

# Real Property, Probate & Trust



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## Tax-Deferred Exchanges of Real Estate: Protecting Your Clients' Interests

By Don Leadroot & Cris Anderson, Asset Preservation, Inc.

### Brief History

The basic rule allowing the tax deferred disposition of income or investment property has been in effect since 1921, I.R.C. §202 (we have had a general federal income tax since 1916). The policy behind I.R.C. §1031 involves the desire to allow owners to dispose of their property and acquire replacement property without incurring a large cost of sale — the capital gain tax. In doing so, the various markets are kept fluid and business owners and investors can continuously replace worn or inadequate property without penalty.

These simple, but critical, requirements are implied:

- The Exchanger acquires “like-kind” Replacement Property.
- The Exchanger receives no cash.
- The transaction must be an exchange — not a sale followed by a purchase.

Treas. Reg. § 1.1002-1(d).

Early forms of exchanges usually involved landowners who simply swapped property. The first “three corner exchange” was approved in 1935, see *Mercantile Trust Co. of Baltimore v. Commissioner* (32 BTA 82(A)). One of the parties acts as an intermediary by holding either property or by holding funds to buy the replacement.

The landmark case *Starker v. U.S.*, 602 F.2d. 1341 (9th Cir. 1979) stands for the proposition that the exchange could be completed on a delayed basis. The 9th Circuit Court of Appeals settled a longstanding question when it said there is nothing in the

tax code or the legislative history that requires exchanges to be simultaneous. *This opened the door for tax- deferred exchanges on a delayed basis.*

Since *Starker*, Congress and the Treasury Department have sought to put limits and definition to exchanges.

- The Tax Reform Act of 1984 changed the “reasonable time” standard of *Starker* to 180 days. Furthermore, the Replacement Property had to be identified within 45 days. Partnership interests were clearly defined as personal property and not suitable for exchange purposes.
- The Tax Reform Act of 1986 was important for investors because the preferred treatment for capital gain income was eliminated.
- The Revenue Reconciliation Act of 1989 eliminated foreign real property as “like-kind” to U.S. real property.
- The Treasury Regulations adopted in 1991 (See TD 8346 1991-1 Cum Bul 150) provided Exchangers with welcome direction as to such issues as identification of Replacement Property, the handling and security of funds between transactions, and the role of Qualified Intermediaries. If an exchange is properly structured and implemented, it will fall within a safe harbor and the Exchanger can have confidence in an audit.

### Basic Rules

Although there are still several gray areas, case law and legislation have allowed tax-deferred exchanges to keep up with modern business practice. Much of the guesswork has been

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eliminated, and exchanging has become a popular and important investment technique.

Under §1031 of the Internal Revenue Code, *property held for productive use in a trade or business as well as bare land held as a long-term investment* qualifies for tax-deferred exchanges. This is good news for real estate investors: **All real estate is considered “like-kind” to any other type of real estate.** The important issue is how the Exchanger uses the property. The Exchanger must be able to demonstrate the Relinquished Property has been held and the Replacement Property will be held for income production or long-term investment purposes.

**Exchanges are not allowed for real estate held for personal use or for resale purposes.**

- “Personal use” property examples include the primary residence of the taxpayer, frequently used vacation or “second home” properties, and homes used rent-free by relatives of the taxpayer. Mixed-use property may qualify if there is an allocation of the sale price, debt, equity and expenses of sale. The tax character of property can change over time, *e.g.*, vacation homes that are turned into rentals or bare land that has been turned into a primary residence upon retirement.
- “Resale property” is commonly defined as property held for sale in the ordinary course of the taxpayer’s trade or business. As in the case of personal use property, the Exchanger can change the tax character of a property over time. For example, a handyman may buy houses, fix them up and put them on the market for sale — clearly not suitable for exchange treatment. If he decides to buy, fix up, then use it as a rental for a suitable period, he could use it in an exchange.

Partnership interests, notes secured by real property, seller’s interests in land sale contracts and property outside the United States and its territories do not qualify for tax deferred exchange treatment under § 1031.

### Exchange Methods & Variations

The balance of this article will focus on the methods and variations utilized by taxpayers exchanging with the use of a Qualified Intermediary. Although simultaneous two-way and three-way exchanges are still a viable method of exchanging, most taxpayers choose to use an Intermediary. Simultaneous exchanges are not a predominant factor in today’s investment and business community.

### The Delayed Exchange

The use of a Qualified Intermediary is essential to complete a valid delayed exchange. A reciprocal trade or actual exchange must take place in each §1031 tax deferred exchange transaction. This means the Exchanger must assign its interest in the Sale Agreement to the Qualified Intermediary (also known as an Accommodator or Facilitator) so that the Intermediary is shown as the seller.

**Practice Tip:** At a minimum, the Purchase and Sale Agreement for both the Relinquished and Replacement Property must be assignable by the Exchanger.

The sale proceeds are sent to the Intermediary and the Exchanger has no *actual or constructive receipt* of the funds at any time during the exchange. The Intermediary is an independent party to the exchange transaction who supplies the necessary documents, such as the Exchange Agreement, Assignments and Closing Instructions. The Intermediary holds the exchange funds until they are needed for the Replacement Property.

A typical delayed exchange starts with a transaction similar to a taxable sale, except that the Intermediary is assigned into the Seller’s position. The exchange begins at the close of the sale, when the Relinquished Property is transferred and the Intermediary receives the exchange proceeds. Tax laws allow the Exchanger a maximum of 45

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days to identify potential Replacement Property and 180 days, or the Exchanger's tax return due date (including extensions) for the year the Relinquished Property closes, whichever is earlier, to close on the purchase of the Replacement Property. Both time frames begin when the sale closes. The proper identification of Replacement Property is critical (Treas. Reg. § 1.1031(k)-1):

- The Identification List must be in writing and signed by the Exchanger.
- It must be delivered to a party to the exchange transaction (generally the Intermediary) within 45 days of the close of the Relinquished Property. Mail, fax or hand delivery may be used.
- The properties listed must be site-specific, that is, described by a street address, tax lot number, legal description or the like.
- The Exchanger may list up to three properties of unlimited value. If more than three properties are listed, their total aggregate value may be no more than 200 percent of the value of the Relinquished Property.

Prior to the close of the purchase of the Replacement Property, the Exchanger assigns the right to purchase the Replacement Property to the Intermediary. The exchange is completed when the Intermediary uses exchange funds to purchase the Replacement Property. Unless involved in a more complex exchange, "direct deeding" is used, and the Intermediary instructs the closing agent to deed the Replacement Property directly to the Exchanger.

**Practice Tip:** A recent Private Letter Ruling (PLR 200027028) shows that an exchange may be disallowed if the exchange funds are not held by the Intermediary until the Exchanger has purchased all of the property to which he is entitled or the end of the exchange period. Plan ahead when preparing the Identification List and closing the first purchase of the exchange to avoid excess funds. If there are excess funds and the 45-day Identification Period has not expired, amend the list to delete unpurchased properties, so that excess funds may be promptly returned.

The delayed exchange offers a relatively simple method to structure exchanges so the sale transaction and the purchase transaction are similar to nonexchange transactions.

### Improvement Exchanges

The improvement exchange gives the Exchanger the opportunity to use all or part of the exchange funds for construction of the Replacement Property. The most common type of improvement exchange is where the Exchanger sells the

Relinquished Property and acquires the improved Replacement Property at a later date. I.R.C. §1031 disallows any construction occurring after the Exchanger receives the Replacement Property from inclusion as part of the exchange. Therefore, the construction has to take place while the Intermediary holds the property.

It is important to understand that all applicable rules of I.R.C. §1031 apply to improvement exchanges. For example, the Exchanger has 45 days to identify the Replacement Property, and no more than 180 days to acquire identified property.

### The Procedure

The improvement exchange begins when the Exchanger sells the Relinquished Property as in a delayed exchange. The proceeds from that sale go to the Intermediary. When the Exchanger contracts to purchase Replacement Property, that contract is assigned to the Intermediary.

When the Replacement Property to be improved can be purchased, the Intermediary uses the exchange funds for its purchase, and the Replacement Property is deeded to the Intermediary. The Exchanger makes arrangements for the construction on the Replacement Property in the Intermediary's name. Construction invoices are sent to the Intermediary and paid with the Exchanger's approval.

When the construction is finished, the Intermediary transfers title to the Replacement Property to the Exchanger. Any construction to be included in the exchange must be built and paid for prior to the date the Exchanger takes title to the Replacement Property. All of this must be accomplished within 180 days of the close of the sale of the Relinquished Property.

### Important Issues

#### Identification of Property to be Constructed

For property to be constructed the identification rules are satisfied "if a legal description is provided for the underlying land and as much detail is provided regarding the construction of the improvements as is practicable at the time identification is made." Treas. Reg. § 1031(k)-1 (e)(2).

- New construction on bare land requires a specific description of the land (legal description or tax lot) and plans and specifications of the new construction.
- Where the Replacement Property is an existing structure in need of remodeling, an address of the building and a summary of the remodeling project will likely suffice.
- For purposes of the 200 percent rule, the value of the identified property is the estimated value of the constructed property when the Exchanger expects to receive it.
- The real estate eventually received by the Exchanger must be "substantially the same property as identified."

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Normal construction changes meet this test: however “substantial changes” do not.

Treas. Reg. §1.1031(k)-I (e)(3).

### Receipt of Replacement Property

The requirement that the Exchanger take title to the Replacement Property within 180 days applies to improvement exchanges. After the Exchanger takes title to the Replacement Property, construction may continue, and the value of that additional construction will not be counted as part of the exchange. The Exchanger should keep in mind:

- There is no requirement that construction be completed within 180 days when the Exchanger receives the Replacement Property to the extent that the improvement is suitable for occupancy or use. The Exchanger will be credited with receiving Replacement Property valued as of the date it is deeded to the Exchanger. For most exchanges, that value is comprised of the amount of the completed construction contract and the value of the land.
- The tax rules specifically prohibit the inclusion of a prepaid, but not completed, construction contract or delivered but not constructed materials in the exchange value.

### Practical Considerations

- Because of the relatively short exchange period, it is critical that the improvement exchange be well planned so that the purchase of the Replacement Property and The construction can begin shortly after the close of the Relinquished Property.
- If a construction loan is required for the improvement exchange, the Exchanger should consult with the lender at the outset. The lender will usually require the Intermediary to sign the loan agreement and the deed of trust to protect the lender’s security interest while the Intermediary holds title. An additional guarantee, secured by other property, may be required of the Exchanger.
- The Intermediary will require liability insurance, possibly an Environmental Contamination-Level I Assessment and an indemnity from the Exchanger.
- The construction contract should be in the name of the Intermediary with a management agreement to the Exchanger so that the Exchanger retains oversight of the construction while the Intermediary is in title.

**Practice Tip:** An Exchanger may not do an improvement exchange where the construction is to take place on land

already owned by the Exchanger. *Bloomington Coca Cola Bottling Co. v. Commissioner*, 189 F.2d. 14 (7th Cir. 1951). However, counsel may wish to consider Private Letter Rulings 8304022 and 9243038, which suggest the IRS may be open to carefully structured transactions that produce the desired outcome.

### Reverse Exchanges

**At long last the IRS has announced its “Safe Harbor for Like-Kind Exchanges.”** See Rev. Proc. 2000-37; 200-40 IRBI (September 15, 2000). This allows the Exchanger the opportunity to complete the purchase of the Replacement Property before the sale of the Relinquished Property.

While many successful reverse exchanges have been completed over the years, tax and legal advisors have been leery about the possibility that the IRS may attack them on the grounds that the Intermediary is not a true, independent party but merely an agent of the Exchanger. The new rules offer a welcome clarification.

### The New Reverse Exchange Guidelines

The new Reverse Exchange Guidelines follow the same general pattern of reverse exchanges as under the court cases. They allow the Intermediary to hold title to either the Relinquished or Replacement property and allow the Exchanger the use and benefits of the property during the exchange period.

Important features of the new rules are:

- The Intermediary, through a “qualified exchange accommodation arrangement” (QEAA), may hold title to either the Relinquished or Replacement Property.
- The Exchanger must have the requisite intent that the purchase of the Replacement Property be part of an exchange—including an agreement with the Intermediary no later than five days after the purchase.
- Within 45 days of the purchase of the Replacement, the Exchanger must “identify” the Relinquished Property to be sold in the exchange.
- The Reverse exchange must be completed within a 180-day period.

### Additional Issues to Consider

- Since the Intermediary must hold title to property during the exchange period, lenders should be consulted prior to structuring a reverse exchange.
- The Exchanger may enter into a lease agreement or management agreement with the Intermediary to enjoy the use of the property held by the Intermediary.
- The reverse exchange may be combined with an improvement exchange to allow for construction to be

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included in the exchange. However, the 180-day time limit makes this exchange less effective for large projects.

- The effective date for the reverse exchange rules is September 15, 2000.

### Final Thought . . .

The new Reverse Exchange Guidelines will undoubtedly make this a more popular and accepted exchange. Once the rules are fully understood and exchange agreements are developed to address them, Exchangers and their advisors will be able to confidently structure exchanges where the Replacement Property is purchased before the Relinquished Property is sold.

**Practice Tip:** As a practical matter, most Intermediaries will want to have an agreement with the Exchanger prior to taking title to a property on their behalf. The Exchanger may loan or advance funds to the Intermediary for the purchase of the Replacement Property. Also, reverse exchanges utilizing a “parking arrangement” outside this procedure may still be able to qualify for tax deferral.

### Single Member LLCs for Reverse and Construction Exchanges

An emerging trend for Intermediaries involves the formation of a single-member LLC for purposes of holding title to property in improvement and reverse exchanges. This provides protection for the Exchanger from potential liability caused by other properties the Intermediary may hold. In fact, a single-member LLC may be set up to take title to the Replacement Property for the Intermediary. When the exchange is completed, the Intermediary causes the LLC, rather than actual title to the property, to be transferred to the Exchanger. This makes the purchase loan and the construction contract much easier to set up, and may alleviate additional title policies or transfer taxes. IRC §7701 allows a single-member LLC that acquires property to be treated as a direct ownership by the investor.

### Important Exchange Issues

#### Seller Financing and Tax Deterred Exchanges

While it is always preferable for the Exchanger to receive all cash for the Relinquished Property, many real estate transactions require the seller to “carry back” a part of the purchase price as financing to assist the buyer. In this situation, the Exchanger (seller) may elect to treat the buyer’s promissory note as an installment sale under IRC §453 and pay any capital gains taxes on the deferred principal payments in the year these payments are received by the Exchanger. Or, the Exchanger may complete a partial exchange and combine the seller-financing portion of the

sale with a tax-deferred exchange for the balance of the sale property. See Treas. Reg. §1.1031(k)-16(2) and 26 CFR Parts 1 and 15a, TD 8535. In this situation, the capital gain attributable to the portion of the sale property that was exchanged will be tax deferred into the Replacement Property. The portion of the capital gain that is attributable to the installment note will be deferred over the life of the note and recognized upon receipt of principal payments. Generally, all of the basis on the sale property will be allocated to the Replacement Property and the installment note will have no basis, which means all payments will be fully taxable.

If the Exchanger wishes to pay no capital gain tax, the note may be included as part of the exchange. *This will complicate the exchange because the seller-financing note must be passed through the exchange and the value of the note must be converted to “down-payment equity” in the Replacement Property at the time of the Replacement Property purchase.* Treas. Reg. § 1.10310(2). To accomplish this, the Intermediary must be named as the payee of the seller-financing note at the close of the Relinquished Property escrow. The note and any security agreements (deed of trust or mortgage) are assets of the Intermediary, but must be fully assignable by the Intermediary. At the Exchanger’s direction, the Intermediary can then use the note in several ways to purchase the Replacement Property:

- Sell the note to a third party for cash and then use the cash to purchase the Exchanger’s Replacement Property. The Exchanger must consider whether a discount charged by the buyer of the note, if applicable, exceeds or is offset by the capital gain tax that would have been paid under normal installment sale rules. Also, the amount of any discount the Exchanger absorbs may be treated as taxable boot.
- Assign the note to the seller of the Replacement Property. This is ideal for the Exchanger, resulting in a complete tax deferral. However, the seller of the Replacement Property does not get installment sale treatment on the receipt of the Exchanger’s note. Also, the seller is likely to want to discount the value of the note.
- Sell the note for cash to the Exchanger or to a friendly party and use the cash to purchase the Exchanger’s Replacement Property. This arrangement should be used only on the advice of the Exchanger’s tax or legal counsel. The Exchanger or friendly party should purchase the note at its full face value, and not at a discount.

**Practice Tip:** There is no legal authority as to this option, however the use of a friendly party such as the Exchanger’s single member LLC, or close relative, may help to shield the Exchanger from the appearance of receiving taxable boot in the form of the note. The

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Exchanger's qualified retirement plan should not purchase the note from the exchange because of the ERISA self-dealing prohibition.

If the above options fail, the Intermediary will assign the note back to the Exchanger at the termination of the exchange. The Exchanger will receive the same installment treatment under IRC §453 as if the Exchanger had not attempted to defer the tax on the installment note through the exchange. Moreover, the date of the recognition of the installment sale gain is the date the note is assigned to the Exchanger from the Intermediary, even if that assignment is in the next tax year.

### Exchanging with a Related Party

Exchanges between related parties are allowed but there are specific rules that must be followed. Related parties are defined in IRC §267 (b) and §707 (b)(1) as any person or entity bearing a relationship to the Exchanger. This includes the following:

- Members of a family (brothers, sisters, spouse, ancestors and lineal descendants);
- Two corporations that are members of the same controlled group;
- An individual in a corporation in which more than 50 percent of the value of the outstanding stock is owned, directly or indirectly, by or for such individual;
- A corporation and a partnership where the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital or profits interest in the partnership;
- A grantor or a fiduciary of any trust;
- A partnership and a person owning, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership; or
- Two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital or profits interest in the partnerships.

Two related parties, owning separate properties, may "swap" those properties with one another and defer the gain under IRC §1031(t). The only requirement is that neither party may dispose of their replacement properties within two years of the exchange. This rule was imposed to prevent taxpayers from using exchanges to shift the tax basis between properties owned by the related parties with the intended purpose of avoiding paying taxes.

The more typical related party exchange scenarios have the Exchanger using an Intermediary to create an exchange with a related party buyer who purchases the Exchanger's Relinquished Property or a related party seller from whom the Exchanger purchases the Replacement Property. Exchanges in which the

*buyer* is the related party seem to have better success in qualifying under the rules and are more acceptable to the IRS as long as both the buyer and the Exchanger hold on to the properties they receive in the exchange for the two-year holding period.

**Practice Tip:** According to PLR 9748006, exchanges in which the related party is the *seller* are not currently favored by the IRS, even if the Exchanger uses an Intermediary to create the "exchange."

Exceptions to the two-year minimum holding period for related parties are allowed if:

- The subsequent disposition of the property is due to the death of the Exchanger or the related party;
- The disposition of the property is due to the compulsory or involuntary conversion of one of the properties under IRC § 1033 (if the exchange occurred before the threat of conversion); or
- The Exchanger can establish that neither the exchange nor the disposition of the property was designed to avoid the payment of federal income tax as one of its principal purposes.

### The Use of Partnerships and LLCs in Tax-Deferred Exchanges

Investors often need to acquire property in a "Special Use Entity" that will assure lenders that the investor will keep the property separate from other property and will not bring the property into a bankruptcy filing if the investor develops financial problems. One desirable feature of the Special Use Entity is that someone other than the investor has the exclusive power to allow the property to be part of a bankruptcy. Partnerships and LLCs are popular forms of Special Use Entities. The real issue is: **If an investor sells property as part of an exchange, and acquires the target property personally, or in a partnership or LLC, or then immediately contributes it to such an entity, does that investor still get tax-deferred exchange treatment under IRC §1031?**

### Important Considerations

The IRS could attack the exchange based on the above format on several grounds:

- IRC §1031(a)(2)(D) expressly prohibits the purchase of a partnership interest as Replacement Property in an exchange, even if the sole asset of the partnership is the real estate. Partnership interests are personal property and are not like-kind to real estate.

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# In the Eye of the Receiver Washington Uniform Estate Tax Apportionment Act

By Frederic G. Emry II

## I. Introduction

For many Americans, any given fall Saturday or Sunday afternoon is a thing of beauty — watching the football spiraling toward the end zone into the expectant hands of a waiting receiver for a touchdown. But when the ball is dropped, the crowd groans. So it is when a beneficiary under a will or trust receives an inheritance as intended. However, many beneficiaries are shocked that their share is reduced by estate taxes at a rate of 37 percent to 55 percent. Others are aghast that their inheritance is not only burdened by their share of estate taxes, but also that they have to pay other beneficiaries' estate taxes at the same rates, which often leaves them with little or nothing. They wonder if somehow the ball wasn't dropped.

The point of all of this is that the emphasis of apportionment of estate taxes is on the *beneficiaries* who receive the property by will, trust or other testamentary device. All the attention for the allocation of estate taxes is on the receiver, not the quarterback/client. Determining who will pay the estate taxes is an important part of estate planning. Projecting on whom the burden of estate taxes falls should be part of every estate plan.

## II. General Rule of the Apportionment of Taxes

Washington has declared it to be public policy since 1986 that estate taxes be paid by heirs and beneficiaries in proportion to what each one receives. Before 1986 there was no state statute, only common law as evidenced by court decisions.

With a few exceptions, or unless the will, trust or other dispositive instrument provides otherwise, the federal estate tax and Washington estate tax is apportioned among all persons interested in the gross estate of the decedent. RCW 83.110.020.

Thus, if a beneficiary receives 10 percent of a decedent's gross estate, then the beneficiary pays 10 percent of the federal and Washington estate taxes. It is fundamentally that simple.

It might be helpful to think of the gross estate as a sum of the assets making up Schedules A through I of Form 706, Estate Tax Return.

Another way of thinking of "gross estate" of a decedent would be everything included in Internal Revenue Code Sections 2031 through Internal Revenue Code Section 2046. Thus IRC Section 2031 defines "gross estate" as including all property, real or personal, tangible or intangible, wherever situated. Under IRC 2033, the value of the gross estate includes the value of all

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- If the investor acquires the property personally, then contributes it to a partnership or LLC, the IRS may conclude the property did not qualify as part of an exchange because it was not held for income or investment purposes.
- Or, based on the step transaction doctrine, the IRS may argue the acquisition was really a partnership interest because that was the outcome of the series of steps.

There is scant authority on this issue:

- Revenue Ruling 75-292 denied exchange treatment to a taxpayer who personally acquired Replacement Property then contributed it to a corporation. The reasoning involved characterizing the corporation as an *entity* distinct from the taxpayer.
- The investor's best authority may be *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985) where the 9th Circuit distinguished Rev. Rul. 75-292 because

*Magneson* contributed the property to a limited partnership where he had a general partnership interest. The court viewed the partnership as an *aggregation* of individual interests and because of the management function involved, said that there was merely a change in the form of ownership of the property.

- One problem with *Magneson* is that other circuit courts have not addressed this issue. In addition, the decision predates IRC §1031(a)(2)(D) and the decision almost equates a partnership interest as like-kind to real estate.

If the investor is going to rely on *Magneson*, a general partnership interest or LLC membership status with significant management control may be advised.

**Practice Tip:** See Private Letter Ruling 199911033 in which the IRS approved of a bankruptcy remote entity formed as an LLC, with the members being the Exchanger, Exchanger's wholly owned corporation and the lender's representative. •

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## In the Eye of the Receiver . . .

property to the extent of the interest therein belonging to the decedent at the time of his or her death. The following are also included: dower or curtesy interests (IRC Section 2034), certain gifts made within three years of death (IRC Section 2035); transfers with retained life estate (IRC Section 2036); transfers taking effect at death (IRC Section 2037); revocable transfers (IRC Section 2038); annuities (IRC Section 2039); joint interests (IRC Section 2040); powers of appointment (IRC Section 2041); proceeds of life insurance (IRC Section 2042); transfers for insufficient consideration (IRC Section 2043); certain property for which a marital deduction was previously allowed (IRC Section 2044); prior interests (IRC Section 2045); and disclaimers (IRC Section 2046).

One should note, however, this excludes taxable gifts made during the decedent's lifetime, even though the taxable gifts are added back into the estate calculation, to arrive at the federal estate tax.

Thus, if the decedent gave during lifetime to Child A an asset equal to the current exemption equivalent amount, and by will devised, an equal amount to Child B, Child B would have to pay all the estate taxes with no recovery from Child A.

### III. Exceptions to the General Apportionment Rule

The statutory exceptions to the apportionment rule of RCW 83.110.020 are found in RCW 83.110.050; RCW 83.110.060, and RCW 83.110.090.

#### A. Apportionment Away From Marital or Charitable Deduction

The exceptions to the apportionment rule in RCW 83.110.020 relate to the following: The surviving spouse who receives marital deduction property outright or in trust is not apportioned any estate taxes on that gift. RCW 83.110.050(2). Similarly, a charitable institution that receives a charitable deduction gift is not apportioned any estate taxes on that gift. RCW 83.110.050(2).

#### B. Qualified Family Owned Business Interest

Certain revisions were made to Chapter RCW 83.110 in the 2000 legislature which was signed into law on March 24, 2000. One of these is the exception to the apportionment rule that was added in RCW 83.110.020 for deductions due to qualified family owned business interest under Internal Revenue Code Section 2057. Thus, a person or trust receiving a qualified family business interest is not apportioned any estate taxes on the qualified family owned business interest up to the amount of the deduction. The reason for the inclusion of qualified family-owned business interest deduction under Internal Revenue Code Section 2057 as an exception in RCW 83.110.050(2) was because the Internal

Revenue Service's instruction to Schedule T of Form 706, Estate Tax Return provides that the deduction under IRC Section 2057 must be reduced by any federal estate tax, state inheritance tax, or generation skipping tax paid out of the qualified family owned business that is being claimed as a deduction.

#### C. Special Farm Use Valuation

In the case of special use valuation for farm property under Internal Revenue Code 2032A, the qualified heirs receiving the farm real property get the benefit of the reduction in estate taxes due to the election of the IRC § 2032A in proportion to their interest in the qualified real property as set forth in the Schedule under RCW 83.110.050(6).

#### D. Estate Taxes on Marital or Charitable Deduction

The most convoluted or complicated section of RCW 83.110 is the exception found in RCW 83.110.050(5). Any estate taxes allocated against a marital deduction gift or a charitable deduction gift reduces the deduction, which, if left unchecked, increases the estate taxes. As a result, the marital deduction or charitable deduction is further reduced, and that reduction increases the estate taxes in a circular pattern. In order to avoid this result, RCW 83.110.050(5) in general provides that the marital deduction gift or charitable deduction gift is burdened with the estate taxes only once, to stop this inter-related marital/charitable deduction and estate tax computation.

#### E. Life Tenant

Another exception to the apportionment rule is RCW 83.110.060 in which the life tenant or term certain beneficiary in property or trust is not apportioned any federal or Washington estate taxes, but fall entirely on the remainderman. The theory is generally that since the value of the remainder interest is reduced by the estate taxes, the life tenant or term certain beneficiary will receive less income. The 2000 legislative revision to RCW 83.110.060 provided that no federal estate tax nor Washington estate tax shall be paid from a charitable remainder annuity trust or a charitable remainder unitrust. The reason for the revision is because the IRS has taken the position that if there is any possibility of any estate taxes being paid out of a charitable remainder trust whether because of a tax clause in a will or trust, or because of a state apportionment statute, then the charitable remainder trust is disqualified from being a tax-exempt trust.

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## In the Eye of the Receiver . . .

### F. Four Federal Exceptions

RCW 83.110.090 contains four important exceptions from the general apportionment of estate taxes as provided in RCW 83.110.020.

Washington apportionment statute appropriately defers to federal statutes covering the same subject matter. Unfortunately, the federal statutes are not homogeneous because they were enacted at different times. The 2000 Legislature Revision named as a matter of convenience in RCW 83.110.090, the four federal statutes that supersede Washington State statute.

All four federal statutes: IRC §§2206, 2207, 2207A and 2207B are rights of recovery statutes rather than apportionment statutes. This distinction is especially significant in one of the statutes, IRC § 2207A.

#### 1. IRC Section 2206

But let's begin from the top with IRC § 2206 as mentioned in RCW 83.110.090.

IRC § 2206 provides that the executor shall be entitled to recover from a beneficiary that portion of the total federal estate taxes as the proceeds of a life insurance policy bears to the taxable estate if any part of the insurance proceeds are included in a decedent's gross estate. IRC § 2206 provides that there is no recovery of estate taxes for life insurance proceeds payable to the surviving spouse allowed as a marital deduction.

#### 2. IRC Section 2207

The second Internal Revenue Code Section mentioned in RCW 83.110.090 is IRC § 2207. IRC § 2207 is very similar to IRC § 2206 in that it provides for the right of the executor to recover from a person receiving property by reason of a decedent's exercise, non-exercise, or release of a power of appointment that is included in decedent's estate. The right of recovery of estate taxes is based on the value of the property subject to the power of appointment bears to the taxable estate. Again, there is no right of recovery for the value of the property to the surviving spouse for which a marital deduction is allowed.

Two points should be noted regarding both IRC § 2206 and IRC § 2207. First of all, the right of recovery is based on the property included in the decedent's estate and apportioned to the *taxable* estate of the decedent and not the decedent's *gross estate*. Thus, the right of recovery under IRC § 2206 and 2207 could produce a result different than the apportionment rule under RCW 83.110.020 in those cases where individuals or classes of persons bear estate expenses from others that do not. Also, to the extent that the estate has mortgaged property, the estate tax apportionment may be different than the right of recovery.

The second point that should be noted is that IRC § 2206 and IRC § 2207 only apply to right of recovery for federal estate tax. Thus, the apportionment rules set forth in RCW 83.110.020 would still apply to Washington State's "pick-up" estate tax.

#### 3. IRC Section 2207A

The third exception set forth in RCW 83.110.090 is IRC § 2207A. The personal representative of the surviving spouse's estate is entitled to recover federal estate taxes from the trustee of the qualified terminable interest property trust (QTIP) that was established by the deceased spouse and for which a marital deduction was elected. The QTIP trust is included in the surviving spouse's estate by reason of Section 2044 of the Internal Revenue Code.

IRC § 2207A provides that the right of recovery of estate taxes by the surviving spouse's estate from the QTIP trust is at the highest marginal estate tax rate, including interest and penalties. To determine the right of recovery under IRC § 2207A, the estate taxes are calculated, including the QTIP trust in the surviving spouse's estate. Then a second calculation is made of the estate taxes without including the QTIP trust in the surviving spouse's estate. The difference between the two is the amount to be recovered from the QTIP trust by the personal representative of the surviving spouse's estate. For example, if the surviving spouse dies in year 2006 with a one million dollar estate, and the QTIP trust for which a marital deduction was elected is also worth one million dollars, then the total estate taxes of \$780,800, less the applicable credit amount of \$345,800 for a net estate tax of \$435,000, are all paid by the QTIP trust. Treasury Reg. 20.2207A-1(b).

If the estate taxes are not paid by the QTIP trust under IRC § 2207A, then the IRS considers that the beneficiaries of the surviving spouse's estate have made a gift to the remainderman of the QTIP trust. The gift will be considered by the IRS as an interest free loan which will result in imputed interest under Internal Revenue Code § 7872. Treasury Reg. 20.2207A-1(a)(2).

Finally, it is important to note that the surviving spouse may waive the right of recovery for his or her estate from the QTIP trust. Also, the surviving spouse can give his or her personal representative the discretion to waive right of recovery. In either case, no gift will have been deemed to have been made. Treasury Reg. 20.2207A-1(a)(3).

Thus, placing provisions in the QTIP trust for non-payment of any estate taxes or waiver of right of recovery will not suffice.

#### 4. IRC Section 2207B

The last exception specified in RCW 83.11.0.090 is IRC § 2207B. This statute provides for recovery of estate taxes for property included in the decedent's gross estate by reason of IRC

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## In the Eye of the Receiver . . .

§ 2036 (relating to transfers with retained life estate). The right of recovery under IRC § 2207B would include the right of recovery from most typical revocable living trusts. The right of recovery is based on the same formula as under IRC § 2206 (Life Insurance) and IRC § 2207 (General Power of Appointment), namely the decedent's estate is entitled to recover that portion of the total estate taxes as the value of the property included in the decedent's estate by reason of IRC § 2036 bears to decedent's taxable estate.

The right of recovery under IRC § 2207B would include right of recovery for federal estate taxes from a qualified retained annuity trust (GRAT) or a qualified personal residence trust (QPRT) that are included in decedent's estate because the decedent's interest did not terminate prior to death.

Several points should be mentioned concerning IRC § 2207B. First of all, if there is more than one person receiving the property, then the right of recovery shall be against each such person. However, IRC § 220713 does not deal with the problem of allocating the federal estate taxes among the recipients of the property.

Also, IRC § 2207B does not involve transfers or trusts that are included in the decedent's estate by reason of IRC § 2037 and IRC § 2038.

Unlike IRC § 2206 and IRC § 2207, IRC § 2207B does not mention the non-recovery from a surviving spouse for which a marital deduction was allowed. As a result, RCW 83.110.050(2) would apply.

However, IRC § 2207B provides that there shall be no right of recovery of federal estate taxes against charitable remainder trusts.

Out of the four exceptions enumerated in RCW 83.110.090, three of them (IRC § 2206, 2207 and 2207B) provide for the right of recovery for federal estate taxes based on the same formula using as the denominator the taxable estate of decedent.

All four Internal Revenue Code Sections specified in RCW 83.110.090 apply the right of recovery only for federal estate taxes and *not* Washington estate taxes. The allocation of Washington estate taxes under the circumstances specified in the four federal statutes (IRC § 2206, 2207, 2207A and 2207B) would be governed by the apportionment rules of RCW 83.110.020.

All four Internal Revenue Code Sections specified in RCW 83.110.090 provide that the decedent in his or her will or revocable trust may specifically indicate an intent to waive any right of recovery under those four federal statutes. Thus, the four federal statutes coordinate with Washington Apportionment Statute RCW 83.110.020 which, likewise, states that the decedent's will or trust may provide a different apportionment or no apportionment at all.

Finally, it does appear that the right of recovery under IRC § 2207B from most typical revocable living trusts could create possible differences in allocation of federal estate tax as compared

to property passing by will because IRC § 2207B bases the recovery on the taxable estate whereas, RCW 83.110.020 bases the apportionment on the gross estate of decedent.

### G. Special Situations Based on Tax Considerations

There are some situations in which the practitioner may wish to pay special attention in preparing an estate plan for a client. In brief summary, some of these situations are enumerated below.

#### 1. GSST Exemption

In order to obtain the full generation skipping tax exemption, which is currently \$1,030,000 per decedent, any estate taxes should be apportioned away from the generation skipping transfer exempt trust. Thus, Washington State Apportionment Act RCW 83.110 should not be followed in this instance, and the decedent's will or trust should specifically provide against allocating or recovering any federal estate tax or Washington estate tax from generation skipping transfer tax exemption property or a GST Exempt Trust.

#### 2. Charitable Remainder Trusts. IRC Section 664

For charitable remainder trusts that a decedent established and that continue beyond the decedent's life, specific provisions should be made for payment of estate taxes other than from the charitable remainder trust.

#### 3. IRA's and Retirement Benefits

Special attention should be paid to coordinating retirement benefits, including IRA accounts, with payment of estate taxes. If the parents want their IRA's to stretch out for the benefit of their children, for instance, who are named as contingent beneficiaries, then special provisions should be made in a decedent's will or trust to provide that no estate taxes will be apportioned to the retirement benefits or IRA's. However, if the parents desire a "qualified trust" be named to receive the remaining retirement benefits, including IRA's, in which the children, grandchildren, or other individuals are the "designated beneficiary," after both of their deaths, then the trust should provide that no retirement benefits, including IRA proceeds paid to the trust, should be used for the payment of any estate taxes.

#### 4. Stock Redemption. IRC Section 303

If part of the client's estate plan is to take advantage of Internal Revenue Code § 303-Stock Redemptions, then it is important that the person receiving the stock to be redeemed must

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## In the Eye of the Receiver . . .

be legally bound to pay the estate taxes. IRC § 303(b)(3). Thus, the practitioner will want to draft a tax clause away from Washington Estate Tax Apportionment Act, RCW 83.110.

### **5. Payment of Estate Taxes in Installments. IRC Section 6166**

In planning a decedent's estate, it may be desirable to take advantage of Internal Revenue Code § 6166 to pay the federal estate tax on a closely held business in installments up to fourteen years. Under RCW 83.110.050(7), the persons receiving the closely held business will also receive the benefits of IRC § 6166. It would be good estate planning to somehow ensure that the persons receiving the closely held business meet the deadline for payment of the estate taxes paid in installments, and in some way ensure payment in the event of acceleration of the unpaid installments in case of a disposition of the closely held business or failure to make timely payments of principal and interest.

### **6. Special Use Valuation for Farm Real Property. IRC Section 2032A**

It seems that the statutory passing of the benefit of reduction in estate taxes through the election of the Internal Revenue Code § 2032A for the special use valuation of farm real property, and the apportionment of estate taxes under RCW 83.110.050(6) has worked reasonably well. Thus, the practitioner may take a cautious approach if one is going to deviate from RCW 83.110.050(6).

### **7. Qualified Family Owned Business Interest. IRC Section 2057**

On the other hand, Internal Revenue Code § 2057 which provides for a deduction for federal estate tax of up to \$675,000 for the adjusted value of qualified family owned business interest is of so recent legislation that the proper allocation of estate taxes is too early to ascertain. As mentioned, RCW 83.110.050 was amended in the 2000 legislature to ensure that the full deduction for qualified family owned business interest is obtained under IRC § 2057 because estate taxes are allocated away from the qualified family owned business interest elected for the deduction. This may be begging the question because it probably means some other family member has to pay the estate taxes on the qualified family owned business, which may be a hardship, especially if that beneficiary is a nonowner or non-participant in the qualified family owned business. If the qualified family owned business is given to one child and an equal amount of assets are given to another child, then the second child will have to pay, not only the estate taxes on that child's share, but also the estate taxes attributable to the qualified family owned business

interest that is elected as a deduction under IRC § 2057 if the full deduction is to be obtained. In any event, the practitioner should be very careful in drafting tax clauses when the client has a qualified family owned business interest. It should also be noted that the result under IRC § 2057 (Qualified Family Owned Business Interest Deduction) is just the opposite of what is required under IRC § 303 for stock redemptions of a closely held business.

### **8. Qualified Conservation Easement. IRC Section 2031(c)**

Lastly, the practitioner may wish to coordinate tax clauses for a client who has a qualified conservation easement or is interested in having the personal representative establish one. Neither federal statutes nor the Washington State Apportionment Act specifically address estate tax allocation concerning a qualified conservation easement.

### **H. Summary**

In summary, there are many issues for the practitioner to consider in planning each client's estate when it may someday be subject to estate taxes. The burden and allocation of estate taxes among the client's eventual beneficiaries and heirs should be developed as part of the overall estate plan to the point that the projected allocation of estate taxes can be adequately discussed with the client during some part of the estate planning process.

Of course, you can "deep six" this paper if estate taxes are abolished. From this person's perspective, it is hard to believe that estate taxes will be completely abolished on both the federal and state level. If that point is reached, then certainly the game will be called off, and both the receiver and quarterback can go home. •

## Recent Developments

### Real Property

Scott B. Osborne, Graham & Dunn PC, Seattle

#### WASHINGTON COURT OF APPEALS

***Farm Owners Ass'n v. Shorelines Bd.*, 100 Wn.App. 341 (2000)**

A landowners' association sought permission to construct a dock over tidelands adjoining property owned by its members located in San Juan County. The San Juan County planning department issued a declaration of non-significance for the project. The initial design of the dock called for a 593-foot structure. After citizens complained about the size of the dock, the length was reduced to 375 feet. At low tide, the float at the end of the dock would rest on the public tidelands, and to foster herring spawn, the association agreed to remove the float for the period from January 1 to March 15 of each year.

The San Juan County hearing examiner denied permission to construct the dock. The examiner found that the marginal convenience provided by the dock was outweighed by the adverse aesthetic impacts the "possibility of setting a precedent, leading to in time to adverse cumulative effects." The association appealed to the County Commissioners, who upheld the hearing examiner. The association then appealed to the Shoreline Hearings Board, which also upheld the county decision, citing the adverse view impact of the dock. An appeal to Thurston County Superior Court followed and the trial court upheld the permit denial.

On appeal to the Court of Appeals, the trial court was affirmed. The fact that the San Juan County planning department issued a declaration of non-significance did not preclude the Board from conducting an independent review of the application under the Shoreline Management Act and considering other applicable state and local regulations. The San Juan County Shoreline Master Program requires that:

Every application for a substantial development permit for dock or pier construction shall be evaluated on the basis of multiple considerations, including but not necessarily limited to . . . scenic views, and public access to the shoreline.

The Board's ruling was supported by sufficient evidence that the benefits of the proposed dock were outweighed by the potential adverse impacts on views and obstruction of public waterways.

It is worth noting that the adverse view impacts referred to in the county policies were not necessarily view impacts from the shore, but rather view impacts on the shoreline as observed from the water. Given the fact that San Juan County is comprised of islands only accessible by water or air, the policy appears to be

designed to ensure that those coming to the islands by water will enjoy scenic views, but must return to the mainland to moor their boats.

***Williams v. Thurston County*, 100 Wn. App. 330 (2000)**

The court has once again ruled against a homeowner seeking to impose liability on municipal authorities as a result of building inspections. Williams remodeled her house. A Thurston County inspector approved the foundation work. Subsequent inspections revealed numerous defects to the foundation. The county acknowledged that the inspector should have discovered the defects, and the inspector was fired. Williams sued the County for damages equal to the difference in the cost of repairing the damage to tie foundation after the other construction had been completed instead of prior to the completion of that additional work. The trial court dismissed the claim.

The Court of Appeals affirmed the dismissal. Williams failed to establish that any special relationship existed with the County beyond the general duty owed the public in connection with building code inspections. The court noted that building permits and building code inspections only authorize construction to proceed; they do not guarantee that all provisions of all applicable codes have been complied with. (*Id page 335*)

This comment is worth remembering the next time a client says that everything is just fine with the project being constructed because the building inspectors have signed off on the construction.

***DeYoung v. Cenex Ltd.*, 100 Wn. App. 885 (2000)**

In a rather complex set of facts, the Court of Appeals has affirmed a jury verdict finding that contamination of farmland by the lessee failed to cause the landowner any damage. The more significant part of this case, however, is the discussion of the effect of the redemption of the property by the tenant-second mortgagee following a foreclosure by the first mortgagee.

DeYoung leased farmland to Schaapman. Cenex and Schaapman entered into a side agreement relating to the operation of the land. Cenex subsequently leased the land directly. DeYoung claimed damages from Cenex's chemical applications to the land. DeYoung claimed that as a result of the damage, he was unable to pay the first mortgage on the property. Ultimately, the first mortgagee foreclosed on the farm. Cenex, the tenant, also held a second mortgage that arose as a result of advancing various operating costs required to farm the property. Following the foreclosure, Cenex redeemed the property.

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## Recent Developments: Real Property

A jury found Cenex to be negligent concerning the contamination of the property, but that the negligence was not the proximate cause of any damage to DeYoung. The trial court dismissed by summary judgment a claim that Cenex violated the Hazardous Waste Management Act, RCW 70.105.

On appeal, the verdict was affirmed. A prior trial had resulted in a dismissal of claims against Cenex relating to the, handling of hazardous waste. The claim at the second trial was barred under the principals of *res judicata*. The court also held that Cenex was entitled to pursue a claim arising from the note evidencing its second mortgage. This was true even though Cenex had redeemed the property from the foreclosure of the first mortgage. In so doing, the court may have finally provided some needed clarification of what can be best described as an unfortunate choice of words in *Washington Mutual Savings Bank v. United States*, 115 Wn.2d 52 (1990) relating to the rights of a junior mortgagee to pursue collection of the secured obligation following a foreclosure of the senior lien.

Cenex's lien was extinguished when Travelers [the senior mortgagee] named Cenex as a party in its foreclosure suit [citations omitted]. Therefore, Cenex was not barred from suing on the note. This result is logical and equitable because the DeYoungs' debt to Cenex was never paid. Instead, Cenex put out another \$150,000 to redeem the land in an effort to protect its security. Cenex needed to get at least \$280,000 from the land to break even: the \$150,000 paid to Travelers, plus the \$130,000 DeYoungs owed on its note with Cenex.

The DeYoungs failed to exercise their right to redeem the land from Cenex or sell their redemption rights in an effort to realize on any excess value that might remain in the land . . . .

### ***Wilhelm v. Beyersdorf*, 100 Wn. App. 836 (2000)**

This case involves the not uncommon occurrence of a road easement physically located in a different place than the legal description granting the easement. Wilhelm obtained a road easement from an adjacent landowner. The easement area was not accurately described and Wilhelm, rejecting the advice from her lawyer, did not obtain a survey to accurately locate the easement. Instead, the access road was constructed on a pre-existing logging road. Beyersdorf, the subsequent purchaser of the adjacent parcel, constructed a well on a portion of the old logging road. Wilhelm commenced an action seeking to enjoin the construction of the well and a reformation of the easement to conform with the location of the road as constructed. The trial court reformed the easement and denied any claims for damages. The trial court also allowed the continued use of the well so long as the use did not interfere with the use of the easement. Beyersdorf appealed, contending that the easement had an inadequate description that was not capable of reformation.

On appeal, the trial court was affirmed. Although the description of the easement area was not precise and did not

describe the area over which the road was actually constructed, the easement nevertheless reflected the grantor's intent to provide access to Wilhelm's property over the Beyersdorf parcel. To the extent that the legal description in the easement failed to reflect that intent, reformation as ordered by the trial court was justified. Since the servient estate was adequately described, the ambiguous description of the easement area was not fatal to the creation of the easement.

The statute of frauds requires that any conveyance of an interest in land, including an easement, must contain a description of the land sufficient to locate it without oral testimony (or it must refer to another instrument that does contain a sufficiency description) [citation omitted]. In the case of an easement, the document does not have to establish the easement's actual location [citing *Berg v. Ting*, 125 Wn. 2d 544 (1995)]. Only the servient estate must be described in sufficient legal terms....

The court also rejected the claim that Beyersdorf was a bona fide purchaser for value, since the easement was disclosed on a title report provided to Beyersdorf and the existence of the road was visible by an inspection of the property. The refusal to grant the damage claim was in the discretion of the trial court. •

## Leave a Legacy Call for Estate Planners

Leave a Legacy is a community and corporate-sponsored public education campaign to encourage people to make planned gifts to their favorite charities in their estates. This successful campaign is a collaboration among hundreds of community organizations, businesses and professionals with the goal of generating increased interest in estate planning and charitable giving.

As part of the campaign, Leave a Legacy has launched "Make a Will, Make a Difference" and is asking for your help in donating time to provide a "no obligation" consultation with individuals who have become aware of the need to provide an estate plan for their family and community.

For more information, please contact Gail MacKenzie, Executive Director at Leave a Legacy 800-682-0090, 206-281-1941 or [www.leavelegacy.org](http://www.leavelegacy.org).

## *Recent Developments*

# Probate and Trust

*Alice E. McCarty and Wendy S. Goffe, Graham & Dunn PC, Seattle*

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### WASHINGTON COURT OF APPEALS

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***Pitzer v. Union Bank*, 141 Wn.2d 539, 9 P.3d 805 (2000).**

**Summary:** The date of a testator's death will determine the applicable law of succession to resolve which individuals have a claim under a decedent's will. Consequently, children born out of wedlock, and not subsequently "acknowledged," will not have a claim against an estate where the decedent died at the time former RCW 11.04.080 governed the status of illegitimate children as pretermitted heirs. The Supreme Court reverses the Court of Appeals.

**Facts:** Anna and Fisher Allotta had three children, Marie Pitzer, Carolann Guilford and James Alotta (collectively referred to as the Respondents). Fisher's sister, Rose, was married to Frank Magrini. Rose and Frank had no children.

Frank died in 1965 and he left his entire estate to his wife, Rose. His will named his nieces and nephews as contingent beneficiaries. Rose and Frank's attorney served as co-executors of the estate. They filed a declaration of completion of administration of Frank's estate in March 1974; the estate automatically closed 30 days later.

Rose died in December 1995. Immediately preceding her death, Rose took her oxygen mask off of her face and indicated that one of the nephews was actually Frank's son. Certain relatives then confessed that they had all known, all along, that the nieces and nephews were actually Frank's children. These relatives indicated that they had known about Frank's paternity of the children for many years, but were sworn to secrecy.

In April 1996, the Respondents petitioned to reopen Frank's estate, claiming that they were qualified as heirs under the pretermitted child statute. They filed as creditors against Rose's estate, claiming that she was unjustly enriched by failing to notify them of their intestate shares of the estate, and they sued Rose's estate to place a constructive trust on the assets equal to their intestate share of Frank's estate. The Respondents have also sued to establish paternity, however, that action is still pending and is not part of this decision.

The trial court dismissed the Respondents' actions. The Court of Appeals reversed and remanded to the trial court for findings consistent with its opinion. The Supreme Court reverses the Court of Appeals, declining to impose a constructive trust or reopen Frank Magrim's estate.

**Discussion:** Citing a 1984 Louisiana Court of Appeals decision, the Court based its decision on the premise that the date of a testator's death generally governs the applicable law of succession. The Court turned to the statute limiting the inheritance rights of illegitimate children, which at the time of Frank's death,

required a written, signed and witnessed acknowledgment of paternity. Former RCW 11.04.080. Without such a writing, all illegitimate children, no matter how strong their proof of their father's paternity, were excluded from any paternal inheritance. The Court found that because former statutes RCW 11.04.080 and 11.76.040 (governing notice to heirs and distributees) were in existence at the time of Frank's death, Rose, as co-executor of Frank's estate, had no duty to notify Respondents of the probate of Frank's estate, because, under the former statute, Respondents were not Frank's heirs.

Therefore, the Court reverses the Court of Appeals, declining to impose a constructive trust on the estate of Rose Magrini in favor of Respondents. The Court also did not find that there were any jurisdictional or due process defects in the failure to notify the Respondents of Frank's probate and therefore, decline to reopen Frank Magrini's estate. The Court found it unnecessary to address the constitutional questions presented by Respondents and did not take up whether former RCW 11.04.080 violated the equal protection clause of the Constitution.

***Estate of Peterson*, 102 Wn. App. 456, 9 P.3d 845 (Div. II 2000).**

**Summary:** The statutory four-month creditor's claim period, under RCW 11.24.010, will not be extended for claims of fraud, in a will contest, where petitioners had knowledge of fraud within the statutory period.

**Facts:** In 1995 while in his 70s, Clarence Peterson (Peterson) married his third wife, Victoria Steve (Victoria). She was in her 20s. Peterson died on October 11, 1997. During the period before his death, Peterson changed his will three times and added two codicils. Each change reduced his other heirs' shares of his estate, while increasing Victoria's share. One codicil stated that if any beneficiary contested his will, his or her share would be reduced to \$10.

After Peterson's death, one of his sons, William J. Peterson (William) was appointed personal representative of the estate. William published the required Notice to Creditors on November 14, 1997, under RCW 11.24.010. Within the statutory four-month period, Betty Ianicelli, Peterson's daughter filed a creditor's claim against the estate. She and another sibling, Lester Peterson, (collectively referred to as the Contestants) also filed a Claim of Heirs on March 11, 1997, three days before the expiration of the four-month filing deadline, to notify the estate of their suspicions of fraudulent conduct by Victoria.

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## REAL PROPERTY COUNCIL REPORT

Warren Koons, Davis Wright Tremaine LLP, Bellevue  
Director - Real Property Council

Real property lawyers in the state continue to be incredibly busy. It reminds me of the old saying, "be careful what you wish for!" The Real Property Council met with the Probate and Trust Council at our annual retreat on September 23, 2000, to discuss possible legislative proposals and other plans for the coming year. Our discussions included the following:

- The Real Property Council supported the Probate and Trust Council's decision to recommend that the statutes (RCW 11.98.130-.150) governing the rule against perpetuities in trust instruments be changed to 150 years following the date of the instrument. We are looking into whether similar statutory changes may be appropriate or necessary with respect to real property conveyances.
- The Real Property Council also generally supported the proposals for legislative changes regarding durable powers of attorney recommended by the Durable Power of Attorney Task Force headed by University of Washington law school Professor Karen Boxx. However, there are competing policy issues pertaining to a third party's acceptance or right to refuse to accept a durable power of attorney. The imposition on a third party of the attorney-in-fact's attorneys fees for the third party's refusal to accept a durable power of attorney was the focus of some in-depth discussion. The DPOA Task Force is currently in the process of further drafting the proposed legislation to address this issue.
- One other item of potential legislation for the upcoming legislative session is a proposal being considered by the Washington Land Title Association to address the issue of delays in the issuance of requests for reconveyances of deeds of trust that have been fully paid. For whatever reason, the problem of having satisfied deeds of trust remain of record seems to be growing. The WLTA's draft proposal involves amending the Deed of Trust Act to authorize escrow companies and title insurance companies to appoint successor trustees and issue requests for reconveyances of deeds of trust if the beneficiary has not requested the reconveyance within 30 days after satisfaction. The Real Property Council has concerns with the proposal as drafted but will be giving further study to the issues before taking a formal position on it.
- News flash: The Washington Legal Opinion Letter Task Force has finished its work and will be issuing its report in the next month or so. The Task Force's report will be a topic covered in the RPPT's "Real Estate Financing — Selected Issues" seminar in Spokane (March 1, 2001) and Seattle (March 2, 2001).
- *If you know of any other real property-related legislative proposals that may or should be brought up this year, or have comments on any of the above, please let us know. We are looking for real property lawyers who are skilled with web pages and the internet to help upgrade the RPPT Web page. Please e-mail your comments and suggestions to me at warrenkoons@dwt.com.* •

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### Recent Developments: Probate and Trust

On April 27, 1998, six weeks after the four-month filing deadline, William rejected his siblings' Claim of Heirs and creditor's claim. He notified them that they must sue him within 30 days of this rejection to preserve their claim, under RCW 11.40.100(l). Within the 30-day period, the Contestants filed a Petition for Revocation of Probate of their father's will and codicils, claiming fraud instead of suing William to preserve their claim. In their Petition, the Contestants detailed how Victoria's conduct and that of her relatives (all of whom, they claimed, were members of a notorious gypsy family and many of whom were awaiting trial for fraud in Pierce County) perpetrated undue influence, duress and fraud on their father to coerce him into changing his will.

Victoria moved to dismiss Contestants' petition under CR 12(b)(1) because it did not fall within the statutory four-month period under RCW 11.2-4.010. The trial court granted the motion and dismissed Contestants' petition.

Contestants filed for reconsideration, asserting that the court should extend the discovery rule to will contests, because Contestants could not have learned all of the underlying facts or the full extent of the fraud perpetrated by Victoria until after the statutory four-month period had expired. The trial court denied the motion and the Contestants appealed.

**Discussion:** The Court held that the common law discovery rule to toll RCW 11.24.010's four-month period for filing a will contest did not apply because the Contestants were aware of the basis of their fraud claims at the time they filed their Claim of Heirs, which was within the statutory four-month period. The Contestants did not prove that they could have only found out about such fraud after the expiration of the filing period. Claimants erred in that they did not preserve their claim by suing the personal representative, but rather, filed a will contest after the expiration of the four-month filing period. Furthermore, the Court stated that extending the discovery rule to will contests in probate proceedings was contrary to the legislative intent behind filing creditor's claims within a timely period. •

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## PROBATE AND TRUST COUNCIL REPORT

*Barbara C. Sherland*  
*Director - Probate and Trust Council*

*For the times, they are a-changin' . . . Bob Dylan*

I am writing my last Probate and Trust Council Report, having handed over the reins as Director of the Council to **Tom Culbertson** of Lukins & Annis in Spokane. Tom is a veteran of the Executive Committee and recently served as chair of the Hole Committee, which oversees the Council's legislative proposals. Tom is a delight to work with and I hope that you will all take an opportunity to get to know him better.

Council members serve two-year terms, so we had two members rotating off and two new members joining us at the midyear meeting. We owe a big thanks to the following retiring members for their dedication and hard work over the past two years:

**Matt McCutchen**, of Perkins Coie in Seattle, was in charge of our CLE programs and did a great job of scheduling CLEs, choosing topics and finding strong chairs for the programs. If you attended a CLE sponsored by our Section these past two years, you have Matt to thank.

**Bruce Smith**, of Brett & Daugert in Bellingham, did a terrific job as the Probate and Trust Co-Chair for this year's

successful midyear meeting. While on the Council, Bruce also took on the task of updating all the probate and trust pamphlets for the Bar.

We welcome new Council members **Wendy Goffe** of Graham and Dunn in Seattle, and **Bill Fleming** of Whalen, Firestone, Landsman, Fleming, Dixon & Matson LLP in Seattle. Tom, Wendy and Bill, as well as our other current Council members, **Lora Brown** and **Ken Myklebust**, and our newsletter editor **Phil Janney**, will be working on a number of exciting Council projects including several new legislative proposals (possibly a revised power of attorney statute and amended rule against perpetuities); Web page enhancement; newsletter revisions; new CLE offerings; as well as our first midyear meeting in Seattle on June 8-9, 2001 (mark your calendar).

It has been a pleasure and a privilege to serve as your director these past two years and I look forward to working with Tom and the Council as the chair-elect of the section this year. •

### Notes from the Chair

*By Serena Carlsen*

The Executive Committee is in full swing, with legislative initiatives, actively planning the 2001 midyear meeting, and starting to think about the 2002 midyear meeting. The 2001 midyear meeting will be held in Seattle Friday, June 8 and Saturday, June 9. Both the location and the date will be firsts for the Section. Due to your support of Section CLEs we are a financially prosperous Section. We intend to utilize some of our success by attracting particularly interesting speakers to speak on cutting-edge topics at this year's midyear meeting.

Barbara Sherland, our chair-elect, is doing a fabulous job coordinating the midyear event. John Gose has agreed to serve as the program chair for the Real Property sessions, and Jim Treadwell has agreed to serve as program chair of the Probate & Trust sessions. Because we are having the midyear in Seattle, we will hold all of the CLE sessions on Friday and Saturday, a departure from our typical three-day program. In addition, we will be offering a separate two-hour credit ethics session on Friday morning. With the Real Property topics focused on legislative changes, technology and secured

transactions (yes, we all may need to brush up on our foreclosure skills!) and the Probate & Trust topics focused on legislative changes, retirement plans, undue influence and a FET update, this year's midyear should be a challenging and informative program.

For the 2002 midyear, Skamania Lodge has been chosen as the venue. Last time we held the midyear at Skamania we had one of our larger turnouts, and we hope to repeat that success.

In the last couple of years we have seen some activity in probate and trust legislation, little in the real property area. I keep asking Warren why all of the bills were submitted when I was the Real Property director, but that is another story. The legislative initiatives on the part of the Section, the new power of attorney statute and the revisions to the Rule Against Perpetuities, are likely to pass and will affect both Real Property and Probate & Trust attorneys. We will keep you apprised of their progress. •

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### Section Officers 2000-2001

#### Serena S. Carlsen, Chair

Dorsey & Whitney LLP  
U.S. Bank Centre  
1420 Fifth Avenue  
Seattle, WA 98101  
Phone: 206-903-8800  
Fax: 206-903-8830  
E-mail: schourup.serena@dorseyllaw.com

#### Thomas M. Culbertson, Probate & Trust Council Director

Lukins & Annis, P.S.  
West 717 Sprague Avenue, Suite 1600  
Spokane WA 99201-0466  
Phone: 509-455-9555  
Fax: 509-747-2323  
E-mail: tculbertson@lukins.com

#### Barbara C. Sherland, Chair-Elect

Stoel Rives LLP  
600 University Street, Suite 3600  
Seattle, WA 98101  
Phone: 206-624-0900  
Fax: 206-386-7500  
E-mail: bcsherland@stoel.com

#### Philip B. Janney, Newsletter Editor

Landerholm, Memovich, Lansverk & Whitesides P.S.  
915 Broadway, Vancouver, WA 98660  
Phone: 360-696-3312  
Fax: 360-696-2122  
E-mail: philj@landerholm.com

#### Warren E. Koons, Real Property Council Director

Davis Wright Tremaine LLP  
1800 Bellevue Place  
Bellevue, WA 98004  
Phone: 425-646-6117  
Fax: 425-646-6199  
E-mail: warrenkoons@dwt.com

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