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The Real Estate Settlement Procedures Act and Internet Transactions

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I. Introduction

The Real Estate Settlement Procedures Act of 1974 (“RESPA” or “Statute”), codified at 12 USC §2601 et seq., is a consumer protection statute that was enacted with the purposes of providing information to real estate borrowers and promoting consumer choice and the reduction of fees in residential real estate transactions. The U.S. Department of Housing and Urban Development (“HUD”) interprets and enforces RESPA and has promulgated advisory opinions and a number of administrative interpretations (also known as “Statements of Policy”) of the Statute and related regulations. One of RESPA’s stated purposes is to eliminate kickbacks and referral fees that increase the cost of certain real estate settlement services.

The recent proliferation of online residential real estate services and related Internet Web sites such as *Bankrate.com*, *LendingTree.com*, *Redfin.com* and *Zillow.com* has transformed the world in which settlement service providers must comply with RESPA regulations. This article summarizes the general regulatory framework of RESPA with regard to offline² (i.e., face-to-face) residential real estate transactions and provides an overview of certain types of online real estate transactions that appear to be permitted within this framework. This article then focuses on RESPA compliance issues that arise in the specific situation of online advertising, including the practice of generating revenue by hosting hyperlinks³ on portal Web sites that rank real estate settlement service providers and/or allow consumers to “click-through”⁴ to settlement service providers’ Web sites. However, Internet advances move faster than changes to RESPA regulations, and the current RESPA regulations do not always translate well to the virtual world. As a result, further guidance regarding the application of the Statute to Internet transactions is needed.

II. Regulatory Framework of RESPA

Section 8 of RESPA, implemented by Regulation X, found at 24 C.F.R. §3500 et seq., provides that a company “may not pay any other company or the employees of any other company for the referral of settlement service business.”⁵ Consequently, Section 8 of RESPA prohibits (A) the payment of any fee, kickback or thing of value, (B) pursuant to any agreement or understanding, (C) incident to or a part of any real estate settlement service, (D) involving a federally-related mortgage loan, (E) in exchange for the referral of business.⁶ As discussed below, mortgages made for residential property are federally-related mortgage loans that are subject to regulation under RESPA. However, it is important to note that business, commercial and agricultural loans are exempt from RESPA regulations.⁷

A. “Payment of Any Thing of Value”

Under Section 8, the term “payment” is synonymous with the giving or receiving of any “thing of value” and does not require a transfer of money.⁸ The definition of “value” is broadly defined in the Statute and encompasses almost every type of consideration, including but not limited to any payment, advance, funds, loan, service or other consideration such as stock, dividends, profits, franchise royalties, credits, retained or increased earnings, services of all types at special or free rates, sales or rentals at special prices or rates, trips, payment of another’s expenses and reductions in credit.⁹

B. “Agreement or Understanding”

Regulation X provides that an “agreement” or “understanding” for the referral of business incident to or part of a settlement service need not be written or verbalized but may be

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established by a practice, pattern or course of conduct.¹⁰ When a thing of value is received repeatedly and is connected in any way with the volume or value of the business referred, the receipt of the thing of value is evidence that it is made pursuant to an agreement or understanding for the referral of business.¹¹

C. "Settlement Services"

RESPA defines the term "settlement" as "the process of executing legally binding documents regarding a lien on property that is subject to a federally-related mortgage loan" (defined below).¹² The definition of "settlement services" subject to RESPA is broad and includes any service provided in connection with a real estate settlement, such as the following:

- Providing title services and certificates, including title searches, title examinations, abstract preparation, insurability determinations, and the issuance of title commitments and title insurance policies.
- Services rendered by an attorney.
- Preparation of documents, including notarization, delivery and recordation, and property surveys.
- The rendering of credit reports or appraisals.
- The rendering of property inspections, including inspections required by applicable law, pest and fungus inspections or any inspections required by the sales contract or mortgage documents prior to transfer of title.
- Services rendered by a real estate agent or broker.
- Services rendered by a mortgage broker (including counseling, taking applications, obtaining verifications and appraisals, and other loan processing and origination services, and communicating with the borrower and lender).
- The origination of a federally-related mortgage loan (including, but not limited to, the taking of loan applications, loan processing, and the underwriting and funding of loans) and the handling of the processing and closing or settlement.
- Providing any services related to the origination, processing or funding of a federally-related mortgage loan.
- Conducting of settlement by a settlement agent and any related services.
- Providing services involving mortgage insurance.
- Providing services involving hazard, flood or other casualty insurance or homeowners' warranties.
- Providing services involving mortgage life, disability, or similar insurance designed to pay a mortgage loan upon disability or death of a borrower, but only if the insurance is required by the lender as a condition of the loan.

- Providing services involving real property taxes or any other assessments or charges on the property.
- Any other services for which a settlement service provider requires a borrower or seller to pay.¹³

As stated above, business, commercial and agricultural loans are exempt from RESPA.¹⁴

D. "Federally-Related Mortgage Loan"

Federally-related mortgage loans are regulated under the Statute. For a loan to qualify as a "federally-related mortgage loan" under RESPA, it must be (1) secured by a first lien or subordinate lien on residential property designed principally for the occupancy of from one to four families¹⁵ and (2) either be (i) insured, regulated, supplemented or assisted in any way by an agency of the United States Federal Government or be intended for resale to various federal mortgage associations, or (ii) made in whole or in part by a creditor, defined in the Truth in Lending Act, codified at 15 U.S.C. §1602, as a person who "regularly extends...consumer credit¹⁶..." and who makes or invests in residential real estate loans aggregating more than \$1,000,000 a year.¹⁷ A consumer is defined as an individual who uses the funds primarily for personal, family, household or agricultural purposes.¹⁸ As stated above, residential mortgages made for residential property are federally-related mortgage loans that are typically subject to regulation under RESPA.

E. "Referral"

The definition of a "referral" under RESPA includes any oral or written action that is (1) directed to a person with the effect of affirmatively influencing a person's selection of a provider of a settlement service or business incident to or part of a settlement service when (2) the person will pay a fee for the settlement service or business or pay a charge attributable to the settlement service or business.¹⁹ In addition, a referral occurs whenever a person paying for a settlement service (or business incident to or a part of a settlement service) is required to use a particular provider of a settlement service (or business incident to or a part of a settlement service).²⁰

F. Single Provider Versus Two or More

Under RESPA Section 8 regulations, any referral of a settlement service is a non-compensable service.²¹ Section 8(b) of RESPA also prohibits the payment or receipt of "any portion, split or percentage of any charge made or received for the rendering of a real estate settlement service...other than for services actually performed."²² In response to conflicting opinions regarding whether Section 8(b) requires at least two parties to split an unearned fee for a violation of RESPA to occur, HUD

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issued Statement of Policy 2001-1 ("Statement 2001-1") to guide courts in interpreting RESPA provisions.²³ Statement 2001-1 provides that Section 8(b) is violated when (1) two or more settlement service providers split an unearned fee, (2) one settlement service provider marks-up the cost of a service performed by another without providing additional necessary services to justify the actual charge, or (3) one settlement service provider charges a fee where no, nominal, or duplicative work is done.^{24,25} Thus, Statement 2001-1 includes a prohibition on transactions where a single service provider overcharges for its services resulting in duplicative or unearned fees.²⁶ The source of the payment does not determine whether or not a service is compensable.²⁷

Despite HUD's interpretation in Statement 2001-1 that Section 8(b) of RESPA contains a prohibition on single service providers overcharging for their services, a majority of courts have held that Section 8(b) governs agreements between two or more providers rather than unilateral overcharges.²⁸ These courts rely on the plain language of Section 8(b) (referring to "splitting charges" between two or more persons)²⁹ and do not determine whether deference should be given to HUD's interpretation.³⁰ However, other courts have given deference to Statement 2001-1 in order to resolve conflicting interpretations of Section 8.³¹ The Ninth Circuit has not yet ruled on the issue but has noted that the provision is intended to prevent service providers from splitting fees amongst themselves.³²

Although interpretations of Section 8(b) are controversial with regard to unilateral charges as outlined above, the Statute, regulations and HUD Statements of Policy provide useful guidance concerning activities involving two or more parties subject to RESPA. Violations of Section 8 are subject to a fine of \$10,000, imprisonment for one year, or both. Additionally, an aggrieved party may sue for three times the amount of the charge for the settlement service.³³

G. Permissible Payments Under RESPA

Despite its stated purpose of prohibiting referral fees and kickbacks in residential real estate transactions, RESPA does permit payments between parties for goods or facilities actually furnished or for services actually performed.³⁴ For example, under Section 8 of RESPA, payment of a fee is permitted (1) to attorneys at law for actual services rendered, (2) by a title company to its duly appointed agent for legitimate services performed in issuing a title policy, and (3) by a lender to its duly appointed agent for actual services performed in making a loan.³⁵ An employer's payment to its own employees for any referral activities is also permitted.³⁶ Furthermore, payment for additional settlement services from a person in a position to refer settlement service business (such as an attorney, lender or real estate broker) is permitted, provided the payment is for actual, necessary and distinct services from the primary services provided by such person.³⁷

In addition, payments pursuant to cooperative brokerage and referral arrangements, or agreements between real estate agents and real estate brokers, are permitted to the extent all parties are acting in a real estate brokerage capacity; payments between real estate brokers and mortgage brokers are not allowed.³⁸ However, due in large part to lobbying by a variety of real estate industry groups, related, controlled or otherwise affiliated real estate service providers may now refer settlement service business to one another. Similarly, parent entities or equity holders may receive a bona fide return on an investment in an affiliated business without those payments being considered illegal referral fees, kickbacks or fee-splitting arrangements. These types of related businesses were originally referred to as "controlled business arrangements" and are now defined as "affiliated business arrangements" under RESPA.³⁹

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III. RESPA Transactions Over the Internet

The regulatory framework of RESPA applies to transactions involving residential real estate settlement services conducted via the Internet just as it does for offline settlement services. In simple scenarios, RESPA regulations appear readily applicable to “traditional” settlement service providers and transactions that are conducted via the Internet, such as services offered on single provider Web sites. For example, an online lender that maintains its own Website – providing only its own home loan information and home mortgage application forms for its own mortgage products – is clearly governed by RESPA.⁴⁰ Under RESPA regulations, the lender is prohibited from splitting fees with, accepting kickbacks from, or providing kickbacks to other settlement service providers in exchange for direct online referrals, such as from a mortgage broker operating its own Web site. In this example, the lender and the mortgage broker’s respective Web sites stand in for the “face-to-face” interaction of a traditional, offline real estate transaction between lender and broker. However, the application of RESPA to new and more complex online services and products presents additional challenges given the unique landscape of the Internet, especially given the participation of third-party Web site operators.

One of the most complex issues regarding compliance with RESPA in Internet transactions involves payments to Web site operators by settlement service providers for activities such as online advertising and “click-through” services. These activities fall in the middle of the spectrum between mere online advertising, on the one hand, and loan origination and broker services on the other.⁴¹ This area of RESPA regulation is still developing and formal guidance from HUD on the subject is warranted.⁴² At this point, consumers can conduct an entire residential real property purchase over the Internet: consumers can search for and view a home online, find and compare mortgage rates, select a loan, obtain title insurance and close the purchase of the home. In order to remain competitive, lenders and other settlement service providers are joining the virtual world in waves, making RESPA compliance issues in online residential real estate transactions that much more acute. This section of the Article will first present HUD guidance that has been used to interpret these issues and then address specific types of Internet transactions that appear to be permissible within the RESPA framework.

A. Computer Loan Origination Services

In addition to the Statute, HUD’s Statement of Policy 1996-1 (“Statement 1996-1”)⁴³ is helpful in evaluating online real estate settlement services and transactions for RESPA compliance. Statement 1996-1 outlines how RESPA governs payments for services from certain computer loan origination (“CLO”) systems. For purposes of Statement 1996-1, a CLO is a computer system that is used by or on behalf of a consumer to facilitate a consumer’s choice among alternative products or settlement

service providers in connection with a particular RESPA-covered real estate transaction.

According to Statement 1996-1, the computer system:

- May provide information concerning products or services;
- May pre-qualify a prospective borrower;
- May provide consumers with an opportunity to select ancillary settlement services;
- May provide prospective borrowers with information regarding the rates and terms of loan products for a particular property in order for the borrower to choose a loan product;
- May collect and transmit information concerning the borrower, the property, and other information on a mortgage loan application for evaluation by a lender or lenders;
- May provide loan origination processing and underwriting services, including but not limited to the taking of loan applications, obtaining verifications and appraisals, and communicating with the borrower and lender; and
- May make a funding decision.⁴⁴

HUD stated that the definition above is not restrictive or exhaustive and merely attempts to describe existing practices of computer service providers. HUD then promulgated a two-part test to determine whether payments to CLOs fall under the permitted payments provision of Section 8 of RESPA.⁴⁵ First, compensable goods, facilities or services must be provided by the CLO in return for payments by settlement service providers. Second, any payment must bear a reasonable relationship to the value of the goods, facilities or services provided.⁴⁶

Under RESPA, a charge between one party to the other for which no or nominal services are performed or for which duplicative fees are charged is a prohibited fee.⁴⁷ To provide further guidance on this point, in Statement 1996-1 HUD gave an example of a third-party CLO that (1) only lists one settlement service provider and (2) only presents basic information to the consumer on the service provider’s products. HUD explained that in that instance there appears to be no compensable service (or at the most, nominal compensable service) provided by the CLO to either the settlement service provider or the consumer. Accordingly, HUD characterized this action as a referral, not a service, and stated that any payment by the settlement service provider for the CLO listing could be considered a referral fee in violation of RESPA.⁴⁸ However, HUD has placed no restrictions on the pricing structure of CLOs other than requiring that the payments be reasonable in relation to the services provided and that they not be for referrals.⁴⁹ The value of the referral may not be taken into account when determining whether the payment exceeds the reasonable value of the goods, facilities or services.⁵⁰

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If the above requirements are met, CLOs may charge settlement service providers a fixed or periodic fee arising from the use of the CLO, including a payment based on closed loans so long as the payment is reasonable given the level of service provided.⁵¹ However, HUD has noted that if a CLO charges different fees to different settlement service providers in similar situations, an incentive may exist for the CLO to steer the consumer to the settlement service provider that pays the highest fees.⁵² HUD may scrutinize transactions entered into under these circumstances to determine if the pricing differentials are actually referral fees. Generally, though, settlement service providers may pay CLOs a reasonable fee for services provided to the settlement service provider, such as having information about the provider's products made available to consumers for comparison with the products of other settlement service providers.⁵³

B. Neutral Displays of Information

As discussed above, the Statute prohibits payments for referrals made pursuant to any agreement to refer business related to settlement services.⁵⁴ Under RESPA, an agreement or understanding for the referral of business may be established by a practice, pattern or course of conduct.⁵⁵ Statement 1996-1 provides that a pattern of non-neutral displays of information may constitute an illegal agreement for referral of business.⁵⁶ For example, "if one lender always appears at the top of any listing of mortgage products, and there is no real difference in interest rates and charges between the products of that lender and other lenders on a particular listing, then this may be a non-neutral presentation of information which affirmatively influences the selection of a settlement service provider."⁵⁷ Furthermore, if there is an affiliate relationship between the CLO and a favored settlement service provider, under certain circumstances the non-neutral presentation of information could be viewed as a required use in violation of RESPA.⁵⁸ HUD has explained that the guidance above should not be read to discourage CLOs from assisting consumers in determining which products are most advantageous to them. For example, if a CLO consistently ranks lenders and their mortgage products on the basis of some factor relevant to the borrower's choice of product, such as the annual percentage rate calculated to include all charges and to account for the expected tenure of the buyer, HUD would consider this practice a permissible neutral display of information.⁵⁹

C. The Prospects List Letter

Guidance for the relatively new phenomenon of hyperlink "click-throughs" and similar Internet services related to real estate transactions can also be found in an informal HUD letter issued on March 24, 1994, by Grant E. Mitchell⁶⁰ (the "Prospects List Letter").⁶¹ In the Prospects List Letter, HUD advised that a settlement service business may pay for or be paid for a prospects list or potential customer list. HUD explained that historically

there has been no objection to such a payment as long as the payment is for the use of the list (i.e., for an actual service, not just a referral). Furthermore, HUD instructed that the payment must not be further conditioned upon the number of closed transactions resulting from the list or on any other consideration, such as an endorsement of the product being offered by the seller of the list.⁶² Similar to the rationale set forth in Statement 1996-1, the Prospects List Letter stands for the proposition that RESPA does not prohibit a payment for actual services performed, so long as the payment is not for an actual referral itself.

D. Hyperlinks and "Click-Throughs"

Although neither the Prospects List Letter nor Statement 1996-1 was written specifically to address Internet transactions, the guidance provided by HUD in both documents has been relied upon by individuals such as Grant E. Mitchell to analyze the legality of payments for certain online services such as hosting hyperlinks and "click-throughs" on operator Web sites. Therese Franzén notes that absent the hyperlink, online banner ads⁶³ closely resemble traditional advertising. Thus, a flat fee for hosting a lender's banner ads on an operator's Web site, without more, appears permissible under general RESPA regulations (so long as the payment is reasonable and in tune with the market).⁶⁴ However, hyperlinks that "click-through" to other web sites, including hyperlinks embedded in banner ads, are unique to the Internet and thus are more problematic.⁶⁵ Due to the lack of guidance from HUD on this issue, the Prospects List Letter has been used to support the position that a Web site operator may charge a lender (or other settlement service provider) a fee for creating a hyperlink on the operator's Web site that links to the lender's Web site.⁶⁶ This position rests on viewing the payment to a Web site operator based on the number of people that visit the operator's Web site as the Internet equivalent of payment for placing an advertisement in a newspaper or magazine where the price of advertising is related to the publication's circulation numbers.⁶⁷ Apparently, HUD has never questioned these types of payments, which are seemingly characterized as "payment for a 'good' (advertising space) or for 'services' (the service of disseminating information to the public about the lender's products)."⁶⁸

On a related note, "click-through rate"⁶⁹ is a useful way to measure the effectiveness of an Internet advertising campaign and in fact, charging a fee for "click-throughs" is one of the primary methods by which many Web site operators seek and maintain revenue streams. Although payment for "click-throughs" raises more RESPA issues with regard to prohibited referrals, some have argued that payment based upon "click-through rate" may be viewed as payment for a stream of prospects, "at least where there is no obvious endorsement of the lender and/or its products by the Web site operator."⁷⁰ This hypothesis requires

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that the payments be minimal, such as a few dollars per item, and that payments for comparable prospects list or advertising rates in the industry be used for comparison.⁷¹ Again, these payments may not be tied to whether the “click-through” results in a loan.⁷²

Taking this analogy one step further, some have argued that an online settlement service provider that conditions payment of a “click-through” fee to the Web site operator on an additional requirement that the consumer provide his or her name, email address and telephone number to the service provider does not appear to violate Section 8 of RESPA.⁷³ Proponents of this position cite the fact that the Prospect’s List Letter seemed to recognize that the payment was not only for a prospect’s name but also for the “use” of the list, including contact information for the prospect.⁷⁴ However, it appears that “if the payment of a ‘click-through’ fee (presumably enhanced in amount) is conditioned on the visitor taking some further action, such as filling out a loan application or closing a loan, this would seem to go beyond the circumstances described in the Prospect’s List Letter.”⁷⁵ In that case, HUD could conclude that such a payment was not for a prospect but rather, an actual referral in violation of Section 8 of RESPA. To safely receive the greatest amount of payments, advocates of this approach recommend that the Web site operator be in a position to undertake or contract to perform, and actually perform, settlement type services, as discussed below.⁷⁶ Otherwise, it is argued, Web site operators or other settlement service providers risk engaging in activities that could be viewed as violating the Statute.

E. CLO Services by Web Site Operators

Based upon the above guidance, if an operator’s Web site is used only for general marketing purposes, rather than for brokerage or loan origination-type services, the two-part test in HUD Statement 1996-1 appears to be the proper test to determine whether or not fees paid for such marketing services are appropriate under RESPA.⁷⁷ Furthermore, Statement 1996-1 indicates that a Web site operator may function as CLO and perform online services such as (1) pre-qualifying a prospective borrower, (2) providing information about rates and terms of loan products, (3) collecting and transmitting information regarding the borrower for evaluation by a lender, and (4) providing loan origination and underwriting services, including taking loan applications.⁷⁸ So long as payment to the Web site operator is made (i) for CLO services and (ii) bears a reasonable relationship to the value of goods, facilities or services provided by the Web site operator, such payments should be permissible under RESPA.⁷⁹ However, some Web site operators do not limit themselves to the CLO activities described above and often cross the blurred line between providing CLO services and performing actual mortgage brokerage or other origination services. Those activities must be examined for RESPA compliance using a different set of criteria discussed below.

F. Online Mortgage Brokerage and Origination Services

Where actual mortgage brokerage and origination services are conducted on the operator’s Web site for which the operator receives payments, a letter from Nicolas Retsinas, HUD Assistant Secretary for Housing dated February 14, 1995 (“IBAA Letter”)⁸⁰ establishes a minimum number of services that a party must perform in order to legally receive compensation for services rendered in a mortgage lending transaction. The IBAA Letter was issued in response to an inquiry regarding what mortgage and origination services are sufficient to justify receipt of a fee without violating RESPA, and lists a number of activities normally performed in the origination of a loan. HUD states that it would generally be satisfied that no RESPA violation had occurred if it found that (1) the lender’s agent or contractor took the loan application, (2) the lender’s agent or contractor performed at least five additional items on the list above, *and* (3) the fee was reasonably related to the market value of the services that were performed.⁸¹ It is important to note that there is some overlap in the services listed for CLOs in Statement 1996-1 and for loan origination services listed in the IBAA Letter. Therefore, the criteria set forth in both documents should be examined to determine which test or standard should be applied to a Web site operator’s activities. Again, guidance from HUD on this issue is warranted.

Relying on the IBAA Letter, some have argued that payment of a flat fee to a Web site operator for each loan originated through that operator’s Web site, or payment of a percentage of the amount of each loan, is only permissible if the Web site operator is performing or arranging for performance of origination-type services.⁸² The test for compensability would be whether the services provided by the operator satisfied the threshold level of origination services listed in the IBAA Letter as illustrated above.⁸³ For example, it could be argued that a Web site operator, performing certain duties such as taking application materials online, or engaging in “counseling services” by displaying information on its Web site about loan rates and terms available from a lender, could be seen as meeting the first part of the IBAA test requiring performance of the origination services set forth in the IBAA Letter.⁸⁴ The second part of the test, whether the compensation is reasonably related to services actually provided, depends on whether comparable fees are paid under similar marketing arrangements; market data for similar services in the same geographic region would be required to determine this.⁸⁵ In Statement of Policy 1999-1,⁸⁶ HUD stated that the IBAA Letter is not dispositive when more comprehensive services are provided.⁸⁷ Consequently, it has been suggested that Web site operators should perform more than six, and as many of the listed services as possible, to ensure that the payments received are for services in compliance with RESPA rather than for referrals.⁸⁸

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IV. Conclusion

The application of RESPA to settlement service provider activities conducted via the Internet is not without challenges. Generally, it appears that RESPA permits Web site operators to receive payments for goods or facilities that are actually furnished or for services that are actually performed.⁸⁹ To determine whether the payments are authorized under RESPA, the Web site operator should ensure that the payments satisfy the two-part test set forth by HUD in Statement 1996-1. First, the goods, facilities or services must be provided by the Web site operator in return for payments by settlement service providers. Second, any payment must bear a reasonable relationship to the value of the goods, facilities or services provided. This two-part test may be applied in situations where persons provide advertising services for settlement service providers or where persons host links on a Web site that "click-through" to settlement service providers

governed by RESPA. HUD may scrutinize Web sites with non-neutral displays of information on settlement service providers, but it appears that Web site operators may rank settlement service providers on a Web site provided that the ranking is based on some factor that is relevant to the borrower's choice of product. Furthermore, it appears that Web site operators may even perform CLO-type services as set forth in Statement 1996-1. In the event that a Web site operator engages in actual loan origination or mortgage brokerage activities, however, these activities should be evaluated according to the criteria set forth in the IBAA Letter. As use of the Internet for residential real estate transactions continues to advance, additional guidance from HUD on RESPA compliance issues in the virtual world is necessary in order to ensure that residential real estate settlement service providers are able to conduct their businesses online without violating RESPA's mandates.

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 2 Not connected to the Internet.
 3 A hyperlink is a link from one part of a page on the Internet to another page or Web site.
 4 The act of an online user clicking on a hyperlink that directs the user to another Web site.
 5 12 U.S.C. §2607, implemented by Regulation X, 24 C.F.R. §3500.14(b).
 6 12 U.S.C. §2607(a); 24 C.F.R. §§3500.14 and 3500.15.
 7 12 U.S.C. §2606; 24 C.F.R. §3500.5. In addition, loans for vacant land and for land of 25 acres or more are exempt from RESPA. *See*, 12 U.S.C. §2606(a); 24 C.F.R. §3500.5(b).
 8 12 U.S.C. §2602(2); 24 C.F.R. §3500.14(d).
 9 12 U.S.C. §2602(2); 24 C.F.R. §3500.14(d).
 10 24 C.F.R. §3500.14(e).
 11 *Id.*
 12 12 U.S.C. §2602(3); 24 C.F.R. §3500.2(b).
 13 *Id.*
 14 12 U.S.C. §2606(a); 24 C.F.R. §3500.5.
 15 12 U.S.C. §2602(1)(A).
 16 15 U.S.C. §1602(f).
 17 12 U.S.C. §2602(1)(B)(i)-(iv).
 18 15 U.S.C. §1602(h).
 19 24 C.F.R. §3500.14(f)(1).
 20 24 C.F.R. §3500.14(f)(2).
 21 24 C.F.R. §3500.14(b).
 22 12 U.S.C. §2607(b); 24 C.F.R. §3500.14(c).
 23 Statement of Policy 2001-1, 66 Fed. Reg. 53052 (Oct. 18, 2001).
 24 *Id.* at 53052, 53057-59.
 25 Statement of Policy 2001-1 also states that a settlement service provider may violate Section 8(b) by charging a fee that is in excess of the reasonable value of the services performed. However, it appears that no court has adopted this position.
 26 24 C.F.R. §3500.14(c).
 27 *Id.*
 28 *See, e.g., Santiago v. GMAC Mortgage Group, Inc.*, 417 F.3d 384 (3rd Cir. 2005); *Boulware v. Crossland*

Mortgage Corp., 291 F.3d 261 (4th Cir. 2002); *Weizeorick v. ABN AMRO Mortgage Group, Inc.*, 337 F.3d 827 (7th Cir. 2003); *Haug v. Bank of America*, 317 F.3d 832 (8th Cir. 2003).
 29 12 U.S.C. §2607(b).
 30 *Chevron U.S.A. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984); *Santiago*, 417 F.3d at 387-88.
 31 *See, e.g.; Kruse v. Wells Fargo Home Mortgage Inc.*, 383 F.3d 49 (2d Cir. 2004); *Sosa v. Chase Manhattan Mortgage Corp.*, 348 F.3d 979 (11th Cir. 2003).
 32 *See Schuetz v. Banc One Mortgage Corp.*, 292 F.3d 1004 (9th Cir. 2002). This interpretation is consistent with Ninth Circuit opinions prior to the issuance of Statement 2001-1 finding that Section 8 prohibited sharing arrangements rather than overcharges by a single provider. *See e.g., Bloom v. Martin*, 865 F. Supp. 1377 (N.D. Cal. 1994), *aff'd on other grounds*, 77 F.3d 318 (9th Cir. 1996).
 33 12 U.S.C. §2607(d).
 34 12 U.S.C. §2607(c); 24 C.F.R. §3500.14(g).
 35 *Id.*
 36 24 C.F.R. §3500.14(g)(1)(vii).
 37 24 C.F.R. §3500.14(g)(3).
 38 12 U.S.C. §2607(c)(3); 24 C.F.R. §3500.14(g)(1)(v).
 39 Such affiliated business relationships are outside the scope of this Article.
 40 Providers of online mortgage broker or lender services are also subject to regulation by each state in which the broker or lender is considered to be "doing business." Such licensing issues are beyond the scope of this Article, but have been addressed elsewhere. *See, e.g., Therese Franzén, Doing Mortgage Business on the Web – Same Rules, Different Venue*, 55 Consumer Fin. L.Q. Rep. 245 (2001).
 41 Therese Franzén, *Doing Mortgage Business on the Web – Same Rules, Different Venue*, 55 Consumer Fin. L.Q. Rep. 245 (2001). Therese G. Franzén is a founding member of the firm Franzén and Salzano, P.C.
 42 HUD has proposed new RESPA rules in the Federal Register but has yet to officially implement amendments.
 43 Statement of Policy 1996-1, 61 Fed. Reg. 29255

(June 7, 1996).
 44 Statement of Policy 1996-1, 61 Fed. Reg. at 29256.
 45 *See*, 12 U.S.C. §2607(c).
 46 24 C.F.R. §3500.14(g); 61 Fed. Reg. at 29256.
 47 24 C.F.R. §3500.14(c); Statement of Policy 1996-1, 61 Fed. Reg. at 29256-57. (This scenario sets aside the issue of a unilateral settlement service provider; all of the related examples involve more than one party).
 48 Statement of Policy 1996-1, 61 Fed. Reg. 29256-57.
 49 Statement of Policy 1996-1, 61 Fed. Reg. at 29257.
 50 24 C.F.R. §3500.14(g); 61 Fed. Reg. at 29257.
 51 Statement of Policy 1996-1, 61 Fed. Reg. 29257; *See also*, Grant E. Mitchell and Robert M. Jaworski, *RESPA and Online Mortgage Lending (with Glossary)*, The Practical Real Estate Lawyer, May 2002, at 23.
 52 Statement of Policy 1996-1, 61 Fed. Reg. at 29257.
 53 *Id.*
 54 12 U.S.C. §2607(a).
 55 24 C.F.R. §3500.14(e).
 56 Statement of Policy 1996-1, 61 Fed. Reg. at 29258.
 57 *Id.*
 58 24 C.F.R. §3500.15(b)(2); Statement of Policy 1996-1, 61 Fed. Reg. at 29258.
 59 Statement of Policy, 1996-1, 61 Fed. Reg. at 29258.
 60 Grant E. Mitchell is an attorney with Lotstein Buckman, LLP, and was formerly Senior Attorney for RESPA at the Department of Housing and Urban Development.
 61 Letter dated March 24, 1994 from Grant E. Mitchell, collected in Barron's *Federal Regulation of Real Estate and Mortgage Lending*, Fourth Edition.
 62 *Id.*
 63 An ad in the form of a graphic image that runs across a Web page or is positioned in a margin or other space reserved for ads. It is typically used to entice site visitors to "click through" to obtain further information.
 64 Franzén, *supra*, at 248.
 65 *Id.*
 66 Mitchell and Jaworski, *supra*, at 19.
 67 *Id.* The same analogy has been used to argue that a

Custodial Accounts: Knowing What to Use and When to Use It

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I. Introduction.

There are many methods for making gifts to minors. These range from the simplicity of outright cash gifts to the complexity of gifts made to trusts that terminate well after the minor has reached adulthood. Gifts made to a custodian under the Uniform Transfers to Minors Act (the “UTMA”) are somewhere in the middle. It is common for clients to make gifts to minor children or grandchildren using custodial accounts as a simple and inexpensive alternative to trusts. Beginning on July 1, 2007, custodianships will become an even more flexible alternative. Under House Bill 2380, which Governor Gregoire signed on March 24, 2006, a transferor may elect to extend a custodianship to age 25 (for transfers on or after July 1, 2007).

This article covers issues related to the creation of a custodianship, operational issues once the custodianship has been established, the various tax issues associated with custodianships, and the methods of prolonging the custodianship beyond its termination date. The article is designed to assist the practitioner when advising clients regarding transfers subject to the UTMA – whether the client is the transferor, custodian or minor.

II. Creation.

A. Scope and Definitions.

Washington’s version of the UTMA (the “Act”) applies to transfers made after July 1, 1991 that make reference to the Act in the custodial designation.² The Act also applies to transfers made before July 1, 1991 as will be discussed below. The Act uses defined terms with which the practitioner should be familiar when analyzing any aspect of a custodianship:

- **Custodial Property:** Any interest in property transferred to a custodian under the Act and the income and proceeds of the transferred property.
- **Custodian:** The person designated as custodian in the original transfer or a successor or substitute custodian.

- **Minor:** An individual who has not attained age 21 (25 after July 1, 2007).
- **Transfer:** A transaction that creates custodial property.
- **Transferor:** A person who makes a transfer under the Act.

A. Mechanical Issues.

1. Applicability of Act to Transfers.

The provisions of the Act apply to all transfers that refer to the Act as part of the designation of custodian if – at the time of the transfer – the transferor, the minor, or the custodian is a Washington resident or the custodial property is located in Washington.³ A custodianship created under Washington’s Act remains subject to its terms even if the residence of any of the parties changes or the custodial property is removed from Washington.⁴ Washington’s statute recognizes the converse of this rule and provides that custodianships validly created under another state’s version of the UTMA are subject to the other state’s laws, but are otherwise enforceable in Washington.⁵

The Comment to the UTMA recognizes that this provision allows transferors to choose a particular state’s version of the UTMA when making a transfer.⁶ As long as there is a sufficient connection to the chosen state at the time of the transfer, the resulting custodianship will be subject to the laws of the chosen state but enforceable by the courts of the transferor’s state of residence.⁷

For example, a Washington parent could make a transfer to a custodian in Alaska subject to Alaska’s version of the UTMA, which allows for custodianships to extend until the minor reaches twenty-five.⁸ Oregon also allows custodianships to be extended to age 25.⁹ As noted above, effective July 1, 2007, Washington will also allow custodianships to be established which extend until the minor turns 25.¹⁰

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The Real Estate Settlement Procedures Act and Internet Transactions

broker may charge a lender advertising fees to place the lender’s banner ad or hyperlinks on the broker’s Web site. See Phillip L. Schulman, *Internet-Based Loan Origination Programs Offer Real Estate Agents Opportunities and Pitfalls...Beware of RESPA*, at <http://www.ccrealtors.org/legal/respa.htm> (last visited January 16, 2007).

68 Mitchell and Jaworski, *supra*, at 19.

69 The number of clicks on a hyperlink/page divided by the number of times it was displayed. Generally it is presented as a percentage.

70 Mitchell and Jaworski, *supra*, at 19.

71 *Id.* See also, Schulman, *supra*.

72 Schulman, *supra*.

73 Mitchell and Jaworski, *supra*, at 19.

74 *Id.*

75 *Id.*

76 *Id.*

77 *Id.* at 21.

78 See Statement of Policy 1996-1, 61 Fed. Reg. at 29256.

79 24 C.F.R. §3500.14(g); Statement of Policy 1996-1, 61 Fed. Reg. 29256.

80 Letter dated February 14, 1995 from Nicolas Retsinas, HUD Ass’t Secretary for Housing, col-

lected in Barron’s *Federal Regulation of Real Estate and Mortgage Lending*, Fourth Edition.

81 *Id.*

82 Mitchell and Jaworski, *supra*, at 20.

83 *Id.*

84 *Id.*

85 *Id.*

86 Statement of Policy 1999-1, 64 Fed. Reg. 10080 (March 1, 1999).

87 *Id.* at 10,085, fn.6.

88 Mitchell and Jaworski, *supra*, at 21.

89 12 U.S.C. §2607(c).

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2. Designation of Custodian.

The transfer creating custodial property must designate a custodian.¹¹ Generally, the custodian may be the transferor, another adult or a trust company.¹² However, when advising a client who is contemplating a gift under the UTMA, it is critical to be aware of the type of property involved. For example, a transferor cannot transfer partnership interests to herself as custodian.¹³ This transfer would be ineffective.¹⁴ The complete list of requirements is set out at RCW § 11.114.090. The Act includes a form to be used for certain transfers. This form appears at the end of this article as Exhibit "A."

The Act allows a transferor to nominate a custodian for a transfer that actually takes place in the future.¹⁵ This nomination can be made in a will, trust, deed, an instrument exercising a power of appointment, or in a writing designating a beneficiary of contractual rights.¹⁶ However, the transferor must nominate a custodian who is allowed to act with respect to the type of property to be transferred.¹⁷ Under this provision, the designation is not operative until the nomination becomes irrevocable or the property transfer actually takes place.¹⁸

Example Language to be used in a will:

Nomination of Custodian

In the event any of my beneficiaries is under the age of twenty-five (25) years at the time of distribution and no trust is provided, [I hereby nominate and appoint _____ as Custodian] OR [my Personal Representative shall designate a Custodian] of his or her share under the Uniform Transfers to Minors Act, to be held and applied on the beneficiary's behalf until the beneficiary reaches the age of twenty-five (25) years, or any later age then provided for under the Uniform Transfers to Minor's Act of the State of Washington, as amended. The Custodian may make discretionary distributions for the health, education, welfare, and support of the beneficiary. In no event shall the Custodian be required by the Court to post any bond whatsoever.

The other innovative aspect of this provision is that it allows the transferor to designate more than one minor. The nomination can instead refer to specific minors or to a class of minors (e.g., "my grandchildren").¹⁹ Once the transfer is complete, each minor's interest is treated as a separate custodianship.²⁰

This technique can be used as a simple alternative to the Irrevocable Life Insurance Trust ("ILIT"). For example, parent irrevocably designates her sibling, as custodian, as the beneficiary of a life insurance policy on her life. The designation names the parent's children as the beneficiaries of the custodianship.

The nomination is immediately effective because it is irrevocable. If the parent has three children, the transfer creates three separate custodianships—one for each child. In future years,

parent makes cash gifts to each custodianship which the custodian uses to pay premiums on the insurance policy. When parent dies, the proceeds are payable to the three custodianships. If the children are over twenty-one, the money is payable outright to the children. Unlike the ILIT, the custodianship is not a separate taxpayer and does not need to file any tax returns. The gift and income tax issues of custodianships are discussed below.

3. Transferors.

The UTMA permits a variety of transferors. As will be discussed below, the duration of the custodianship is dictated by the identity of the transferor. For this reason, it is critical to identify the transferor when analyzing a custodianship.

In the most simple form of transfer, the donor makes a gift by using the appropriate form of custodial designation.²¹ A personal representative or trustee may act as the transferor as authorized in the governing will or trust.²² Where the relevant will or trust does not authorize a custodial transfer, the personal representative may nevertheless transfer property for a minor to a custodian where (i) the personal representative or trustee considers it to be in the minor's best interest, (ii) the transfer is not prohibited or inconsistent with the governing instrument, and (iii) the court approves the transfer if the property is worth more than thirty thousand dollars.²³ The Act also permits debtors of a minor to create a custodianship.²⁴

4. Property.

One the major advances of the UTMA over its predecessor, the Uniform Gifts to Minors Act ("UGMA"), is that it allows many more types of property to be transferred to a custodian. The terms of the UGMA generally limited custodial property to money, insurance and annuity contracts, and securities.²⁵

Under the UTMA, virtually any form of property may be transferred to a custodian.²⁶

For example, it is now possible to transfer real estate and partnership interests to custodianships.²⁷ Even prior to the adoption of the UTMA, Washington allowed gifts of real property under its version of the UGMA.²⁸ Each category of property comes with specific requirements that must be followed in order to create a valid custodianship.

B. Effect of Creation.

1. Rights of Parties.

Several significant things happen as a result of a valid transfer under the Act. The first two relate to the ownership of custodial property. First, a valid transfer is irrevocable once made.²⁹ Second, title to the custodial property indefeasibly vests in the minor at the time of the transfer.³⁰

The next two relate to the rights granted to the custodianship's parties. A valid transfer incorporates within it all of the Act's

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provisions.³¹ As a result, the custodian has all of the rights, powers, duties, and authority contained in the Act and the minor has only those rights, powers, duties, or authority specifically granted in the Act.³² Accordingly, the minor's rights with respect to custodial property are subject to the custodian's rights.³³

2. Single Custodianship.

a) Rules & Effect.

Under the Act, a transfer can be made only for one minor and only one person can be the custodian.³⁴ All custodial property held under the Act by the same custodian for the benefit of the same minor is treated as a single custodianship. Some jurisdictions do allow more than one custodian.³⁵

Although this provision seems fairly innocuous, the UTMA attaches to it great significance. While the UTMA provides that this section clarifies the ability of later transferors to transfer property to an existing custodianship without creating a new custodianship, it more significantly provides that the single custodianship rule only applies to transfers under the "Act."³⁶ Transfers for the benefit of the same minor to the same custodian made under another state's version on the UTMA or under the UGMA must be treated as separate custodianships.³⁷ This is because the terms of each custodianship are likely to be different.³⁸

Washington's version of the UTMA provides that it applies to transfers made before its effective date, except where this would impair vested rights or extend the duration of a pre-existing custodianship.³⁹ *RCW 11.114.220(2)*. This provision tracks the UTMA, which states that pre-existing custodianships will continue to terminate as provided under the UGMA.⁴⁰

Perhaps more significantly, the Act "validates" transfers made before its effective date that would not have been permissible under the UGMA.⁴¹

b) Example of Effect on Existing Custodianships.

Grandparent dies in Seattle in 1989. Grandparent's will contains a specific bequest of stock to a grandchild who is then three years old. The will does not direct the personal representative to place the bequest in a custodianship. The personal representative nevertheless transfers the stock to the grandchild's parents as custodians under the UGMA when the estate closes in 1990.

Washington enacts the UTMA a year after the estate closes. The Act validates the transfer notwithstanding the fact that it was not allowed under the UGMA.⁴²

When does the custodianship terminate? If it was validly created under the UGMA, the answer is when the grandchild turns twenty-one in 2007.⁴³ But, if the transfer was not valid under the UGMA, but was validated in 1991 and subject to the UTMA rules, the answer is when the grandchild turns eighteen in 2004.⁴⁴ The open question is whether validating an otherwise invalid custodianship impairs any "constitutionally vested" right the

minor might have to demand outright possession of the stock following an invalid attempt to create a custodianship.⁴⁵

III. Operation.

A. The Custodian.

The custodian is directed to take control of custodial property as soon as it is made available, followed by taking any appropriate steps to register or record title to the property.⁴⁶ Once these initial steps are complete, the custodian is directed to manage and invest custodial property subject to the same standards applicable to other fiduciaries.⁴⁷ This includes the requirement that a custodian with special skills or expertise is required to use those skills or expertise.⁴⁸ The Act requires the custodian to keep records of all transactions and to make them available on request of the minor (if over 18), the minor's parent or legal representative.⁴⁹

1. Investment of Custodial Property.

a) Generally.

The Act refers specifically to Chapter 11.100 RCW (Investment of Trust Funds) as the applicable investment standard, but lists several exceptions.⁵⁰ The most notable of these is that a custodian is not required to give notice of significant non-routine transactions.⁵¹ There is no requirement to diversify with respect to property received from the transferor.⁵²

Washington uses a "total asset management" approach under its prudent investor rule.⁵³ This requires a fiduciary to consider the following non-exclusive list of factors when evaluating an investment or investment strategy: (i) probable income and safety of capital, (ii) marketability, (iii) general economic conditions, (iv) the investment's term, (v) the custodianship's duration and liquidity needs, (vi) the minor's requirements, (vii) the minor's other assets and earning capacity, and (viii) any resulting increased or decreased tax liability.⁵⁴

Washington departed from the UTMA by referring to its own investment standard. The UTMA uses the "prudent person" rule contained in the Uniform Probate Code to take advantage of an existing body of case law.⁵⁵ Specifically, the UTMA directs the custodian to "observe the standard of care that would be observed by a prudent person dealing with property of another and is not limited by any other statute restricting investments by fiduciaries."⁵⁶ The Comment to the UTMA contends that its use of the phrase "of another" imposes a stricter investment standard than the UGMA.⁵⁷

Like Washington's current prudent investor rule, the UGMA previously directed custodians to use the same discretion in making investments as one would use when dealing with one's own property.⁵⁸ This standard mirrored the common law rule.⁵⁹ The current Restatement position is that investments are considered based on the trust's total return.⁶⁰

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However, unlike the current Restatement, Washington courts construing the prudent investor rule have held that the issue is not total return, but how well the fiduciary has balanced competing interests in the trust.⁶¹ In the custodianship context, the measure might be how well the custodian balances the minor's current and future needs since there is no one else with an interest in the custodianship.

b) Investment in 529 Accounts.

The custodian may consider investing the custodial funds in a "529" or "qualified tuition" account. The 529 plan is designed to provide income tax incentives to saving and spending for college or other higher education expenses. Cash may be transferred to a 529 plan, and the income generated by the plan is not taxed as long as it is withdrawn for higher education expenses. Each state has its own 529 plan although the account owner may invest in any state's plan he chooses. Typically, the account owner does not get to choose the investment portfolio. Each state's plan provides a portfolio based on the age of the beneficiary. The account owner may be able to change the investment structure once per year.

The custodian must analyze the tax implications of the proposed investment. By investing in the 529 plan, the custodian can shift taxable income to future years, and perhaps avoid it altogether if the funds are spent on qualified higher education expenses. The 529 plan will accept only cash, so in the event other assets in the custodial account must be liquidated to create cash, there could be a taxable event which may reduce the tax incentive to invest in the 529 plan.

The custodian would also need to carefully evaluate the 529 plan to ensure it fulfills his fiduciary responsibility to the minor. The custodian would have to be convinced that the investments required by the 529 plan would meet the standards for investment of custodial funds. Assets in a custodial account are not subject to the claims of the creditors of the custodian. It would be critical that the title on the 529 account would be in the name of the custodian as custodian, not as an individual. When the minor reaches the age of majority for the state under which the UTMA account is designated, the minor becomes the owner of the account. The custodian will also need to consider whether it is a breach of custodial duty to tie up the use of the money without tax consequence for a time that may last beyond the period of the custodianship.

Another issue to consider is a parent's obligation for payment of college expenses for the minor. If custodial funds in a 529 plan are used by the parent, as custodian, for higher education expenses, it may constitute a non-qualified withdrawal and be subject to tax and penalties.

Before investing custodial funds in a 529 account, the custodian needs to evaluate the proposed 529 plan (they are not

identical), and the fiduciary and income tax consequences of the investment.

2. Distributions.

The custodian generally has complete discretion over distributions of custodial property. The custodian may make distributions for the "use and benefit" of the minor regardless of (i) the duty or ability of anyone to support the minor and, (ii) regardless of other property or income that the minor has available.⁶² Distributions to the minor are deemed not to affect support obligations that might otherwise be owed to the minor.⁶³ In the trust context, Washington courts have ruled that a minor's funds cannot be used to offset a parent's support obligation.⁶⁴ The tax issues raised by this provision are discussed below.

However, an "interested person" (or the minor if over 18) may petition the court to require the custodian to make distributions.⁶⁵ This section applies not only to the minor's parents, but also a guardian, transferor, public agency with custody of the minor and a creditor of the minor.⁶⁶ The Act contains no spendthrift provisions and creditors may reach custodial property as discussed below.

3. Powers & Duties.

The Act grants the custodian broad powers over custodial property. Not only does the custodian have all the powers of a trustee under RCW § 11.98.070, but also all the rights, powers and authority that unmarried adults have over their own property – provided that the custodian can only exercise these rights and powers in a custodial capacity and cannot avoid liability for a breach of the standard of care discussed above.⁶⁷

With the reference to the trustee statute, the custodian is granted a wide range of powers over the custodial property. Among some of more important of these powers is a custodian's ability to:

- Lend and borrow money.
- Lease custodial property for terms that may extend beyond the duration of the custodianship.
- Insure custodial property.
- Make distributions directly to the minor or to a custodian under the uniform gifts to minors act of any state.
- Mortgage or otherwise encumber custodial property for a term that may extend beyond the duration of the custodianship.
- Manage any business interest received by the custodian without the duty to diversify.
- Use custodial property to establish a new business enterprise – subject to a duty to diversify.⁶⁸

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Custodians are generally not required to work for free. The Act entitles a custodian to reimbursement for reasonable expenses and allows custodians (other than those who made gifts and designated themselves) the option (exercisable annually) to charge compensation for services performed for the custodianship.⁶⁹ The custodian pays a price, however, for the exercise of this option. A custodian who is not compensated for services is not liable to the custodianship for losses it suffers unless caused by bad faith, gross negligence or breach of the applicable investment standard.⁷⁰

The Act allows the custodian a great deal of flexibility when considering exit strategies. Generally, a custodian can resign at any time.⁷¹ The resignation is effective on delivery of written notice and delivery of the custodial property to a successor custodian.⁷²

However, the custodian can also designate a successor who will not take over until a later date.⁷³ The custodian is permitted to designate either a trust company or an adult other than the transferor, who will not become the successor custodian until the serving custodian either resigns, dies, becomes incapacitated or is removed.⁷⁴ A sample form designation is attached as Exhibit "B."

B. The Minor.

Unlike the broad powers the Act grants to custodians, the Act provides minors with only limited rights. Although custodial property belongs to the minor, the minor must go to court to compel distributions if the custodian refuses.⁷⁵ If the minor is dissatisfied with the custodian's performance, the minor may petition the court to remove the custodian for cause.⁷⁶

The minor (if over 18), an adult member of the minor's family, or the transferor, may petition the court to order a custodian to provide an accounting.⁷⁷ As set out above, the minor may not be able to recover for losses revealed in the accounting where the custodian did not charge for custodial services. The Act requires an accounting if a custodian is removed for cause.⁷⁸

C. Third Parties.

Unlike assets held in a spendthrift trust, a minor's creditors may reach custodial property. The Act permits third parties to proceed against the custodial property where a claim is based on (i) a contract entered into by the custodian in a custodial capacity, (ii) an obligation arising from the ownership or control of custodial property, or (iii) a tort committed during the custodianship.⁷⁹

The Act does provide limited relief for the minor. If the claim is one arising from the ownership of custodial property, the minor is not personally liable unless also personally at fault.⁸⁰ For example, if the custodianship owns a building which collapses through no personal fault of the minor, anyone injured would have recourse only against the assets of the custodianship and not

the minor personally.⁸¹ Under the "single custodianship" theory, assets held in one custodianship would probably not be liable for claims based on injury caused by property held in a separate custodianship.

D. Termination.

The termination date for a custodianship varies depending on the type of transfer.⁸² For basic transfers, such as gifts and those authorized by a will or trust, the custodianship terminates when the minor reaches age twenty-one (or twenty-five if extended pursuant to the statute – for custodianships established after July 1, 2007).⁸³ For transfers made by an obligor of the minor or by a personal representative or trustee that are not authorized by a will or trust, the custodianship terminates when the minor reaches age eighteen.⁸⁴ In either event, if the minor dies before reaching the appropriate age, the custodian is required to transfer all custodial property to the minor's estate.⁸⁵ Since only a person over eighteen can make a valid will in Washington, custodial property will pass to a minor's parents by intestate succession.⁸⁶

IV. Tax & Other Issues.

A. Choosing a Custodian.

Many of the tax issues associated with custodianships depend on whether or not the transferor also acts as custodian. To avoid many of these issues, transferors should consider naming someone other than themselves or spouse as custodian.

B. Gift Tax Treatment.

The gift tax applies to the transfer of property by gift.⁸⁷ A gift is complete for gift tax purposes when the donor can no longer control the disposition of the transferred property.⁸⁸ The IRS has ruled that gifts made under the UGMA are completed gifts because title to the gifted property vests irrevocably in the minor at the time of the transfer.⁸⁹ This should apply equally to gifts made under the UTMA.

An annual gift tax exclusion of \$12,000 (indexed for inflation) is available for gifts of a present interest.⁹⁰ Transfers under the UGMA qualify for the annual gift tax exclusion.⁹¹ This is because the UGMA (and now the UTMA) mirror current Code Sec. 2503(c).⁹² Section 2503(c) provides that a gift to a minor will qualify for the annual gift tax exclusion where (i) the property and income thereon may be expended by or for the benefit of the minor before attaining age twenty-one, (ii) any amounts remaining will be distributed to the minor at age **twenty-one**, and (iii) if the minor dies before reaching twenty-one the property will be distributed to the minor's estate or as the minor appoints.

CAUTION: An UTMA gift that extends the termination to age 25, however, will not qualify for the annual exclusion. In this case, the donor would need to file a gift tax return and apply a

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portion of the donor's exemption equivalent amount to the transfer. A client who wants to preserve his or her exemption equivalent amount by qualifying a gift for the annual exclusion should not extend the termination date to age 25.

C. Estate Tax Treatment.

The power that qualifies a custodial transfer for the gift tax annual exclusion also causes custodial property to be included in the donor's estate if the donor dies while acting as custodian. This is because the IRS has ruled that a custodian's power to distribute or accumulate income for the minor's benefit is a retained Code Sec. 2038 power to affect beneficial enjoyment. *Rev. Rul. 59-357*. This rule applies to any power to affect the time or manner of enjoyment of the transferred property – even though the identity of the beneficiary is not affected. *Treas. Reg. § 20.2038-1(a)*.

A similar issue is presented if the donor designates his or her spouse as the custodian. If the spouse can use custodial property to satisfy the decedent's support obligations with respect to the minor, the spouse will be treated as having a general power of appointment.⁹³ The spouse can escape inclusion by resigning as custodian and surviving three years.⁹⁴ Washington law prohibits the use of a minor's own property to meet a parent's support obligation unless the parents are otherwise not able to support the minor.⁹⁵ This should shield a spouse residing in Washington from the risk of having custodial powers treated as a general power of appointment.

D. Generation Skipping Transfer Tax.

Custodial transfers raise many generation skipping transfer tax ("GSTT") issues. Although a complete discussion of the GSTT is well beyond the scope of this article, the practitioner should consider how a planned transfer will be treated for GSTT purposes. The GSTT has an annual exclusion similar to the gift tax annual exclusion.⁹⁶ A custodial transfer qualifies for the GSTT annual exclusion because it is treated as a nontaxable gift and it meets the GSTT trust rules.⁹⁷ If the grandparent always limits transfers to within the annual exclusion, they will be exempt from GSTT and many of the issues discussed below will be avoided.

The most basic generation skipping transfer is an outright gift to a grandchild. This is termed a "direct skip" because the grandchild is two generations below the grandparent and receives the property outright.⁹⁸ The donor's GSTT exemption is automatically allocated to direct skips at the time of the transfer.⁹⁹ The result is that, to the extent the donor has sufficient exemption available the gift, together with future income and appreciation, will be exempt from the GSTT. As of 2004, the GSTT exemption is tied to the estate tax exemption equivalent amount and is set to increase to \$3,500,000 before the GSTT is repealed in 2009.¹⁰⁰

However, gifts made under the UTMA are not these simple, direct skips. Instead, custodial transfers are treated as gifts to a trust for purpose of the GSTT.¹⁰¹ The general rule is that a transfer to a trust is a direct skip as long as no one other than a skip person has an interest in the trust.¹⁰² This means that the automatic allocation rules apply to UTMA transfers and the resulting custodianship will generally be exempt from the GSTT. However, in cases where the transferor elects to extend the custodianship to age twenty-five, the transfer will likely not qualify for the GSTT annual exclusion because it is not a "nontaxable gift" within the meaning of I.R.C. § 2503(b).¹⁰³

However, a transfer to a custodian will not be treated as a direct skip if the donor also acts as custodian. Where the transferred property would be included in the transferor's estate if the transferor died immediately following the transfer, the timing of the "skip" and allocation of GSTT exemption are delayed.¹⁰⁴ As discussed above, custodial property is potentially includible in a donor's estate under Code Sec. 2038. As a result, there is no generation skipping transfer and no allocation of GSTT exemption, until the donor either dies or ceases to act as custodian.¹⁰⁵ The result is that the value of the transferred property is determined as of the delayed date of the skip.¹⁰⁶

The other surprise in store for the grandparent is that distributions from the custodial account made while the grandparent is still acting as custodian are taxable distributions.¹⁰⁷ The GSTT due on a taxable termination is payable by the transferee – the minor.¹⁰⁸ In order to avoid tax liability, the grandparent would need to file a gift tax return for the year of the distribution and affirmatively allocate enough GSTT exemption to cover the amount of the transfer.¹⁰⁹

E. Income Tax Issues.

A custodianship is not a trust for income tax purposes. Instead, income on custodial property is generally taxable to the minor directly at the minor's tax rates – with the exception of the "kiddie tax" and the grantor trust rules.

1. "Kiddie Tax."

Code Sec. 1(g) taxes a portion of the unearned income of children under age eighteen at their parents' top marginal tax rate. A child's unearned income includes income generated on custodial property, and includes the typical varieties of passive income – interest, dividends, rent, etc.¹¹⁰

Of course, if the custodian invests custodial property in non-income producing assets such as vacant land or stocks that do not pay dividends, there would be no unearned income to tax. The custodian is free to pursue this investment strategy within the limits of Washington's prudent investor rule.¹¹¹ Since the custodian is directed to consider the potential tax liability associated with any particular investment or strategy, investing to minimize taxes

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Custodial Accounts: Knowing What to Use and When to Use It

should be permissible.¹¹² In states adopting a “total return” investment standard, there is no question that investing to maximize capital appreciation over current income is permissible.¹¹³

Nevertheless, parents may be able to realize some tax benefit by transferring income producing property to children under eighteen. The first \$800 of the child’s income is exempt from tax due to the child’s standard deduction.¹¹⁴ The next \$800 of the child’s unearned income is taxed at the child’s tax rate.¹¹⁵ Only unearned income over \$1,600 is taxed at the parents’ top rate.¹¹⁶

2. Grantor Trust Rules & Parental Support Obligations.

If income from custodial property is used to offset a parent’s obligation to support a child, the parent is taxed on that income. The result is the same whether the parent with the support obligation is the custodian or not.¹¹⁷ Regulations clarify what type of support obligation will trigger taxation under these rules:

The term “legal obligation” includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent’s own resources. For example, a parent has a “legal obligation” within the meaning of the preceding sentence to support his minor child if under local law property or income from property owned by the child cannot be used for his support so long as his parent is able to support him.¹¹⁸

Washington cases discussing a parent’s support obligation in the dissolution context hold that a duty of support exists only as long as the child is in fact dependent on the parent for support.¹¹⁹ Unless the dissolution decree specifically provides otherwise, the duty to support a child terminates as a matter of law when the child reaches eighteen or earlier if the child is in fact no longer financially dependent on the parent.¹²⁰ In fact, a child’s “extraordinary income” can reduce a parent’s basic support obligation.¹²¹

Whatever the extent and duration of the support obligation, Washington case law makes clear that a child’s assets may not be used to meet that obligation unless the parents are not financially able to do so.¹²² This qualifies the support obligation as a “legal obligation” within the meaning of the regulations. Even though the Act prohibits use of custodial property to satisfy a parent’s support obligation, the grantor trust rules will tax amount used for this purpose to the parent.

V. Planning for Termination.

Believe it or not, many donors do not want custodianships to terminate when the minor turns twenty-one. There are some methods available to delay an outright distribution – but all must be reviewed in light of the custodian’s fiduciary obligations to the minor. However, if a donor is concerned about termination or

wants to make substantial gifts, a trust is probably the better alternative.

If the minor is cooperative, upon reaching majority (eighteen in Washington) the minor can enter into a binding contract with the custodian directing the custodian to place custodial property into an irrevocable trust when the custodianship terminates. This method is similar to the termination “window” approach that the IRS has approved in the Section 2503(c) Trust context.¹²³ Otherwise the custodian is required to distribute remaining custodial property to the minor upon termination of the custodianship.¹²⁴

Because the custodian is granted the same powers as a trustee, the custodian can, in fact, tie up custodial property beyond the term of the custodianship. This can be done in combination with other classic estate planning vehicles such as the family limited partnership (“FLP”) or limited liability company (“LLC”). These entities can be used either before or after the custodianship has been established.

If the custodianship has been established, the custodian can participate with the minor’s parents in the formation of an LLC. Custodians are specifically empowered to participate in the creation and operation of any business or enterprise.¹²⁵ The custodian would contribute custodial property to the new LLC in exchange for LLC units. The LLC would be manager managed, with the parents acting as managers. Following the termination of the custodianship, the custodian would distribute the LLC units to the minor. The minor would have only those participation and economic rights as contained in the LLC agreement, but would own the units outright - consistent with the Act.

The parents can get more benefit if they first form the LLC and then make gifts of LLC units to the custodianship. In this manner, the parents can take advantage of marketability and other discounts to maximize their gift tax annual exclusions. This strategy is better for another reason as well. The custodian is not under a duty to diversify with respect to property received from a transferor and may continue to hold the property in the form received without liability to the minor.¹²⁶ Recall however, that a custodianship is invalid where the parent transfers partnership or LLC interests to him or herself as custodian.¹²⁷

As discussed above, the custodian can also use custodial property to purchase life insurance on the life of the minor’s parent and may encumber or lease custodial property for terms extending beyond the duration of the custodianship.^{*128} As long as these actions do not interfere with the minor’s right to receive custodial property when the custodianship terminates and can be justified under the prudent investor rule, the custodian can safely undertake them.

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EXHIBIT "A" – TRANSFER UNDER THE WASHINGTON UNIFORM TRANSFERS TO MINORS ACT

I, (name of transferor or name and representative capacity if a fiduciary) hereby transfer to (name of custodian), as custodian for _____ (name of minor) under the Washington uniform transfers to minors act, the following: (insert a description of the custodial property sufficient to identify it).

(Electing the following paragraph is optional to the transferor):

If _____ (name of custodian) is or becomes unable to act or to continue to act as custodian, the alternate or successor custodian shall be the first of the following persons, in order of preference and succession, who is then able and willing to act as custodian: (insert the name(s) of the alternate or successor custodian(s)).

1.
2.
3.

(Electing the following paragraph is optional to the transferor):

I elect to extend the custodianship to the minor's twenty-fifth birthday. I UNDERSTAND THAT ELECTING TO EXTEND CUSTODIANSHIP TO AGE TWENTY-FIVE MAY CAUSE ME TO LOSE MY ANNUAL EXCLUSION FROM FEDERAL GIFT TAX AND THAT I SHOULD CONSULT WITH AN ATTORNEY OR TAX ADVISOR BEFORE MAKING THIS ELECTION.

Dated: _____

(Signature)

_____ (name of custodian) acknowledges receipt of the property described above as custodian for the minor named above under the Washington uniform transfers to minors act.

Dated: _____

(Signature of Custodian)

Footnotes

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| <p>1 Craig R. Aird is a graduate of Seattle University Law School and the University of Washington Law School Graduate Program in Taxation. After spending two years working in Frankfurt, Germany, for KPMG, he was recently returned to Seattle where he is an associate at Amicus Law Group, PC where his practice focuses on estate planning, trust litigation, and working with private foundations and public charities.</p> <p>2 RCW § 11.114.020(1).</p> <p>3 RCW § 11.114.020.</p> <p>4 <i>Id.</i></p> <p>5 <i>Id.</i></p> <p>6 UTMA § 2 comt c.</p> <p>7 <i>Id.</i>; Smith v. Smith, 487 S.E.2d 212, 215 (Va. 1997) (Virginia Act did not apply to transfer where transferor, property, custodian and minor all located in other state at time of transfer).</p> <p>8 UTMA § 2, Actions in Adopting Jurisdictions (Alaska).</p> <p>9 ORS 126.872</p> <p>10 RCW § 11.114.090 [effective July 1, 2007].</p> <p>11 RCW § 11.114.090.</p> <p>12 <i>Id.</i></p> <p>13 RCW § 11.114.090(g).</p> <p>14 RCW § 11.114.110(1)(b).</p> <p>15 RCW § 11.114.030(1).</p> <p>16 <i>Id.</i></p> | <p>17 RCW § 11.114.030(2).</p> <p>18 RCW § 11.114.030(4).</p> <p>19 RCW § 11.114.030(3).</p> <p>20 <i>Id.</i></p> <p>21 RCW § 11.114.040.</p> <p>22 RCW § 11.114.050.</p> <p>23 RCW § 11.114.060(1).</p> <p>24 RCW § 11.114.070.</p> <p>25 <i>See</i>, UGMA § 2(a) (1966).</p> <p>26 UTMA § 9.</p> <p>27 <i>See, e.g.</i>, RCW § 11.114.090(1)(e) (real estate), (1)(g) (residual category).</p> <p>28 <i>See</i> former RCW 11.93.020.</p> <p>29 RCW § 11.114.110(2).</p> <p>30 <i>Id.</i></p> <p>31 RCW § 11.114.110(3).</p> <p>32 RCW § 11.114.110(2).</p> <p>33 Comt. to UTMA § 11.</p> <p>34 RCW § 11.114.100.</p> <p>35 UTMA § 10, Actions in Adopting Jurisdictions (Tennessee allows two custodians).</p> <p>36 Comt. to UTMA § 10.</p> <p>37 <i>Id.</i></p> <p>38 <i>Id.</i></p> <p>39 RCW 11.114.220(2).</p> <p>40 Comt. to UTMA § 22(b); In re Appointment of a</p> | <p>Successor Custodian under N.Y. UGMA for Property of Nadler, 662 N.Y.S.2d 732, 733-34 (1997) (enactment of UTMA could not extend duration of custodianships that would terminate at eighteen under UGMA).</p> <p>41 RCW § 11.114.220(1).</p> <p>42 RCW § 11.114.220(1); Comt. to UTMA § 22(a) (UTMA purports to validate pre-Act transfers from estates and trusts).</p> <p>43 UGMA § 4(d).</p> <p>44 RCW § 11.114.200(2).</p> <p>45 RCW § 11.114.220(2).</p> <p>46 RCW § 11.114.120(1).</p> <p>47 RCW § 11.114.120(2).</p> <p>48 <i>Id.</i></p> <p>49 RCW § 11.114.120(5).</p> <p>50 <i>Id.</i></p> <p>51 <i>See</i> RCW § 11.100.140.</p> <p>52 RCW § 11.114.120(2).</p> <p>53 RCW § 11.100.020(1).</p> <p>54 RCW § 11.100.020(2).</p> <p>55 Comt. to UTMA § 12(b).</p> <p>56 UTMA § 12(b).</p> <p>57 Comt. to UTMA § 12(b).</p> <p>58 Compare UGMA § 4(e) with RCW 11.100.020.</p> <p>59 <i>See</i>. Restatement (Second) Trusts § 174.</p> |
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Notes from the Chair

by: Stephen R. Crossland, Cashmere

Over the past several months, the RPPT Section's Executive Committee has been very active addressing the concerns expressed by many of our members regarding newly adopted Rule 1.15A of the Rules of Professional Conduct ("RPC 1.15A") regarding safeguarding of client property. In particular, RPC 1.15A(e) requires a lawyer to "provide at least annually a written accounting to a client or third person for whom the lawyer is holding property." In Paragraph [5] of the Washington Comments, the term "property" includes "original documents affecting legal rights such as wills or deeds."

An RPPT subcommittee chaired Pamela McClaran has contacted the Washington State Supreme Court and WSBA Board of Governors to express the Section's concern regarding the cost to implement the new rule properly, the impossibility of actually implementing it fully in a reasonable period of time, and whether implementation of the rule will actually provide benefits to clients commensurate with the additional cost.

Members of the subcommittee attended a Board of Governors meeting on January 11, 2007 to propose that the annual accounting requirement apply only to "funds" and not to original documents such as wills or deeds. I am pleased to report that at that meeting the Board of Governors adopted a resolution to ask the Supreme Court to revise the rule as we requested. It is not known at this time when the Supreme Court will consider the Board of Governors' proposal.

Nominations for Executive Committee Membership

Pursuant to the Bylaws of the Real Property, Probate & Trust Section, Thomas M. Culbertson of Lukins & Annis, P.S. (Spokane), a member of the Section's Nominating Committee, is accepting nominations for two positions on the Probate and Trust Council and two positions on the Real Property Council for the 2007-2008 term of the Executive Committee.

Nominations must be received by Thomas M. Culbertson no less than 90 days prior to the Section's June 8, 2007, annual meeting. The nomination must be endorsed by three members of the Section and must state the name and the WSBA number of the nominee and the Council for which he or she is being nominated. The nominee must be a member of the Section. The nomination must contain a brief written statement from the nominee and a summary of his or her qualifications for the position.

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| 60 Restatement (Third) Trusts § 227 comt. e. | 83 <i>Id.</i> | 107 Treas. Reg. § 26.2642-4(b), Ex. 5. |
| 61 <i>See, e.g.</i> , In re Estate of Cooper, 81 Wn. App. 79, 89, 913 P.2d 393 (1993). | 84 <i>Id.</i> | 108 I.R.C. § 2603(a)(1). |
| 62 RCW § 11.114.140(1). | 85 <i>Id.</i> | 109 Treas. Reg. 26.2632-1(c). |
| 63 RCW § 11.114.140(3). | 86 RCW § 11.12.010. | 110 Treas. Reg. § 1.1(i)-1T, Q&A 6, 15. |
| 64 <i>Huff v. Huff</i> , 68 Wn.2d 501, 502, 413 P.2d 818 (1966). | 87 I.R.C. § 2501(a). | 111 RCW § 11.100.020. |
| 65 RCW § 11.114.140(2). | 88 Treas. Reg. § 25.2511-2(b). | 112 <i>Id.</i> |
| 66 Comt. to UTMA Comt. to UTMA § 14(b). | 89 Rev. Rul. 59-357, 1959-2 C.B. 212. | 113 R.3d Trusts § 227. |
| 67 RCW § 11.114.130(1), (2). | 90 I.R.C. § 2503(b). | 114 I.R.C. § 1(g)(4). |
| 68 RCW § 11.98.079. | 91 Rev. Rul. 59-357. | 115 <i>Id.</i> |
| 69 RCW § 11.114.150(1), (2). | 92 <i>Id.</i> | 116 I.R.C. § 1(g)(3). |
| 70 RCW § 11.114.150(2). | 93 Treas. Reg. § 20.2041-1(c)(1). | 117 I.R.C. §§ 677(b), 678(b). |
| 71 RCW § 11.114.180(3). | 94 Treas. Reg. § 20.2041-3(d)(2). | 118 Treas. Reg. § 1.662(a)-4. |
| 72 <i>Id.</i> | 95 In re Guardianship of Ivarsson, 60 Wn.2d 733, 740-41, 375 P.2d 509 (1966). | 119 <i>Childers v. Childers</i> , 89 Wn.2d 592, 597-98, 575 P.2d 201 (1978). |
| 73 RCW § 11.114.180(2). | 96 I.R.C. § 2642(c). | 120 <i>Balch v. Balch</i> , 75 Wn. App. 776, 778-79, 880 P.2d 78 (1994). |
| 74 <i>Id.</i> | 97 I.R.C. § 2642(c)(2). | 121 RCW § 26.19.075(1)(vii). |
| 75 RCW § 11.114.140. | 98 I.R.C. §§ 2612(b), 2613(a)(1). | 122 In re Ivarsson, 60 Wn.2d at 740. |
| 76 RCW § 11.114.180(6). | 99 I.R.C. § 2632(b)(1). | 123 Rev. Rul. 74-43, 1974-1 C.B. 285. |
| 77 RCW § 11.114.190(1). | 100 I.R.C. § 2631(c), as amended by 2001 Act. | 124 RCW § 11.114.200. |
| 78 RCW § 11.114.190(4). | 101 Treas. Reg. § 26.2652-1(b)(2), Ex. 1. | 125 RCW § 11.98.070(22). |
| 79 RCW § 11.114.170(1). | 102 I.R.C. § 2613(a)(2). | 126 RCW § 11.114.120(2). |
| 80 RCW § 11.114.170(3). | 103 I.R.C. § 2642(c)(3). | 127 RCW § 11.114.110(1)(b). |
| 81 Comt. to UTMA § 17. | 104 I.R.C. § 2642(f). | 128 RCW § 11.114.120(3); RCW § 11.98.070(9), (18). |
| 82 RCW § 11.114.200. | 105 Treas. Reg. § 26.2632-1(c). | |
| | 106 I.R.C. § 2642(b). | |

Recent Developments

Real Property

by Scott Osborne – K&L Gates, Seattle, Washington

Van Dinter v. Orr, 157 Wn.2d 329 (2006)

The Supreme Court in *Van Dinter v. Orr*, 157 Wn.2d 329 (2006), considered a buyer's claim for damages against a seller and a title insurance company arising from an undisclosed capital facilities charge for sewer service. The Court found the merits of the claim to be wanting.

In 1999, Spokane County ("County") installed a sewer along East Sprague Avenue. The sewer system was financed by a capital facilities rate that was to be added to the property owner's monthly sewer bill for a period of 20 years. Joseph and Lori Orr owned an unimproved lot on East Sprague that was included within the area affected by the sewer development. The capital facilities rate was computed based upon the volume of water utilized by the improvements constructed on the lot. Until the lot was improved, the capital facilities rate was not imposed.

On January 22, 2003, Orr sold the lot to Van Dinter, who began to develop the property as an automobile dealership. Van Dinter received a warranty deed to the property and a title insurance policy from First American Title Insurance Company ("FATCO"). A lender's policy of title insurance issued to AmercianWest Bank, which financed the purchase. Although the listing information stated that the property had sewer available, there was no disclosure of the capital facilities rate to be imposed on the property and neither the lender's nor the owner's policy of title insurance showed the capital facilities rate as an encumbrance.

When Van Dinter connected to the sewer, the County imposed a \$10,775.50 capital facilities charge based on the estimated volume of water to be used by the development. This amount was to be repaid over 20 years, and the County sent Van Dinter a bill for the monthly payment. When Van Dinter received the bill, he submitted it to FATCO, claiming that the obligation was an undisclosed encumbrance on the property for which the FATCO policy was responsible. FATCO denied the claim. Van Dinter sued FATCO and Orr on March 22, 2004, claiming that FATCO breached its insurance contract and that Orr negligently misrepresented the property and breached the warranties under the warranty deed. Van Dinter asserted a claim against FATCO under both the owner's and lender's policy, since the lender had assigned any claim it had under the lender's policy to Van Dinter.

All parties then moved for summary judgment. The trial court dismissed all of Van Dinter's claims, finding that the capital facilities rate was not an encumbrance and there was no misrepresentation.

Van Dinter appealed to Division III of the Court of Appeals. In an unpublished decision (*Van Dinter v. Orr*, 2005 Wash.App. LEXIS 1887), the Court of Appeals affirmed the holding that the capital facilities rate was not an encumbrance, so the claim for breach under the warranty deed was affirmed. Presumably, this

holding would have disposed of all of the title insurance claims, but the Court of Appeals went on to affirm the dismissal of the assigned claim under the lender's title policy because the lender had not suffered any loss, and the dismissal of the claim under the owner's policy because this claim had not been raised in the complaint, and was raised for the first time on appeal.

The Court of Appeals also held that there was no misrepresentation by Orr as to whether sewer was "available" to the property, but concluded that there was an issue of material fact as to whether the failure by Orr to disclose the existence of the capital facilities rate constituted a negligent misrepresentation. The Court of Appeals relied on Restatement (Second) of Torts, §551 for the proposition that liability can exist if Orr had a duty to disclose, but failed to do so.

Van Dinter appealed, and Orr appealed that portion of the Court of Appeals ruling concerning the negligent misrepresentation claim. The Supreme Court reinstated the trial court's dismissal of all of the claims against Van Dinter and affirmed the dismissal of the title insurance claims.

The capital facilities rate would not constitute an encumbrance on the property unless there had been a failure to pay the charge and the County filed a lien. Since there had been no failure to pay at the time of the sale to Van Dinter and no lien had been filed, there was no encumbrance. This holding resolved the claims against FATCO and also the claim of a breach of the warranties under the warranty deed.

As to the negligent misrepresentation claim, the Court found that Orr had no duty to Van Dinter that had been breached based on the following standard:

The duty to disclose in a business transaction arises if imposed by a fiduciary relationship or other similar relationship of trust or confidence or if necessary to prevent a partial or ambiguous statement of fact from being misleading. [citation omitted] ... the duty arises when the facts are peculiarly within the knowledge of one person and could not be readily obtained by the other; or where, by lack of business experience of one of the parties, the other takes advantage of the situation by remaining silent. *Id.* p. 334.

Because Van Dinter knew that the sewer had been installed, and could have readily determined the charge to be paid upon development of the property by asking the County, there was no special relationship created with Orr. In the absence of a duty to disclose, there could be no claim arising from a failure to disclose.

This case is consistent with other recent decisions that have refused to impose liability for claimed breaches of warranties

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arising from conditions that were reasonably discoverable by the buyer of the property. See for example *Warner v. Design & Build Homes*, 128 Wn.App. 34 (2005) [cracks in exterior stucco], *Hoel v. Rose*, 125 Wn.App. 14 (2005) [area of property], and *Denaxas v. Sandstone Court*, 148 Wn.2d 654 (2003) [area of property]. While this position is far removed from *caveat emptor*, it does recognize the responsibility of contracting parties not to proceed in willful ignorance; a pure heart and empty head may be suitable for a holder in due course, but can be fatal to a purchaser of real estate.

Heg v. Alldredge, 157 Wn.2d 154 (2006)

In *Heg v. Alldredge*, 157 Wn.2d 154 (2006), the Court considered the minimum evidence needed to establish a claim for abandonment of an easement. Some evidence more than mere non-use of a recorded easement was required to withstand a motion for summary judgment.

Pope & Talbot owned property on Whidbey Island abutting Admiralty Inlet. The property was originally heavily wooded and was located between Admiralty Inlet on the west, Smugglers Cove Road on the east and Whidbey Island State Park on the south. In the 1940s, the property had been divided into several lettered tracts, A through I. Tracts A, B, C and D were larger parcels that together formed a generally rectangular piece of property, with tracts A and C abutting Smugglers Cove Road and tracts B and D being waterfront lots immediately to the west of tracts A and C. Tracts E through I were smaller waterfront lots to the south of tract D.

In 1957, Pope & Talbot granted a road easement by the creation of two other tracts, tracts 1 and 2. The easement proceeded westerly along the southern border of Tract C to the easterly border of the smaller waterfront tracts, and then proceeded generally north along the border of tracts C and D to the corner where tracts A, B, C and D all joined. The road easement was a 60-foot wide tract as it bisected tracts C and D and a 40-foot wide tract along the southern boundary of tract C.

The easement provided in part:

This easement shall be for ingress, egress, access and road purposes.

This easement shall vest in each owner of property which abuts upon the tracts of land hereinabove described and this easement shall be an easement running with the land both as to burden and benefit as to each such abutting tract.

By the time the road easement had been granted, tracts A and B, comprising approximately 22 acres, had been sold and a private road over tract A had been established, which provided access from Smugglers Cove Road to the waterfront tract B. In 1967, the owner of tracts A and B placed a road cut abutting the dead end portion of the road easement on tract 1, which created

a 4- to 6-foot barrier between the road easement and tracts A and B.

Pope & Talbot sold the remaining tracts to various purchasers, although Pope and Talbot retained the ownership of the easement parcels, tracts 1 and 2. The 40-foot easement connecting Smugglers Cove Road to the waterfront tracts (tract 2) was improved and was known as Smugglers Lagoon Lane. The 60-foot easement bisecting tracts C and D (which was tract 1) was never improved. In 1989, Alldredge purchased tracts C and D and Pope & Talbot quit claimed to Alldredge that portion of tract 1 (the road easement) that bisected the tracts.

In 1993, Heg purchased tracts A and B. The warranty deed to Heg conveyed the property together with the easement granted by Pope and Talbot. Two boundary line adjustments affecting the property were then completed. One increased the size of tract B at the expense of tract A. The other swapped roughly equal sized parcels between tracts B and D. None of these transactions, however, involved the easement.

Over the years, Alldredge had improved tracts C and D, which together comprised approximately 11 acres. The two parcels were treated as a single tract. The easement area was incorporated into the landscaping of the property. Alldredge was an attorney in California, and was planning on living at the property after retirement.

Relations between Heg and Alldredge apparently deteriorated, and in 2001, Heg filed a complaint to quiet title in the easement and requesting that all improvements be removed from the easement. Alldredge asserted six affirmative defenses: (i) failure to name other parties that were benefited by the easement; (ii) abandonment of the easement by Heg's predecessor's in interest; (iii) the easement was not intended to benefit the Heg tracts; (iv) adverse possession, statute of limitations, and laches; (v) unclean hands; and (vi) misrepresentation by Heg as to the intent to utilize the easement. In 2002, Heg moved for summary judgment, which the trial court granted. The trial court found the easement to be appurtenant to tracts A and B; Heg was not estopped from using the easement; there was no abandonment of the easement simply by non-use; and the balancing of equities asserted by Alldredge only related to specific uses that might be imposed on the easement, as opposed to whether the easement actually existed.

Alldredge appealed, and in *Heg v. Alldredge*, 124 Wn.App. 297 (2004), the Court of Appeals reversed the summary judgment. The Court of Appeals held in a 2 – 1 decision, that a long period of non-use, coupled with an alternative means of ingress and egress, could be interpreted by a trier of fact as an abandonment of the easement. The dissent asserted that the majority allowed the easement to be extinguished merely because Heg had an alternative means of ingress and egress, which was not a proper basis for termination of an easement right.

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Recent Developments: Real Property

The Supreme Court reinstated the holding of the trial court. The Court noted that

Extinguishing an easement through abandonment requires more than mere nonuse – the nonuse “must be accompanied with the express or implied intention of abandonment.” [citations omitted] ... Acts evidencing abandonment of an easement must be unequivocal and decisive and inconsistent with the continued existence of the easement. *Id.* at p. 161.

The Court noted that the evidence supporting the finding of an intent to abandon the easement consisted solely of non-use, the installation of the road cut and the existence of an alternative means of access through tract A to Smugglers Cove Road. The Court distinguished the rulings relied upon by the Court of Appeals, noting that these cases all dealt with the physical location of a means of ingress and egress to a location different from that stated in the easement. Those cases, and the legal theory supporting those rulings, were not applicable to Heg, since the alternative source of ingress and egress over tract A existed prior to, and totally independent of, the creation of the contested easement.

Similarly, *Northern Pacific Railway v. Tacoma Junk Co.*, 128 Wash. 1 (1926), the case relied upon to find that the installation of the road cut supported a finding of abandonment, was distinguishable. The easement in *Northern Pacific* provided that cessation of use and removal of the railway tracks were recited in the easement itself as constituting abandonment. In the Heg easement, there was no similar provision, and since the easement had never been used, it was impossible to say that the installation of the road cut constituted a cessation of use.

Finally, the Court rejected the collateral estoppel argument. The facts recited in the Court of Appeals’ decision go into much greater detail as to the dealings between the neighbors on a variety of issues that proved to be contentious. The facts emphasized the conversations between Heg and Alldredge relating to the boundary line adjustment that was completed. These facts, as recited by the Court of Appeals, imply that Heg had more or less induced the completion of the swap of parcels with the suggestion that the easement would be relinquished. The Supreme Court had a different view of the facts and specifically rejected the proposition that the acts of Heg’s predecessors in interest could estop the current enforcement of the easement rights. As far as the Court was concerned, the record simply did not contain any evidence of acts by Heg inconsistent with the claim that the easement continued to exist.

As indicated above, the Court of Appeals provided a more detailed rendition of the dealings between Alldredge and Heg leading up to the lawsuit. The Court of Appeals also included a diagram of the easement area, which was very helpful in understanding the location of the easement and the impact on the

various properties. If the easement continued to exist, Heg retained much greater flexibility in providing access to tract B and portions of tract A, which would facilitate the further subdivision of tract A. On the other hand, the existence of the easement more or less cut the Alldredge property in half and prevented the enjoyment of the property as a single parcel. Overall, however, the Court of Appeals opinion indicated a greater willingness of the Supreme Court to allow the interpersonal relationship of the parties to affect the enforcement of the recorded easement.

This decision reinforces the holdings in *Crisp v. Vanlaeken*, 130 Wn.App. 320 (2005) – a Division II Court of Appeals decision – and *MacMeekin v. Low Income Housing Institute*, 111 Wn.App. 188 (2002) – a Division I Court of Appeals decision – that rejected the attempt to adopt the rule recited in RESTATEMENT (THIRD) OF PROPERTY (SERVITUDES) §4.8(3) (2000) in the context of relocating (as opposed to extinguishing) easements:

Washington appellate courts have not adopted the approach of *Restatement (Third) of Property (Servitudes)* (2000) under which an easement generally may be relocated by the owner of the servient estate, regardless of how the easement was acquired, so long as the relocation will not significantly lessen the utility of the easement, increase the burdens on the owner of the easement in its use and enjoyment, or frustrate the purpose for which the easement was created. We decline to adopt the *Restatement (Third)* approach, and adhere to the traditional rule that easements may not be relocated absent mutual consent of the owners of the dominant and servient estates, regardless of how the easement was created. *MacMeekin, supra*, at p. 190.

Neither *MacMeekin* nor *Vanlaeken* were cited by Division I in its *Heg* opinion, presumably on the theory that, as observed by Ralph Waldo Emerson “a foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines” that interferes with a result-oriented thought process.

Article Ideas?

Please contact Ryan Rein if you are interested in writing an article for the newsletter or if you have ideas for article topics. Ryan’s phone number is 206-389-1610 and his email is rrein@riddellwilliams.com.

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