It is hard to believe that it is May already. Twenty eighteen is flying by us. In a moment of reflection, I want to share that I attended the memorial service for Allan B. Head, retired long-time Executive Director of the North Carolina Bar Association. Allan passed away in March after a long battle with cancer. The memorial service was a moving tribute to a dynamic leader and truly great man. White Memorial Presbyterian Church, in Raleigh, was filled to capacity with those impacted by Allan’s life. His life reflected his passions: God, family, country, volunteerism and the North Carolina Bar Association. We were reminded of one of Allan’s favorite “Head Notes.” He said, “Leave the campsite better than when you arrived.” Quite the gentle reminder to us all to leave the world a better place.

The final plans are in place for 39th Annual Estate Planning & Fiduciary Law Program, to be held July 26-28, 2018, at Kiawah Island! Registration for the program opened April 5. The program content looks outstanding. Specifically, we will again have federal, state and legislative recent developments, developments in asset protection trusts and the new tax laws enacted at the end of 2017, and a practical discussion of the living probate procedure. We have a few panels scheduled as well. One will focus on the intersection of family law and estate planning, while another will feature some of the clerks around the state discussing estate administration. We

2017 Formal Ethics Opinion 2 Provides Additional Guidance About Estate and Trust Checking Accounts

By John G. Kelso

This article discusses 2017 Formal Ethics Opinion 2 (herein “FEO 2” or “the Opinion”), entitled “Maintaining Fiduciary Account in Accordance with Rule 1.15.” FEO 2 was published in the Fall 2017 edition of the State Bar Journal and was adopted by the State Bar Council at its meeting on October 27, 2017. FEO 2 includes eight different Inquiries and Opinions in response. This article focuses on Inquiry #2 and Opinion #2.

Before the proposed FEO 2 was adopted it was discussed at a meeting of the Estate Planning & Fiduciary Law Section Council and, as part of the official comments process, a letter was prepared by the Section’s Ethics Committee and submitted by Linda Johnson, as our Section Chair, to the State Bar Council raising questions and concerns about the proposed Opinion. After the Opinion was adopted, a reply letter (herein “the Reply Letter”) was sent back to Linda Johnson by Nichole P. McLaughlin, State Bar Assistant Ethics Counsel and District Bar Liaison. The Reply Letter provides helpful information to supplement the FEO and might help allay some concerns about the oversight obligations described in FEO 2.

Although you might want to read the entire FEO 2, for purposes of this article it will be helpful to set out the fact pattern of Inquiry #2 verbatim:

Lawyer represents Estate of B and the personal representative of Estate of B in her official capacity. Lawyer opens a checking account for the estate and designates the personal representative as the signatory on the account. The personal representative will receive the bank statements. Lawyer, however, intends to retain possession of the checkbook, preparing checks for the personal representative’s signature as needed and depositing estate funds into the account when obtained. What are Lawyer’s obligations for the account under Rule 1.15?

Opinion #2 consists of three paragraphs. The first two paragraphs explain that in this situation, since the lawyer does not have signature authority, the lawyer is not required to comply with the requirements of Rules 1.15-2 and 1.15-3 involving review and reconciliation of bank statements and canceled checks. However, the

Continued on page 2

Continued on page 3
lawyer’s physical possession of the checkbook means that the lawyer must follow the requirements of Rule 1.15 including properly safeguarding the estate checkbook itself. The third paragraph, quoted in full below, is where it gets more involved:

Lawyer represents the estate and the personal representative in her official capacity. RPC 137. Therefore, Lawyer has a duty to provide competent and diligent representation. Rule 1.1 and Rule 1.3. Competent and diligent representation requires Lawyer to advise the personal representative of her fiduciary responsibilities relative to the safekeeping of the funds of the estate and her duty to administer the estate in compliance with the law. See generally 2002 FEO 3 (lawyer for estate may seek removal of personal representative if the personal representative’s breach of fiduciary duties constitutes grounds for removal under the law). To ensure that the estate account is properly managed, checks are not written against insufficient funds, and estate funds are protected from theft, competent and diligent representation dictates that Lawyer periodically meet with the personal representative to review the estate account documents, including the bank statements and canceled checks. If Lawyer prepares checks for the personal representative’s signature, Lawyer must conduct a periodic review of the balance for the estate account sufficient to guard against the preparation of a check for the personal representative’s signature that would exceed the balance of the account. (Italics added.)

The last two sentences of that paragraph – italicized above just for emphasis – are the source of much of the Section Council’s concern about the Opinion. Apparently those two sentences were also a focus of the Ethics Committee: an earlier version of proposed FEO 2 had been approved by the Ethics Committee of the State Bar in April and was published in the Summer 2017 edition of the State Bar Journal, but that earlier version did not include those two sentences. Those sentences were added in July when the proposed FEO 2 was revised and republished in the Fall edition of the State Bar Journal, which was the version that was later adopted by the State Bar Council.

While it may make for dry reading material, this article will quote extensively from the Reply Letter since the Reply Letter provides very helpful additional guidance to FEO 2, but lawyers may have some different interpretations and want to decide for themselves what actions to take. In the numbered items below, the question is a shortened version of the question that was asked, the “Reply” is a direct quote from the Reply Letter, and the “Comments,” if any, are my own opinion.

1. Are these new duties being communicated to the bar by Proposed FEO 2, or have these duties previously been imposed by cited Rules?
   Reply: When a lawyer represents an estate, she has a professional obligation to see that the estate is properly administered. The duties imposed by opinion #2 are existing duties required by Rule 1.1, Competence, and Rule 1.3, Diligence.

2. Do these duties apply only when the lawyer is holding the checkbook as in the fact pattern? Do any of these duties apply when the lawyer is not holding the checkbook?
   Reply: The lawyer is obligated to follow the requirements of Rule 1.15 as applicable to items over which the lawyer has possession or control, such as properly safeguarding checks received for the estate or properly safeguarding the checkbook for the estate account. The duty to identify, hold, and maintain entrusted property separate from the property of the lawyer, as set forth in Rule 1.15-2(a), applies only when the lawyer has possession of estate property, such as the checkbook.

Comment 1: Keep in mind that the fact pattern of Inquiry #2 of FEO 2 is somewhat unusual. The lawyer is not the PR, but is representing the PR. The inquiry states that “Lawyer opens a checking account for the estate and designates the personal representative as the signatory on the account.” In my experience it would be highly unusual for the lawyer to open an account for a third party (the estate) and to “designate” the PR as the signatory, if this is even possible. That seems to imply that someone other than the PR could have been the signatory for the account, and it was the lawyer’s choice to designate the PR as the signatory. This particular fact does not seem to be important in the rest of the Opinion, but if it were not relevant then why would the inquiry spell out such an unusual set of facts? From the Reply Letter, however, the key fact seems to be the lawyer’s possession of the checkbook, not how the lawyer came to have possession.

Comment 2: In my view the Opinion extends the scope of Rule 1.15, applicable to items over which the lawyer has possession or control. This Opinion seems to equate the checkbook itself to the funds going into and coming out of the account. The “entrusted property” is the checkbook, not the funds in the account.

Comment 3: It appears that the entire issue raised by this Opinion is avoided if the lawyer does not hold the checkbook. To be on the safe side, it might also be better if the lawyer does not assist the PR with the physical process of writing out checks. Or would it be different if the lawyer held the checkbook but simply gave checks to the PR at the PR’s request, without preparing checks for the PRs signature?

3. Does the duty to conduct a review of the estate account documents require a physical meeting between lawyer and...
PR, or can the periodic review be handled without an in-person meeting?

Reply: The periodic reviews need not occur in person, but may instead take place over the phone or by mail if reasonable under the circumstances.

Comment: I am not exactly sure how a review would work by phone or mail, unless it is both by mail (to share documents) and by phone (to discuss them). But this does appear to make the obligation easier to satisfy.

4. Can the review of the estate account documents be handled by the lawyer's staff under the lawyer's supervision?

Reply: The reviews can be delegated to non-lawyer staff provided that person is properly supervised by the lawyer. Rule 5.3.

Comment: Again, this makes the review process easier to accomplish, although since the idea is that the review should help prevent checks from being written against insufficient funds, I suppose both the staff review and the lawyer's supervision of the staff review must occur prior to giving the PR checks to sign.

5. If one of the stated purposes of the review is to “ensure that … checks are not written against insufficient funds,” how exactly can that be ensured?

Reply: When the lawyer who has possession of the checkbook will write checks for the personal representative’s signature, the opinion provides that the lawyer is obliged to periodically review the estate documents with the personal representative to ensure that the lawyer is not writing checks that will cause overdraft of the estate account. The Ethics Committee recognizes that periodic meetings with the personal representative to review past transactions cannot provide absolute protection against the estate account falling below a zero balance. The reviews, however, will reduce the likelihood of overdrawing the account.

6. Do any of these duties also apply to trusts, or to other matters where a lawyer is representing a fiduciary who is writing checks, or is it just for estates?

Reply: The duties imposed by the opinion apply to any matter for which the lawyer will either serve as a fiduciary or represent a fiduciary.

7. What does “periodically” mean: monthly? quarterly? twice a year?

Reply: The Rules of Professional Conduct are “rules of reason,” as described in Rule 0.2, Scope. As such, the expectation is that a lawyer will exercise discretion in determining how often a review is necessary. The frequency of a review of the estate records may depend on the level of activity in the estate account. While a clerk of court’s review provides additional oversight of the estate account, that review does not fulfill the lawyer’s independent duty because the lawyer cannot delegate a professional obligation to a person over whom the lawyer has no supervisory authority.

Comment: This response also reinforces the idea that the review of account documents contemplated by FEO 2 is different from the lawyer’s required reviews of account documents when the lawyer is serving as the fiduciary.

8. Can the PR limit the scope of representation and direct the lawyer in writing that the lawyer is not being engaged to provide this oversight, or otherwise change the level of oversight?

Reply: A lawyer’s professional obligations cannot be waived by a client. Therefore, the lawyer cannot ask the personal representative to waive the periodic reviews required by the opinion.

Comment: In asking the question, the thought was that the client would be the one who might feel this type of review is unnecessary and an unwanted expense, not that the lawyer would ask the PR to waive it to reduce the lawyer’s duties.

9. If the PR refuses to comply (perhaps for cost reasons), or PR is habitually late in providing information or participating in review meetings, what are the lawyer’s duties?

Reply: If the personal representative is not cooperative and does not provide the information requested for the reviews, or repeatedly fails to timely provide such information, the lawyer may seek to withdraw from the representation pursuant to Rule 1.16.

Comment: This raises an interesting question, specifically the difference between what the lawyer “may” do and what the lawyer “should” or “must” do, if anything. That question is beyond the scope of this article.

10. If the lawyer becomes aware - either through any required review or otherwise - that any problems have occurred with respect to management of the estate account, does Proposed FEO 2 impose a duty on the lawyer to do anything about it?

Reply: The reference to 2002 FEO 3 (lawyer for estate may seek removal of personal representative if the personal representative’s breach of fiduciary duties constitutes grounds for removal under the law) in the new opinion reminds lawyers of the duty to advise the personal representative of his or her fiduciary responsibilities when a lawyer learns that the personal representative’s personal interests conflict with the interests of the estate. The
opinion requires the lawyer to take some action but it does not require the lawyer to notify the clerk of court if the lawyer learns that the personal representative has breached her fiduciary duty to the estate.

For my own practice, the two takeaways from Opinion #2 of FEO 2 are (1) don’t keep the checkbook for the PR, and (2) don’t write out checks for the PR to sign. Those are unfortunate results of FEO 2 since in many cases the lawyer’s keeping the checkbook probably helped achieve the goals that FEO 2 is ostensibly trying to promote, but now some lawyers will be less willing to take on that obligation – and clients may not be willing to pay for the lawyer’s review time. A third takeaway, not discussed above but easy to implement, is to make sure that the lawyer’s standard correspondence to PRs at the beginning of the administration process should “advise the personal representative of her fiduciary responsibilities relative to the safekeeping of the funds of the estate.”

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Timing Is Everything
By Linda F. Johnson

World-renowned golf pro Arnold Palmer said, “Timing is everything in life and golf.” (www.asquotes.com). While this author cannot speak to whether timing is truly everything, timing is certainly everything in dealing with the basis opportunities that arise from the death of an S corporation shareholder who owns 100 percent of the shares at the shareholder’s death.

Background – Share Basis (Outside Basis) vs. Asset Basis (Inside Basis)

The income, losses, deductions, and credits from an investment in an S corporation are taxed directly to the shareholders. I.R.C. § 1366(a)(1); I.R.C. § 1377(a)(1). A shareholder’s basis in S corporation stock is calculated through a system of adjustments to the shareholder’s initial capital contribution or the cost of the shares purchased. This basis system is similar to the rules that apply to partnerships and LLCs. I.R.C. § 731-737, 751(b) and 755.

The basis is increased by the taxable income that is allocated annually to the shareholder. I.R.C. § 1367(a)(1). In computing basis in shares of stock, the shareholder starts with his initial capital contribution to the S corporation or the initial cost of the shares he purchased (the same as a C corporation). That amount is then increased or decreased based on the flow-through income amounts from the S corporation. Income and capital gains will increase share basis, while operating losses, capital losses, and distributions will decrease share basis. https://www.irs.gov/businesses/small-businesses-self-employed/s-corporation-stock-and-debt-basis. These adjustments to share basis are made without regard to the value of the corporation’s assets.

Simply summarized, the tax effect of a distribution by the S corporation to its shareholder depends on the shareholder’s basis in the S corporation’s shares. If the distribution allocated to the shareholder exceeds his basis, then the difference is taxed to the shareholder as capital gain (distribution – basis = capital gain). I.R.C. § 1368(b)(2). If there is a liquidating distribution of an S corporation and assets are distributed in kind, then the distribution is treated as a sale of assets to the shareholder at fair market value (FMV). I.R.C. § 336. The S corporation calculates its gain or loss as if the assets were sold to a third party. The S corporation then reports the amount of gain or loss that passes through to the shareholder. I.R.C. § 1366(a).

For example, assume a shareholder made a capital contribution to X Corporation of $50,000, which X Corporation invested. At the time of liquidation, the fair market value of X Corporation’s asset was $150,000. If, on liquidation, the asset is distributed to the shareholder in kind, X Corporation is deemed to have sold the asset at its fair market value, and X Corporation has a $100,000 capital gain, which flows through to the shareholder.

Opportunities at the Death of a Shareholder

What happens upon the death of an S corporation shareholder? The shares owned by the decedent shareholder receive a step-up in basis, that is, a revaluation to fair market value as of date of death. I.R.C. § 1014. Fair market value is defined as: “… the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent’s gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.” Treas. Reg. § 20.2031-1.

The S corporation’s assets, however, do not receive a basis step-up at the shareholder’s death. This can result in the inside basis of the assets differing from the outside basis of the shares. There can be a significant difference between the fair market value of the assets inside the corporation and their tax basis. How can the heirs, who inherit the shares, receive a benefit from the increase in the value of the shares? What happens if the S corporation’s assets are sold? What happens if the corporation’s assets are distributed to the new shareholder?

The heir shareholders, if willing to liquidate the S corporation, can use S corporation stock basis rules, and recognize a loss to offset