Approved March 25, 1988
Date

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY.

The meeting was called to order by Representative Robert S. Wunsch at
Chairperson

3:30 ~~a.m.~~/p.m. on March 21, 1988 in room 313-S of the Capitol.

All members were present except:
Representatives O'Neal, Peterson, Sebelius, Vancrum and Wagnon, who were excused.

Committee staff present:
Jerry Donaldson, Legislative Research Department
Jill Wolters, Revisor of Statutes Office
Mary Jane Holt, Committee Secretary

Conferees appearing before the committee:
Tom Peebles, Kennedy & Coe, Salina
Ron Smith, Kansas Bar Association
Danton Rice, Legal Counsel, Deputy Assistant Secretary of State
Kyle G. Smith, Assistant Attorney General, K.B.I.
Jim Clark, Kansas County & District Attorneys Association

Hearing on S.B. 565 -- Charitable trusts administration act

Tom Peebles informed the Committee S.B. 565 codifies the common law doctrine of cy pres in regard to trusts for charity. The doctrine permits a court, when a charitable gift has failed usually because the specific charity had ceased to operate, to allow a similar charity to carry out the donor's intent. The bill also allows a court to reform the terms of a trust to allow the charitable portion to qualify for the federal tax deduction. The bill also authorizes the Kansas Attorney General to be notified of the opportunity to represent the public interest and the charity, (see Attachment I.

Ron Smith stated the Kansas Bar Association supports this legislation.

Testimony of Lou Allen, Assistant Attorney General, supporting passage of S.B. 565, was distributed to the Committee, (see Attachment II.

The hearing was closed on S.B. 565.

Representative Bideau moved and Representative Allen seconded to report S.B. 565 favorable for passage. The motion passed.

Hearing on S.B. 680 -- Amendments to Kansas revised uniform limited partnership act

Danton Rice testified S.B. 680 is a clean-up bill to the Kansas Revised Uniform Limited Partnership Act. He recommended an amendment on page 11, lines 386 and 387 by deleting the words "the certificate of limited partnership and in". The deleted language will make it clear that the types of material matters that a limited partner may approve or disapprove of, without being considered a general partner, are stated only in the partnership agreement and not in the certificate of limited partnership, (see Attachment III. He said the Secretary of State also approves of the amendments the Kansas Bar Association is going to propose.

Ron Smith Presented four amendments to S.B. 680 as suggested by John McCabe of the Uniform Laws Commission, (see Attachment IV).

The hearing was closed on S.B. 680.

Representative Solbach moved and Representative Whiteman seconded to adopt the amendment proposed by Danton Rice. The motion passed.

MINUTES OF THE HOUSE COMMITTEE ON JUDICIARY,

room 313-S, Statehouse, at 3:30 ~~a.m.~~/p.m. on March 21, 1988

A motion was made by Representative Whiteman to reinsert the striken language on lines 255, 256 and 257, "(4) the continuation of the partnbership under K.S.A. 561 a451 and amendments thereto after the withdrawal of a general partner; or". Representative Solbach seconded and the motion passed.

Representative Shriver moved to strike lines 250, 251 and 252 on page 7, "(1) A change in the amount or character of the contribution of any partner, any partner's obligation to make a contribution or the time set for the return of a partner's contribution". The motion was seconded and passed.

Representative Walker moved to insert language in line 451 on page 12 requiring the partnership agreement specify in writing how a limited partnership can substitute or bring on board other general partners. Representative Roy seconded and the motion passed.

A motion was made by Representative Adam and seconded by Representative Kennard to reinsert lines 223 and 224, "the latest date upon which the limited partnership is to dissolve". The motion passed.

Representative Snowbarger moved and Representative Solbach seconded to report S.B. 680, as amended, favorable for passage. The motion passed.

Hearing on S.B. 691 -- Interception of wire, oral & electronic communications.

Kyle G. Smith testified S.B. 691 brings Kansas statutes into compliance with federal statutes which was mandated in 1986, (see Attachment V).

Jim Clark testified in support of S.B. 680. If no action is taken this session, the present Kansas Electronic Law will no longer be in effect and Kansas will be unable to conduct wiretaps at all.

The hearing was closed on S.B. 691.

A motion was made by Representative Crowell and seconded by Representative Buehler to report S.B. 691 favorably for passage. The motion passed.

Representative reported on proposed amendments to H.B. 3000, (see Attachment VI).

Representative Bideau raised the question of the 51%, 49% issue, as to what is meant by primarily ground transportation. The Chairman stated it was the intent of the Committee that primarily ground transportation would mean 51% of their business would be ground transportation.

The minutes of March 2, 3, 4 and 14 were approved as of March 18, 1988.

The Committee meeting was adjourned at 4:45 p.m. The next meeting will be Tuesday, March 22, 1988 at 3:30 p.m. in room 313-S.

GUEST REGISTER

DATE March 21, 1988

NAME	ORGANIZATION	ADDRESS
Jan Vacek	KSCPA	Topeka
Tom Cobbler	Kennedy & Coe CPA	Salina
Brenda Bragden	AG	Topeka
Kyle G. Smith	KBI	Topeka
FREVA POTTER	PEOPLES NATURAL GAS	TOPEKA
Tom Taylor	KPL Gas Service	Topeka
Terry Leonard	KG&E	Topeka
Jon Ford	KCDAA	Topeka
D. Johnson	KBI.	Topeka
D Jeanne Kutzley	AG	Topeka

SENATE BILL NO. 565

Many charitable gifts are made through a trust in which either an income interest or a remainder interest is given to a charity (the person with the income interest is entitled to only the current profits generated by the property in the trust, while the remainderman is entitled to all the property after the income interest expires). These trusts are usually referred to as split-interest charitable trusts. The interest in a split-interest charitable trust which is not given to a charity is usually given to a family member. As an example, a spouse will leave his or her assets in a trust with the income going to the surviving spouse for life, and the remainder interest going to a charity. In order for a split-interest charitable trust to qualify for either an income or an estate tax charitable deduction the trust must satisfy some extremely technical requirements under the Federal Internal Revenue Code and regulations. Noncompliance with these rules can result in the trust not qualifying for either an income or estate tax deduction, even though the charity still receives its interest in the trust. Since the tax burden will usually be paid from trust assets, the tax payment generally lessens the amount the charity ultimately receives. An IRS agent estimated that this occurs three to four times a year in Kansas.

In recognition of the fact that noncompliance with the split-interest charitable trust rules results in lost revenues to charities, Congress passed legislation to allow a split-interest charitable trust that was in noncompliance with the charitable trust rules under the IRC to be reformed under state law in order to bring the trust into compliance; thereby, saving the charitable deduction. Congress passed this legislation to encourage charitable gifts. The 10th Circuit Court of Appeals in Flanagan, Admr. v. U.S., 87-1 USTC ¶13,718, held that this legislation shows a congressional intent to prefer charitable gifts to estate taxes as "a case of absolute priority."

Senate Bill No. 565 will allow charitable trusts to be reformed under Kansas law so that the trust can avail itself of the reformation provisions of Federal law. Without Senate Bill No. 565 it is doubtful whether this reformation can be accomplished under Kansas law. Attached is the article, "How to Achieve Reformation of Defective Split-Interest Charitable Trusts," March/April 1987 issue of Estate Planning. This article explains in detail the reformation legislation passed by Congress and that many states have set up reformation procedures. Senate Bill No. 565 is based on a North Carolina statute.

8095

Attachment I

How to achieve reformation of defective split-interest charitable trusts

Failure to comply with technical charitable trust rules may be cured by reformation of the charitable trust. As indicated in this article, reformation is possible even where the trust instrument does not show the required charitable intent.

by DOUGLAS M. LAURICE, *Attorney, Palo Alto, California*

SPLIT-INTEREST GIFTS to charitable organizations have long been used to obtain income, gift and estate tax deductions while preserving some interest in the property for private, noncharitable use. Detailed and specific rules concerning charitable deductions through split-interest gifts were first enacted as part of the Tax Reform Act of 1969. The law presently permits split-interest gifts in the form of charitable remainder trusts, charitable lead trusts, pooled income funds, and remainder interests in a farm or personal residence. Various Code sections provide specific rules applicable to charitable split-interest trusts. Also, the private foundation rules enacted as part of the Tax Reform Act of 1969 are applicable to charitable split-interest trusts. In addition, the IRS has taken a narrow view of the applicability of the rules, and Revenue Rulings have also imposed specific requirements as to what must be included in split-interest trusts.

Section 664(d) defines two types of charitable remainder trusts. A charitable remainder annuity trust is one that distributes at least 5% of the corpus at least once a year to an individual beneficiary. The term may extend for the life or lives of one or more individuals or for a term of years not to exceed 20. The remainder interest must go to a qualified charity. Under Section 664(f), enacted as part of the Deficit Reduction Act of 1984, the interest of a private beneficiary may terminate prior to death or the stated term of years if the happening of the contingency accelerates the charitable remainder.

A charitable remainder unitrust is similar to the annuity trust, except that the individual beneficiary receives a fixed percentage (at least 5%) of the fair market value of the trust principal each year. While sample language for drafting charitable remainder trusts is set forth in *Rev. Rul.* 72-395,[1] that Ruling has been specifically modified or clarified.[2] Thus, drafting such trusts requires a good deal of careful preparation.

DOUGLAS M. LAURICE is a partner in the law firm of Wilson, Sonsini, Goodrich & Rosati, in Palo Alto, California. He was a contributor to Estate Planning for the General Practitioner *(California CEB, 1979).*

Statutory basis for reformation

The restrictions on split-interest trusts contained in the 1969 Act applied to gifts made and decedents dying after 1969. Congress recognized that the detailed and technical requirements of the 1969 Act would cause problems for drafters and estate planners. Accordingly, a transitional rule allowed defective trusts to be reformed. This was originally intended to be a temporary measure, but subsequent changes in the law and the narrow approach of the IRS in its interpretation of the law prompted Congress to continue granting extensions to that transitional rule. The 1984 Act amended Section 2055(e)(3) to provide a permanent rule for correction or reformation of charitable remainder trusts and charitable lead trusts which do not otherwise meet the requirements of the 1969 Act.

The 1984 Act generally permits reformation after 1978 in either of two situations. In the words of the Senate Finance Committee, "reformation will be allowed where either the instrument evidences an intention to comply with the 1969 Act rules or the

reformation proceedings are begun before there is an opportunity for the Internal Revenue Service to audit the matter.[3] The first situation depends on satisfaction of an "intent" requirement. As will be explained later, an intent to comply with the 1969 Act rules exists where the instrument is basically in the form of either an annuity trust or a unitrust. The second situation exists if judicial reformation proceedings are begun within 90 days of the due date, including extensions, for the estate tax return reporting the transfer to the trust or, if no estate tax return is required, the first income tax return for the trust.

As provided by Section 2055(e)(3)(B)(iii), reformations must be retroactive to the date of death in the case of testamentary trusts. Through Section 170 (f)(7), Section 2055(e)(3) also covers the reformations of inter vivos trusts. Reformations of inter vivos trusts must be retroactive to the date of creation. In addition, the actuarial values and the duration of the charitable and noncharitable interests under a trust must remain approximately the same both before and after reformation, under Section 2055(e)(3)(B)(ii). Variations of up to 5% are permitted.

A special rule provided by Section 2055(e)(3)(F) applies where all of the noncharitable "income" beneficiaries of a charitable remainder trust have died before the due date (including extensions) for the filing of an estate tax return which claims a charitable deduction based on the value of the trust. In this situation, the trust will be deemed to have been reformed. A deduction is allowed for the value of the charitable interest as if the trust had been a qualified trust on the date of the decedent's death. Although the statute is unclear, the deduction should be allowed without reduction for any intervening income interests.

The provisions of the 1984 Act apply retroactively to any reformation made after 1978, as well as those accomplished currently. In some cases, where deductions were previously disallowed for contributions to faulty trusts, opportunities may still exist to correct the trust instruments. This is definitely the case with respect to wills and trusts executed before 1979. As to other instruments, relief may depend on whether reformation proceedings were commenced before 10/14/84 (*i.e.*, within 90 days of the date of enactment of the 1984 Act).

Section 2055(e)(3) in operation

Section 2055(e)(3) requires the "qualified reformation" of a "reformable interest" into a "qualified interest." A reformable interest is one for which a deduction would have been allowed except for failure to meet the technical requirements applicable to split-interest charitable trusts.[4] In general, any interest which "would have been deductible" is reformable. However, having once determined that an interest would have been deductible, the next consideration is whether the trust instrument shows an intent to comply with the appropriate rules. Unlike the Senate Report, the statute does not speak in terms of intent. Nevertheless, it is clear under Section 2055(e)(3)(C)(ii) that a charitable interest is not a reformable interest unless the income or remainder interests of the noncharitable beneficiaries are expressed in terms of either a specified dollar amount (as is the case with an annuity trust) or a fixed percentage of the fair market value of the property (as is the case with a unitrust). In these cases, reformation may be accomplished at any time.

A trust instrument will not meet the above intent requirement if it contains any sort of invasion power for the noncharitable beneficiary. However, payments to a noncharitable beneficiary of the lesser of the trust income or some fixed percentage of the fair market value of the trust property will be considered to meet these requirements.[5] Even if the trust does not remotely resemble one of the permitted forms of split-interest trusts (*i.e.*, it does not satisfy the intent requirement), the instrument may still be reformable under Section 2055(e)(3)(C) if either (1) the interest passes under a will executed before 1979 or under a trust created before 1979, or (2) a judicial proceeding is begun before 90 days after the due date for the estate tax return (including extensions) or, if no estate tax return is required, the due date, including extensions, for the first income tax return of the trust.

A reformable interest must be reformed through a "qualified reformation." A qualified reformation is a change of the governing instrument through a court proceeding, amendment, construction or other permissible means. The Senate Report states that the change must be binding on all relevant parties under local law.[6] Thus, it seems that any procedure which effectively transforms the reformable interest into a qualified interest is sufficient to meet the statute. However, the general rule is limited by the following provisions:

1. The difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest cannot exceed 5% of the actuarial value of the reformable (original) interest pursuant to Section 2055(e)(3)(B).

2. For charitable remainder trusts, Section 2055 (e)(3)(B)(ii)(I) requires that the reformed interest of the noncharitable beneficiary terminate when it would have terminated under the original document. However, an exception applies if the noncharitable interest is a term of years in excess of 20. In that case, the requirement will be met if the term is reduced to 20.

3. For charitable lead trusts, the reformed interest must be for the same period as the original interest, according to Section 2055(c)(3)(B)(ii)(II).

Allowable charitable deduction

Once a defective split-interest trust is reformed, a charitable deduction is allowable. However, the amount of the allowable deduction may not exceed what the deduction would have been but for failure of the trust to meet the split-interest trust requirements. The *General Explanation* of the 1984 Act indicates that the deduction allowable is equal to the lesser of (1) the actuarial value of the charitable interest after the reformation, or (2) the actuarial value of the charitable interest before the reformation for which a deduction would have been allowable.[7] While practitioners may encounter some problems valuing prereformation interests, in most cases the defects will involve administrative and other technical points and the values before and after reformation will be the same. Where the trust does not look much like the reformed trust, the problems will be greater. In this connection, the *General Explanation* notes that in determining the value of the charitable interest under the unreformed trust, Congress intended that trusts to which *Rev. Proc.* 73-9[8] applies be treated as if they had complied with that Revenue Procedure. This permits deductions where the Service determines that the value of an interest may be unascertainable because of broad fiduciary discretion in administration or investment of the trust. It also authorizes the parties to enter into an agreement with the Service limiting the powers of the trustee in such a manner that the interests of noncharitable beneficiaries may not be favored as against those of the charitable beneficiaries.

Under Section 2055(e)(3)(G), the statute of limitations remains open for one year after notification to the IRS that a reformation has occurred.

Section 2055(e)(3)(H) requires the Treasury to prescribe Regulations necessary to carry out the purposes of the new provisions. Section 2055(e)(3)(I) requires Regulations to provide for, among other things, the reformation of remainder interests in residences and farms, and the reformation of pooled income funds. Despite these directions, these Regulations have not yet been promulgated. There have been a number of letter rulings issued and, while most aspects of the new provisions are reasonably straightforward, problem areas do remain.

One significant area of uncertainty under the 1984 Act involves the limitations on qualified interests. As discussed above, the difference between the actuarial value of the qualified interest and the actuarial value of the reformable interest may not exceed 5% of the actual value of the reformable (original) interest. It is not clear from this language how one measures the variation. It seems that the language permits a 5% up-or-down variation from the original value, *i.e.*, the value of the reformable or original interest. For example, if the value of the charitable interest under a trust is $500,000 prior to reformation, presumably the value of the qualified or reformed interest could range between $475,000 and $525,000. However, if the value of the qualified interest was $525,000, keep in mind that the deduction is nevertheless limited to the value of the original, unreformed interest, or $500,000. All of the letter rulings issued thus far are based on a representation that the 5% limitation is met. Further guidance must await either Regulations or a Revenue Ruling.

Timing considerations

Under the reformation rules of the 1984 Act, timing is often a critical concern. Where there is an intent to comply with the 1969 Act rules, *i.e.*, where the interests of the noncharitable beneficiaries is expressed in fixed dollar amounts or as a fixed percentage of the fair market value of the property, Section 2055(e)(3)(C)(ii) imposes no time limit for reformation. However, where there is no such intent to comply, Section 2055(e)(3)(C)(iii) ties the reformation to the filing date for the estate tax return or, in cases where no estate tax return is required, the due date for the first income tax return of the trust. Also, as noted above, the statute of limitations with respect to those returns remains open for one year after the date of notification to the IRS that a reformation has occurred. Accordingly, once a qualified reformation has appropriately converted a reformable interest into a qualified interest, the practitioner must be attentive to provide the necessary notice to the Service.

Most of the reported instances of reformation

CITATIONS

[1] 1972-2 CB 340.
[2] *Rev. Ruls.* 80-123, 1980-1 CB 205; 82-128, 1982-2 CB 71; 82-165, 1982-2 CB 117.
[3] S. Print No. 98-169 Vol. 1, 98th Cong., 2d Sess., 732 (1984).
[4] Section 2055(e)(3)(C)(i).
[5] S. Print No. 98-169, *supra* note 3, at 734.
[6] *Id.*
[7] Section 2055(e)(3)(B); Staff of the Joint Committee on Taxation, *General Explanation of the Deficit Reduction Act of 1984*, p. 1118.
[8] 1973-1 CB 758.
[9] See, *e.g.*, *Oxford Orphanage, Inc.*, 587 F. Supp. 1231, 84-1 USTC ¶13,575, 54 AFTR2d 84-6445 (DC N.C., 1984), *rev'd* 775 F.2d 570, 85-2 USTC ¶13,643, 56 AFTR2d 85-6588 (CA-4, 1985).
[10] S. Print No. 98-169, *supra* note 3, at 734.
[11] 1974-2 CB 157.
[12] S. Print No. 98-169, *supra* note 3, at 733, fn.4.
[13] *General Explanation*, *supra* note 7 at 1117.
[14] See *e.g.*, *State ex rel. Edmisten v. Sands*, 307 N.C. 670, 300 S.E. 2d 387 (1983). *Ltr. Ruls.* 8644048, 8639054 and 8542037.
[15] See *e.g.*, *In re Estate of Danforth*, 81 N.Y. Misc.2d 452, 75-2 USTC ¶13,095, 36 AFTR2d 75-6515 (Surr. Ct. N.Y., 1975), *In re Estate of Barker*, 370 N.Y.S.2d 404, 75-2 USTC ¶13,103, 36 AFTR2d 75-6539 (Surr. Ct. N.Y., 1975). *Ltr. Ruls.* 8634017 and 8647036.
[16] See *e.g.*, *Ltr. Rul.* 8639072.
[17] *Ltr. Rul.* 7828036.

arise in cases involving split-interest trusts created, on the death of the grantor, either by will or by revocable trust. When death occurs, the practitioner should examine the documents which create the charitable trust closely and at the earliest opportunity. If a defect is found, the next step will depend on the nature of the defect and perhaps the date of the document.

If the governing instrument clearly expresses the interests of the noncharitable beneficiaries in either annuity trust or unitrust form (typically, this would be the case where a qualifying charitable trust was intended, but some technical point was overlooked), the time to commence the qualified reformation is not critical, regardless of the date of the document. Nevertheless, it is always advisable to complete reformation at the earliest possible time to avoid unnecessary problems with the Service. Also, in cases involving a tax refund, it is possible that interest will be denied for the period between the due date of the return and the date of reformation.[9] Finally, although the policy behind the 1984 Act suggests a liberal interpretation of the intent requirement, the practitioner has minimal guidance at this time. If there is any doubt at all that the document satisfies the intent requirement, the practitioner should proceed as if a timely judicial reformation is necessary.

In the case of documents which do not evidence the necessary intent to comply with the rules of the 1969 Act, qualified reformation must be commenced within the time limits discussed above. If a timely judicial reformation is not possible, the document should be reformed in any event, particularly if there is any argument at all that it does not meet the intent requirement. Also, as discussed below, it is always possible that future legislation will give new life to a seemingly futile reformation proceeding.

The "intent" requirement

If the governing instrument does not meet the intent requirement, but the interest passes under a will executed before 1979, or under a trust created before that date, again the timeliness of the reformation is not an issue. It appears that the interest may be reformed at any time and that the statute of limitations for assessing any deficiency of tax attributable to the reformation is extended one year from the date notice is given to the Service of the reformation. More troublesome, however, are documents executed after 1978 which have already taken effect.

As previously discussed, if a will or a trust was executed after 1978, judicial reformation proceedings must be timely commenced unless the intent requirement is satisfied. Where the trust has gone into effect (either the trust was an inter vivos trust or the settlor has died), the applicable period for filing the proceeding may have run prior to enactment of the 1984 Act. Under Section 1022 of the 1984 Act, the 90th day after the applicable filing date is deemed not to have occurred prior to 10/18/84 (90 days after enactment). Documents falling into this category can only be reformed under the 1984 Act if the reformation proceedings were begun prior to that date. *Letter Ruling* 8649060 illustrates why this point is still worthy of discussion. There, a revocable unitrust agreement was executed by the decedent in 1979, shortly before his death that year. The trust was reformed in July 1980. However, the Service denied an estate tax deduction because Section 2055(e)(3), as then in effect, applied only to the reformation of pre-1979 documents. Notwithstanding that letter ruling, for purposes of the 1984 Act the 1980 reformation was deemed to be a timely commencement of judicial reformation proceedings.

There has likely been a number of judicial reformations attempted in recent years with respect to post-1979 documents. Assuming that the reformation otherwise meets the requirements of the 1984 Act, the results have new life under that Act. Notice to the Service of the reformation should provide a one-year period in which to claim refunds.

Reformation proceedings

As previously noted, the 1984 Act permits reformation to be accomplished by any permissible means so long as all of the relevant parties are bound.[10] In cases where the intent requirement is not met, a judicial reformation is necessary. Some states (California for example) have statutes giving its courts jurisdiction over proceedings for the reformation of instruments that fail to meet the technical requirements of the 1969 Act. These statutes usually specify who may bring the action and who must be a party. In the absence of such a statute, or where such statutes apply only to pre-1978 documents, most courts should nevertheless be willing to entertain proceedings for construction of the document or to authorize an amendment for these purposes. The practitioner should be careful to include all relevant parties in the proceedings. This presumably means all affected beneficiaries and the state attorney general or other official responsible for the supervision of charitable entities. The Federal government need not be a party if the Service continues to adhere to its position set forth in *Rev. Rul.* 74-283[11] that reformation proceedings are exceptions to the principle that, in the determination of a Federal tax question, the Government is not bound by retroactive determinations of a state trial court.

The 1984 Act provides no guidance on the ques-

tion of what constitutes a timely commencement of a judicial reformation where such proceedings are required. However, the Senate Report does indicate in a footnote that where a judicial proceeding is begun in one court, and it is later determined that the proceeding should have been commenced in another court, the proceeding will be considered timely filed if the first proceeding was timely.[12] The *General Explanation* also states that Congress intended that for the commencement to be timely, the pleading must describe the nature of the defect that must be cured. The filing of a general protective pleading is not sufficient.[13]

Prior to commencing any reformation proceeding, the practitioner must pay close attention to valuation issues. It is important to determine in advance that the terms of the reformed instrument will meet the requirements of the statute. Mention has already been made of the uncertainty under the 1984 Act concerning how the 5% value limitation should be applied. Another related question involves the reformation of income-only trusts or other trusts that deviate substantially from the required form. In these cases, it is suggested that the trust be reformed to pay a percentage or annuity amount that approximates, as closely as possible, the income to be produced by the trust while still producing a valuation of the charitable interest that is within 5% of the value of the interest prior to reformation.

Drafting considerations

The provisions of the 1984 Act remove much of the concern that has existed since 1978 over the inability to cure defects in instruments drafted to comply with the 1969 Act. However, the 1984 Act does not change in any way the provisions which must be included in charitable trusts. The requirements are highly technical and the drafting of a charitable trust should not be attempted without first acquiring a comprehensive familiarity with those rules. Careful drafting should continue to be the practitioner's first line of defense against future problems.

Many of the reported instances of reformation involve situations where the drafter stated an intent to create a unitrust or annuity trust, but neglected to include all of the necessary or required provisions (the laws of most states accomplish much of this by statute).[14] In these situations, the drafter overlooked some detail or technical point which the Service deemed necessary. If the practitioner takes a "checklist" approach to drafting, *i.e.*, each instrument is reviewed in light of the statute, the Regulations and the major Rulings discussed above, reformations will be necessary only in very rare cases involving minor points. The intent requirements under the 1984 Act will almost always be met and reformation should be a minor procedure.

The more difficult cases are those where the drafter apparently was not aware of the applicable requirements. A common situation is where the drafter seems to be following the pre-1970 rules and the trust gives an ordinary income interest to the beneficiary.[15] Other cases involve situations where there is no apparent awareness of the requirements.[16] In these situations, the practitioner will have been consulted for the purpose of creating something deductible with a document that clearly does not meet the 1969 Act requirements. Unfortunately, many of these documents will also fail the intent requirement, particularly if there is a power to invade principal. Nevertheless, the rules of the 1984 Act at least provide an opportunity for reformation so long as the problems are identified early and timely judicial proceedings are commenced.

Finally, practitioners should consider including in the instruments they draft a specific and limited power of amendment which authorizes the trustee to reform a reformable interest into a qualified interest in accordance with Section 2055(e)(3) and the Regulations thereunder. Such a provision should also provide that all parties interested in the trust shall be absolutely bound by any such amendment. The Service has ruled that the power of a trustee of a charitable remainder trust to amend the trust was ineffective to cure defects in the instrument.[17] However, that occurred under the law as it existed prior to the 1984 Act. Even if the ruling was correct then, Section 2055(e)(3)(B) specifically permits reformation by amendment. Arguably such a provision is specifically authorized. It certainly would be beneficial in cases of minor defects. In any event, there is nothing to be lost by including such a provision. Undoubtedly future Regulations or rulings will have to address this point.

Conclusion

The provisions of the 1984 Act go a long way toward solving what became a continuing issue for Congress. The rules embody a policy that favors allowance of the charitable deduction if at all possible. It would seem that the abuses which prompted the 1969 Act are no longer a problem and so long as an instrument can be conformed to meet those rules, there is no good reason for making the availability of the deduction entirely dependent on the skill of the drafter. Still, general practitioners have largely and wisely left the field to the experts. Unfortunately, many potential donors are probably unwilling to pay substantial fees for what should be a routine transaction. Moreover, even though charities often assume

much of the "set-up" costs, this too is an added expense that reduces the revenue available for charitable purposes. The reasonable approach of the 1984 Act should insure that most trusts that can be reformed to meet the rules of the 1969 Act will be entitled to a deduction.

For the practitioner, early detection of defects remains important. If recognized in a timely manner, reformation should be routine in most cases. Careful drafting is still as important as ever, but the consequences of error are definitely less under the 1984 Act. New documents should include powers of amendment to facilitate minor changes. Finally, limited opportunities exist to cure problems that previously seemed incurable. *

How S corporations can avoid new tax on gains

S CORPORATIONS can obtain partial relief from the new tax imposed on built-in gains recognized within ten years of the election under guidelines in *Rev. Rul.* 86-141, IRB 1986-49, 6.

As a result of new Section 1374, the making of an S election will not allow corporations to avoid a corporate level tax on dispositions of appreciated property unless the S election was filed before 1987 and effective for the first tax year after the year of election. However, partial relief from the tax on pre-S election appreciation of assets is available under a special transitional rule in Section 633(d) of the Tax Reform Act.

To be eligible, the corporation must be more than 50% owned, by value, by ten or fewer qualified persons (individuals, estates, trusts) on 8/1/86 and thereafter. Also, the corporation's value as of the date of adoption of a plan of complete liquidation (or on 8/1/86, if greater) cannot exceed $5 million. Valuation is based on the fair market value of all of the corporation's stock.

Under these circumstances, the corporation can liquidate before 1989 and avoid recognition of gain on the disposition of its long-term capital gain assets and Section 1231 property. Gain will be recognized, however, on the sale or distribution of ordinary and short-term capital assets.

For corporations valued between $5 million and $10 million, gain is recognized to the extent it exceeds the applicable percentage of each long-term gain. The applicable percentage is 100%, reduced by an amount that bears the same ratio to 100% as the excess of the applicable value over $5 million bears to $5 million. As a result, Section 1374 as it existed before TRA '86 applies to the applicable percentage of gain and Section 1374 as amended applies to the excess gain recognized. Under Section 1374, before its amendment, capital gains of S corporations were taxed if assets were sold within three years of the time the election was effective, capital gains exceeded 50% of taxable income, and taxable income was more than $25,000. This was to prevent use of an S corporation to avoid capital gains tax.

Under new Section 1374(b), the built-in gains tax is the highest corporate rate for the year of disposition applied to the lesser of (a) built-in gains or (b) the amount of corporate taxable income if the S election had not been made. The tax applies when the first S corporation taxable year is after 1986. Thus, only old Section 1374 applies to corporations that made a valid S election before 1987; *i.e.*, the date of election, rather than the year it is effective, is determinative.

The Ruling further gives consent to an S election for small business corporations that become S corporations before 1989 and whose prior revocation or termination of S status occurred before 10/22/86. Such corporations should file their election with the appropriate Service Center on Form 2553, indicating at the top of page 1 that it is "FILED UNDER REV. RUL. 86-141," along with required shareholder consents. *

Farmer's use of cash method clearly reflected its income

A TAXPAYER'S use of the cash method of accounting could not be attacked as not clearly reflecting income under Section 446, according to TAM 8641002, as long as the taxpayer complied with the requirements of Section 464. Thus, the Service has conceded that the material distortion of income test it used to counter tax shelter abuses has been superseded by specific Code sections.

Farmers who are generally exempt from the requirement of using inventories had been allowed unrestricted use of a simple cash method of accounting. This led to high-bracket taxpayers using sideline investments in farming operations to shelter other income, by prepaying feed and other expenses years before any related farming income was earned. In *Rev. Ruls.* 75-152, 1975-1 CB 144, and 79-229, 1979-2 CB 210, the Service restricted the situations in which a cash-method farmer could take a current deduction for prepaid feed expenses, by requiring (among other tests) that the deduction not result in a material distortion of income. That test was grounded in the requirement of Section 446 that the taxpayer's accounting method clearly reflect income. The Service

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Testimony Of Lou Allen
Assistant Attorney General
on Senate Bill ~~656~~ 565
House Judiciary
March 28, 1988

Dear Mr. Chairman and Members of the Committee:

I am submitting written testimony today in support of S.B. ~~656~~ 565 regarding the creation of the Charitable Trusts Administration Act.

Attorney General Stephan supports passage of proposed S.B. ~~656~~ 565 for the following reasons:

1) This bill would codify the common law doctrine of Cy Pres which has been judicially recognized in Kansas. The courts, however, have never had the factual situation in which to apply the doctrine. Codification of the doctrine would provide statutory guidelines to the courts for application of the doctrine as well as providing procedural guidelines and protection for the parties involved.

2) Additionally, this bill would codify the common law responsibilities of the attorney general to be notified and given the opportunity to be heard thus, allowing greater protection of the public's interests with regard to charitable trusts.

3) Finally, charitable trusts are for the benefit of society and for charitable purposes. Statutory guidelines to the court and parties involved for enforcing charitable trust which might otherwise fail would benefit and perpetuate the purposes for which charitable trusts are enacted; society and charitable purposes. The attorney general would appreciate codification of the common law practice of notification to the attorney general and the opportunity to be heard so as to allow better protection of the interests of society and the purposes for which charitable trusts are set up.

For the reasons stated above, the attorney general supports enacting S.B. ~~656~~ 565, creating the charitable trusts administration act.

Any questions, please feel free to contact Lou Allen, Assistant Attorney General at 296-3751.

Attachment II

Bill Graves
Secretary of State

2nd Floor, State Capitol
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STATE OF KANSAS

TESTIMONY BEFORE THE ~~SENATE~~ House JUDICIARY COMMITTEE
ON SB 680

By: Danton B. Rice - Legal Counsel
Deputy Assistant Secretary of State

Senate bill 680 is a clean-up bill to the Kansas Revised Uniform Limited Partnership Act. During the 1987 legislative session Kansas adopted numerous revisions to our Limited Partnership Act based upon similar changes to the Delaware and Uniform Acts. This bill will complete the process by correcting several technical oversights.

This bill does, however, require one further amendment. In section 9 of the bill on page 11, at lines 385 and 386, the words "the certificate of limited partnership and in" need to be deleted. The section deals with actions of a limited partner that do not render them a general partner for purposes of liability. The deleted language will make it clear that the types of "material matters" that a limited partner may approve or disapprove of, without being considered a general partner, are stated only in the partnership agreement and not in the certificate of limited partnership.

Senate bill 680, with the modification indicated, will result in Kansas having the most modern limited partnership act available. In addition, it will continue the trend of making our limited partnership act and corporate code virtually identical to those of the state of Delaware. This allows businesses and attorneys in Kansas to use the vast number of reported court opinions in Delaware to assist them in making day to day business decisions.

The Secretary of State strongly supports Senate bill 680.

Attachment III

or

(F) the admission, *removal or retention* of a ~~general partner or a~~ limited partner;

(6) to request or attend a meeting of partners; or

(7) to approve or disapprove, by voting or otherwise, any material matters which are related to the business of the partnership and which are stated in ~~the certificate of limited partnership and~~ in the partnership agreement.

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by the limited partner in the control of the business of the limited partnership.

(d) A limited partner who knowingly permits the limited partner's name to be used in the name of the limited partnership, except under circumstances permitted by K.S.A. 56-1a102 and amendments thereto, is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

Sec. 10. K.S.A. 56-1a204 is hereby amended to read as follows: 56-1a204. (a) Except as provided in subsection (b), a person who makes a contribution to a partnership and who erroneously but in good faith believes that the person has become a limited partner in the partnership is not a general partner in the partnership and is not bound by its obligations by reason of making the contribution, receiving distributions from the partnership or exercising any rights of a limited partner if, on ascertaining the mistake~~:~~

~~(1) In the case of a person who wishes to be a limited partner, the person causes an appropriate certificate to be executed and filed; or (2)~~, *such person* withdraws from future equity participation in the enterprise by ~~executing and filing in the office of the secretary of state a certificate declaring withdrawal under this section~~ *taking such action as may be necessary to withdraw.*

(b) A person who makes a contribution under the circumstances described in subsection (a) is liable as a general partner to any third party who transacts business with the partnership prior to the occurrence of either of the events referred to in

KANSAS BAR ASSOCIATION
A SECOND CENTURY OF SERVICE
1882

March 21, 1988
SB 680

Mr. Chairman, members of the House Judiciary Committee. I am Ron Smith, Legislative Counsel, KBA.

I ran the suggested amendments to this legislation past John McCabe of the Uniform Laws Commission, which drafted the initial law. His general reaction was not in opposition to the changes but wanted me to point out the following:

1. The stricken language beginning at line 223, old subsection (a)(5), John McCabe doesn't think is an appropriate deletion. While it may be in conformity with Delaware, he does not think it appropriate not to keep that information on the certificate. The change blurs the structural difference between corporations and partnerships, and is not burdensome to a limited partnership. They can always amend the date that is filed.

2. John wanted to know if the deletion on page 7, line 254 is a mistake? He thinks for conformity sake you might delete subsection (c)(1) but thinks subsection (c)(4) should be kept. When a partnership elects to continue operation the Uniform Laws Commission thinks it is

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Attachment IV

important that you give notice of decision to continue, and that is what K.S.A. 56-1a451 does.

3. In lines 407-412, McCabe doesn't think much of this policy choice. Sec. 10 handles situations where people contribute to a partnership and then think they are a limited partner, but really aren't, and sets up how you end your liability as a partner. The change in the language here indicates that withdrawal can be casual, not official, using less specific language. He thinks a person who has gotten into this predicament ought to be required to more formally withdraw in order to get the statutory protections. But McCabe also said the shortened certificate makes his concern less important.

4. Finally, in the section beginning at line 448, this creates the power by which a limited partnership can substitute or bring on board other general partners. If this change is going to provide for different method of bringing in different general partners, McCabe suggests line 451 be amended to require the partnership agreement specify <u>in writing</u> how that will be done. That precludes oral modifications.

He had no other specific recommendations or suggestions.

KANSAS BUREAU OF INVESTIGATION

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TESTIMONY

Kyle G. Smith
Assistant Attorney General
Kansas Bureau of Investigation

Senate Bill 691

Before House Judiciary Committee
Monday, March 21, 1988
Room 313S
State Capitol

Mr. Chairman and Members of the Committee,

On behalf of the Attorney General and the Kansas Bureau of Investigation, I am here today urging the passage of Senate Bill 691, which is a revision of the Kansas Electronic Surveillance Statute.

On October 21, 1986, the Electronic Communications Privacy Act of 1986 was signed into law by President Reagan. This is a major revision of the law on electronic surveillance which is controlled by Title III of the Omnibus Crime Control and Safe Street Act of 1968. The 1968 federal law preempted the field of electronic surveillance and state law enforcement officers can only proceed with electronic surveillance if they follow the federal mandate.

The 1986 Act provided a two year grace period for states to amend their statutes to come into compliance with these revisions. Senate Bill 691 is such a revision. It should be stressed at the outset the importance of the passage of this bill. Without these revisions we will be unable to conduct wiretaps at all.

Wiretap investigations and electronic surveillance, while rarely utilized, are almost the only effective weapon in the war against organized crime and larger drug distribution networks. If we don't make the revisions and come into compliance with the federal statutes we will no longer be able to utilize this most effective tool in criminal investigation.

Attachment V

The revisions deal with several areas. One of the main problems was the 1968 Act dealt only with oral communications, be they over a telephone line or a "bug" planted in a room or vehicle.

As the committee is aware, communications have evolved geometrically and there is a whole field of electronic communications, which would include such matters as electronic mail, computer transmissions via modem, cellular telephones and voice pagers, which are not specifically covered by existing statutes. Therefore, one of the main thrusts in Part I of the federal act was to update and deal with these advances in communication technology and protecting those interests that needed to be protected by providing procedures to be followed for their interception.

There are also several procedural changes, the need for which have been borne out by the experiences since the 1968 statute was passed.

The federal act and Senate Bill 691 provide for up to ten days for a wiretap to be installed after the order is entered. Wiretap orders are limited by the federal statute to not more than thirty days, and as is sometimes the case when dealing with the phone company, things don't always move as fast as one might want. Therefore, this provision postpones the running of the thirty days until the wiretap is actually consumated, or ten days, whichever is shorter. This should avoid a certain amount of requested extensions for wiretaps.

Frequently, intercepted communications will be in a foreign language, or a code will be utilized by a participant in an illegal activity, and the personnel manning a listening post may not have the expertise to determine whether such conversations are pertinent or innocuous. This determination is essential because the wiretap statutes require that any non-pertinent conversations intercepted must be "minimized". In other words, the recording equipment must be turned off and conversations not listened to. This revision allows these conversations, when in foreign language or obviously in code, to be tape recorded in their entirety until an expert can be obtained to determine what is actually being said.

Along with this is the revision allowing contract assistance in operating interception. An example would be being able to hire an interpreter if we had a case where Vietnamese was being spoken.

There is also specific statutory authority now in subsection 10 of this bill to provide for a roving tap. Traditionally, an order for interception had to designate what phone and where it was located that was the target of the interception. Obviously, phones don't commit crimes, people do. This provision allows us to target an individual and obtain an order to tap lines wherever that person may go if certain procedural safeguards are followed.

Finally, under procedure, there is a broader definition of law enforcement officer, which is not a part of the federal statute, but addresses a need that we have observed on our own. Currently, only state law enforcement officers can be utilized in operating a wiretap or electronic surveillance situation. More and more the scope and capabilities of drug traffickers and organized crime operations are being met by task forces combining the resources and abilities of various federal, state and local law enforcement agencies. In the past we have been unable to utilize agents of the DEA or FBI in monitoring conversations, because our statute limited law enforcement officers to only those authorized by state law. This amendment would broaden the definition to include federal law enforcement agents of various federal agencies.

Substantive changes in the federal act include expanding by over two dozen the number of offenses for which a wiretap may be obtained. These are generally called predicate offenses, because the law has allowed states to obtain wiretaps only if their wiretap statute specifically lists the given offenses for which wiretaps may be obtained. Currently there are fourteen predicate offenses in the Kansas Statute. After reviewing the federal additions, Senate Bill 691 includes only three additional offenses. Those being: aggravated escape, aggravated failure to appear and arson. These would seem to be appropriate additions to the predicate offense list inasmuch as they do tend to be crimes where conspiracies or other persons might have knowledge and communications between those persons might be subject to interception.

The second substantive change in the federal act and in Section 5 of Senate Bill 691, is the creation of a criminal offense for revealing the existence of a court authorized electronic surveillance. I would urge this provision as well, particularly in light of the number of man hours, the amount of money and the risk to human life in these rather extensive operations. Certainly, since one can only get a wiretap for certain felony offenses, any person aiding such a felon by divulging the existence of such a wiretap, should also be subject to felony prosecution, just as a

person aiding a felon under the Aiding a Felon Statute, K.S.A. 21-3812, is guilty of a class E felony. The federal offense is punishable by a five year imprisonment. The state offense would be a one year minimum, two-five maximum.

Finally, new Sections 6-10, codify for the first time under state law, the requirements for obtaining devices known as pen registers and trap and trace devices. These devices allow for the recording of telephone numbers called from a number in the case of pen registers, and for obtaining the numbers of people calling to the number in the case of trap and devices, but not the contents of those communications. These sections merely copy the federal law, which has been the case law of Kansas, but should assist attorneys and judges throughout the state by spelling out the form and procedures to be used in obtaining such devices.

It should be noted that there is a Part II to the Federal Act of 1986, which deals with obtaining stored electronic communications. Senate Bill 691 does not address this question, but I believe this rather complex area can be addressed by future sessions as long as we get the framework, which is contained in Senate Bill 691, in place this year.

I wish to thank the Committee for it's consideration, and once again stress that if we don't make these provisions in our electronic surveillance statute, it would be a serious blow to our capabilities to combat the more sophisticated criminal organizations operating in this state.

The Attorney General's Office urges quick passage of Senate Bill 691.

As Amended by House Committee

Session of 1988

HOUSE BILL No. 3000

By Committee on Judiciary

2-22

AN ACT regulating travel promoters.

Be it enacted by the Legislature of the State of Kansas:

Section 1. The legislature finds and declares that certain advertising, sales and business practices of travel promoters have worked financial hardship upon the people of this state; that the travel business has a significant impact upon the economy and well being of this state and its people; that problems have arisen which are peculiar to the travel promoter business; and that the public welfare requires regulation of travel promoters in order to eliminate unfair advertising, sales and business practices. The purpose of this act is to establish standards which will safeguard the people against financial hardship and to encourage competition, fair dealing and prosperity in the travel business.

Sec. 2. As used in this act:

(a) "Travel promoter" means a person who sells, provides, furnishes, contracts or arranges, or advertises that such person can or may arrange, or has arranged, wholesale or retail air or sea transportation either separately or in conjunction with other services. Travel promoter does not include: (1) An air carrier, (2) a sea carrier ~~or~~, (3) an officially appointed agent of an air carrier who is a member in good standing of the airline reporting corporation, (4) a nonprofit organization, ~~or (5) a travel promoter who has in force $300,000 or more of liability insurance coverage for professional errors and omissions and a surety bond or equivalent surety in the amount of $100,000 or more for the benefit of consumers in the event of a bankruptcy on the part of such travel promoter~~.

(b) "Air carrier" means a transporter by air of persons subject

communicates an offer,

bonafide

exempt from federal income tax pursuant to section 501(c) of the Internal Revenue Code of 1986 as in effect on the effective date of this act, (5) a member of the National Tour Association, or (6) a person who offers, sells, provides, furnishes, contracts or arranges, or advertises that such person can or may arrange, or has arranged primarily ground transportation

Attachment VI