising, attendance at conferences, articles in national press, and website material. See Boxx, *Gray's Ghost*, note 26 *supra*, at 1211-12.)

59 *Id.* at 1227.

60 *Id.* at 1215.

61 See Osborne, *Asset Protection and Jurisdiction Selection: Clearing Up Your Situs Headaches*, note 7 *supra*, at 14-24 for a full discussion of this statutory interpretation argument.

62 U.S. Const. art. VI.

63 Resident settlors could still rely on the Alaska SSDS Trust statute as a state law exemption independent of Bankruptcy Code § 541(c)(2). Nonresident settlors could not because Bankruptcy Code § 522(b)(2) limits state law exemptions to those of the debtor's domicile state.

64 See the choice of law discussion above with respect to the full faith and credit clause scenario.

65 See note 52 *supra*.

66 This scenario has occurred involving offshore trusts. See Boxx, *Gray's Ghost*, note 26 *supra* at 1227-30.

67 *Id.* at 1229.

68 *Id.*

69 E.g., *Federal Trade Comm. v. Affordable Media, LLC*, 179 F.3d 1228 (CA-9, 1999); *In Re Portnoy*, 201 B.R. 685 (S.D.N.Y. 1996); and *In Re Brown*, 4 Alaska B.R. 279 (D. Alaska, Mar. 11, 1996).

70 Only two private letter rulings exist: PLR 9837007, which concluded that gifts were complete when made to an Alaska SSDS Trust designed for transfer tax reduction, and PLR 200148028, which found that gifts were incomplete when made to a Delaware trust designed only for asset protection and also ruled that the Delaware trust was not a grantor trust for income tax purposes.

71 In regard to personal jurisdiction issues, Professor Boxx states, "unfortunately, a decision that would expose the trust assets to the judgment in this context would be too fact-specific to have much relevance to future cases, since it would turn on personal jurisdiction of a particular state over a particular trustee. However, depending on the policy analysis done to determine personal jurisdiction, the decision could be a sufficient cautionary tale that would make the trusts less attractive or, at least, affect future litigation strategy." *Gray's Ghost*, note 26 *supra*, at 1221, n.149.

72 In regard to the I.R.C. § 2036(a)(1) issue, Professor Pennell concludes, "[t]his issue will take time to resolve, and there may be fits and starts as various courts analyze the question." Pennell, 2 Estate Planning, *supra* note 15, at § 7.3.4.2, pp. 7.345-7.346.

73 If spouses are co-settlors, conservative drafting will include a provision that states that if trust assets are included in the gross estate of the first settlor to die, then such assets will be distributed to a QTIP trust for the surviving spouse.

74 Section 2001(b).

Continued... **From the Chair**
by Warren Sinsheimer, Esq.*

group of applicants for membership on EXCOMM this Spring, and the choices were not easy. We are optimistic that you will find your executive committee will remain vital and responsive to the needs of the California Trusts and Estates lawyer.

Finally, I want to thank the editors of this Quarterly. These are volunteers who put in huge amounts of time to make sure that you receive a useful, practical and informative publication four times a year. They deal with a wide array of problems and frustrations in doing that. They do so with good will, humor and commitment. Barry Fitzpatrick (Executive Editor from Rancho Santa Fe), George Montgomery (Editor from San Francisco) and Albert Handelman (Assistant Editor from Santa Rosa) are a fine team. They make all of us look good, and we thank them.

Thanks again to all of you for your continued support of this Section.

* *Sinsheimer, Schiebellhut & Baggett, San Luis Obispo, California*



NINTH CIRCUIT REVERSES POSITION ON TIME PERIOD FOR REFUND CLAIMS INVOLVING LATE FILED TAX RETURNS

*By James R. Chisholm, Esq.**

“Judge Learned Hand once described the Tax Code as a ‘fantastic labyrinth[]’ whose words ‘merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception’ Learned Hand, Thomas Walter Swan, 57 Yale L.J. 167, 169 (1947). Like Theseus of old we are compelled to enter this labyrinth - but without his ball of thread.”¹

The Internal Revenue Code describes comprehensive procedures for taxpayers to follow to obtain tax refunds from the Internal Revenue Service. Any time a taxpayer pays an amount to the Service, there is a possibility that the taxpayer may subsequently determine that all or a portion of the amount paid to the Service should be refunded. The procedures set forth in IRC § 6511 for obtaining such refunds when the corresponding tax return is timely filed are straightforward. The procedure for obtaining such a refund in the Ninth Circuit in the situation where the tax return is not timely filed, however, was complicated by the Ninth Circuit Court of Appeals opinion in *Miller v. United States*, 38 F.3rd 473 (9th Cir. 1994).

Fortunately, the Ninth Circuit Court of Appeals has now stated that it is no longer bound by *Miller*. In *Omohundro v. United States*, 2002 U.S. App. LEXIS 16628 (9th Cir. Cal. Aug. 19, 2002), the Court, in a per curiam decision, declined to follow its earlier opinion in *Miller* and held that under IRC § 6511(a) a taxpayer’s claim for refund is timely if it is filed within three years from the date the taxpayer’s income tax return is filed, regardless of when the return is filed.

I. BACKGROUND

The basic rules for a refund or credit of an overpaid tax are set forth in IRC § 6511, which provides in pertinent part as follows:²

“(a) **Period Of Limitation On Filing Claim.** Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the

tax was paid.³ Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

“(b) **Limitation On Allowance Of Credits And Refunds.**

“(1) **Filing Of Claim Within Prescribed Period.** No credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) for the filing of a claim for credit or refund, unless a claim for credit or refund is filed by the taxpayer within such period.

“(2) **Limit On Amount Of Credit Or Refund.**

“(A) **Limit Where Claim Filed Within 3-year Period.** If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

“(B) **Limit Where Claim Not Filed Within 3-year Period.** If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.

“(C) **Limit If No Claim Filed.** If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under subparagraph (A) or (B), as the case may be, if claim was filed on the date the credit or refund is allowed.”

Accordingly, with respect to all taxes (other than those payable by stamp) where a return is required, IRC § 6511(a) establishes three alternative filing deadlines for refund claims – one such deadline gives the taxpayer 3 years to file a refund claim, while the other two give 2 years. In essence, IRC § 6511(a), when read in conjunction with IRC § 6511(b)(1), provides that a refund claim is timely if filed: (1) within 3 years from the time the return was filed; or (2) 2 years from the time the tax was paid, whichever of such periods expires the later; or (3) if no return was filed by the taxpayer, within 2 years from the time the tax was paid.

Although IRC § 6511(a) is not hard to follow, it does not specifically address the situation where a return is filed late, after its due date.⁴ Although the statute omits any reference to timely filing, cases involving delinquent returns filed more than 2 years but less than 3 years from the due date of the return had resulted



in a split of authority in the federal circuit courts.⁵

II. PRIOR POSITION IN THE NINTH CIRCUIT

In *Miller*, taxes were withheld from the taxpayers' 1986 wages and were deemed to have been paid on April 15, 1987.⁶ On April 15, 1989, two years after the payment of the taxes, the taxpayers still had not filed their 1986 return. The IRS mailed a notice of deficiency to the taxpayers on August 23, 1989. Taxpayers filed their return for 1986 on April 16, 1990 (a Monday), asserting a claim for refund. The Service disallowed the claim. The taxpayers then filed suit in District Court arguing that IRC § 6511(a) did not require a timely filed return to start the three-year period citing the legislative history to the section.⁷ The District Court, however, interpreted IRC § 6511 as providing a three-year period for filing only where the return was filed before the April 15, 1987, filing deadline citing another district court opinion which held, without authority or explanation, that "section 6511(a) must be read to refer to a 'timely' filed return." The District Court then concluded that the three-year period for filing a claim was unavailable to taxpayers because they had filed their return after it was due and granted the government's motion to dismiss.

On review, the Ninth Circuit upheld the District Court and held that the time for determining whether a taxpayer had filed a return was two years after the tax was paid, even if the taxpayer had later filed a return. In fact, the opinion holds that the two-year period would be applicable even if the taxpayer had actually filed a return more than two years, but less than three years, after the tax was paid. The Court's opinion focused on two issues – first, the purpose of IRC § 6511 to foreclose untimely claims and, second, forum shopping.⁸ The opinion is an unusual one, a distinct minority among courts that have considered the complexities of IRC § 6511.⁹

III. SUBSEQUENT HISTORY

There was no indication in the 1994 *Miller* opinion that Rev. Rul. 76-511 had been raised by either the IRS or the taxpayer. But subsequent to *Miller*, in a 1995 Field Service Advice¹⁰ the Service stated that *Miller* was contrary to its position in Rev. Rul. 76-511.¹¹ In addition, the Service also disagreed with a subsequent unpublished opinion of the Ninth Circuit which extended the *Miller* holding with respect to IRC § 6511(a) in the context of Tax Court cases.¹²

Under the facts of Rev. Rul. 76-511, during the calendar year 1972, A's employer withheld Federal income tax from A's wages, which were treated as paid on April 15, 1973. On April 30, 1976, A filed a 1972 Federal income tax return showing an overpayment of tax and seeking a refund. A had not requested an extension of time for filing the return. The ruling concludes that

A's return should be treated as a timely claim, but the claim should be denied because of § 6511(b)(2)(A):

"In this case, A filed a claim for refund within the 3-year period of limitation prescribed by section 6511(a) of the Code, because, under section 301.6402-3 of the regulations, A's 1972 income tax return was a claim for refund. However, under the provisions of section 6513(b)(1), the overpayment is deemed to have been made on April 15, 1973, which is not within the 3-year period immediately preceding April 30, 1976, the date the claim was filed. Therefore, although the claim for refund was timely filed, allowance of the refund is specifically barred by the provisions of section 6511(b)(2)(A). *If A had filed the 1972 income tax return on April 1, 1976, the refund would have been allowable since the overpayment would have been made within the 3-year period immediately preceding the filing of the claim.*" (Emphasis added.)¹³

In 1996, the United States Supreme Court had a chance to resolve the question of the applicable statutory period when it decided *Commissioner v. Lundy*, 516 U.S. 235 (1966). The taxpayer had received a notice of deficiency more than two years but less than three years after the due date of his unfiled return. Unlike the taxpayer in *Miller*, however, Lundy made his overpayment claim in a timely Tax Court petition. Unfortunately, the Supreme Court limited its analysis to the narrow facts before it rather than interpreting the general provision of IRC § 6511. The Court applied IRC § 6512, the Tax Court-specific provision, to preclude Lundy from litigating his overpayment claim in the Tax Court. In 1997, Congress amended IRC § 6512 to reverse Lundy and allow a three-year period for such claims in the Tax Court.¹⁴

In 1998, the IRS reiterated its support for Rev. Rul. 76-511,¹⁵ and explained the reasoning of the ruling as follows:

"The rationale underlying Rev. Rul. 76-511 is that section 6511 provides no time limit within which a return must be filed in the context of claims for refund. Section 6511(a) provides only that to be timely, a claim must be filed within three years from the time the return was filed, regardless of when the return is filed. Therefore, for purposes of section 6511(a), it is immaterial whether a return is filed three years or six years after the due date. Of course, a refund claim would be barred under section 6511(b) if made more than three years after the taxes were paid. The proscription of section 6511(a), which sets a two year limitation if no return is filed by the taxpayer, does not apply in this instance because a return has actually been filed."¹⁶

In *Baral v. United States*, 528 U.S. 431 (Feb. 2000), Baral claimed that he (and his employer on his behalf) had remitted more estimated and withholding taxes with respect to his 1988 taxable year than he actually owed and requested that the Service apply the excess as a credit toward his outstanding tax obligations for the 1989 taxable year. He did not file his return for 1988 until



nearly four years after the return's extended due date. The Service denied the requested credit. In doing so it did not dispute that Baral had timely filed the request under the relevant filing deadline – “within 3 years from the return was filed or 2 years from the time the tax was paid, whichever of such periods expires later.” The Service concluded, however, that the claim exceeded the ceiling imposed by IRC § 6511(b)(2)(A) in that Baral had paid no portion of the overpaid tax during the relevant look-back period. The issue before the Supreme Court was whether the remittances were “payments” for purposes of IRC § 6511(b)(A)(2). The Court agreed with the Government's position that they were payments and, since they were not made within the 3-year look-back period, Baral was not entitled to a refund.

In *Weisbart v. United States*, 222 F.3rd 93 (2nd Cir. 2000), the taxpayer's 1991 tax return was filed on August 17, 1995, three years after the extended due date of the return, requesting a refund. The Service denied the claim and Weisbart filed a refund action in the District Court. The IRS moved for summary judgment arguing that Weisbart's refund claims were barred by IRC § 6511(b)(2)(A). The District Court agreed and granted the motion. Surprisingly, in its brief on appeal, the Service requested that the Court decline to follow the *Miller* case. The Service conceded that IRC § 6511(a) gave Weisbart 3 years from the filing of his tax return to file his refund claim, even though the return itself was untimely. The IRS cited Rev. Rul. 76-511 on this subject. The Court then reviewed the legislative history of IRC § 6511(a)¹⁷ and concluded, contrary to *Miller*, that a timely filed return is no longer required in order to satisfy the 3-year deadline of IRC § 6511(a).

Three weeks after the decision in *Weisbart*, the Eight Circuit Court of Appeal, in *Anastasoff*, 223 F.3rd 898 (8th Cir. 2000), reached the opposite result under identical facts. The attorneys for *Anastasoff* then filed a motion for rehearing *en banc*. At this point several events occurred indicating that the IRS had reversed its position. First, the IRS allowed the appeal period to run in *Weisbart* without filing a petition for a writ of certiorari, despite the conflict between the two circuits. Second, and more surprising, when the taxpayer in *Anastasoff* filed her motion for rehearing *en banc*, the IRS informed the Court that a refund would be granted resulting in the case being dismissed as moot. Third, the IRS also conceded a third case with identical facts when it informed the Fourth Circuit Court of Appeal that it would concede the pending appeal of *Manka*, 86 AFTR 2nd 2000-7566 (DC Va., 2000), in which the district court had ruled in favor of the IRS. The timing and swiftness of the concessions were surprising – all three of the cases were conceded within a week of each other.¹⁸

Finally, in FSA 200033006¹⁹ the Service again reiterated its support for Rev. Rul. 76-511 and stated that

“[t]he Service does not follow the stricter 2-year rule set forth in *Miller v. United States*. In dictum, the Supreme Court recently agreed with the Service's reading of the statute. See *Baral v. United States* (‘Since Baral had filed his [delinquent] return on June 1, 1993, and had earlier received a 4-month extension from the initial due date, the relevant look-back period under section 6511(b)(2)(A) extended from June 1, 1993, back to February 1, 1990 (i.e., three years plus four months).’).”

IV. NINTH CIRCUIT'S CURRENT POSITION

With all of the above background, it was only a matter of time until another Ninth Circuit case came along. Enter Mrs. Omohundro. Her 1993 tax return was due on extension on October 15, 1994. Her tax return, which was also considered a claim for refund, was filed on October 14, 1997. After various attempts to settle with the Service failed, Omohundro filed a complaint for a refund in the District Court for the Central District of California. The Service then successfully moved to dismiss the complaint citing *Miller*. At this point, counsel for Omohundro were aware of the cases discussed above and the Service's published position on Rev. Rul. 76-511. Counsel for Omohundro then appealed the matter to the Ninth Circuit Court of Appeal citing the developments discussed above as well Rev. Rul. 76-511. Concurrently, the Service decided, consistent with its action in *Anastasoff* and *Maka*, to reverse its position on the *Miller*²⁰ case and argued on appeal with Omohundro that the Court should overturn *Miller*. It is interesting to note that the IRS could have simply notified the Court that it was going to pay the refund claimed by Mrs. Omohundro thereby rendering the case moot like it did in *Anastasoff*.

Although both the taxpayer and the Service contended on appeal that *Miller* was incorrectly decided and that it did not bind the Court, the Court stated that it was not bound by a prior decision of a panel if a subsequent *en banc* decision, Supreme Court decision, or legislation undermined it.²¹ The Court then stated that, in deciding *Miller*, the Court did not consider Rev. Rul. 76-511 which was directly on point and in effect at the time. The Court then reviewed certain subsequent cases and legislation and found the Revenue Ruling to be consistent with later IRS announcements. Secondly, it found that the IRS interpretation of IRC § 6511(a) argued on appeal was supported by the legislative history of the statute.²² Finally, it found that subsequent legislation had undermined its reasoning in *Miller* regarding forum shopping. The Taxpayer Relief Act of 1997 eliminated any disparity in deadlines between tax court and district court by amending IRC § 6512(b)(3). In this regard, the Court stated that “under the current statute, *Miller* actually creates a disparity since a taxpayer must file a return within two years of payment of the tax in district court, but need not do so in tax court.” In conclusion, the Court held that under § 6511(a) a taxpayer's claim



for credit or a refund is timely if it is filed within three years from the date his income tax return is filed, regardless of when the return is filed.

V. RECOMMENDATIONS

Taxpayers should review all situations where a tax return is delinquent to determine if a claim for refund will be ultimately filed. If a return is delinquent, then the taxpayer should determine when the 3-year period will expire in order to be sure a refund claim will not be barred as untimely.

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Endnotes

1. Introductory statement by Circuit Judge McLaughlin in *Weisbart v. United States*, 222 F.3rd 93 (2nd Cir. 2000).
2. For a detailed discussion of the limitations on credits or refunds under IRC §§ 6511 and 6513, see Saltzman, *IRS Practice and Procedure*, 2nd Ed., Warren, Gorham & Lamont, ¶ 11.05.
3. Prior to 1958, the first sentence of IRC § 6511(a) read as follows:

“Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was required to be filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid.”

The Technical Amendments Act of 1958, P.L. 85-866, § 82(a), 72 Stat. 1606, 1663, deleted the underlined phrase "required to be" from the first sentence of IRC § 6511(a); see also S. Rep. No. 85-1983 (1958) and Conf. Rep. No. 85-2632 (1958) reprinted in 1958 U.S.C.C.A.N. 4791, 4887, and 5022.
4. For a review of the cases dealing with refund claims taxpayers make on delinquent returns filed more than two and less than three years after the due date of the returns, see Lederman, *Late Returns Claiming Refunds: Negotiating the 'Fantastic Labyrinth,'* 2000 TNT 224-67 (Nov. 17, 2000).
5. See, e.g., *Weisbart v. United States*, 222 F.3rd 93 (2nd Cir. 2000), which ruled contrary to *Miller*.
6. IRC § 6513(b)(1).
7. Note 3 supra.
8. For an excellent discussion of the Court's peculiar conclusions on these two issues, see Jones, *The Second and Eight Circuits Disagree on Late Returns and Refunds*, 93 J. Tax'n 212 (Oct. 2000).
9. Jones, note , supra.
10. 1995 WL 1770355.

11. Rev. Rul. 76-511, 1976-2 C.B. 428.
12. Note 10 supra.
13. Note 1, supra.
14. See P.L. 105-34, § 1282, 111 Stat. 788 (1997). IRC § 6512(b)(3) was amended to add the following sentence at the end of paragraph 3.

In a case described in subparagraph (B) where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date, *the applicable period under subsections (a) and (b)(2) of section 6511 shall be 3 years.*” [Emphasis added.]

15. See FSA 1998-23, Doc 98-15792, 98 TNT 98-22 (released in 1998).
16. *Id.*
17. Note 3 supra.
18. For an interesting discussion of the IRS' change in its position in *Weisbart* and *Anastasoff*, see Jones, Note 3, *supra*. See also Jones, *IRS Reverses Its Position on Late Returns and Refund Claims: The Mailbox Rule Will Apply*, 94 J. Tax'n 81 (Feb. 2001).
19. 2000 FSA LEXIS 87 (August 18, 2000).
20. The comments regarding the background of the *Omohundro* case were obtained by the author from counsel for Mrs. Omohundro.
21. *Omohundro v. United States*, 2002 U.S. App. LEXIS 16628, 16629 (9th Cir. Cal. Aug. 19, 2002)
22. See Note 3 supra.



CAUGHT IN THE 'NET

By John A. Hartog, Esq.*

As a change of pace the author has decided to discuss a common cyberspace tool that contains its own traps for the unwary.

ELECTRONIC MAIL ISSUES

I. A FEW TIPS

Since everyone is (or should be) using email, here are a few reminders. Learn a few time-saving features on your email program. If the reader is like most other victims of the Gates monopoly, the program the reader is most likely to be using is Outlook. Try using the Rule Wizard to automatically file your email from mailing lists and newsletters and the email that you send out. This feature will assist the user in filtering the correspondence that does not require immediate attention. You can also avoid format flaws by setting the default width of your email to be narrow enough (e.g., 65 characters) so that each of your lines does not end up wrapping around to two lines, avoiding awkward reading. To do this, go to "Outlook Tools," "Options," "Mail Format," "Settings," "Automatically wrap," set to "65."

The emailer should also consider using a Signature Block. A signature block is to be distinguished from a digital signature, which is discussed later in this column. Like your paper letterhead, a signature block lets others know who you are and how to communicate with you. Using a signature block will also have the salutary effect of compelling the e-correspondent always to use a permanent email address.

Acronyms can save the user time, although they can be annoying and apparently contradictory to the lawyer's objective of clear writing. Some examples are FTF for face to face, FWIW for for what it's worth, JK for just kidding, NP for no problem, YMMV for your mileage may vary.

One of the great benefits of email is the ability to attach files to the correspondence. A common problem with attaching large files is the delay caused by those large files. Zipping files reduces them, thus making them faster to send and receive. Zipped files need to be unzipped in order for them to be usable. Winzip and PKZIP are leading products for compressing and decompressing files.

II. EMAIL SECURITY ISSUES; CONVENIENT BUT NOT SECURE?

Email is fast and cheap, but how secure is it? The answer is that in practice it is private enough, especially if security measures are taken as necessary. Nevertheless, readers would be

mistaken to assume that the practical privacy of email will always suffice to protect client confidences. Although it is a federal crime to intercept email (18 U.S.C. § 2511), criminality is often an ineffective deterrent. The criminal liability of the "hacker" will not protect you from disciplinary action for failing to safeguard client confidences or from civil liability if a damaged client brings a malpractice action.

Email can be made more secure through encryption. At the very least, lawyers should use encryption programs when communicating confidentially with clients. Equally important is that the client also use an encryption program when communicating with counsel. Passwords are a traditional form of encryption using a single password or "secret key" approach. Those who know the password (i.e., have the key) can open the document. This approach requires that the attorney will still need to convey the "secret key" to the recipient by some other secure method or by some less than fully secure method.

Public Key Encryption is a modern method of encryption using a two key method, a "public" key and a "private" key. A message encrypted or "locked" with either one of the pair of keys can only be decrypted or unlocked with the other of the same pair. The private key is kept secret, but the public key can be widely distributed, e.g., on a website. Thus, a client or other person can send the lawyer a file encrypted using the public key and only the holder of the private key will be able to decrypt it. Some common email encryption programs are PGP (Pretty Good Privacy) and S/MIME. Note that the encryption on a web browser that allows for secure communication to and from a secure site does not encrypt the user's email.

Digital signatures use a public key encryption to verify who sent a particular message. Software is making digital signatures easier to use. These digital signatures may come to be used to bind a party in commercial transactions. The Science and Technology Section of the ABA has prepared legal guidelines regarding the use of digital signatures, available for free download at: www.abanet.org/scitech/ec/isc/dsgfree.html.

Maintaining adequate security of your email, as well as of your computer and your office, is one of your professional duties. While there is no clear legal standard for when email should be encrypted, lawyers should be mindful that as encryption gets easier and more widely used, the standard for safeguarding client's privacy will rise. Use of encryption can demonstrate the lawyer's intention to keep the information confidential. In the unfortunate event of professional negligence litigation, being able to establish such intent can be very helpful. Practitioners should also consider obtaining a client's consent, release and waiver after full disclosure of the potential risks before using email for confidential communications.

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LITIGATION ALERT

By Mary F. Gillick, Esq.*

I. BENEFICIARY WHO FACILITATED PREPARATION OF WILL AND TRUST BUT DID NOT HIMSELF DICTATE OR TRANSCRIBE THE INSTRUMENTS DID NOT CAUSE THE INSTRUMENTS TO BE TRANSCRIBED WITHIN THE MEANING OF PROBATE CODE § 21350

In *Rice v. Clark*, 28 Cal.4th 89 (2002), the California Supreme Court ruled that a will and trust were not invalid even though the primary beneficiary participated in the instruments' preparation and execution, because the primary beneficiary did not himself directly participate in transcribing the instruments.

Richard Clark ("Clark") first met the decedent after repairing the garage door at her home. Clark gradually began taking on additional duties, and after six years he began helping the decedent with her bill paying, bookkeeping, tax information, grocery shopping and so forth. The decedent met with an attorney to change her will and explained that she wanted to leave her entire estate to Clark and his wife, Janet Clark, with Owen Rice as a contingent beneficiary if both of the Clarks predeceased her. Clark was present during the entire meeting, but the attorney testified that the decedent appeared mentally competent and expressed her wishes clearly. After the meeting, Clark telephoned the attorney and scheduled a signing appointment for the decedent. The decedent eventually signed the documents creating the will and trust. After the decedent's death, Rice petitioned for a declaration that the donative transfers to the Clarks were invalid under Probate Code § 21350. The trial court concluded that Clark did not meet all of the criteria of § 21350. Although Clark had taken part in arranging for the challenged instruments' preparation, the court determined that he did none of the thinking or writing himself and did not order or request any other person to do so.

The Court of Appeal affirmed. After reviewing the statutory scheme and legislative intent of its drafters, the Supreme Court affirmed the appellate court's ruling because "Clark did not direct or oversee, or otherwise participate directly in, the will's or trust's transcription," he merely facilitated the instruments' preparation and execution.

II. DECEDENT'S ORAL INSTRUCTION TO DAUGHTER TO VEST REAL PROPERTY IN DECEDENT AND DAUGHTER AS JOINT TENANTS WAS VALID UNDER DOCTRINE OF AMANUENSIS

In *Estate of Stephens*, 28 Cal.4th 665 (2002), the California

Supreme Court ruled that the transfer of a house from decedent to daughter was valid, even though the daughter signed the deed on behalf of the decedent. The Court held that the signature was a mere mechanical act and not an exercise of judgment or discretion; thus, the decedent's oral instruction to sign the document was sufficient.

Although the decedent's original will divided his property equally between his two children, prior to his death the decedent orally instructed his daughter to sign his name on a grant deed that vested title to his residence in himself and her as joint tenants; she did so outside of his presence and he later orally ratified the conveyance. After the decedent passed away, his son petitioned for the return of the real property to the decedent's estate.

The trial court declared the transfer was valid pursuant to the "amanuensis" rule, which provides that where the signing of a grantor's name is done with the grantor's express authority, the person signing the grantor's name is not deemed an agent but is instead regarded as a mere instrument or amanuensis of the grantor, and that signature is deemed to be that of the grantor.

The Court of Appeal reversed the trial court's ruling on the grounds that the daughter only had written authority (in the form of power of attorney) to sell, convey and transfer the decedent's real property. Therefore, the daughter lacked authority to convey the property to herself as a gift and the transfer was void.

The California Supreme Court reversed the ruling of the Court of Appeal on the basis of the amanuensis rule. The Court explained that even though the daughter was an interested party to the transaction, she acted as a mere amanuensis, signing the deed at the decedent's direct request. Because her signature was a mere mechanical act, and not an exercise of judgment or discretion, the decedent's oral instruction to his daughter was sufficient to make the transfer valid.

III. WHEN A NONFIDUCIARY DEFENDANT IS NEITHER AN EMPLOYEE NOR AN AGENT OF THE FIDUCIARY, THE DEFENDANT IS NOT LIABLE TO THE PLAINTIFF ON A CONSPIRACY THEORY BECAUSE A NONFIDUCIARY IS LEGALLY INCAPABLE OF BREACHING A FIDUCIARY DUTY

In *Everest Investors 8 v. Whitehall Real Estate Limited Partnership XI*, 100 Cal.App.4th 1102 (2002), the Second District Court of Appeal held that defendant could not be liable to plaintiff for conspiring with the fiduciary to breach the fiduciary's duty to plaintiff because the defendant lacked a fiduciary relationship with the plaintiff.

Everest was a limited partner in several partnerships formed by McNeil Investors. In 1995, some of the McNeil partnerships' limited partners (but not Everest) sued the General Partners for



breach of fiduciary duty, alleging they had acted for their own benefit and not for the benefit of the partnerships. In 1998, in an attempt to settle the 1995 lawsuits, the General Partners allegedly conspired among themselves and with Whitehall Real Estate Limited Partnership XI to sell the McNeil partnerships to Whitehall. However, the General Partners did not solicit bids or otherwise attempt to maximize the return on the limited partners' investments as required by the General Partners' status as fiduciaries. Instead, the General Partners allegedly conspired with Whitehall to sell all of the limited partnerships to Whitehall for less than their fair market value so as to benefit the General Partners and Whitehall at the expense of the limited partners. Everest brought suit against the General Partners for breach of fiduciary duty, and sought to hold Whitehall liable for the breach of fiduciary duty as a co-conspirator.

Whitehall argued that it did not owe a fiduciary duty to Everest; therefore, as a matter of law, it could not be held liable for conspiring to breach the General Partners' fiduciary duty to Everest. Everest conceded that Whitehall did not owe an independent fiduciary duty to Everest and did not claim that Whitehall was the agent or employee of the General Partners. Rather, Everest insisted that Whitehall could be liable for conspiracy to breach the General Partners' fiduciary duties because Whitehall was acting to further its own interests.

The trial court ruled that a cause of action for civil conspiracy does not arise if the alleged conspirator, although a participant in the agreement underlying the injury, was not personally bound by the duty violated by the wrongdoing. The appellate court affirmed the trial court's holding, distinguishing *Doctor's Co. v. Superior Court*, 49 Cal.3d 39 (1989), *Pierce v. Lyman*, 1 Cal.App.4th 1093 (1991), *Kidron v. Movie Acquisition Corp.*, 40 Cal.App.4th 1571 (1995), *City of Atascadero v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 68 Cal.App.4th 445 (1998), and *Wolf v. Mitchell, Silberberg & Knupp*, 76 Cal.App.4th 1030 (1999).

IV. A POSTNUPTIAL AGREEMENT IS VALID AND ENFORCEABLE WHERE BOTH PARTIES VOLUNTARILY ENTERED INTO THE AGREEMENT; THERE WAS NO CONFLICT OF INTEREST WHERE THE ATTORNEY FOR THE HUSBAND EXPLAINED THAT HE REPRESENTED ONLY THE HUSBAND AND THE WIFE, ALSO AN ATTORNEY, REPRESENTED HERSELF, MADE CHANGES AND SIGNED THE AGREEMENT

In *Friedman v. Friedman*, 100 Cal.App.4th 65 (2002), the Second District Court of Appeal affirmed the trial court's ruling that a postnuptial agreement was valid and enforceable.

Prior to marriage, wife worked as an attorney for a prestigious law firm and explained to husband that if they married, she wanted to keep her law practice as her separate

property. Husband agreed, and the two married. Shortly after marriage, husband retained an attorney with Hatch & Parent to draft a postnuptial agreement. The attorney explained to wife that she would have to retain separate counsel or represent herself. After receiving a draft of the postnuptial agreement, wife made changes to the agreement and those changes were incorporated into the final draft. The postnuptial agreement also reflected that husband was represented by counsel and that wife was an attorney acting as her own legal counsel. Later, husband and wife created an estate plan with another lawyer at Hatch & Parent.

After husband's business flourished, the two parties had marital difficulties, and the wife filed a petition for marital dissolution and claimed that the postnuptial agreement was invalid because husband's attorney had failed to obtain a written conflict of interest waiver as required by California Rules of Professional Conduct, Rule 3-310(C). The trial court found that Hatch & Parent represented both parties in drafting their estate plan, but did not represent both parties in drafting the postnuptial agreement. Because there was no actual conflict of interest, the oral and written advisement provided by Hatch & Parent was sufficient. The appellate court affirmed the trial court's decision and awarded husband costs on appeal, noting that even if there was a technical violation of Rule 3-310, the violation was not serious enough to render the agreement unenforceable.

V. REQUESTING NOTICE WAIVERS IN ALL APPLICATIONS FOR TEMPORARY CONSERVATORSHIPS VIOLATES THE CONSTITUTIONAL GUARANTEE OF DUE PROCESS

In *Edward W. v. Lamkins*, 99 Cal.App.4th 516 (2002), the First District Court of Appeal ruled that failing to provide notice to individuals detained in psychiatric treatment facilities before obtaining temporary conservatorships over those individuals violates due process.

A psychiatric patient, by his guardian ad litem, challenged the ex parte appointment of temporary conservators for individuals determined to be gravely disabled within the meaning of Welfare & Institutions Code §§ 5000, et. seq. Probate Code § 2250(c) generally requires five days' notice before appointment of a temporary conservator. However, the office of the Solano County Public Guardian regularly sought waiver of the five-day notice on the grounds that providing notice could lead to the premature release of gravely disabled patients.

The trial court ruled that § 2250, by permitting trial courts to waive the five-day notice requirement for good cause, grants discretion to the public guardian to request such waiver. The court also concluded that the practice of the Solano County Public Guardian's office did not violate due process after balancing the additional benefits of an opportunity to be heard against the existing statutory protections and the burdens created



by requiring notice.

The Court of Appeal reversed the trial court's decision and held that the absence of notice violated the psychiatric patient's right to equal protection. The trial court was ordered to grant the petition for writ of mandate and request for declaratory relief.

VI. THE STATE IS ENTITLED TO RECOVER COSTS OF MEDICAL SERVICES RENDERED TO DECEDENT FROM THE BENEFICIARIES OF REAL PROPERTY CONVEYED TO THEM BY DECEDENT PRIOR TO HER DEATH BECAUSE THE DECEDENT RETAINED A LIEF ESTATE IN THE PROPERTY AND THE RIGHT TO REVOKE THE BENEFICIARIES' INTEREST

In *Bonta v. Burke*, 98 Cal.App.4th 788 (2002), the Third District Court of Appeal held that the state may seek reimbursement for medical services rendered to the decedent from the beneficiaries of real property conveyed to them by the recipient of the medical services.

In 1994, the decedent executed a grant deed granting a fee simple interest in her house to her daughters, but retained a life estate in the property and the right to revoke the remainder. In 1996, four months before the decedent's death, the daughters recorded the deed.

From September 1994 until the decedent's death in December 1996, the Department of Health Services paid for the decedent's health care services and health care premiums. After the decedent's death, the Director of Health Care Services filed a complaint to enforce and collect money due on a Medi-Cal creditor's claim. The trial court granted summary judgment for the daughters on the grounds that they had received a vested interest in the property in 1994 and that the property did not pass to them by distribution or survival. The Department of Health Services appealed.

The Court of Appeal reversed the trial court's decision, explaining that as long as the recipient of the medical services reserves an interest in the property and the power to revoke the gift of the remainder, the property is part of her estate (for purposes of the Medi-Cal Estate Recovery program) and subject to claims for reimbursement. As a life tenant, the decedent retained not only the enjoyment of the property but also, as the holder of the right to revoke the remainder, the unbridled power to divest her daughters of any interest whatsoever. Therefore, the property had no value to the beneficiaries until the decedent's death. Because the real property did not pass to the daughters until the time of the decedent's death, the Department of Health Services was entitled to recover from the real property beneficiaries the cost of the medical services rendered to the decedent.

VII. ARBITRATION AGREEMENT SIGNED BY CHILDREN REGARDING DEATH OF NURSING HOME RESIDENT IS NOT BINDING

In *Pagarigan v. Libby Care Center, Inc.*, 99 Cal. App. 4th 298 (2002), the Second District Court of Appeal held that arbitration agreements signed by the children of a nursing home resident were not binding because the mother had not signed a durable power of attorney and lacked the capacity to authorize the daughters to enter into the arbitration agreements on her behalf.

The decedent was admitted in a comatose state to a nursing facility and remained there for nearly a year. Plaintiff children alleged that while their mother was under the care and treatment of the nursing facility, she developed a severe pressure sore on her lower back measuring approximately five by eight inches, she lost weight and became malnourished and dehydrated, and she developed an infection at the site where a gastric tube had been surgically implanted in her abdomen. The infection was not treated immediately so it continued and her condition worsened until the infection was so serious that it could not be treated successfully. Therefore, plaintiffs brought an action against the nursing home as decedent's successors-in-interest.

Defendants filed a petition to compel arbitration based on two arbitration agreements signed by the plaintiffs approximately one week after their mother was admitted to the nursing facility. Plaintiffs opposed arbitration on twelve separate grounds, and the trial court denied the petition to compel arbitration without specifying its reasons. Defendants appealed.

The appellate court identified two independently adequate reasons for affirming the trial court's ruling: (1) defendants failed to produce any evidence that plaintiffs had authority to enter into an arbitration contract on behalf of their mother; and (2) defendants failed to provide any evidence they were entitled to seek enforcement of the arbitration agreements.

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FEDERAL TAX ALERT: Selected Federal Tax Legislation, Cases & Rulings

By James M. Allen, Esq.*

This article will provide a summary of selected developments in federal taxation since the Summer Quarterly of particular interest to trust and estates attorneys.

I. FEDERAL LEGISLATIVE ACTIVITY

A. Charity Aid, Recovery and Empowerment Act of 2002

The Charity Aid, Recovery and Empowerment ("CARE") Act of 2002 (H.R. 7) has been approved by the Senate Finance Committee, having previously passed the House of Representatives. The Bill has not yet been voted upon by the full Senate. On July 16, 2002, the statutory language and Senate Finance Report was issued. Of particular interest to estate planning attorneys is a provision which would modify the tax on unrelated business taxable income of charitable remainder trusts as well as a provision which would allow tax-free distributions from individual retirement arrangements when such distributions are for charitable purposes. The new law would impose a 100% excise tax on the unrelated business taxable income of a charitable remainder trust. However, the present rule that takes away the income tax exemption of a charitable remainder trust for any year in which the trust has any unrelated business income would be removed. The new law would also provide an exclusion from gross income for otherwise taxable IRA distributions in the case of a qualified charitable distribution. A qualified charitable distribution is defined as any distribution from an IRA that is made directly to (1) an organization to which deductible contributions can be made, or (2) a split interest entity, that is, a charitable remainder trust, a pooled income fund or a charitable gift annuity. Direct distributions are eligible for the exclusion only if made on or after the date the IRA owner obtains age 70-1/2. However, distributions to a split interest entity are eligible once the owner attains the age of 59-1/2.

B. Retirement Savings Security Act of 2002

On June 21, 2002, the House of Representatives passed the Retirement Saving Security Act of 2002 (H.R. 4931). This Bill would make permanent the pension and income retirement arrangement provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001.

II. FEDERAL REGULATORY ACTIVITY

A. REG-164754-01, 2002-30 IRB 212

As promised earlier this year, the Internal Revenue Service has issued proposed regulations governing the taxation of split-dollar life insurance arrangements. The regulations would apply to any split-dollar life insurance arrangement entered into after the date the regulations are finalized and to pre-existing arrangements that are materially modified after the date the final regulations are issued. The proposed regulations provide two mutually-exclusive regimes, the economic benefit regime where the policy owner is treated as providing economic benefits to the non-owner and the loan regime where the non-owner of the life insurance contract is treated as loaning premium payments to the contract owner. Briefly, under the economic benefit regime, the value of the economic benefit is treated as transferred from the owner to the non-owner. Thus, depending on the circumstances, the transaction may be treated as compensation, a dividend or a gift. Under the loan regime, a payment made by the non-owner to the owner is treated as a loan and the below market interest rate rules of IRC § 7872 would apply.

B. REG-123345-01, 67 F.R. 47755

The Internal Revenue Service has issued proposed regulations which would provide that the amount of property transferred from a donee's spouse to a recipient is reduced by the amount of recoverable gift tax on the transaction. The proposed regulations would amend the rules under IRC § 2519 dealing with the dispositions of certain life estates, as well as the rules governing recovery rights for marital deduction property under IRC § 2207A.

C. REG-115781-01, 67 F.R. 48070

The Internal Revenue Service has proposed regulations that would broaden the charitable deduction rules for certain split interest trusts that pay income to charities. Proposed regulations under IRC §§ 170, 2055 and 2522 would allow payment of a non-charitable income interest if it is paid as a guaranteed annuity or as a unitrust interest even though the payments begin before the trust makes payments to charities.

D. IR-2002-83, 2002 IRB LEXIS 305

The Internal Revenue Service has announced that it has launched an enhanced compliance effort to encourage taxpayers to properly report partnership, S corporation and trust income or losses on their individual tax returns. The Internal Revenue Service earlier this year began matching information reported on Schedule K-1 with income or losses reported on Form 1040 and other schedules.



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III. FEDERAL CASES AND RULINGS – ESTATE TAX

A. Credit for Tax on Prior Transfers (IRC § 2013)

1. CCA 200218003

This Chief Counsel’s advice considers the computation of the credit for tax on prior transfers in light of the creation of a QTIP trust upon the death of the first spouse. The National Office concludes that, for purposes of computing the tax on prior transfers credit, the value of the property transferred to the surviving spouse includes the entire value of the QTIP portion of the marital trust, plus the value of the surviving spouse’s life interest in the non-QTIP portion.

B. Valuation of Farm Real Property (IRC § 2032A)

1. Rev. Rul. 2002-26, 2002-19 IRB 906

This Revenue Ruling contains a list of the 2002 interest rates on new Farm Credit Bank loans that are to be used in computing the special use value of farm real property pursuant to IRC § 2032A. The ruling also contains a list of the states comprised within each farm credit district.

C. Definition of Gross Estate (IRC § 2031)

1. Estate of Frazier v. Commissioner, T.C. Memo 2002-120

On remand from the Ninth Circuit Court of Appeals, which had held that a lease between the decedent and a nut processing and sales company partly owned by the decedent on which the company had installed buildings and other improvements at its expense, included an implied right to remove trade fixtures, the Tax Court rules that the lunch room, pole barn, cold storage units, scan room, well, nut bin, shop and storage building, steel equipment cover and asphalt paving are not removable trade fixtures under California law and thus should be included in the valuation of the decedent’s estate. However, a fumigation chamber and water tanks are removable trade fixtures and are thus not included.

D. Transfers with Retained Life Estate (IRC § 2036)

1. Strangi v. Commissioner (also Gulig v. Commissioner), 293 F. 3d 279 (5th Cir. 2002)

The Internal Revenue Service was allowed to amend its pleadings to add a claim that assets transferred by a decedent to a limited partnership were includable in the decedent’s gross estate under IRC § 2036. In an earlier Tax Court case (Estate of Strangi v. Commissioner, 115 T.C. 478), the Tax Court held that a family limited partnership had substance, IRC § 2703 did not apply, a taxable gift did not occur upon formation and a combined 31% discount was appropriate. The Tax Court suggested that IRC

§2036 might apply but refused to allow the Internal Revenue Service to amend its pleadings. The Court of Appeals reversed and remanded the case for consideration of the IRC § 2036 issue.

2. Estate of Harper v. Commissioner, T. C. Memo 2002-121

The Tax Court has held that assets transferred by a decedent to a limited partnership were includable in the decedent’s gross estate under IRC § 2036(a) because the decedent retained the economic benefit of the property. Eight months before his death, the decedent created a family limited partnership with his son and daughter and contributed a majority of his assets to the partnership. The decedent then made gifts of a 24% and a 36% limited partnership interest to his son and his daughter, leaving the decedent with a 39% interest at the time of his death. The Tax Court agreed with the Internal Revenue Service that the entire property was includable in the decedent’s estate, holding that there was an implied agreement that the decedent would retain enjoyment of the assets. As evidence of the implied agreement, the Court cited the commingling of the decedent’s and the partnership’s funds as well as a history of disproportionate distributions from the partnership to the decedent. The Court also determined that the partnership was created primarily to provide the decedent with an alternate testamentary vehicle as there was little change in the decedent’s relationship to the assets prior to his death.

E. Power of Appointment (IRC §2041)

1. PLR 200219034

The beneficiary’s proposed testamentary exercise of her power of appointment would not cause the trust property to be included in the beneficiary’s gross estate. The trust prohibited the beneficiary from appointing any property to herself, her estate, her creditors or her estate’s creditors. The beneficiary proposed to exercise her power by will providing that the trust property was to be divided equally among her children no later than the day 21 years after the death of the last survivor of the original settlor’s issue who were living at the original settlor’s death, although each child of the beneficiary would have a limited power of appointment. The Internal Revenue Service ruled that the beneficiary’s power of appointment was not a general power of appointment. The Service further ruled that the limited powers of appointment to be created by the beneficiary’s proposed exercise of her power of appointment could not, under state law, be validly exercised in the manner that postponed or suspended the vesting of the trust property for a period extending beyond the applicable perpetuities period.

2. PLR 200229013

A settlor established an irrevocable trust for the benefit of her



issue and other relatives. The trust was funded with stock of a closely-held corporation. Under certain circumstances, the directors of a family trust company can appoint a distribution committee. This ruling holds that the power of certain beneficiaries to remove and appoint directors of the family trust company will not constitute a power to affect the beneficial enjoyment of the trust property under IRC §§ 2036 and 2038 or otherwise cause them to be deemed to have a general power of appointment under IRC § 2041 with respect to the trust assets.

F. Certain Property for Which Marital Deduction Was Previously Allowed (IRC § 2044)

1. *Estate of Bailey v. Commissioner, T.C. Memo 2002-152*

The value of a decedent's 25% interest in a closely-held company was determined by computing the company's net asset value and then applying a combined 50% minority interest and lack of marketability discount. The court ruled that a separate 25% interest held in a qualified terminable interest property trust that was includable in the decedent's gross estate under IRC § 2044 was valued identically to the 25% interest owned outright by the decedent. Apparently the interests were not combined for discount purposes.

2. *PLR 200219003*

The entire value of a trust was includable in the gross estate of the second spouse to die because a qualified terminable interest property ("QTIP") election had been made and was valid for estate tax purposes. The trustee elected to treat the entire trust as a QTIP trust, which was more trust property than was necessary to reduce the first spouse to die's gross estate to zero. The ruling holds that the trustee's election could not be partially revoked or otherwise disregarded.

3. *TAM 200223020*

The amount includable in a surviving spouse's gross estate with respect to a QTIP trust that was initially overfunded was the trust's value on the date of the surviving spouse's death adjusted to eliminate the overfunding. The executor for the first spouse to die initially made a QTIP election but erroneously indicated that the marital trust was being funded with an amount that included the amount that was supposed to pass to a family trust. The Internal Revenue Service held that the amount allowable as a marital deduction for the estate of the first spouse was the amount that should have funded the trust for the surviving spouse's benefit, not the amount actually used to fund the trust.

G. Expenses, Indebtedness and Taxes (IRC § 2053)

1. *Estate of Grant v. Commissioner, 294 F. 3d 352*

(2nd Cir. 2002)

The Court of Appeals for the Second Circuit has held that a decedent's estate was entitled to deduct for federal estate tax purposes personal representatives' fees based on the value of the estate's probate property and trustee's commissions held by the decedent's revocable trust. The court further held that the estate was not permitted to deduct either the personal representatives' travel expenses or the expenses incurred in selling the decedent's personal residence. The court found that the time spent by the personal representatives on the trust assets was not necessary for the administration of the estate because the trust assets passed by operation of law, not by the action of the personal representatives.

2. *Succession of Helis v. United States, 52 Fed. Cl. 745 (Fed. Cl. 2002)*

A decedent's estate that previously elected to defer payment of estate tax over 15 years under IRC § 6166 and paid interest on the deferred payments is entitled to deduct overpaid interest following the court's determination that the Internal Revenue Service had overstated the value of the taxable estate. The Court points out that the estate will be required to recognize the refunded interest as income in the year received.

H. Charitable Deduction (IRC § 2055)

1. *TAM 200224006*

A testamentary trust that designated a charitable organization as the remainder beneficiary met the IRC § 2055(e)(3) requirements for a reformable interest and was eligible for a qualified reformation. Under the terms of the decedent's will, the decedent's sisters were to receive a specified dollar amount each month for life with the remainder passing to a designated charity. According to the Internal Revenue Service, the trust possessed the reformable interest necessary for a qualified reformation because the payment to the non-charitable beneficiaries were expressed in specific dollar amounts.

2. *PLR 200227015*

The Internal Revenue Service has explained that an interest passing to a charitable trust is a reformable interest because the value of the charitable interest at the date of the decedent's death was ascertainable and thus separable from the non-charitable interests. Although the payments to the individual beneficiaries were not expressed in specific dollar amounts or a fixed percentage, a judicial proceeding was timely commenced by the trustees to reform the trust (i.e., within 90 days after the extended due date for filing of the decedent's tax return).

I. Marital Deduction (IRC § 2056)

1. *Estate of Sansone v. United States, 2002-2*



USTC ¶60,442 (9th Cir. 2002), 2002 U.S. App. LEXIS 11703

The decedent's estate was entitled to a marital deduction for the amount of the corpus of a qualified terminable interest property trust that is necessary to generate the guaranteed annual lifetime payment to the decedent's wife. The trust, funded with \$1.5 million, provided that the wife was entitled to receive \$100,000 per year for her lifetime with the amount to be increased annually to take into account inflation. The Ninth Circuit has held that the marital deduction is limited to the \$1.04 million of trust corpus required to generate the wife's \$100,000 lifetime annuity. Additionally, the Appellate Court determined that the trust was not a qualified charitable remainder trust because it was neither a charitable remainder annuity trust nor a charitable remainder unitrust.

2. *PLR 200222024*

Prior to her death the decedent transferred cash, a life insurance policy, personal property and her farm to a trust. The trust agreement provided that upon her death, her husband would have the exclusive right to enjoy certain real and personal property for his lifetime. The trust also directed that a marital trust be created. However, the trust expressly stated that the husband was not to be paid any of the marital trust income during his lifetime. A local court subsequently ordered a reformation of the trust in order for the marital trust to qualify for the estate tax marital deduction. The Internal Revenue Service has ruled that the husband possessed a qualified income interest for life in certain of the decedent's real and personal property. However, since the trust expressly stated that the income and principal was to be distributed to the decedent's descendants and not the husband, the ruling concludes that the surviving spouse did not have a qualified income interest for life in other assets of the marital trust.

IV. FEDERAL CASES AND RULINGS – GIFT TAX

A. Imposition of Gift Tax (IRC § 2501) *PLR 200229018*

Severance of marital trust does not result in taxable gifts under either IRC § 2501 or IRC § 2519. Upon decedent's death, his living trust created a marital trust to pay income to his spouse for life with the balance of the trust being held for the benefit of three children. The trustee of the marital trust proposes to divide the trust into three equal trusts with the surviving spouse receiving income during her life and the trustee having the power to distribute principal to the surviving spouse for care and support and, upon the death of the surviving spouse, each trust will be added to trusts created for the decedent's three children.

B. Transfers in General (IRC § 2511)

1. *Cordes, et al. v. Commissioner, T.C. Memo 2002-124*

The transfers of stock in family-owned closely held corporations by and between family members will not be subject to the federal gift tax because only bare legal title was transferred. The corporations consisted of three automobile dealerships and a financing company. During the years in question, the husband who capitalized the corporations served as the president and controlled the daily operations of each company as well as all other corporate matters. According to the court, the husband's dominance in corporate affairs and in business decisions, along with the acquiescence of the other family members, demonstrated that the husband exercised complete control and was the sole beneficial owner of the corporations. As a result, the transfers were merely of legal title and did not constitute taxable gifts.

2. *Estate of Powell v. Commissioner, 286 F.3d 723 (4th Cir. 2002)*

The Fourth Circuit Court of Appeals has upheld the District Court's conclusion that payments by a decedent in the sum of approximately \$800,000 to his long-time personal secretary constituted gifts rather than compensation. The husband gave \$798,250 to his secretary, reporting the transfers as gifts, with his wife consenting to split the gifts. Following the deaths of both the husband and the wife, the executor of the wife's estate filed amended gift and income tax returns attempting to recharacterize the payments as compensation. The characterization of the payments as gifts was supported by the husband's fatherly affection and concern for his secretary, lifelong practice of making substantial gifts to the secretary, contemporaneous oral and written expressions that the payments were intended to be gifts and the filing of gift tax returns reporting the payments as gifts.

C. Valuation of Gifts (IRC § 2512)

1. *Polack v. Commissioner, T.C. Memo 2002-145*

The Internal Revenue Service's gift tax valuation of closely-held stock transferred by a donor to his four children was controlling because it was better supported by the evidence than the donor's valuation of his shares. The Internal Revenue Service's projection of the amount of refund income as well as the company's capital expenditures was based on credible testimony and the company's operational history. In contrast, the donor's projection was based on unsubstantiated assertions and lacked evidentiary foundation.

D. Certain Property Settlements (IRC § 2516)

1. *PLR 200221021*



A change in title of closely-held stock from an ex-husband's name to his ex-wife's name that occurred several years after the couple's divorce was not subject to federal gift tax. Noting that the wife has received all of the economic benefits associated with the stock allocated to her by the divorce decree, the Internal Revenue Service ruled that the transfer of the shares to the wife was a transfer made for adequate consideration for purposes of IRC § 2516. According to the Internal Revenue Service, there were valid business reasons for delaying the transfer of title beyond the period set forth in IRC § 2516.

2. *PLR 200221042*

A husband and wife created a charitable remainder unitrust and funded it with a gift of community property. After the wife commenced divorce proceedings, the husband and wife entered into a property settlement agreement that dealt with all of their properties, including their community property interest in the trust. The property settlement agreement will divide the trust into two separate charitable remainder unitrusts, one for the husband and one for the wife. The Internal Revenue Service has ruled that the husband's transfer to the wife of his community property interest in the unitrust amount that will be transferred to the wife's trust and wife's transfer to the husband of her community property interest in the amount that will be transferred to the husband's trust will not constitute transfers subject to gift tax.

E. Disclaimers (IRC § 2518)

1. *Estate of Walshire v. United States, 288 F. 3d 342 (8th Cir. 2002)*

The Eighth Circuit has held that Reg. § 25.2518-3(b), which requires that a disclaimer be of an entire undivided interest in property and prohibits a disclaimer of a remainder interest while retaining a life estate, is valid. The decedent attempted to disclaim the remainder interest in his one-fourth share of his brother's residuary estate while reserving the income and use of the property during his lifetime. The executors of the decedent's estate did not include the value of the disclaimed property on his estate tax return. The Appellate Court, in affirming the District Court's decision, held that it is not improper for the regulation at issue to allow only "vertical" divisions of an interest and prohibit the kind of "horizontal" division attempted by the decedent. The court also found that the decedent had accepted the benefit of the disclaimed property by retaining the income from the property during his life.

F. Disposition of Life Estates in QTIP Trust (IRC § 2519)

1. *PLR 200224016*

The severance of a marital trust and the surviving spouse's

renunciation of her interest in all but one of the resulting trusts does not jeopardize the status of the trust as QTIP trust. Prior to the funding of the marital trust the trustees, acting pursuant to authority granted in the decedent's will, will divide the marital trust into five separate trusts and the surviving spouse will renounce her interest in four of the five trusts created. The Internal Revenue Service has ruled that the surviving spouse's renunciation will be treated as a disposition by her of a qualified income interest in these four trusts but not in the fifth trust.

2. *PLR 200223047*

This ruling reaches an identical result to the ruling cited immediately above on only slightly different facts.

G. Charitable Gifts (IRC § 2522) PLR 200226012

The taxpayer, who was a citizen of a foreign country but a permanent resident of the United States, intends to establish a private foundation in the foreign country and will contribute cash and an undivided interest in a remainder interest that the taxpayer owns in shares of a corporation. Due to the fact that the foreign private foundation will contain charitable provisions for a special representative who is not related or subordinate to the taxpayer, the Internal Revenue Service found that the taxpayer's gift will be a completed gift and furthermore that the transfer to the private foundation of an undivided portion of her entire remainder interest will qualify for deduction under IRC § 2522.

H. Limitations on Assessment and Collection (IRC § 6501) CCA 200221010

An Internal Revenue Service legal memorandum has concluded that the taxpayer did not disclose limited liability company gifts in a manner adequate to apprise the Internal Revenue Service of the nature and the amount of the gifts. As a consequence, the period of limitations is held open indefinitely or, alternatively, for at least six years. The memorandum recited that a gift tax return should contain, at a minimum, a description of the transferred property, the identity of the transferor and each transferee, the relationship between the parties and a description of the method used to determine the value of the gift. The memorandum concluded that the taxpayer did not include an adequate description of the gifts to two trusts because he did not identify the number of units being transferred, the percentage of ownership interest that those units represented or the nature of the units. The transferor only identified the name of the limited liability company, the purported value and the fact that the units were class B units.

V. FEDERAL CASES AND RULINGS – GENERATION-SKIPPING TRANSFER TAX



A. Generation-Skipping Tax Exemption (IRC § 2631)

1. *PLR 200227022*

The grantors of grantor-retained annuity trusts can allocate their GST exemption to trusts that receive remainders of the GRATs only after the close of the estate tax inclusion period. This ruling illustrates the applicability of the estate tax inclusion period rule contained in IRC § 2642(f). The Internal Revenue Service reasoned that if a grantor of the GRAT died immediately after the GRAT's funding, the trust would be includable in the grantor's estate under IRC § 2036. Therefore, IRC § 2642(f) applies and prevents allocation of the grantor's unused IRC § 2631 generation-skipping transfer tax exemption before the closing of the estate tax inclusion period as defined in IRC § 2642(f)(3). In this case, the estate tax inclusion period ends on the earlier of the end of the trust or the death of the grantor.

B. Special Rules for Allocation of GST Exemption (IRC §2632)

1. *PLR 200224018*

The information contained in the copies of three trust agreements attached to a decedent's federal estate tax return was sufficient to constitute substantial compliance with the requirements for making a timely allocation of the decedent's generation-skipping tax exemption. One of the trusts contained directions that the trust assets be divided into two separate trusts, one of the trusts (the "GST trust") having a value equal to the decedent's available GST exemption. No entries, however, were made on the applicable schedule on the estate tax return. The Internal Revenue Service concluded that the trust agreements contain sufficient information to constitute substantial compliance with the requirements for a timely allocation.

VI. FEDERAL CASES AND RULINGS – SPECIAL VALUATION RULES

A. Special Valuation Rules for Transfers of Interest in Trust (IRC § 2702)

1. *PLRs 200220014-015*

In two virtually identical rulings, the Internal Revenue Service has ruled that the partial conversion of a qualified personal residence trust ("QPRT") into a grantor retained annuity trust ("GRAT") upon the sale of the residence that had appreciated in value between the date the QPRT was funded and the date the residence was sold will not result in additional gifts to the remainder beneficiaries or any gift tax consequences to the taxpayer notwithstanding that the annuity amount was determined using the actuarial values and asset values that existed

on the date the QPRT was formed.

2. *TAM 20023003*

Revocable spousal annuity interest provided under a grantor retained annuity trust which entitles grantor's spouse to receive the annuity that grantor would have received had grantor lived for the entire annuity term is not a qualified interest and is not to be taken into account in reducing the value of the gift. The ruling relies on the Seventh Circuit case of *Cook v. Commissioner*, 269 F.3d 854 (7th Cir. 2001) and the Tax Court case of *Schott v. Commissioner*, T.C. Memo 2001-110, both of which determined that similar interests were not qualified interests for purposes of IRC § 2702.

B. Treatment of Certain Lapsing Rights and Restrictions (IRC § 2704)

1. *Kerr v. Commissioner*, 292 F. 3d 490 (5th Cir. 2002)

The Fifth Circuit has held that liquidation restrictions could be taken into account to lower gift tax costs for transfers of family partnership interests to a grantor retained annuity trust because they were not applicable restrictions under IRC § 2704(b)(3)(B). The taxpayers created two family limited partnerships with the intention of making gifts of limited partnership interests to their children. The couple then transferred some limited partnership interests to a state university. Approximately six months later, each spouse created an irrevocable grantor retained annuity trust and designated their children and grandchildren as remainder beneficiaries. The couple then transferred limited partnership interest to the GRATs and to the children directly. In reporting the transaction on their gift tax returns, the couple disregarded IRC § 2704 and applied marketability discounts because of partnership agreement restrictions on liquidation. In affirming the Tax Court, the Appellate Court agreed that the partnership restrictions were not applicable restrictions. The restrictions could not be removed without the involvement of non-family members because modification of the partnership agreement would require the approval of the state university.

VII. FEDERAL CASES AND RULINGS – INCOME TAX AND MISCELLANEOUS

A. Exclusion of Death Benefits (IRC § 101)

1. *PLR 200228019*

A husband created two trusts, one for the benefit of his three children and the second for the benefit of his lineal descendants. The taxpayer then created a third trust, the Transferee Trust, which intends to purchase three variable life insurance policies held by one of the earlier trusts. The Internal Revenue Service



reasoned that since both the Transferee Trust and the earlier trust are grantor trusts and treated as owned by the taxpayer, the transfer of the three variable life insurance policies is disregarded for federal income tax purposes and the death benefit exclusion of IRC § 101(a)(1) will be unaffected.

B. Charitable Deductions (IRC § 170)

1. Addis v. Commissioner, 118 T.C. No. 32

In what may be the final gasp of charitable split dollar, the Tax Court has denied deductions for charitable contributions associated with a charitable split dollar-life insurance arrangement because the receipts provided by the charity incorrectly stated that no goods or services were provided. The contributions were made before the law was changed to crack down on split-dollar charitable contributions. The taxpayers set up a trust which purchased approximately \$1,000,000 of life insurance on one taxpayer's life. Her husband then informed the head of National Heritage Foundation (NHF), a public charity, of the policy and offered NHF an option to acquire an interest in it. The husband and NHF agreed that if NHF paid \$36,000 (the balance due on the premium on the policy) it would be entitled to approximately 56% of the policy's death benefit. Thereafter, the taxpayers sent a \$36,000 check to NHF on behalf of their family foundation stating that NHF was not required to use the \$36,000 to pay the policy premium but that they expected it to do so. The premium was thereafter paid. Not surprisingly, the Court denied the charitable deduction.

C. Deduction by Estate or Trust for Payments to Charity (IRC § 642(c))

1. PLR 200221011

When the decedent died, his assets included an individual retirement account which was payable to his estate. The decedent's will provided that the residue of the estate must be given to organizations that are tax-exempt as described in IRC § 2055(a). The Internal Revenue Service concluded that the amounts from the IRA will be income in respect of the decedent but that the amounts will be considered to be gross income permanently set aside for charitable purposes and therefore deductible by the estate in the year of receipt.

D. Lien for Taxes (IRC § 6321)

1. Murphy v. Maryland Controller of the Treasury, 2002- USTC ¶64,444 (D.C. Md. 2002), 2002 U.S. Dist. LEXIS 11315

The settlement proceeds from two malpractice actions filed against an estate's attorney were subject to the Internal Revenue Service's tax lien against the estate because the proceeds

constituted property of the estate. The plaintiff, who is both the estate's primary beneficiary and a co-personal representative, filed two malpractice actions against the estate's lawyer. The plaintiff brought the suits both as the estate's co-personal representative and in his individual capacity. The plaintiff contended that he had a superior claim to the portion of the proceeds attributable to his individual claims as a beneficiary. The court disagreed and held that he did not have standing to sue the attorney under state (Maryland) law as the estate's primary beneficiary since he failed to show that he had a direct employment relationship with the attorney or was the intended third party beneficiary of the attorney's legal services.

E. Attorneys' Fees (IRC § 7430)

1. Wilkes v. United States, 289 F. 3d 684 (11th Cir. 2002)

An estate was entitled to an award of attorneys' fees because the government's position in the underlying estate tax litigation was not substantially justified. The estate's executor elected pursuant to former IRC § 2210 to have an employee stock ownership plan pay a portion of the estate tax liability. After the ESOP failed to pay the tax, the Internal Revenue Service sought collection from the estate contending that IRC § 2210 discharged, the executor of his personal liability only and that the estate remained liable for the tax. The District Court disagreed holding that IRC § 2210 discharged both the executor of his individual liability and the estate of its liability. Thereafter, the estate filed a motion for attorneys' fees and the District Court awarded these fees after it concluded that the government's position in the litigation was not substantially justified. The Appellate Court affirmed, holding that the District Court did not abuse its discretion. The court ruled that it was clear from the language of IRC § 2210 and related provisions that the ESOP was a substitute for the estate with respect to the tax and not simply a primary obligor with the estate remaining secondarily liable.

* *Leland, Parachini, Steinberg, Matzger & Melnick, LLP, San Francisco, California*



NOMINATING COMMITTEE

Do you want to become involved with the Trusts and Estates section?

Publication of the *California Trusts and Estates Quarterly* is just one of several projects carried out by the "Executive Committee" of the Trusts and Estates Section of the State Bar. The Executive Committee consists of about 17 regular members (who serve a 3-year term), 15 advisors (who serve a 3-year term) and 5+ special advisors, all of whom volunteer to serve on the Committee. Some of the major work of the Executive Committee includes:

- Our members volunteer to be the editorial staff to produce the Quarterly.
- Each year the California legislature proposes numerous bills that would amend the Probate Code or other California statutes affecting the practice of trusts and estates. We review virtually every such bill and offer support or constructive criticism or opposition, as appropriate.
- Each year we identify issues of California law that might benefit by an amendment to current California statutes. Our Executive Committee members debate alternatives and develop appropriate proposals for future California legislation.
- We organize several continuing education programs each year, including the programs presented at the State Bar annual meeting and the programs presented at the annual Section Education Institute.

We are looking for new members. Here are the general pre-requisites for an applicant:

- An applicant should be a member of the Trusts and Estates Section and be actively involved in the practice of trusts and estates matters in California (whether in private practice, in-house counsel at a bank or other institution, or in the government sector).
- An applicant should be willing to participate in the Executive Committee's meetings, consisting each year of about seven all-day Saturday meetings and one weekend meeting.
- An applicant should be willing to serve for a 3-year term with the option of the Executive Committee to have the applicant continue as a "advisor" for a second 3-year term.
- The applicant should be comfortable in receiving and sending email and email attachments because a substantial portion of the committee's work is accomplished in this way.

Deadline: The Executive Committee year runs from October through the following September to correspond to the State Bar's fiscal year. For the year commencing October 2003, the application deadline is **January 31, 2003**. You may obtain the application online by following the links from the State Bar website (or by typing in the following: www.calbar.ca.gov/calbar/pdfs/appapp0203.pdf). If you have any questions, please contact Warren A. Sinsheimer by email at wasa@ssblaw.com.



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