Approved March 3, 1988
Date

MINUTES OF THE SENATE COMMITTEE ON JUDICIARY.

The meeting was called to order by Senator Robert Frey at
Chairperson

10:00 a.m./~~p.m.~~ on March 1, 1988 in room 514-S of the Capitol.

~~All~~ members ~~were~~ present ~~except~~: Senators Frey, Hoferer, Burke, Feleciano, Gaines, Langworthy, Parrish, Steineger, Winter and Yost.

Committee staff present:
Gordon Self, Office of Revisor of Statutes
Mike Heim, Legislative Research Department
Jerry Donaldson, Legislative Research Department

Conferees appearing before the committee:
Ron Smith, Kansas Bar Association
Danton B. Rice, Office of Secretary of State
Professor John Kuether, Washburn University Law School
Tom Peebles, Attorney for CPA Firm

House Bill 2487 - Uniform Trade Secrets Act

Ron Smith, Kansas Bar Association, stated his association supports these cleanup amendments to the Uniform Trade Secrets Act. The changes in the bill were recommended by the American Bar Association's Patent Law Section, and the Uniform Laws Commission. They concern the rights, duties and liabilities concerning "intellectual property". A copy of his statement is attached (See Attachment I).

Following committee discussion, Senator Gaines moved to report the bill favorably. Senator Parrish seconded the motion. The motion carried.

Senate Bill 680 - Amendments to Kansas revised uniform limited partnership act.

Danton B. Rice, Office of Secretary of State, explained during the 1987 legislative session Kansas adopted numerous revisions to our Limited Partnership Act based upon similar changes to the Delaware and Uniform Act. This bill will complete the process by correcting several technical oversights. Mr. Rice proposed amending the bill by deleting Section 4. He also recommended adding two subsections (c) and (d) to New Section 20. A copy of his statement is attached (See Attachment II).

Following committee discussion of the bill, Senator Gaines moved to amend the bill by deleting Section 4. Senator Parrish seconded the motion. The motion carried. Senator Gaines moved to amend the bill by adding new subsections (c) and (d) to New Section 20. Senator Langworthy seconded the motion. The motion carried. Senator Gaines moved to report the bill favorably as amended. Senator Langworthy seconded the motion. The motion carried.

Senate Bill 565 - Charitable trusts administration act.

Ron Smith, Kansas Bar Association, introduced Professor John Kuether from Washburn University Law School.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

CONTINUATION SHEET

MINUTES OF THE SENATE COMMITTEE ON JUDICIARY,

room 514-S, Statehouse, at 10:00 a.m./p.m. on March 1, 1988

Senate Bill 565 continued

Professor Kuether pointed out the bill contains two apparently inadvertent omissions in Section 1(c)(2) and in Section 2. He then explained the substantive provisions in the bill. A copy of his statement is attached (See Attachment III).

Tom Peebles, Attorney for CPA Firm, testified the bill 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 the bill it is doubtful whether this reformation can be accomplished under Kansas law. Copies of his handout are attached (See Attachments IV). Committee discussion was held with Mr. Peebles and Professor Kuether.

Senator Steineger moved to amend the bill by inserting language in Section 1(c)(2) as recommended by Professor Kuether. Senator Gaines seconded the motion. The motion carried. Senator Parrish moved to amend the bill in Section 1 by adding "as to all wills and trusts not previously construed" in new subsection (d). Senator Gaines seconded the motion. The motion carried. Senator Gaines moved to report the bill favorably as amended. Senator Steineger seconded the motion. The motion carried.

The meeting adjourned.

A copy of the guest list is attached (See Attachment V).

GUEST LIST

COMMITTEE: SENATE JUDICIARY COMMITTEE DATE: 3-1-88

NAME (PLEASE PRINT)	ADDRESS	COMPANY/ORGANIZATION
1 Darton Rice		SOS
2 Janet Stubbs	Topeka	HBAK
3 Jan B. Vacek	Topeka	KSCPA
4 [illegible] Anderson	Topeka	KSCPA
5 Tom Peebles	Salina	Kennedy & Coe
6 JOHN KUETHER	TOPEKA	KBA
7 [illegible]		DOB
8 Ron Smith	"	KBA

Att. V

3-1-88

KANSAS BAR ASSOCIATION

1200 Harrison
P.O. Box 1037
Topeka, Kansas 66601
(913) 234-5696

March 2, 1987
HB 2487

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

> KBA supports these cleanup amendments to the Uniform Trade Secrets Act.

The changes in this bill were recommended by the American Bar Association's Patent Law Section, and the Uniform Laws Commission. They concern the rights, duties and liabilities concerning "intellectual property."

The Kansas Trade Secrets Act is found at KSA 60-3320 et seq. These amendments do the following:

1. Subsection (b) amendments allow the court, when considering appropriate instances where an injunction is in order under the Act, allows such relief to include the alternative of paying a "reasonable royalty" for the misappropriation of the intellectual property. It defines the "exceptional circumstances" when this reasonable royalty alternative may be imposed.

2. Subsection 2(a) changes just allows the aggrieved party in a trade secrets dispute to seek actual damages or liability for a "reasonable royalty" as well as current law, which allows a suit for "unjust enrichment."

Att. I

3. Sections 3(a) and 3(b) simply clarify that the Trade Secrets act allows both contractual and tort-based remedies for those who have suffered damages by the actions of another that misappropriate and use a trade secret.

4. Section 4 is clarification. Current law does not apply the act to misappropriation of a trade secret that occurred before July 1, 1981, the effective date of the act. The new language simply means that if the "misappropriation" of the trade secret occurred before that time, that "continuing misappropriation" of the same trade secret cannot now be enforced under the act. The continuing misappropriation must be tied into an original pre-existing act.

A copy of the ABA resolutions and explanatory information is enclosed.

3-1-88

Bill Graves
Secretary of State

2nd Floor, State Capitol
Topeka, KS 66612-1594
(913) 296-2236

STATE OF KANSAS

TESTIMONY BEFORE THE SENATE 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 further amendments to make several sections consistent with either the Delaware Revised Uniform Limited Partnership Act or our corporate code. Section 4 of the bill makes a change that will allow a limited partnership to conduct any business with the exception of banking and insurance. Current law merely states that a limited partnership may conduct any lawful business except as otherwise provided by law of the state. This changes the current presumption and may unduly broaden the scope of permissible business activities that a limited partnership may pursue.

In addition, new section 20 is missing several key provisions of the Delaware law with regard to the merger of limited partnerships (attached). These sections make it clear that, following a merger of domestic limited partnerships, the surviving limited partnership assumes all debts and obligations of the limited partnership that is merged out of existence and that the survivor may be served with process for any obligations of such limited partnership.

Senate bill 680, with the modifications 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.

Att. II

Amendment to New Section 20

add at line 598

(c) If following a merger or consolidation of one or more domestic limited partnerships and one or more limited partnerships formed under the laws of any state, the surviving or resulting limited partnership is not a domestic limited partnership, there shall be attached to the certificate of cancellation filed pursuant to K.S.A. 56-1a153 for each such domestic limited partnership a certificate executed by the surviving or resulting limited partnership, stating that the surviving or resulting limited partnership agrees that it may be served with process in the state of Kansas in any action, suit or proceeding for the enforcement of any obligation of such domestic limited partnership, irrevocably appointing the secretary of state as its agent to accept service of process in any such action, suit or proceeding and specifying the address to which a copy of such process shall be mailed to it to the secretary of state.

(d) When the certificate of cancellation required by new section 20 (b) shall have become effective, for all purposes of the laws of the state of Kansas, all of the rights, privileges and powers of each of the limited partnerships that have merged or consolidated, and all property, real personal and mixed, and all debts due to any of said limited partnerships, as well as all other things and causes of action belonging to each of such limited partnerships shall be vested in the surviving or resulting limited partnership, and shall thereafter be the property of the surviving or resulting limited partnership as they were of each of the limited partnerships that have merged or consolidated, and the title to any real property vested by deed or otherwise, under the laws of the state of Kansas, in any such limited partnerships, shall not revert or be in any way impaired by reason of this act; but all rights of creditors and all liens upon any property of any of said limited partnerships shall be preserved unimpaired, and all debts, liabilities and duties of each of the limited partnerships that have merged or consolidated shall thenceforth attach to the surviving or resulting limited partnership, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.

3-1-88

SENATE BILL 565

The Charitable Trusts Administration Act

Testimony by John F. Kuether

I. The bill contains two apparently inadvertent omissions:
Section 1. (c) (2) at line 0075 should read:
"the Internal Revenue Code of 1986, or corresponding provisions of any subsequent federal tax laws and charitable remainder trusts described in section 664 of the Internal Revenue Code of 1986 or corresponding provisions of any subsequent federal tax laws, to include, if required to do so...

Section 2. should provide: the legislation is effective on publication "as to all wills and trusts not previously construed."

II. The Substantive Provisions

A. Section 1 (a)

This section is a codification of the common law doctrine of cy pres ("sigh pray"). Under the doctrine, when a charitable gift was made by will but failed, usually because the specific charity had ceased to operate, a court could allow a similar charity to carry out the donor's general charitable intent. The doctrine is not applied if the donor had provided for the fact that the charity might not take and had made any other disposition.

Although the Kansas courts have recognized the doctrine, it has not been applied because the court has always found the donor had a specific, and not a general, charitable intent. In other cases the donor has provided for a gift over.

B. Section 1 (b)

In 1969, and several times since, Congress has specified extremely complex rules regulating the terms of a trust which has a part charitable and part private interest.

As a result, many gifts to charity have failed to meet the federal requirements for deductibility. The charity still receives the property, but it receives less because income or transfer taxes are imposed on the charity's portion of the gift.

Section 1 (b) of the bill allows a court to reform the terms of the trust to allow the charitable portion to qualify for tax deductibility.

The bill contains procedural safeguards. Subsection (1) requires the written consent of all the charitable and non-

Att. III

charitable beneficiaries. Subsection (2) requires that the court find that the interest of the beneficiaries is substantially preserved. It also authorizes the Kansas Attorney General to be notified of the opportunity to represent the public interest and the charity.

The bill is necessary because of the extremely complex rules governing the provisions which may, or must, or can not, be in a qualifying split interest charitable trust. The bill is modeled on legislation enacted in North Carolina in 1967 and amended in 1971 in response to the passage of the new federal requirements for charitable trusts.

The bill is fully supported by the Kansas Bar Association, The Real Estate, Probate and Trust Law Section of the Kansas Bar Association, and the Kansas Society of Certified Public Accountants.

3-1-88
Peebles

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

Att. IV

3-1-88

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.* 7828006.

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