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Water Rights Deficit Erodes Land Use Permitting: A Review of *Foster v. Washington State Dept. of Ecology*

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In *Foster v. Washington State Dept. of Ecology*, a recent decision overturning a water permit issued to a municipality by the Washington State Department of Ecology ("Ecology"), the Washington State Supreme Court held that withdrawals of water that impaired minimum flows based on overriding considerations of public interest were required to be temporary.[1] The *Foster* decision raises significant questions regarding the ability of Ecology to approve new water uses in connection with municipalities' efforts to accommodate growth and development in land use applications. The somewhat confusing decision has far-reaching impacts, and potentially unintended consequences. Ecology and the city of Yelm have sought reconsideration of the Supreme Court's ruling, and review is pending.

Water Law Fundamentals

To understand the Washington State Supreme Court's decision in *Foster*, and its impacts, requires an understanding of fundamentals of Washington state water law. Washington state is a prior appropriations state, which means water rights are "first in time, first in right."[2] This long-established approach to water law means that an impairment of a senior water right, even a de minimis impairment, is not allowed.[3] In order to properly grant an application for a new water permit, Ecology must be satisfied that the permit meets the following four criteria: (1) water is available for appropriation (2) for a beneficial use and (3) an appropriation will not impair existing rights or (4) be detrimental to the public welfare.[4]

In 1971, as part of the Water Resources Act, the establishment of base (or minimum) flows in rivers and streams was mandated by RCW 90.54.020(3), which provides in part:

> The quality of the natural environment shall be protected and, where possible, enhanced as follows: … Perennial rivers and streams of the state shall be retained with base flows necessary to provide for preservation of wildlife, fish, scenic, aesthetic and other environmental values, and navigational values.

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Pursuant to this legislative direction, Ecology adopted rules establishing minimum flows, enacted for the purpose of preserving instream flows in various watersheds throughout the state at specified levels. Minimum flow rules are established by administrative rule and the rules themselves are a water right with a priority date from the time that the rules are adopted.[5] These minimum flows are, in most respects, like any other water appropriation and are generally subject to the prior appropriation approach.[6] Most existing land use within the state relies upon water rights that predate minimum flow rules, and are therefore senior to the minimum flows.

Minimum flows do differ from other water appropriations in the state in a critical respect: "withdrawals of water" that would impair a minimum flow may be permitted, but only under a narrow exception referred to as the "overriding considerations of public interest," or "OCPI," exception.[7] The OCPI exception reads as follows:

> (3) The quality of the natural environmental shall be protected and, where possible, enhanced as follows:
>
> (a) Perennial rivers and streams of the state shall be retained with base flows necessary to provide for preservation of wildlife, fish, scenic, aesthetic and other environmental values, and navigational values. Lakes and ponds shall be retained substantially in their natural condition. *Withdrawals of water which would conflict therewith shall be authorized only in those situations where it is clear that overriding considerations of the public interest will be served.*[8]

The last sentence is what is commonly referred to as the "OCPI" exception. The Washington State Supreme Court has held that the terms "base flows" and "minimum flows" are synonymous for purposes of this exception.[9] This article will use the term "minimum flows" as a matter of consistency.

Obligations of Municipalities with Respect to Water Resources in Land Use Planning

To understand the *Foster* decision and its impacts on land use planning, a review of the Growth Management Act ("GMA") requirements and related case law is helpful. The Washington State Supreme Court has held that local governments must regulate to some extent to assure that land use is not inconsistent with available water resources and that local governments must plan for the protection of water resources in their land use planning.[10] The GMA directs that the rural and land use elements of a local government's plan include measures that protect groundwater resources.[11] Additionally, the GMA requires that local governments assure potable water is available when issuing building permits and approving subdivision applications.[12] Specifically:

> A proposed subdivision and dedication shall not be approved unless the city, town, or county legislative body makes written findings that: (a) Appropriate provisions are made for … potable water supplies. [13]

In addition to the requirements under RCW 58.17 *et seq.*, RCW 19.27.097 requires that applicants for building permits for buildings that need potable water provide evidence of an adequate water supply for the intended use of the building.

In a series of cases, courts have found an increasing obligation on the part of local governments and land use permitting agencies to confirm how the land use proposed in an application will be reliably supplied with potable water. Moreover, the Washington State Department of Health requires a firm and consumptive supply of water to be available for all potable uses, which most land uses require to be potable supplies. Minimum flow rules are typically constructed to be triggered when flows are less than 10 percent of average. This means that any water right obtained with a priority date after the date of the minimum flow rule is subject to curtailment or interruption in order to satisfy the minimum flow rule, unless special permission is granted that eliminates curtailment.

The GMA both requires local governments to assure reliable water resources exist and mandates local governments to accommodate growth. One of the specific planning goals under the GMA is to "[e]ncourage development in urban areas where adequate public facilities and services exist or can be provided in an efficient manner."[14] Many local governments with fully appropriated watersheds in their jurisdiction thus find themselves in a difficult dilemma of weighing those competing obligations.

Watershed Planning and Mitigation Strategies

Hopes for resolving the looming crisis between local governments' obligations to accommodate growth and their obligations to assure reliable water resources (which are already fully appropriated in many watersheds within the state) in connection with land use applications have largely relied upon watershed planning and mitigation efforts.

Watershed planning is authorized by the Washington state legislature as a means of optimizing the allocation of water within a watershed. Many watersheds participated in planning efforts that allocated additional water in conflict with the relevant minimum flow rule in exchange for mitigation efforts intended to enhance instream flow values. Most

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of these watershed plans were the result of many years of exhaustive effort by dozens of representative stakeholders and consultants to arrive at plans that have nearly unanimous support. To implement watershed plans, Ecology has typically found that the watershed plan demonstrates that OCPI justifies appropriations that would otherwise conflict with the relevant minimum flow rule. Ecology's OCPI rational used an economic analysis to evaluate the various public interests expected to be burdened and benefited by its decision.

Another strategy to resolve the conflict between accommodation of growth and assurance of reliable water sources is mitigation. Mitigation typically involves the retiring of existing water rights and the reintroduction of reclaimed water back into the stream system in order to offset new water uses, which is commonly referred to as "water-for-water" or "in-kind mitigation." Mitigating the adverse effects of a new water appropriation is a case-by-case approach that in many ways mimics the exchange of new water rights for mitigation found in watershed plans. Mitigation is very common in permitting exercises of all kinds. Mitigation is more legally compelling when the proposed mitigation plan closely resembles the nature and scope of the application's adverse impacts. There is a natural tension in the marrying of mitigation to impacts. The more closely the proposed mitigation resembles the impacts, the less likely it is that the mitigation is needed in the first place. Put simply, if a party is able to mitigate the issuance of a new water right by retiring another water right that looks just like it, then the party probably already has the needed water right.

Both mitigation and watershed planning strategies have suffered dramatic setbacks in recent Washington State Supreme Court cases: the *Swinomish* case previously cited, and the *Foster* case.

The *Swinomish* Decision

In *Swinomish*, the Washington State Supreme Court invalidated the new water appropriations supported by the Skagit River watershed plan.[15] In connection with the Skagit River watershed plan, Ecology had approved 27 general future reservations of water in the Skagit Basin, which indisputably would impair existing minimum flows.[16] Because of this impairment, Ecology could only approve the reservations if the OCPI exception was satisfied.[17] Under the OCPI analysis, Ecology determined that the following "test" should be done to determine if the exception applies: (1) whether and to what extent important public interests are served by the proposed reservations, (2) whether and to what extent the reservations would harm any public interests, and (3) whether the public interests served clearly override harm to public interests; a simple "balancing test."[18]

The Washington State Supreme Court rejected Ecology's balancing test and its application of the OCPI exception in *Swinomish*, holding that the OCPI exception is "not a device for a wide-ranging reweighing or reallocation of water."[19] Rather, the "[OCPI] exception is very narrow … and requires extraordinary circumstances before the minimum flow water right can be impaired."[20] The Washington State Supreme Court found that "Ecology's test is insufficient to identify 'overriding' considerations of public interest while giving effect to legislative intent that water for population growth would not trump domestic water needs in every instance and every area in the state where rural development is thought to be desirable."[21]

The Washington State Supreme Court found that the Skagit River watershed plan failed to evaluate the relevant public interests in a way that would support the intent of the minimum flow legislation giving rise to the minimum flow rules. The Washington State Supreme Court observed that if minimum flows were but one of many public interests then there would always be a sufficient cause

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to override the rule because "[t]here is no question that continuing population growth is a certainty and limited water availability is a certainty."[22]

Since the Washington State Supreme Court's decision in *Swinomish*, Ecology has officially informed all watershed plan participants that it will no longer support the issuance of any new water rights as called out in any watershed plan due to this ruling. Ecology hoped to rectify this wholesale invalidation of a generation's worth of stakeholder consensus by supporting legislation that ratifies the remaining plans. This effort failed in its first attempt last year. The current effort to this end is to ratify the Wenatchee River Plan with SB6513.

The *Foster* Decision

In the *Foster* case, the Washington State Supreme Court reviewed a challenge to the issuance of a water permit by Ecology to the city of Yelm.[23] Like many growing cities in our state, the cities of Olympia, Lacey, and Yelm face the challenge of acquiring reliable water sources to accommodate expected growth. The city of Yelm's application for this water permit arose from approximately 20 years of analysis and dialog with stakeholders, resulting in a robust mitigation plan among many municipalities and agencies to offset the impacts of the proposed city of Yelm appropriation. As part of their growth planning, the cities of Lacey and Yelm applied for the right to withdraw a certain number of acre-feet per year of new groundwater. As part of the same plan, the City of Olympia (and the Nisqually Indian Tribe) also filed certain change applications for existing water rights. The water basins impacted by these applications were subject to conditions of minimum flow regulations.[24]

In its review of the new water permit application submitted by the city of Yelm, Ecology used the OCPI exception.[25] It was undisputed that the city of Yelm's water permit would impair the existing minimum flows and, therefore, the permit application would have to be denied unless the OCPI exception applied.[26] Ecology ultimately issued the permit, finding that OCPI was established such that the minimum flow could be impaired as proposed.[27]

As in *Swinomish*, Ecology, the Pollution Control Hearings Board, and the Thurston County Superior Court found that OCPI was satisfied, but again the Supreme Court determined that OCPI was misapplied in a manner that failed to respect the minimum flow legislation.[28]

The Washington State Supreme Court found that Ecology wrongfully applied the OCPI exception to the water permit application and mitigation plan at issue in the case, and that the exception was not intended to be utilized in routine questions of urban growth and increased water need, stating that, "municipal water needs, far from extraordinary, are common and likely to occur frequently as strains on limited water resources increase throughout the state."[29]

The Washington State Supreme Court further found that the city of Yelm's water permit, like the reservations in *Swinomish*, is a permanent legal water right that would impair established minimum flows indefinitely.[30] Therefore, the Washington State Supreme Court found that Ecology was not authorized to approve the permit application.[31] Again, as in *Swinomish*, the Washington State Supreme Court found in *Foster* that the public interests to be considered were not sufficiently broad to allow even ecological benefits to offset an instream flow incursion.[32]

The Washington State Supreme Court stated that a mitigation plan "is just that: a plan meant to offset the impairment of the minimum flows."[33] "The mitigation plan itself is not the 'extraordinary circumstances' meant to justify use of the OCPI exception."[34] A mitigation plan "does not mitigate the injury that occurs when a junior water right holder impairs a senior water right."[35]

In a further finding as part of its analysis, the Washington State Supreme Court astonished the regulatory and consulting community by opining for the first time that the legislature's use of the word "withdrawal" instead of the word "appropriation" in the OCPI exception necessarily meant that all OCPI determinations could only be temporary in duration.[36] Heretofore, "withdrawal" was typically used to differentiate a ground water appropriation from surface water appropriation, and had no temporal significance at all.

The Washington State Supreme Court stated:

> the OCPI exception does not allow for the permanent impairment of minimum flows. If the legislature had intended to allow Ecology to approve permanent impairment of minimum flows, it would have used the term "appropriations" in the OCPI exception. It did not. The term "withdrawals of water," however, shows a legislative intent that any impairment of minimum flows must be temporary.[37]

The Washington State Supreme Court found that the "OCPI exception allows for the *impairment* of minimum flows," but it does not permit *appropriation* of minimum flows.[38] Quite the contrary, the Supreme Court stated that it has repeatedly held that "[n]othing in the language used in RCW 90.54.020(3)(a) says that the [OCPI] exception is intended as an alternative method for appropriating water when the requirements of RCW 90.03.290(3) cannot be satisfied for the proposed appropriation" and that "the [OCPI] exception cannot reasonably be read to replace the many statutes that pertain to appropriation of the state's water and minimum flows."[39]

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Analysis and Impacts of *Foster*

The *Foster* decision will dramatically impact Washington state water law and land use planning moving forward. First and foremost, temporary water rights will not meet the Department of Health requirements for potable supply. Conversely, the majority of opponents to new appropriations are solely motivated by ecological considerations. The Washington State Supreme Court's ruling in *Foster* can be seen to have divested all stakeholders of any ability to reconcile competing interests in new appropriations. Alternatively, OCPI has been used to temporarily suspend or reduce minimum flow rule enforcement during droughts. If this is the application that the Washington State Supreme Court intended, then a pattern of OCPI application in this manner would yield the same result as permanent junior rights that are excused from curtailment. Judicial participation would then take place as injunctive relief sought on an expedited basis in the context of a drought emergency rather than at the end of 20 years of careful analysis.

Minimum flow rules are intended to promote statutorily defined instream flow values. If an exchange of mitigation for a new appropriation can demonstrate a net increase to instream flow values, then perhaps the right may be issued in a manner that might otherwise conflict with the rule because it satisfies the reason for the rule's existence more than does strict enforcement of the rule. RCW 90.54.020(3)(a) states that minimum flows are to provide for the "preservation of wildlife, fish, scenic, aesthetic and other environmental values, and navigational values…" If the benefits and burdens of a proposal shows net benefits to the "preservation of wild life, fish, scenic, aesthetic and other environmental values and navigational values" then the purpose of the Water Resources Act is served. So long as the Act's purpose is served it seems that the Washington State Supreme Court could be satisfied that such an incursion into the instream flow rule would not obviate the intent of the Act.

The Washington State Supreme Court also expressed a concern that junior rights not being subject to senior rights would upset the prior appropriations conceptual framework. However, mitigation proposed in this way enlarges the instream flow values intended to be protected by the instream flow rule. The new appropriation can then be found to have no potential to either impair the instream flow right or limit the ability of others to obtain junior rights in the same manner. While the new appropriation decreases instream flows prescribed by the rule it increases other more valuable attributes of the instream flow right in a way that allows a no-impairment conclusion.

Many land use regulators will likely face difficulties in accommodating growth when quantities permitted prior to minimum flow rules run out. Rural land use planning often relies upon small-quantity wells that are exempt from permitting requirements. The attorneys for the municipality in *Foster* argued that this decision would lead to the proliferation of unpermitted, exempt groundwater wells as a means for addressing public water supply demand. In this view, such an outcome would lead to greater harm to instream flows and would encourage, rather than discourage, urban sprawl. However, being exempt from permitting requirements does not exempt the appropriation, however small, from being subject to curtailment if minimum flows are not met. Hydrogeological models show that aquifers tapped by wells are typically in hydraulic continuity with adjacent streams such that withdrawals from the aquifer adversely affect the stream's ability to meet minimum flow rule quantities.

Moreover, the Washington State Supreme Court's re-interpretation of the definitions of "withdrawals" and "appropriations" will result in consequential, but likely unintended, impacts. The entire groundwater code uses the term "withdrawal" in many places. To add temporal significance to this term where none previously was understood could profoundly confuse its meaning and call into question any permanent action taken in reliance on the code. Previously, these terms have been used interchangeably in water law, with the term "withdrawal" typically being used to differentiate a ground water appropriation from surface water appropriation, but otherwise having no temporal significance at all. This new interpretation will likely have a broad impact on Washington water law moving forward, if left unmodified by the Washington State Supreme Court or the legislature.

Conclusion

The *Foster* decision limits the ability to use watershed plans and mitigation in basins that have adopted minimum flow rules, including the Wenatchee River Basin near these authors' homes, resulting in limited flexibility of Ecology to approve new water uses. Urban growth and increased water needs are a routine dilemma, and as stated by the Washington State Supreme Court, "municipal water needs, far from extraordinary, are common and likely to occur frequently as strains on limited water resources increase throughout the state." With this limit on the use of the overriding consideration of public interests exception and the corresponding limits on mitigation, communities will have few options to efficiently allocate this precious resource.

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Did *Aragona* Answer All Questions? An Analysis of Outstanding Issues for Trusts Owning Rental Real Estate

by Katie S. Groblewski and RoseMary Reed – Stokes Lawrence P.S.

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It has long been the case that a loss produced from passive activity can only be used to offset passive activity income. Therefore, taxpayers often prefer for business activities to be characterized as non-passive or "active" to avoid the passive activity loss rules. With the introduction of the 3.8 percent Medicare surtax, there is a heightened interest in whether income that a trust derives from its business holdings is passive or non-passive. If such income is passive under the passive activity rules, the passive income will be included in the trust's net investment income and subject to the surtax. On the other hand, if such income is considered non-passive, then it is excluded from net investment income and the surtax will not apply.

Frank Aragona Trust v. C.I.R., 142 T.C. 165 (2014), is the first Tax Court case to address whether the income earned by an irrevocable trust holding rental real estate is non-passive. This commentary provides an overview of the issues related to whether and how the trustee of a trust can "actively manage" real estate rentals, post-*Aragona*, thereby avoiding the passive loss rules. This commentary also provides some practical pointers to consider when drafting trust documents or assisting clients with structuring the management of trust-owned rental real estate.

"Passive Activities," Generally

The passive loss rules work to limit the amount and type of business deductions that an affected taxpayer may take on its income tax return. Under IRC §469(a), passive activity losses for a trust are limited to the aggregate income from the trust's passive activities.[1] It is generally more desirable to be treated as engaging in non-passive activities for income tax purposes because passive activity losses may not be used to offset "active business" or "portfolio" income (e.g., interest, dividends).[2] In addition, a trust with net investment income (NII) above a certain threshold will be subject to the 3.8 percent "Medicare" surtax. NII includes income from a passive activity within the meaning of IRC §469.[3]

Passive activity is defined as any activity (a) which involves the conduct of any trade or business, in which (b) the taxpayer does not materially participate.[4] The taxpayer bears the burden of showing that an activity is non-passive vis-à-vis material participation.[5] A taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.[6] There are generally seven tests that may be applied to a taxpayer's activities to determine whether the taxpayer is materially participating in the activity per the Treasury Regulations ("Regulations").[7] (These tests will be referred to herein as the "Regulatory Tests"). The Regulatory Tests consist largely of tests related to the number of hours spent working in the particular trade or business activity.[8] A specific test related to the material participation in a trade or business activity by a trust has not been created under the Regulations.[9]

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1 Foster v. Washington State Dept. of Ecology, 184 Wn.2d 465, 477, 362 P.3d 959 (2015).
2 RCW 90.03.010; *Postema v. Pollution Control Hr'gs Bd.*, 142 Wn.2d 68, 79, 11 P.3d 726 (2000).
3 RCW 90.03.290; *Postema*, 142 Wn.2d at 80.
4 RCW 90.03.290(3).
5 RCW 90.03.345; *Postema*, 142 Wn.2d at 81.
6 *Id.*
7 RCW 90.54.020; *Postema*, 142 Wn.2d at 81.
8 RCW 90.54.020 (emphasis added).
9 *Postema*, 142 Wn.2d at 81.
10 *See Kittitas County v. Eastern Washington Growth Management Hr'gs Bd.*, 172 Wn.2d 144, 178-79, 256 P.3d 1193 (2011).
11 *Id.*; *see also* RCW 36.70A.070(1), (5)(c)(iv).
12 RCW 58.17.110; *Swinomish Indian Tribal Community v. Dept. of Ecology*, 178 Wn.2d 571, 311 P.3d 6 (2013).
13 RCW 58.17.110(2).
14 RCW 36.70A.020.
15 *Swinomish*, 178 Wn.2d at 602.
16 *Id.* at 578.
17 *Id.* at 579, 583.
18 *Id.* at 583-585.
19 *Id.* at 585.
20 *Id.* at 576.
21 *Id.* at 588; *see also Foster*, 184 Wn.2d at 473 (The Washington State Supreme Court noted that, in the *Swinomish* case, it found that Ecology's use of the exception was an "end-run around the normal appropriation process, conflicting with both the prior appropriation doctrine and Washington's comprehensive water statutes").
22 *Id.* at 587.
23 *Foster*, 184 Wn.2d at 468-69.
24 WAC 173-511 and 173-513.
25 *Foster*, 184 Wn.2d at 469.
26 *Id.* at 469-70.
27 *Id.*
28 *Id.* at 477.
29 *Id.* at 476-77.
30 *Id.* at 475-77.
31 *Id.*
32 *Id.*
33 *Id.* at 476.
34 *Id.*
35 *Id.*
36 *Id.* at 474-75.
37 *Id.* at 475.
38 *Id.*
39 *Id.* at 475-76.

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Rental Real Estate Activities are Generally Considered "Passive"

Real estate rental activities are statutorily per se passive activities, regardless of whether the taxpayer materially participates in the activities.[10] However, IRC §469(c)(7) provides an exception to the per se passive nature of rental activities. This exception is commonly known as the "real estate operator exception" and must be evaluated each tax year to determine whether the taxpayer qualifies for the exception.

To qualify for the "real estate operator exception," the taxpayer must meet a three-part test:

(1) He or she must have materially participated in a rental real estate business (i.e., a "real property trade or business") under the Regulatory Tests. If this element is met then,

(2) More than half of the total personal services provided by the taxpayer must have been performed in such business; and

(3) The taxpayer must have performed more than 750 hours of services in such business.[11]

Each component of the "real estate operator exception" contains terms of art. The phrase "real property trades or businesses" is defined to include "any interest in a real estate business that gives rise to deductions under IRC §212," which is a fairly broad classification.[12] Material participation in a "real property trade or business," is determined under the Regulatory Tests.[13] "Personal services" do not include work performed as an investor or work performed as an employee unless the employee is at least a 5 percent owner of the employer.[14] The manner of ownership of the employer by the employee and the legal capacity in which an employee provides services is a relevant, technical inquiry, without much informative guidance.[15]

The primary difficulty regarding trusts in this context is accounting for the activities of the trustee and any employees and agents that are collectively managing the trust (or in some cases distinct underlying assets) in order to satisfy the elements of the "real estate operator exception" test. Case law offers some clarity, as discussed below.

Pre-*Aragona* "Passive Activity" Cases

Until *Aragona*, no cases addressed how rental real estate management by a trust could be a non-passive activity. There have only been a handful of cases and rulings addressing various types of businesses owned by trusts. Since 2003, the IRS has consistently taken the position that to determine whether a trust "materially participates" in a trade or business, one must look *only* to the activities of the trustee and ensure that the trustee's activities are occurring in its capacity as a fiduciary, rather than as an employee or an entity officer. The Service has consistently asserted that the policy behind the passive and non-passive activity distinction itself and the various Regulatory Tests require that the IRS narrowly and strictly interpret the rules.

The first case addressing trusts and the passive activity rules was *Mattie K. Carter Trust v. U.S.*, 256 F. Supp. 2d 536 (N.D. Texas 2003). *Mattie K. Carter* involved a ranching business operated directly by a trust and not through an intervening corporate entity. The issue before the court was whose activities on behalf of the trust should count in determining whether the trust materially participated in the ranch business. The Service argued that only the trustee's activities, performed as a fiduciary, should count. The taxpayer argued that since the trust (and not the trustee) was the taxpayer under IRC §469(a)(2)(A), the taxpayer's participation in the business should be measured by the activities of all of those acting in furtherance of the trust's business (i.e., its fiduciaries, employees and agents). The court agreed with the taxpayer's argument, finding that it was only "common sense" that material participation of the trust in its ranching business be measured by all those acting on behalf of the trust.[16]

However, when the issue came up again in 2007, the Service refused to follow the *Mattie K. Carter* court's rationale. In TAM 200733023, the testamentary trust at issue owned a majority interest in an LLC which, in turn, conducted its own underlying business activities. The trust document permitted the trustee to appoint a "special trustee" with respect to the trust property. The trustee contracted with various "special trustees" to manage the trust's interest in the LLC. The trust asserted that the activities of the special trustees in managing the trust's business assets (such as reviewing financials for the LLC and selling the trust's interest in the LLC), should be included when determining whether the trust materially participated in the business.

Without distinguishing the case from *Mattie K. Carter*, the Service concluded that only the services of a "fiduciary trustee" should be considered for the material participation Regulatory Tests. The Service reasoned that the "special trustees" were not "fiduciary trustees" because they were "appointed solely to perform certain contractual acts intended to satisfy the material participation standard of IRC §469(h)." Essentially, the IRS asserted that the "special trustees" were more like agents with specific authority (which, incidentally did not include the ability to bind the trust contractually), instead of trustees with corresponding fiduciary obligations.

The Service then released TAM 201317010, which not only continued to ignore the ruling in *Mattie K. Carter*, but specifically rebutted its findings. In this TAM, the trust had a "special trustee" who was also the president of an S-

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corporation that was owned in part by the trust. The special trustee also personally owned stock in the S-corporation. The special trustee's fiduciary authority was limited by the trust instrument to voting the corporate stock and making decisions about the sale of the corporate stock. In addition, the special trustee was actively involved in the day-to-day operations of the S-corporation as its President.

The taxpayer-trust argued that the activities of the special trustee as a trustee, as President of the S-corporation, and as an individual shareholder were indistinguishable and that all activities of the person should count towards the trust's material participation. To counter the taxpayer's arguments and to specifically rebut the holding in *Mattie K. Carter*, the Service articulated two rationales: (1) the policy behind the passive loss rules does not permit attribution of employee activities towards the Regulatory Tests and (2) there are specific types of fiduciary duties that must exist in order to count a fiduciary's activities towards satisfying the Regulatory Tests.

Regarding the policy behind the Regulatory Tests, the Service stated,

> As a general matter, the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement. Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently.

The Service essentially argued that by casting such a wide net and including the activities of all parties that work to operate a business, the Regulatory Tests become irrelevant.

The Service also asserted that like the hypothetical "business owner," only the trustee, acting in a fiduciary capacity, may cause a trust to materially participate in a trade or business. The Service argued that a "fiduciary" is defined under IRC §7701(a)(6)[17] and also cited a Ninth Circuit case to assert that a fiduciary "must be vested with some degree of discretionary power to act on behalf of a trust."[18] By defining the scope of "fiduciary" duties in this way, the Service could extrapolate that in this case, only the special trustee's specifically enumerated fiduciary duties to vote or sell the stock of the S-corporation should count towards the trust's attempt to establish material participation. It was then determined that contextually, those particular activities did not rise to the level of being "regular, continuous, and substantial" under the Regulatory Tests. Accordingly, the trust's business activities were considered passive.

Holding in *Aragona*

Mattie K. Carter and the TAMs discussed above involved trusts with interests in businesses other than rental real estate businesses. *Aragona* was the first Tax Court case that expressly addressed the management of rental real estate by a trust and the application of the "real estate operator exception" under IRC §469(c)(7) to trusts. The holding in *Aragona* in favor of the taxpayer-trust is significant because it refutes the Service's position that a trust can never qualify for the "real estate operator exception" under IRC §469(c)(7). This case also affirms that activities of trustees can be considered for purposes of material participation even if the trustee also performs such activities as an employee or as a minority shareholder of an entity through which the trust conducts its activities. However, for planning purposes, there are still questions that remain unanswered under *Aragona*.

In *Aragona*, the trust owned rental real estate and was involved in other real estate holding and development activities. There were six trustees of the trust who were also trust beneficiaries. The trust wholly-owned Holiday Enterprises, LLC, a disregarded entity for tax purposes, which managed most (but not all) of the trust's rental real estate properties. The trust also conducted some of its real estate activities directly, while the rest were conducted through other closely-held entities in which the trust owned a majority interest. One of the six trustees was responsible for the day-to-day operations of the trust (the "executive trustee"). The executive trustee and two of the other trustees also worked as full-time employees of Holiday Enterprises, LLC. Holiday Enterprises, LLC had several other non-trustee employees, including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks.[19]

The primary issue in the case was whether a trust could qualify for the "real estate operator exception" so that the trust's rental real estate activities could qualify as non-passive activities. The Service argued the trust could not qualify for the exception because a required element of the three-part test was providing "personal services," which could only be done by an individual (or a C-corporation in certain enumerated circumstances).[20] The court, however, found that "a trust is an arrangement in which trustees manage assets for the trust's beneficiaries [, and i]f the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered work performed by an individual in connection with a trade or business."[21] Accordingly, the court concluded that it was possible for a trust to satisfy the "real estate operator exception" set forth in IRC §469(c)(7).[22] This reasoning from the Tax Court is similar to the "common sense" approach taken by the court in *Mattie K. Carter*.

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Another issue addressed in *Aragona* was the types of activities of the trust, undertaken by people acting in various roles, that would count towards satisfying the three-part test for the "real estate operator exception." The court began by reviewing the trust's material participation in a "real property trade or business." The Service argued that (1) only the activities of the trustees could be considered, and (2) the activities of the three trustees who were employed by Holiday Enterprises, LLC should be disregarded because they performed those services as employees of the LLC, not as trustees. The Service repeated its arguments from *Mattie K. Carter* and the 2007 and 2013 TAMs. The court, however, held that the activities of the trustees, in their capacities as trustees *and* as employees of Holiday Enterprises, LLC must be considered.[23] Note that the court never addressed whether the activities of the 20 non-trustee employees of the LLC should be considered because the activities of the trustees (in both capacities) easily met the material participation standard under the Regulatory Tests.[24]

It is also important to note that the court considered the scope of a trustee's fiduciary duties under relevant state law when deciding whether the trustees' actions as employees would be counted. The court acknowledged that Michigan law required trustees "to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary."[25] Additionally, under Michigan law, "[t]rustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust."[26] Because the trustees were still bound by their fiduciary duties to the trust beneficiaries when acting as employees of the LLC, those activities counted for purposes of the material participation test. Therefore, it is important to review the relevant state law interpretation of fiduciary duties of a trustee when claiming a structure of operations analogous to *Aragona*. This facet of the holding also shows that perhaps the court did not stray too far from the Service's position of requiring fiduciary duties to exist before counting the individual's services in the material participation context.

Finally, it is also important to note that the court did not review the additional two elements of the three-part test (i.e., the personal services test and the 750-hour test). These two elements raise other issues, including whether the activities of the trustee-employees should have been counted where IRC §469(c)(7)(D)(ii) precludes counting services performed as an employee unless the employee owns 5 percent or more of the employer. A trustee is not the "owner" of a trust or an entity that is an asset of a trust. In *Aragona*, two of the trustee-employees did individually own minority interests in some of the entities through which the trust managed its real estate, but there was no discussion of the percentages that they owned or of the management activities associated with the part-owned entities in the court's ruling.[27] Instead, the court held that the Service had simply failed to argue the merits related to the second and third elements of the "real estate operator exception" test and thus waived the issue in favor of the taxpayer.[28] This result, while favorable to the trust in *Aragona*, does not provide guidance for other trusts that use entity and entity-employee structures to manage trust real estate.

Outstanding Issues with Trust Management

The following three central issues related to trust management of rental real estate remain unclear after *Aragona*:

1. State-specific interpretation and the scope of a trustee's fiduciary duties likely impact the ability to count a trustee's activities when the trustee is acting as an employee or as a minority shareholder.
2. Problems could arise under the IRC §469(c)(7)(D)(ii) exception related to performance of services by a trustee who is a non-owner employee. Technically, one is traditionally an employee as an individual, and if the employer is an entity that is wholly-owned by the trust (and not at all by the individual employee), then the Service could assert that the employee's activities do not count towards "personal services" under the "real estate operator exception" test.[29]
3. The question of whether the activities of non-trustee employees of a trust's wholly-owned entity count toward material participation under the Regulatory Tests remains unanswered. *Mattie K. Carter* remains the sole authority holding that activities of non-trustee employees of a trust (but not of a trust-owned entity) can be considered for purposes of material participation under the Regulatory Tests. No case has analyzed the "real estate operator exception" test with respect to the non-trustee employees. But, given that it would be even less likely that non-trustee employees would be owners of their employer entity, their services could be disregarded for parts two and three of the "real estate operator exception" test.

Practice Tips and Planning Ideas

Given the holding of *Aragona*, if non-passive activity is desired for income tax purposes, what should planners consider when assisting clients with management of rental real estate in a trust?

Choice of Trustee. The only absolute guidance from *Aragona* is that the activities of the trustee in managing the

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trust's real estate holdings will be considered for purposes of satisfying all three parts of the "real estate operator exception" test. Therefore, selecting a trustee who will regularly, continuously and substantially participate in the management of the rental real estate is critical. This may weigh against choosing a family member who would otherwise be reasonably qualified to serve as trustee. It could also influence trust provisions regarding replacement of trustees with a trustee who can satisfy the "real estate operator exception" test (i.e., a trustee who is willing to work full time – or nearly so – exclusively on trust real estate management).

Entity and Management Structure. There are various items that would drive an advisor to recommend managing a trust's real estate activities via a wholly-owned LLC, and having the trustee act as an employee of such entity. These items include, for example, employer liability protection, Social Security pay-in for the employee, and the possibility of providing employee benefits for the trustee-employee. It is clear, however, that the Service would argue that only the activities of the trustee, in such capacity, would count towards material participation under the Regulatory Tests and towards personal services under the "real estate operator exception" test. It would therefore be important to design a structure where the trustee's activities are analogous to the trustee-employees in *Aragona*, as a threshold matter. This would necessarily include having the trustees materially participating in the management of a trust's wholly-owned management entity.

Additionally, in *Aragona*, the court found that Michigan law stated that a trustee could not avoid his or her fiduciary duties by performing his or her managerial actions as an employee via a wholly-trust-owned corporate entity. It would also therefore be important to review state law to ensure that trustee-employee activities would fall under the umbrella of a trustee's general fiduciary obligations.

Like Michigan, Washington law provides that a "trustee must exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property… [and t]he trustee owes to the beneficiaries of the trust the highest degree of good faith, diligence, fidelity, loyalty, and integrity, and the duty to deal fairly and justly with them and solely in their interests."[30] In addition, Washington's fiduciary duty of loyalty[31] is based upon the Uniform Trust Code ("UTC") §802, the comments to which clearly indicate that a trustee may not avoid its fiduciary duty by managing trust property through a corporate entity.[32] While Washington did not specifically adopt UTC §802(g) related to trustee management of corporate assets, the drafting task force indicated that it elected not to do so because it felt that the concept was already well established under Washington law and the common law.[33]

Under RCW 11.98.070(21), Washington law permits the trustee to manage a trust-owned business entity and to delegate, in the trustee's discretion, facets of the management of that business.[34] In addition, except in cases where the Settlor has specifically stated the trustee is a directed trustee, Washington law provides that a trustee who delegates certain trust functions is not relieved of his or her fiduciary duties merely as a result of the delegation. [35] Newly enacted Washington legislation, which is based upon section 9 of the Uniform Prudent Investor Act ("UPIA"), provides that a trustee must act with "reasonable care, skill and caution" when selecting a delegee, defining the scope of delegation, reviewing the delegee's work and enforcing the delegation.[36] This would necessarily include a delegation of duties relating to trust business activities by the trustee to himself or herself as a trust employee. In Washington, and perhaps in other states whose laws are based on the UTC and UPIA, it appears that the fiduciary duties of a trustee cannot be arbitrarily shed by the trustee who plays multiple roles in the trust administration (e.g., trustee, entity manager and/or entity employee).

Modifications of Fiduciary Standards. The court in *Aragona* specifically focused upon the trustee-employees' duty of loyalty under Michigan law when espousing such trustee-employees' fiduciary status. In many states, it is possible to waive or modify the fiduciary duty standards. Indeed, in many estate plans involving family businesses, it is advisable for the Settlor to modify some or all fiduciary duties, specifically the duty of loyalty, when the Settlor's desired fiduciaries have multiple roles in the business and estate plan.[37] Given the Service's focus on activities undertaken in a "fiduciary capacity" and the Tax Court's focus on the duty of loyalty, it could be problematic if the Settlor of a trust modifies the trustee's fiduciary duties, including specifically the duty of loyalty, in the trust agreement. Accordingly, the drafting attorney and Settlor should proceed carefully where at least some of the trustee's activities as an employee (e.g., salary, commissions, or sales that may benefit the trustee personally) are subject to a reduced fiduciary standard (e.g., to the duty of good faith as opposed to the duty of loyalty). It may be appropriate for the reduced fiduciary standard to be limited to discrete, enumerated circumstances instead of a blanket reduction of the standard. Otherwise the trustee is at risk of being distinguished from the trustees in *Aragona*, thereby falling outside of its purview.

Recordkeeping. The taxpayer bears the burden of proof in establishing that its activities were sufficient to satisfy the "real estate operator exception" test. It is therefore critical that for all years, all parties participating in a trust's real

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estate business, especially the trustee, maintain adequate records of their rental business activities, including time spent, the types of work performed, and the capacity in which work is performed. Additionally, it is important that the characterizations reflected in the timekeeping records are consistent with cash flow and tax reporting choices. For example, it may be advantageous for various income tax reasons to have a trustee take an employee salary from the trust-owned company rather than be paid a trustee fee. However, it may be problematic to claim that recorded time spent was undertaken as a trustee if the trustee does not take a trustee fee and instead draws a salary as an employee. Ultimately, the financial impacts of the structure of the trust's management must be weighed against a possible passive activity classification.

Staff Appropriately. If the trustee's activities alone (either as trustee or employee) would not meet the requirements of the "real estate operator exception" test, then it is unlikely that the non-trustee employees' activities will be considered by the Service. While *Mattie K. Carter* held that the actions of a trust's employees and agents can be considered for the "material participation" test, in that case, the trust conducted its ranch business directly, not through corporate entities. In a situation where a trust holds its real estate assets in separate corporate entities, it is unclear whether the holding from *Mattie K. Carter* would apply for purposes of satisfying the Regulatory Tests and the more onerous "real estate operator exception" test.

Further, in *Aragona*, the trust's wholly-owned LLC actually conducted the day-to-day management of the trust's rental real estate, where as it is common for trusts to engage an unrelated third-party property management entity to manage the property day-to-day. Therefore, it is possible that even if the Tax Court would extend *Aragona* to non-trustee employees of a trust-owned entity, it is unclear whether the court would go one step further and count the activities of the third-party property manager hired by the trustee. Regardless, even more problematic in the context of a rental real estate business is that the "real estate operator exception" test requires that personal services performed by an employee of the taxpayer not include work performed as an employee unless such employee is at least a 5 percent owner of the employer.[38] Given the Service's position of interpreting the passive activity rules and regulations narrowly, the use of a third-party property manager may work against the taxpayer's arguments of an otherwise actively involved trustee.

Conclusion

While the Tax Court's holding in *Aragona* was positive for trust taxpayers, many unanswered questions remain. It is clear that the passive activity rules are complex and that the existing Regulations are not easily analogized to ownership and management of assets inside of a trust. It is also clear that the Service has consistently argued for literal and narrow interpretations of the existing Regulations in situations where businesses are managed by trusts.

Where significant wealth is held in the form of family businesses, including rental real estate businesses, it is important for advisors and their clients to review the intricate matrix of the passive activity rules when designing succession plans. Most critically, it is important to have honest discussions with clients and their family members about the choice of fiduciaries for the estate plan, the practical aspects of managing trust property and the potential financial impacts of the resulting managerial structure. Planning proactively with full knowledge of all of the details will put the trust taxpayer in the best position possible to claim non-passive activities. However, it remains necessary to balance the tax impacts against the practical structure of the trust and to design a plan that works best for the entire family in the long term.

1 The passive activity loss for a given year is the amount, if any, by which the passive activity deductions for the taxable year exceed the passive activity gross income for the taxable year. Temp. Treas. Reg. §1-469.2T(b)(1).

2 IRC §469(e).

3 IRC §1411(c)(2).

4 IRC §469(c)(1).

5 *See, e.g.*, Michael T. Donovan and Timothy G. Stewart, *Material Participation by Trusts: Questions Remain After Frank Aragona Trust*, 121 J. TAX'N 5 (July 2014). *See also* Temp. Treas. Reg. §1.469-5T(f)(1).

6 IRC §469(h)(1).

7 Temp. Treas. Reg. §1.469-5T(a).

8 *See, e.g.*, Temp. Treas. Reg. §1.469-5T(a)(1). An in-depth discussion of these tests is outside of the scope of this commentary.

9 *See* Temp. Treas. Reg. §1.469-5T(g).

10 IRC §469(c)(2) and (4).

11 IRC §469(h); IRC §469(c)(7)(B). Elements 1 and 2 are often referred to as the "Personal Services Test" and element 3 is often referred to as the "750 Hours Test."

12 IRC §469 (c)(7)(C); Treas. Reg. §1.469-9(b)(2).

13 *See generally* Daniel N. Shaviro, *Passive Loss Rules*, 549-2nd Tax Mgmt. Portfolio (BNA) at A-45. Taxpayers who make grouping elections under the passive loss rules may have to carefully parse how to evaluate which "activities" count as "real property trade or business" for the Regulatory Tests, but since no grouping election exists for the Trust, we believe that the Trust may use the Regulatory Tests to show "material participation" in its "real property trade or business."

14 IRC §469 (c)(7)(D)(ii); Treas. Reg. §1.469-9(c)(5). The ownership attribution rules of IRC §318 apply when considering percentage of ownership. Note that Treas. Reg. §1.469-9(c)(5) includes one inconsistent reference to ownership of the employer-entity by the "taxpayer" instead of the employee, which could nullify the issue related to this subsection in the case of a trust-owned management entity. There is no real guidance as to the application of this Regulation.

15 *See generally* Shaviro, *supra* at A-46.

16 256 F. Supp. 2d 541.

17 IRC §7701(a)(6) provides, "The term 'fiduciary' means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person."

18 TAM 201317010, citing to *United States v. Anderson*, 132 F.2d 98 (9th Cir. 1942).

19 Frank Aragona Trust v. C.I.R., 142 T.C. 165, 167-168 (2014).

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Mine, Yours, Ours? Dissecting the Character of Assets Post-Death

by Adrienne McEntee of Terrell Marshall Daudt & Willie PLLC and Tiffany Gorton of Kutscher Hereford Bertram Burkart PLLC

The characterization of property, both real and personal, is established at the time it is acquired.[1] RCW 26.16 defines community and separate property. Generally, property is presumed to be community property if it is acquired during marriage, although spouses may agree otherwise, and factual circumstances – including the spouses' treatment of both community and separate property – directly affects distribution upon death or dissolution.[2] Property is separate property if acquired before marriage, acquired during marriage by gift or inheritance, or acquired during marriage with the proceeds of separate property.[3]

These seemingly straight forward rules can become complicated when a couple combines assets. Generally, property acquired during the marriage maintains the same character as the funds used to purchase it.[4] If property is acquired during the marriage using the separate funds or property of one spouse, and that spouse intends to maintain the newly acquired property as his or her separate property, care must be taken to treat the property as separate. Separate property will maintain its character throughout its changes and transitions so long as the separate property remains traceable and identifiable; however, once separate property becomes so commingled that it is no longer distinguishable, then the entire commingled fund or property subsequently acquired thereby becomes community property.[5]

The issue of commingling comes up frequently with bank accounts and other financial assets that are not as easy as real property, for example, to keep separate. Whether assets have been so commingled that they lose their separate character is a very fact-intensive question and uncertainties in tracing the funds will typically be resolved in favor of characterization of the asset as community property.[6] When separate funds and community funds are placed in an account together, it can be very difficult to trace those funds for purposes of maintaining or determining their original character. For example, in *Dougherty*, the wife had a separate bank account at the time she and her husband married. However, after marriage, she added her husband to the account and both of them deposited funds in and wrote checks from the account.[7] The court reasoned that because both spouses contributed to the account and any deposits made after marriage were presumably for the benefit of the community, the entire balance of the account was community. The court in *Dougherty* mentioned that the initial pre-marriage balance of the account was unknown; perhaps the result would have been different if there were more known facts regarding the initial balance, subsequent deposits, and withdrawals.

When the facts and circumstances provide clarity in tracing the funds, the asset will maintain its original character and be distributed accordingly. In *Chumbley*, the wife received stock options from her employer as compensation for services after the marriage. She exercised the options

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20 *Id* at 174.
21 *Id* at 175.
22 The court also stated that if Congress wanted to exclude trusts from the IRC §469(c)(7) exception, it could have done so by limiting the exception to "any natural person" as it had done in other provisions of the passive activity loss rules under IRC §469. *Id* at 176.
23 *Id* at 178.
24 *Id* at 178-179. Here, the court analyzed whether the trust materially participated in a "real property trade or business." The court specifically looked to the Regulatory Tests under IRC §469(h)(1) to determine whether the activities constituted material participation.
25 *Id* at 179.
26 *Id*.
27 *Id* at 168, 179-180.
28 *Id* at 180.
29 Additionally, if a portion of a trust's management entity is also individually held by a trustee-employee, it is likely that the trustee will need to prove that time spent related to such entity should be allocated to his capacity as a trustee or as an employee and not as an individual owner.
30 Monroe v. Winn, 16 Wn.2d 497, 508, 133 P.2d 952 (1943).
31 The duty of loyalty has been codified in Washington in RCW 11.98.078.
32 *See* Comment to Uniform Trust Code §802(g). "When the trust owns the entirety of the shares of a corporation, the corporate assets are in effect trust assets that the trustee determines to hold in corporate form. The trustee may not use the corporate form to escape the fiduciary duties of trust law. Thus, for example, a trustee whose duty of impartiality would require the trustee to make current distributions for the support of current beneficiaries may not evade that duty by holding assets in corporate form and pleading the discretion of corporate directors to determine dividend policy. Rather, the trustee must vote for corporate directors who will follow a dividend policy consistent with the trustee's trust-law duty of impartiality."
33 Karen E. Boxx and Katie S. Groblewski, *Washington Trust Laws' Extreme Makeover: Blending with the Uniform Trust Code and Taking Reform Further with Innovations in Notice, Situs and Representation*, 88 Wash. L. Rev. 813, 881 (2013).
34 *See also* RESTATEMENT (SECOND) OF TRUSTS, §193, com. a. (1959), which provides that "[i]t is the duty of the trustee in voting shares of stock to use proper care to promote the interests of the beneficiary," and that the fiduciary responsibility of a trustee in voting a control block "is heavier than where he holds only a small fraction of the shares." This comment relates specifically to voting shares but would easily be translatable to other areas of management of a trust business.
35 Washington Laws of 2015, ch.115 §§ 2 & 3 (SB 5302) (effective July 24, 2015), modifying former RCW 11.98.070(27).
36 Washington Laws of 2015, ch.115 § 3(1) (SB 5302)(effective July 24, 2015). *See also* Comments to §9 of the Uniform Prudent Investor Act, which state that even where the trustee is relieved from liability for the delegee's actions once delegation occurs, the trustee is responsible for properly choosing the delegee and the scope of the delegation and the beneficiaries can sue the trustee for improper delegation or alternatively, force the trustee to sue the delegee for improper actions during an otherwise proper delegation. These provisions are not intended to waive a trustee's fiduciary obligations when delegating.
37 *See generally, e.g.*, Karen E. Boxx, *Too Many Tiaras: Conflicting Fiduciary Duties in the Family-Owned Business Context*, 49 Hous. L. Rev. 233 (2012).
38 *See supra*, n. 14.

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using her own separate funds, so she effectively purchased the stocks using both community assets (the options) and separate assets (the cash to exercise the options). The court concluded that the asset was purchased using two types of property rather than the more frequent scenario where an asset exists as separate property and community property is subsequently added to it, or vice versa. *Chumbley* stands for the proposition that when property is purchased with clearly traceable community and separate funds, a court is able to make a pro rata distribution to the spouses. Depending on the facts of each case, if the funds are clearly traceable, they will maintain their separate character.

When community effort or funds are used to improve the separate property of the other spouse, the community may be entitled to reimbursement in the form of an equitable lien for the improvements.[8] Unlike commingling, an equitable lien does not change the character of the underlying asset. The issue of an equitable lien on behalf of the community often arises in association with real property. Courts have consistently found that when community services, funds, or personal services have been expended to improve the separate real estate of one spouse, the presumption that an increase in value to separate property is also separate property may be rebutted by direct and positive evidence that the resulting increase in the value of such real estate is community to the extent it results from the community effort or funds.[9] Such increase in value takes the form of an equitable lien against the real estate.

The existence of a valid right to reimbursement or equitable lien, as with other property characterization issues, hinges on the facts and circumstances of each individual situation. Accordingly, a court will look at the facts of each case and it may offset the community's right of reimbursement against any reciprocal benefit received by the community for its use and enjoyment of the separate property involved.[10]

In addition, special issues can arise with characterizing certain nonprobate assets. For example, where premiums of a life insurance policy are paid entirely with community funds, the policy, and the proceeds therefrom, will be characterized as a community asset.[11] The ownership character of a term life insurance policy depends on the character of the funds used to pay the premium for the most recent term.[12] For example, where the last insurance premium payment was paid as a fringe benefit of employment to a married employee, the premium payment is presumed to be community earnings and the proceeds for that term would likewise be characterized as community.[13]

Other examples include certain state-sponsored retirement plans.[14] Whether financed through employee salary deduction, or exclusively by the employer, retirement benefits are considered deferred compensation for past services and thus are determined to be community property to the extent earned during marriage.[15] Although a spouse may unilaterally manage and control retirement accounts (and other community property) in the manner he or she would manage his or her own separate property, subject to certain exceptions, a spouse shall not devise or bequeath by will more than one-half of his or her retirement accounts.[16]

But what happens when an employee designates a beneficiary for his or her retirement account prior to marriage, subsequently marries without updating his or her beneficiary designation, and then dies before retirement? How the Washington Department of Retirement Systems addresses the issue may depend on whether the asset is part of a defined benefit plan or a combination defined benefit/defined contribution plan.

For example, take Washington State Teachers' Retirement Systems, which is comprised of three sub-plans.[17] Plan 1 is a defined benefit plan where members receive a fixed monthly pension amount regardless of the amount they actually contribute during employment.[18] Plan 2 is also a defined benefit plan, under which a member upon retirement will receive a monthly benefit for the rest of his or her life that is based on years of public service and a percentage of average final compensation.[19] If a Plan 1 member dies prior to retirement, but failed to update his or her beneficiary designation after marriage, any accumulated contributions "shall be made to the surviving spouse as if in fact such spouse had been nominated by written designation."[20] The same is true for Plan 2.[21]

Plan 3 is a hybrid plan, comprised of both defined benefit and defined contribution components.[22] If a Plan 3 member dies prior to retirement, the surviving spouse "shall receive" an allowance from the defined benefit component of the plan regardless of a different beneficiary designation.[23] In contrast, under RCW 41.34.070, the distribution of the defined contribution portion of Plan 3 "shall be made to such person or persons as the member shall have nominated by written designation duly executed and filed with the department."[24] Strikingly absent in RCW 41.34.070 is the language in Plans 1 and 2 which provides for a surviving spouse in the event a member fails to update his or her beneficiary designation after marriage. As a result, only if there is no designated beneficiary living at the time of the Plan 3 member's death will the account "be paid to the member's surviving spouse."[25]

RCW 41.34.070 is inconsistent with community property principles to the extent that it purports to enforce a beneficiary designation regardless of a surviving spouse's one-half interest in retirement assets acquired during marriage.[26] Although the specific conflict between RCW 41.34.070 and community property law has not been addressed by Washington courts, in Neeley v. Lockton, the

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Washington State Supreme Court set forth the general rule that "contracts, and particularly beneficiary designations, will control only to the extent that they are not inconsistent with the community property law."[27] Statutes like RCW 41.34.070, which directs payment to a non-spouse designee, does not alter this rule unless there is evidence of legislative intent to rebut the presumption toward community property. The "Legislature may establish by statute the designated beneficiaries of a statutory death or survivorship benefit, notwithstanding traditional community property principles."[28] However, in order to do so, the legislature must be explicit in its intent that a statute rebuts the presumption of community property, which is firmly embedded in the policy of this state.[29] RCW 41.34.070 is silent regarding community property principles and the rights of the surviving spouse.

Given that Washington's community property laws appear to trump provisions in RCW 41.34.070 that direct the Department of Retirement Systems ("DRS") to distribute Plan 3 contributions to contractual beneficiaries that were designated prior to marriage, how does a practitioner representing a surviving spouse address this conflict? One could reasonably conclude that given the tension between RCW 41.34.070 and community property principles, DRS should always initiate an interpleader action when it is aware of a conflict, and have the beneficiary or beneficiaries on the one hand and the surviving spouse on the other present their arguments to the court for resolution.

In one case the authors are aware of, DRS advised a surviving spouse of the following:

> Retirement law requires that we pay any benefits to the named beneficiary of a deceased's member's account, unless we receive instructions from a court to pay an alternate payee.
>
> While retirement law does direct us to pay the named beneficiary, we recognize that you may feel you have an interest in this benefit. In order for us to ensure we pay the benefit correctly, you will be responsible for filing a Trust and Estate Dispute Resolution Act (TEDRA) petition with the courts to determine how and whom the benefit should be paid.[30]

In other words, although DRS recognizes the tension between statutes governing state-sponsored retirement plans and community property principles, it places the burden on the surviving spouse to initiate a TEDRA action asking that the court invalidate, or limit to the decedent's undivided one-half interest in the community property, to whomever the Decedent designated as his/her beneficiary.

1 In re Dougherty's Estate, 27 Wn.2d 11, 176 P.2d 335; In re Marriage of Chumbley, 150 Wn.2d 1, 74 P. 3d 129 (2003).

2 RCW 26.16.030; White v. White, 105 Wn. App. 545, 549-50, 20 P.3d 481, 484 (2001).

3 RCW 26.16.010; White, 105 Wn. App. at 549-50.

4 In re Marriage of Chumbley, 150 Wn.2d 1, 6, 74 P.3d 129 (2003).

5 In re Marriage of Shui, 132 Wn. App. 568, 584, 125 P.3d 180 (2005); In re Dougherty's Estate, 27 Wn.2d 11, 19, 176 P. 2d 335 (1947).

6 In re Marriage of Gillespie, 89 Wn. App 390, 400, 948 P.2d 1338 (1997).

7 In re Dougherty's Estate, 27 Wn.2d at 12-14.

8 Connell v. Francisco, 127 Wn.2d 339, 351, 898 P.2d 831 (1995).

9 Elam v. Elam, 97 Wn.2d 811, 816, 650 P.2d 213 (1982).

10 Connell v. Francisco, 127 Wn.2d at 352.

11 Francis v. Francis, 89 Wn.2d 511, 515, 573 P.2d 369 (1978).

12 Aetna Life Insurance Company v. Wadsworth, 102 Wn.2d 652, 659, 689 P.2d 46 (1984); Aetna Life Insurance Company v. Bunt, 110 Wn.2d 368, 371, 754 P.2d 993 (1988).

13 *Id.*

14 This article addresses only the state-sponsored retirement plans: Public Employees' Retirement System (PERS) (most state employees and elected officials); Teachers' Retirement System (TRS) (certified public school teachers); and School Employees' Retirement System.

15 DeRevere v. DeRevere, 5 Wn. App. 741, 745-46, 491 P.2d 249 (1971); In re Marriage of Harris, 107 Wn. App. 597, 602, 27 P.3d 656 (2001); In re Marriage of Knies, 96 Wn. App. 243, 251, 979 P.2d 482 (1999); In re Marriage of Nuss, 65 Wn. App. 334, 343, 828 P.2d 627 (1992).

16 RCW 26.16.030(1). In the context of ERISA-based retirement plans, spousal consent is required to designate a beneficiary other than the spouse. See 19 Wash. Prac., Fam. and Community Prop. L. § 13.4.

17 Washington offers a comprehensive system of pension benefits for qualifying state employees, most of whom qualify for PERS (most state employees and elected officials); TRS (certified public school teachers); and SERS (noncertified school district staff). Washington Educ. Ass'n v. Washington Dept. of Retirement Systems, 181 Wn.2d 212, 217, 332 P.3d 428 (2014). "There are three different pension plans, and benefits offered by Plans 1, 2 and 3 are consistent across the three systems." *Id*. Employees in PERS and TRS fall into either Plan 1, Plan 2, or Plan 3. SERS employees are divided between Plan 2 and Plan 3. Id. at fn 1.

18 *Id*.

19 RCW 41.32.760 (TRS); RCW 41.40.620 (PERS); RCW 41.35.400 (SERS).

20 RCW 41.32.520 (TRS); RCW 41.40.270 (PERS).

21 RCW 41.32.805 (TRS); RCW 41.40.700 (PERS); RCW 41.35.460 (SERS).

22 *Id*.

23 RCW 41.32.895 (TRS); RCW 41.40.835 (PERS); RCW 41.35.710 (SERS).

24 RCW 41.34.070. This provision applies equally to Plan 3 under TRS, PERS, and SERS. See RCW 41.34.030.

25 *Id*.

26 RCW 26.16.030(1).

27 63 Wn.2d 929, 931-32, 389 P.2d 909 (1964).

28 Arnold v. Dep't of Retirement Systems, 128 Wn.2d 765, 912 P.2d 463 (1996) (holding legislature's designation of beneficiaries of LEOFF death benefit to exclude divorced spouse superseded characterization of divorced spouse's interest in such death benefit under community property principles).

29 Dean v. Lehman, 143 Wn.2d 12, 21, 18 P.3d 523 (2001) (holding, in part, that spouses had standing to initiate class action by virtue of community property interest in funds received by inmates, and rejecting argument that statute requiring deduction of portion of funds received by prison inmates explicitly rebuts presumption of the community nature of marital property).

Recent Developments

Real Property

by Brian Lewis – Ryan, Swanson & Cleveland, PLLC

Easement by Plat Dedication

In *Crystal Ridge Homeowners Association v. The City of Bothell*, 182 Wn.2d 665 (2015), the Washington State Supreme Court considered a municipal government's maintenance obligations for stormwater facilities located within an easement dedicated to the municipality under the terms of a developer's approved plat.

Snohomish County approved the Plat of Crystal Ridge Division Two ("Plat") in 1987. The approved final Plat contained a statement that "drainage easements designated on this plat are hereby reserved for and granted to Snohomish County for the right of ingress and egress for the purpose of maintaining and operating stormwater facilities." A common area within the Plat known as Tract 999 contained a 25-foot sanitary sewer and drainage easement. Two buried pipes were located within the Tract 999 easement area including an "interceptor pipe" used to intercept and divert groundwater to an offsite detention pond. In 2002, the City of Bothell ("City") annexed the property contained within the Plat. In doing so, the City assumed the County's obligations under the Plat.

In 2010, several homeowners sued the City alleging that the interceptor pipe failed and damaged their properties. The City argued that the language of the easement dedication did not impose upon the City a duty to maintain the facilities located within the easement area, including the interceptor pipe. The trial court granted summary judgment in favor of the homeowners. The appellate court affirmed the grant of summary judgment and the City sought review by the Washington State Supreme Court.

In Washington, the duty to maintain an easement area is generally on the holder of the easement rather than the owner of the servient property. Although the language of the Plat dedication did not expressly address "groundwater" but only described "stormwater facilities" the court found that neither the Plat nor the developer intended to draw any distinction between groundwater drainage and stormwater drainage under the Plat. The court also rejected the City's argument that the Plat dedication merely granted an easement for "ingress and egress" without corresponding maintenance obligations.

Three justices published a lengthy dissenting opinion relying mostly on the Plat's failure to impose express maintenance obligations on the City. Those justices would have granted summary judgment in favor of the City on the grounds that the language on the face of the Plat showed no intent to dedicate the contents of the drainage easement and did not impose on the City an express duty to maintain the interceptor pipe. Considering the dissent, practitioners should remember to include express maintenance obligations when drafting easements by dedication and clarify ownership of any improvements located within the easement area.

Homestead Exemption for Out-of-State Property

In *In the Matter of the Bankruptcy Petition of Larry Charles Weiber*, 182 Wn.2d 919 (2015), the Washington State Supreme Court, responding to a certified question from United States Bankruptcy Court for the Western District of Washington, confirmed that the homestead exemption established under RCW 6.13.010-.240 does not apply to real property located outside of Washington. Although Washington's homestead exemption statutes do not expressly prohibit extraterritorial application, the court determined that the entirety of the statute shows that "the exemption is intertwined with procedures and requirements that can apply only to courts and agencies in Washington." While other states have permitted extraterritorial application of their homestead exemption statutes (including Oregon and California), this result is consistent with the majority rule. Accordingly, the debtor involved in the bankruptcy case described in the opinion would not be permitted to claim a homestead exemption for property he owned in Alaska.

Request for Nominations

Please take notice that the Real Property, Probate and Trust ("RPPT") Section of the Washington State Bar Association ("WSBA") will be accepting nominations for the following open Executive Committee positions:

(a) Probate and Trust Council Director;
(b) Two Probate and Trust Members; and
(c) Two Real Property Members.

Nominations should be submitted to Joseph McCarthy by email at joseph.mccarthy@stoel.com no later than **March 18, 2016**. Nominations to be accepted must: (a) include the nominee's name and WSBA bar number; (b) include the position for which the person is being nominated; (c) be endorsed by three members of RPPT; and (d) contain a brief written statement of the nominee's qualifications for the position. Only members of the RPPT section may be nominated.

Recent Developments

Probate and Trust

by A. Paul Firuz – Miller Nash Graham & Dunn LLP and Kristina M. Ash – Smith & Zuccarini, P.S.

Definition of "Proper Court" under the Nonclaim Statute. *Porter v. Boisso*, 188 Wn. App. 286 (Div. III), 354 P.3d 892 (2015).

This case examines the issue of the proper court in which a claimant may – or must – file a post-rejection lawsuit against the personal representative. The *Porter* court held that such a claimant may file suit in any superior court, not just the court that has jurisdiction over the probate. It also held that a claim for specific performance to enforce a contract for land is not a creditor's claim under RCW 11.40.010.

Kevin Porter alleged that he had entered into a contract with Charles Boisso to purchase real property located in Pierce County. According to Porter, he had already paid $116,900 toward the total purchase price of $120,000, leaving a balance of just over $3,000 to be paid on the contract at the time of Boisso's death.

Boisso's estate was probated in Kittitas County, with letters of administration granted on November 13, 2012. On December 17, 2012, Mr. Porter filed a notice of a creditor's claim in the probate action. The estate rejected the claim on December 31 and, as required by RCW 11.40.100, advised Mr. Porter that he needed to bring suit in the "proper Court" or his claim would be forever barred.

On January 29, 2013, Mr. Porter filed suit in Pierce County, requesting a declaratory judgment specifying his right and interest in the property and compelling specific performance. In the alternative, he sought damages for unjust enrichment. The Boisso estate moved to dismiss the complaint, arguing that venue and jurisdiction were improper. Mr. Porter entered a motion to transfer venue to Kittitas County on May 3, 2013. In May 2013, the estate filed a motion to dismiss on collateral estoppel grounds. The Superior Court of Kittitas County granted the estate's motion and awarded the estate attorney fees of $29,942.

The court of appeals first addressed whether Mr. Porter's claims were subject to the nonclaim statute, RCW 11.40.010. The court noted that a vendor's interest in a contract for real property was an interest in personal property. But Mr. Porter was seeking to *pay* money to the estate, not to collect a debt incurred by the decedent. Therefore, the court held that Mr. Porter's claims for a declaratory judgment and specific performance were not claims against a decedent within the meaning of RCW 11.40.010, and thus not subject to the nonclaims statute.

The court then addressed his claims for unjust enrichment and restitution, holding that such claims *are* claims against a decedent within the meaning of RCW 11.40.010, and therefore are subject to the nonclaims statute.

The court turned to the issue of whether the only "proper court" was the court in which the probate was being administered. Quoting Article IV, Section 6 of the state constitution, the court noted, "'The superior court shall have original jurisdiction in all cases at law which involve … all matters of probate.'" The court then stated the difference between jurisdiction and venue, and held that *any* superior court was the "proper court" for the purposes of jurisdiction. The court then noted that in *Ralph v. State Dep't of Natural Resources*, 182 Wn.2d 242, 255, 343 P.3d 342, (2014), a case decided after Porter had filed his suit in Pierce County, there was a question whether a county court would have subject-matter jurisdiction over real property located in another county. The court then held that Mr. Porter had filed his post-rejection lawsuit in the proper court.

A Suit Under the Nonclaim Statute Must be Brought as an Ordinary Civil Action. *Est. of Berry*, 189 Wn. App. 368 (Div.I), 358 P.3d 426 (2015).

Like *Porter*, *Estate of Berry* examines the nonclaim statute, but examines whether a creditor's claim can be brought under the Trust and Estate Dispute Resolution Act (TEDRA) in chapter 11.98A RCW. The court held that the claim must be brought as an ordinary action and not under TEDRA.

In *Est. of Berry*, Lula Mae Hunter executed a will on January 31, 1989, leaving her residence to her minor niece, Lula Sloans until her niece's death or until she no longer wanted it, then to Betty Jean Berry. Sloans was also the residual beneficiary in the will. Hunter then died in 1991 while Sloans was still a minor. Sloans' mother, on behalf of Sloans, and Berry entered into an agreement under a predecessor of TEDRA giving Berry the right to occupy the residence as long as she maintained the property and paid the taxes. Berry lived in the residence until her death on August 5, 2013.

Berry's estate was probated by her children, Nadine and Robert Berry, who listed the residence as the principal asset of the Berry estate. On December 20, 2013, Sloans filed a creditor's claim with the Berry estate, claiming a breach of maintenance obligations and making a claim against the estate to the extent that the decedent may have conveyed Sloans' interest in the property. The claim was rejected January 21, 2014, and 29 days later, Sloans paid the filing fee and filed a "Petition on Rejection of Creditor's Claims," and attached the pre-TEDRA agreement under the probate cause number for the Berry estate. The petition named Nadine and Robert Berry as the respondents

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in their capacity as co-administrators, and their attorney accepted service on their behalf.

A court commissioner denied Sloans' request for mediation, dismissed her suit, and ordered her to pay fees to the estate.

On appeal, the court held that a rejected creditor's claim could not be brought as a TEDRA petition because she was only a claimant, not a creditor, so she did not fall within the definition of a party. Nonetheless, the court concluded that because Sloans' creditor claim action was timely, service was effective, and the court had personal jurisdiction, Sloans' mistake was procedural and not jurisdictional. Thus, the court reversed the dismissal and award of attorneys' fees, and remanded the matter to the lower court.

Once again, this case highlights the importance of following procedure when filing a petition on the rejection of a creditor's claim, but may give some comfort that so long as some of the procedural safeguards are followed (e.g. service of process, timely filing the suit), a court may still allow the claim.

A Will-Contest Action Cannot be Commenced Without Personally Serving the Personal Representative. *In re Estate of Jepsen*, 184 Wn.2d 376, 358 P.3d 403 (2015).

Virginia Jepsen died in November 2011. In December of that year, Ms. Jepsen's will was admitted to probate, her estate was declared solvent, and Julie Miles was appointed as personal representative (the "PR") with nonintervention powers.

In March 2012, Ms. Jepsen's son filed a petition contesting the validity of his mother's will. This petition was e-mailed to the PR's attorney on the date it was filed, but was never personally served on the PR. The PR filed a response to the petition in April 2012, denying the petition's substantive allegations without raising any affirmative defenses.

The PR never agreed to accept e-mail service on her attorney rather than personal service of the petition, however, and in October 2012 the PR filed a motion to dismiss the petition because it had not been personally served on the PR within 90 days of filing.

The majority held that because personal service on the PR is a necessary step to commence a will-contest action under RCW 11.24.010, no will-contest action was commenced in this case in the absence of personal service. Because no action was commenced, the probate of Ms. Jepsen's will was determined to be final and binding.

The dissent aligned with the superior court and the Court of appeals, reasoning that the estate had waived its defense When it responded to the improperly served petition. Under their logic, this case should have hinged on whether RCW 11.24.010 confers personal jurisdiction over the PR or subject-matter jurisdiction.

Personal jurisdiction can be waived; subject-matter jurisdiction cannot be waived, and may be raised as an affirmative defense at any time during the litigation. Because the dissent saw RCW 11.24.010 as conferring personal jurisdiction over the PR, it argued that a defense based on improper service was waived by the estate when it responded to the petition without raising the court's lack of personal jurisdiction.

Drafting Attorney, Attorney Representing Personal Representative, and Attorney Representing Trustee do not owe Duties to Nonclient Beneficiaries. Linth v. Gay, __ Wn. App. ___ 2015 WL 5567050 (Div. II) (September 22, 2015).

In July 2000, Evelyn Plant signed a revocable living trust agreement drafted by her attorney, Carl Gay. The following month, Ms. Plant signed an amendment to the trust agreement that significantly altered the original trust's dispositive provisions.

The initial trust agreement provided that a property called "Green Point" was to be conveyed to Crista Ministries, Inc., subject to certain rights in that property granted to Jennifer Linth. Under the amended trust, Ms. Linth was given greater rights to the property, Crista Ministries was removed as a beneficiary, and Green Point was ultimately to pass to a nonprofit, the Franklin and Evelyn Plant Green Point Foundation (the "Foundation"), which had yet to be created. The Foundation was supposed to be created according to a plan, which the trust agreement referenced and which was to be attached to the trust amendment as Exhibit 1.

Ms. Plant signed the amended trust agreement in August 2000, but at the time of signing, no Exhibit 1 was attached, and the plan to create the Foundation had not yet been drawn up. The trustee hired an agent to create the Foundation, but before that work was completed, Ms. Plant died in 2001.

Crista Ministries disputed the validity of the amendment; Ms. Linth sought to enforce it. Ms. Linth filed a TEDRA action for a declaration of rights under the trust agreement in 2001, and in 2005, the parties signed a Nonjudicial Dispute Resolution Agreement to resolve the TEDRA action.

In 2009, Ms. Linth filed a legal malpractice suit against Mr. Gay; the superior court found that Mr. Gay had no duty to Ms. Linth as a nonclient beneficiary, and granted Mr. Gay's motion for summary judgment. The Court of Appeals affirmed, noting that no genuine issues of material fact existed about whether Mr. Gay owed Ms. Linth a duty as primary beneficiary of Ms. Plant's trust.

Practice Tip: How Broker Tools Can Help Real Estate Lawyers

by Tim Jones, Broker – JLL, Foundation Law PLLC

I practiced real estate law for nine years before I became an office broker. My legal back-ground is serving me well as an officer broker. I've also learned a number of things as a broker that I wish I had known about the practical aspects of real estate when I practiced law full time. Brokers keep track of competitive terms, called "comps," "lease comps," "loan comps," or "sales comps." Sales comps and loan comps are similar to lease comps and work in similar ways. Here is a sample lease comp:

Tenant: Acme Tenant Company	
Building: Friendly Owner, LLC	
Term: 5 years	
Lease commencement: 11/1/15	
LED: 1/31/21	Lease expiration date = LED
Floor: 25th	
Free rent: 2 months	
Rate: $38 FS with 3% annual escalations	Fully serviced lease = FS
TIs: $40/RSF	Tenant improvement allowance = TIs
	Rentable square feet = RSF

As an attorney, I did not consider the value of comps other than for understanding market rates. In this practice tip, I focus on lease comps, and I'll share a few examples of how lease comps can be a useful resource to your law practice.

Track record. A good set of lease comps will show you market trends and the scope of concessions that are being given to tenants, such as the amount of the free rent or the tenant improvement allowance. In addition to market trends, with your lease comp set, you will have a database that lists your client names, the total amount of square footage you have worked on as an attorney, and the total value of your transactional leasing history (calculated by multiplying (i) annual rent rate by (ii) square footage by (iii) term). Comps will show you how the building charges for taxes, insurance and operating expenses. In a gross lease, taxes, insurance and operating expenses are included in the rent rate. In a triple net lease, or "NNN," taxes, insurance and operating expenses are not included in the rent rate and are billed separately. Sometimes these concepts are blended, and you can make a note of that as well. Comps can be enhanced to include landlord names, floor numbers for leases in multi-story buildings, and the type of annual rate increases (e.g., 3 percent annual escalations, or $1 annual increases to the rent rate). Some comps also include lease options – early termination options or renewal rights – or other rights, such as whether the premises include a space pocket. A space pocket is a portion of the premises that is reserved for a tenant during the term. The tenant is not charged rent for the space pocket during a specific amount of the lease term. The tenant eventually has to take occupancy of the space pocket and, as a result, in some markets space pockets are referred to as "must take" space.

Service your client. Pay attention to the critical dates that are important to your clients. There may be a notice period for lease renewals. Or, there may be a deadline for submitting payment requests for a tenant improvement allowance. Your comp also needs to include the lease expiration date. This is a good trigger for you, and it's a very important one for brokers. You should contact your client at least a year before the lease expiration date (or at the commencement of the renewal notice period), to check

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Recent Developments: Probate and Trust

Ms. Linth argued that Mr. Gay, as the drafting attorney, owed a duty to her as a beneficiary to ensure that the amendment to Ms. Plant's trust was complete, and that he had failed to meet that duty. She also argued that following Ms. Plant's death, Mr. Gay had negligently represented Ms. Plant's personal representative and trustee, and that his duty to those clients extended to the beneficiaries of the trust. The court found in both instances that Mr. Gay's duty did not extend to Ms. Linth. As the drafting attorney, his duty was to his client: Ms. Plant. Similarly, his duty as the attorney for the personal representative and trustee extended to those clients, but not to the beneficiaries. If Ms. Linth had a complaint about a fiduciary's actions (or inactions), then her proper recourse would have been to sue that fiduciary, not to sue the attorney representing that fiduciary.

Because Ms. Linth was unable to prove that Mr. Gay owed any duty to her, the court held that her claim of malpractice could not succeed. (The court did not address the question of whether a fiduciary might have succeeded in bringing a malpractice claim against Mr. Gay under the same set of facts, or whether Ms. Linth might have succeeded in bringing a suit against one of the fiduciaries.)

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Practice Tip: How Broker Tools Can Help Real Estate Lawyers

in with your client. When you contact your clients, ask whether they need you to draft a lease or lease amendment, or review a letter of intent.

Customize the comp. As a lawyer, you may want to vary the comp in the above example and customize it by adding your legal fee total. Including how much you charged will give you a concise, personal record of your real estate deal work, and will let you easily determine how much you typically charge for certain kinds of leases. Over time, this will make you better at estimating your fees for a client. You will understand the big picture of your work so that you can give a potential client a fee estimate on the fly. As another way to customize your comps, you can add notes to your comp with details about things you learned during each deal, or problems to avoid, or things you liked about the transaction. I also recommend adding the name of the lawyer who represented the other party to the transaction. This will help you take note of real estate lawyers for future recruiting efforts, referrals, or Washington Super Lawyer nominations. In addition, you will have a better idea of analyzing what your competition is doing. If you start to add a lot of information to your comp set, you may want to do a simple lease abstract instead of a comp. The lease abstract is a lease summary of key terms with citations to referenced sections.

Confidentiality. Be careful not to share your comps with other people outside your firm. The comps may contain confidential information and any sharing of this information may be a breach of the attorney-client privilege. Similar to lawyers, brokers are often bound by confidentiality terms via a non-disclosure agreement, listing agreement, or other confidentiality measure. But, even if the brokers don't spill the beans about the lease terms, there are other sources for comps. Comps may be extracted from the public record if the underlying documents are recorded, and comps will be included in the marketing materials for the sale of large buildings. These marketing materials are referred to in the real estate industry as "the OM" or Offering Memorandum. OMs are jam-packed with information about the building and its tenants.

The elegance of a comp. There is a certain elegance to a comp that may not be appreciated by many real estate lawyers. Comps give you additional insight into the negotiations that led to the deal terms. As a younger lawyer, I never paid attention to the reoccurring fact that most office leases are for terms of 3, 5, 7, or 10 years, possibly with a couple or few months of term tacked on, e.g, 3.1 years, 5.2 years, 7.3 years or 10.5 years. I didn't appreciate that the residual number of months added to those 3, 5, 7, or 10 year terms represent the amount of free rent that the landlord agreed to give the tenant. As a standard lease concession, landlords often abate a portion of the rent for a period of time and the abated rent is referred to as free rent. The landlords include the free rent as part of the lease term. In a lease for a term of 5.3 months, you can make a safe bet that the landlord probably agreed to give the tenant three months of rent. If you see a lease for a term of 5 years then there is less certainty about the amount of free rent. In such a scenario, either the landlord declined to give any free rent, or the parties agreed to apply the free rent to the amount of term that was originally requested by the tenant instead of tacking on additional term.

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