UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	:	
Plaintiff,	:	
v.	:	**10 Civ. 457 (GLS/DRH)**
McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC, McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, FIRST INDEPENDENT INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, TIMOTHY M. MCGINN, DAVID L. SMITH, LYNN A. SMITH, DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY MCGINN,	:	
Defendants,	:	
LYNN A. SMITH, and NANCY MCGINN,	:	
Relief Defendants, and	:	
DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,	:	
Intervenor.	:	

NOTICE OF MOTION

PLEASE TAKE NOTICE that upon the Court's Memorandum-Decision and Order filed November 22, 2010 (Docket #194), which allowed Plaintiff leave to move for sanctions without the necessity of a pre-motion conference; the Memorandum of Law in support of Plaintiff's Motion for Sanctions dated January 31, 2011; and the Declaration of Lara Shalov Mehraban dated January 31, 2011, and the accompanying exhibits; and upon all prior proceedings and

filings herein, Plaintiff Securities and Exchange Commission will move, on Thursday, March 17, 2011, at 9:30 a.m., or at any other date convenient to the Court, before the Honorable David R. Homer, United States Magistrate Judge, United States District Court, Northern District of New York, 445 Broadway, Albany, NY, for an order that: (1) Lynn Smith, Jill Dunn, Thomas Urbelis and David Wojeski are jointly and severally liable for payment of the SEC's attorney fees and costs of $164,000 reasonably incurred in responding to the bad faith conduct; (2) all funds transferred from the Trust account between July 7, 2010 and August 3, 2010, should be returned within 14 business days to the Court registry or to the Trust account; (3) an evidentiary hearing be held to hear evidence regarding the conduct of James Featherstonhaugh, and the crime-fraud exception to the attorney-client privilege apply so the testimony can be heard regarding communications between Lynn Smith and James Featherstonhaugh, and Jill Dunn and David Wojeski; and (4) such other and further relief as the Court deems appropriate; and

PLEASE TAKE FURTHER NOTICE that pursuant to Local Rule 7.1(b)(2), opposition papers must be filed and served not less than seventeen days prior to the return date.

Dated: New York, NY
January 31, 2011

Respectfully submitted,

s/ David Stoelting
Attorney Bar Number: 516163
Attorney for Plaintiff
Securities and Exchange Commission
3 World Financial Center, Room 400
New York, NY 10281
Telephone: (212) 336-0174
Fax: (212) 336-1324
E-mail: stoeltingd@sec.gov

Of Counsel:

Kevin McGrath
Lara Shalov Mehraban
Haimavathi V. Marlier

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MEMORANDUM OF LAW IN SUPPORT OF
PLAINTIFF'S MOTION FOR SANCTIONS

Dated: January 31, 2011

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Pursuant to the order of November 22, 2010, in which the Court, *sua sponte*, granted plaintiff leave to move for sanctions, the Securities and Exchange Commission respectfully submits this memorandum of law in support of its motion for sanctions against Lynn Smith, David Wojeski, Jill Dunn, and Thomas Urbelis, and to conduct an evidentiary hearing regarding the conduct of James Featherstonhaugh.[1]

PRELIMINARY STATEMENT

To persuade the Court to unfreeze $3.5 million, L. Smith, Wojeski, Dunn, Urbelis and others misrepresented the nature and purpose of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04 (the "Trust"). The lawyers, parties and witnesses with an interest in the Trust portrayed it as a simple family trust, and concealed a private annuity agreement requiring the Trust to pay the Smiths millions of dollars (the "Annuity Agreement"). Beginning with the Trust's appearance in late May 2010, and continuing through November 2010, persons associated with the Trust submitted numerous false affidavits and declarations, and gave false testimony in depositions and hearings.

The scheme almost worked. During the three-day preliminary injunction hearing in June 2010, witness after witness falsely testified that the Trust was nothing more than a simple family trust created by thoughtful parents for the benefit of their children. No witness or lawyer disclosed the highly material fact that the stock that funded the Trust was sold, not donated, to the Trust, and that the Trust was obligated under the Annuity Agreement to pay back the Smiths most, if not all, of the Trust's assets. Those associated with the Trust had a clear financial motive in misrepresenting the nature of the Trust. In the weeks after the Court released the Trust

[1] The Court has issued three Memorandum-Decision and Orders dealing with the Trust and related issues: on July 7, 2010, Dkt. 86 ("MDO I"); on November 22, 2010, Dkt. 194 ("MDO II"); and on January 11, 2011, Dkt. 254 ("MDO III").

from the asset freeze, nearly $1 million in Trust money was parceled out among L. Smith, Featherstonhaugh, Dunn, Wojeski and others.

The record before the Court supports the imposition of sanctions on Dunn, L. Smith, Wojeski, and Urbelis. Accordingly, plaintiff requests that the Court order:

(1) that Wojeski, Urbelis, Dunn and L. Smith be held jointly and severally liable for payment of plaintiff's attorney fees and costs incurred in connection with its motion for reconsideration, which are reasonably estimated at $164,000, and that these funds be paid to the Court Registry for the benefit of the victims;

(2) that all funds transferred from the Trust account between July 7, 2010, and August 3, 2010, be returned to the Trust account or the Court registry fund within fourteen business days, and remain frozen pursuant to the Court's preliminary injunction order;

(3) that an evidentiary hearing be held to hear testimony regarding the scheme, and to determine whether there is sufficient evidence to warrant sanctions on Featherstonhaugh, who filed false and misleading documents on behalf of L. Smith. At this hearing, and in connection with any document discovery beforehand, the attorney-client privilege should not apply to protect communications between L. Smith and Featherstonhaugh, and between Dunn and Wojeski. As shown below, L. Smith committed a fraud on the Court and her communications with Featherstonhaugh were in furtherance of that fraud; similarly, Dunn's communications with Wojeski were in furtherance of the fraud. Accordingly, the crime-fraud exception to the attorney-client privilege vitiates the privilege and should apply to the testimony at such a hearing and to document discovery prior to the hearing; and

(4) such other and further relief as the Court deems appropriate.

THE COURT'S FINDINGS WARRANTING SANCTIONS

The Court's previous decisions set forth the conduct warranting sanctions. *See* MDO I, II, and III. The principal findings are listed below:

1. "[T]he conduct of those associated with the Trust - principally Urbelis and Lynn Smith - in failing to disclose the Annuity Agreement satisfies the requirements for fraud, misrepresentation, and misconduct. Their failure to disclose the agreement was exacerbated by their statements and testimony that the Trust was created solely to benefit the Smiths' children without disclosing the additional fact that the Trust was also created to pay a substantial annuity in the future to David and Lynn Smith." MDO II, at 20 n.17.

2. "[T]hose associated with [the Annuity Agreement] acted fraudulently to conceal its existence." MDO III, at 2.

3. "[T]he Annuity Agreement had been withheld from the SEC by those associated with the Trust through fraud, concealment and misrepresentation." MDO III, at 4.

4. "Lynn Smith's assertion that she simply forgot the agreement that was to pay her and her husband nearly $500,000 annually in their later years is rejected as incredible." MDO II, at 20 n.17.

5. During discovery and during the preliminary injunction hearing, Lynn Smith "failed to disclose the existence of the Annuity Agreement despite numerous questions for which disclosure was reasonably have been required." MDO II, at 6-7.

6. "[O]n the issue of the Smiths' interest in the Trust, the Annuity Agreement constituted the proverbial 'smoking gun.' The Trust's recognition of this truth is demonstrated by the lengths to which those associated with them and the Trust went to conceal the existence of the Annuity Agreement in the face of legal, ethical, and professional obligations to the contrary." MDO III, at 6.

7. "Urbelis failed to disclose the existence of the Annuity Agreement during the deposition despite being asked questions and giving answers which reasonably should have elicited such disclosure." MDO II, at 7.

8. "Lynn Smith failed to disclose the Annuity Agreement in response to a document demand and when giving testimony under oath on two separate occasions." MDO II, at 7.

9. "Prior to the July 7, 2010 decision, Urbelis also failed to disclose the Annuity Agreement even though served with a subpoena which required him to produce that agreement and even though he testified at a deposition during which he was asked questions which should have elicited disclosure of the Annuity Agreement." MDO II, at 7-8.

10. "[T]he SEC asked questions of the only individuals with actual knowledge of the Annuity Agreement which should have led to its disclosure." MDO II, at 8.

11. "Dunn's testimony and assertions regarding the telephone conversation and discovery of the Annuity Agreement have been inconsistent and contradictory." MDO II, at 10.

12. "The timing, sequence, and character of these events undermine the credibility of Dunn's assertions." MDO II, at 11.

13. "Dunn thus possesses a financial interest in avoiding an order restraining the Trust's assets which might require return of legal fees already paid or prevent payment of legal fees in the future." MDO II, at 13.

14. The Trust engaged in "wrongful conduct in failing to disclose the agreement prior to July 7, 2010." MDO II, at 18.

15. "Wojeski, as successor Trustee to Urbelis, had a fiduciary duty of at least ordinary care to the Trust and its beneficiaries to identify any obligation of the Trust, such as the Annuity Agreement." MDO II, at 19.

FACTS WARRANTING SANCTIONS

Lynn Smith

L. Smith submitted three false documents in May 2010 – a statement of assets and two affidavits. Dkt. 19, 23, 34. She also testified falsely during her deposition and in the preliminary injunction hearing. In these filings, and in her deposition and hearing testimony, L. Smith did not disclose the Annuity Agreement; nor did she disclose her right, together with her husband, to receive $489,932.00 annually, or almost $10 million in total, in annuity payments from the Trust. Dkt. 19. As the donor of the Trust and a party to the Annuity Agreement, L. Smith knew that her written statements and testimony were false.

Thomas Urbelis

Urbelis, an attorney and a longstanding friend of David and L. Smith, was the trustee for the Trust from its creation in August 2004 until his resignation in May 2010. As a party to the Annuity Agreement and as Trustee, Urbelis knew that the Trust was required to pay millions of

dollars to the Smiths beginning in 2015, and that the Charter One stock was sold to the Trust, not donated. On May 28, 2010, the SEC served a document and deposition subpoena on Urbelis (Dkt. 103, Exh.5) requesting, among other things, "[a]ll documents concerning the Trust," and "[a]ll documents concerning your duties and responsibilities as Trustee of the Trust." Urbelis had the Annuity Agreement in his possession, but failed to produce a copy before the Court's July 7, 2010, decision.

During his deposition on June 1, 2010, Urbelis failed to disclose the existence of the Annuity Agreement, or the fact that Lynn and David Smith had a right to collect millions of dollars from the Trust. Urbelis also failed to disclose the fact that one of his responsibilities as trustee was to ensure that there were sufficient assets in the Trust to enable it to fulfill its obligation to make millions of dollars of payments to David and Lynn Smith beginning in 2015 and continuing until their deaths. Dkt. 46-1, Exh. 11 (Urbelis depo.).

Shortly after his deposition, Urbelis told an SEC attorney that he had produced all documents related to the Trust, even though he had not yet produced the Annuity Agreement. *See* Dkt. 142-1, at ¶ 5 (Decl. of Lara Shalov Mehraban, dated Sept. 14, 2010).

Urbelis produced the Annuity Agreement only after the SEC learned from Dunn of its existence and specifically requested its production from Urbelis.

Jill Dunn

Dunn knew that the Trust was a "private annuity trust" rather than a typical irrevocable trust even before filing her appearance on May 26, 2010. Transcript of evidentiary hearing held Nov. 16, 2010 ("Hrg. Tr.") at 60, 61, Decl. of Lara Shalov Mehraban dated Jan. 31, 2011 ("Mehraban Decl."), Exh. A. Dunn testified that she knew that the Trust was a "private annuity

trust" since late April or early May 2010, and that "[t]he first time I heard the trust mentioned, it was characterized as a private annuity trust." *Id.*

Dunn, who had access to the three parties to the Annuity Agreement, also understood the significance of the private annuity trust. She knew that, with regard to the $4.5 million that the Smiths transferred to the Trust in September 2004, that "there was no capital gains realized and no gift tax required because it was a private annuity trust." Hrg. Tr. at 59. Dunn did research on private annuity trusts, spoke with two accountants and reviewed the website of the National Association of Private Annuity Trusts. Hrg. Tr. 59, 63-64. *See* Decl. of Jill A. Dunn, dated Sept. 3, 2010, Dkt. 134 at ¶ 26. Dunn also spoke with L. Smith and Urbelis, who were parties to the Annuity Agreement. *See* Declaration of Jill A. Dunn, dated May 26, 2010, Dkt. 33 at ¶1. Further, Dunn knew that the Declaration of Trust did not create a private annuity and she admitted that there "had to be some other form or document" that created the private annuity. Hrg. Tr. at 63.

Despite this knowledge, Dunn filed a memorandum of law in support of the Trust's motion to intervene stating that the Trust was "created specifically to pass assets from Mrs. Smith to her children during her lifetime, in much the same way her father passed assets to her upon his death." Dkt. 35, at 5-6. Dunn also submitted declarations from Wojeski and L. Smith in support of the intervention that she knew were false, or recklessly disregarded their falsity.

During the preliminary injunction hearing, Dunn elicited testimony from Wojeski, L. Smith, Geoffrey Smith and John D'Aleo that was tailored to conceal the truth. Each witness used the purposefully ambiguous term "transfer" to describe the Trust's purchase of stock from the Smiths, and the "transfer" was never described as a purchase and sale. Instead, each witness

uniformly testified that the Trust's purpose was to benefit the Smith's children, implying that the "transfer" was a gift, not a sale.

In her closing statement, Dunn continued to portray the Trust as a standard trust and stated that when the Trust was created L. Smith "relinquished all title, ownership, control, beneficial, equitable, actual, or legal any interest whatsoever in that stock was gone from her hands the moment she transferred it." PI Tr. at 625.

David Wojeski

In his declaration filed May 26, 2010, Wojeski, a certified public accountant with over 20 years of experience (PI Tr. at 546), described the Trust as "a textbook example of an irrevocable trust." Wojeski Decl. dated May 26, 2010, ¶ 3 (Dkt. 32). Wojeski also stated without reservation that David and L. Smith "have no interest, whether present, future or reversionary, in the trust, its income or its assets." Wojeski Decl. dated May 26, 2010, ¶ 5 (Dkt. 32).

Wojeski, however, knew or acted in reckless disregard that these statements were false. Wojeski reviewed carefully the Trust's 2004 to 2008 tax returns and the Declaration of Trust, and spoke with Dunn and D'Aleo about the Trust. Wojeski Decl. dated May 26, 2010, ¶ 3 (Dkt. 32). In addition, two weeks before the preliminary injunction hearing, Wojeski met in Dunn's office with both D. Smith and D'Aleo. PI Tr. at 566-67. As discussed below, D'Aleo performed a detailed analysis of every transaction involving the Trust. He concluded that the Trust had properly paid all its taxes, a conclusion that could not be reached without knowledge that the Charter One stock had been sold to the Trust in return for the annuity payments, thereby avoiding capital gains taxes for the Trust and gift taxes for the Smiths. Wojeski, even before agreeing to be the Trustee, met with D'Aleo and reviewed a "roll forward" D'Aleo had prepared, which included an analysis of what "went into the trust to fund it, which was the bank stock[,]"

and Wojeski further understood that D'Aleo had "accounted for all of that in/out activity," and D'Aleo "walked me through what he did." PI Tr. at 549-51. Wojeski testified that "I did look at the trust tax returns, I did look at the tax liabilities that were paid, and I did tie them back to his roll forward." PI Tr. at 552. Based on this analysis, Wojeski testified that "the taxes had been paid . . . I was fine with it from that standpoint." PI Tr. at 555.

Wojeski, therefore, knew or recklessly disregarded that the Charter One stock was sold to the Trust and not donated, and that the Trust was contractually obligated to pay most or all of its assets back to the Smiths. Despite this knowledge, Wojeski persisted in portraying the Trust as nothing more than a standard irrevocable trust, and he failed to disclose the Trust's contractual obligation to pay essentially all of its assets back to the Smiths.

Wojeski testified, in response to questions posed by Dunn, that the Trust was a simple irrevocable trust, and he described the transfer of stock to the Trust as a gift rather than as a purchase and sale:

> **Q. And when you reviewed that trust declaration, did you come to any conclusions as to whether there was anything usual or unusual about this trust declaration?**
> A. No, not really. I don't really know what the necessary purpose was. It could have been for wealth transfer. It could have been for estate planning issues. It could have been to – you know, it's pretty broad, meaning that *the same thing could have been accomplished with an outright gift to the two children*, but the two children could have squandered the money. So that's pretty typical of why you would set it up that way. (PI Tr. 550-551) (emphasis added).

Wojeski also provided the following false and misleading response on cross examination when he was asked whether he would transfer funds to Geoffrey Smith if asked for funds:

> [F]rom the donor's intent, *they essentially have made a gift to their children*.... The main reason it's probably outside – out in a trust is so that the kids don't take it and blow it on something. So they at

> least have some control from a trustee's standpoint who at least can put the brakes on it and say Jeff [sic], I don't think it's a great idea to put a million dollars into a typewriter business, you know, or something to that extent. So I think there's some discretion over it. *But it is really the kids' money.*" (PI Tr. 561-62) (emphases added)

The Accounting Expert Retained by Dunn and Featherstonhaugh

D'Aleo is an experienced accountant who was retained by both Dunn and Featherstonhaugh to examine the records of the Trust and to give testimony regarding the Trust and other issues. D'Aleo has longstanding ties to Featherstonhaugh. D'Aleo met with L. Smith and Wojeski to discuss the Trust, among other issues. PI Tr. at 423, 566-67.

D'Aleo testified essentially as an expert witness, on behalf of both L. Smith and the Trust. He vouched that the Trust was the simple irrevocable Trust that L. Smith, Dunn and Wojeski said it was, and that the Trust paid all of its taxes. D'Aleo testified that he reviewed all the Trust's tax returns and account statements in detail, and he received an "account transcript" that Wojeski had obtained from the Internal Revenue Service. PI Tr. at 446-447. D'Aleo also testified about the largest financial transaction in the Trust's history – the receipt by the Trust of its one and only asset, the $4.5 million of Charter One stock in September 2004:

> **Q. Mr. D'Aleo, did there come a time that an issue came up during -- following your preparation of the asset inventory for Lynn Smith that you were questioned as to why you did not include within that asset inventory an NFS stock account held under the name of the David and Lynn Smith irrevocable trust by its trustee Thomas Urbelis?**
> A. Yes.
> **Q. And was there a reason that you -- reason you didn't include that stock account inventory of assets?**
> A. Well, it was first indicated to me when we inquired that it was an irrevocable trust, and that if it is an irrevocable trust, then the assets were transferred into the trust, that those assets are not owned by David or Lynn Smith but, in fact, are owned by the trust.
> **Q. Okay. Did you review the trust declaration?**
> A. I did. I have seen a copy of it. I can't say I looked at every line of it,

but I have seen the declaration of trust.

Q. Did you reach any conclusions regarding it when you reviewed it?

A. It was a relatively standard trust document. And, accordingly, it would meet the criteria of being a trust. A trust is a separate entity, a legal entity. It's a separate taxpayer. The assets that are put into it are -- is funded, are assets owned by that entity, the trust.
(PI Tr. at 445-46.)

D'Aleo's testimony was false and misleading. First, D'Aleo knew or recklessly disregarded that the "transfer" of Charter One stock was a purchase and sale and not a donation or gift. This is apparent from D'Aleo's testimony that, based on his extensive review of the Trust's tax returns, the Trust had paid all tax liabilities. PI Tr. at 465. D'Aleo knew that the stock had appreciated in value, and that the tax consequences to the Trust from a sale are much different than a gift. PI Tr. at 487-89. If the stock had been donated to the Trust then the Trust would have been liable to pay capital gains taxes (which it did not) when the Charter One stock was converted to cash in September 2004. If the stock had been sold, then the Trust would have taken the stock at a "stepped-up basis," i.e., at the amount that the Trust paid for the stock, which means the Trust avoided capital gains taxes (which is what did occur). *See* Mehraban Decl. Exh. B (Hrg. Exh. 13). As Dunn testified, in a private annuity trust "there was no capital gains realized and no gift tax required." Hrg. Tr. at 59. D'Aleo, therefore, must have known the stock was sold to the Trust, not donated or gifted; otherwise, he never could have reached the conclusion that the Trust had paid all its tax liabilities.

Second, D'Aleo was careful, as were all defense witnesses, to use the ambiguous word "transfer" instead of truthfully stating that the stock was sold to the Trust. Testifying that the stock was "transferred," instead of truthfully saying that it was sold to the Trust, avoided questions about why the stock was sold and the terms of the sale.

Third, D'Aleo testified that he had numerous conversations with Ron Simons, the

accountant at Piaker who helped David Smith create the Annuity Agreement. PI Tr. at 448, 464, 465. Indeed, as documents produced by the Trust in November 2010 establish, Simons advised D. Smith on the tax advantages of the private annuity. Mehraban Decl. Exh. B. It is reasonable to assume that Simons, who was also accessible to Dunn and Featherstonhaugh, told D'Aleo about the private annuity.

Dunn and Featherstonhaugh were both in a position to know that D'Aleo provided false and misleading testimony on behalf of their clients.

Affidavits of Dunn and Wojeski in October and September 2010

Dunn and Wojeski filed affidavits that were later shown to be false, stating that they had no knowledge of the existence of a private annuity agreement until July 27, 2010. Their apparent motive was to protect Dunn. The SEC's motion for reconsideration alleged that Dunn had used the phrase "private annuity agreement" in a phone call on July 22, 2010, and these declarations were intended as proof that Dunn could not have used that phrase. By concealing their knowledge, Dunn and Wojeski intended to mislead the Court.

In fact, Dunn's phone conversation with the SEC on July 22, 2010, occurred at a time when she and Wojeski appear to have had discussions about the Annuity Agreement. On July 20, 2010, Wojeski received a fax from David Smith and forwarded that fax in an e-mail to Dunn on July 21, 2010. Dkt. 188, Ex. A. That e-mail included several documents containing the terms of the "Private Annuity Contract" entered into by the Smiths and the Trust in 2004, and which continue to be binding on the Trust. According to his time records, on July 20, 21 and 22, 2010, after receiving this e-mail, Wojeski spent several hours reviewing and researching private annuities. Mehraban Decl. Exh. C (Wojeski's time records). Wojeski and Dunn talked on each of these three days. Dunn then drafted a hold harmless agreement for Wojeski, which the Smiths

signed on July 22, 2010. Mehraban Decl. Exh. D.

Dunn, nevertheless, filed a declaration on September 3, 2010, stating that "I did not know of the existence of a private annuity agreement until I received it from Mr. Urbelis on July 27." Dkt. 134 ¶ 36. Wojeski similarly stated in his declaration filed October 7, 2010 that "[t]he first I learned of the existence of an annuity agreement was in late July, when my attorney informed me that the former trustee had just produced the agreement simultaneously to her and to the SEC's counsel." Dkt. 147 ¶ 2.

Dunn also concealed the e-mail and her knowledge when she received a document request from the SEC on July 27, 2010, and another document request served on the Trustee on September 17, 2010, asking for any and all documents regarding the Annuity Agreement. (Mehraban Decl. Exhs. E and F. Dunn continued to conceal the fax and the email until hours before the evidentiary hearing on November 16, 2010.

Dunn's Testimony During the Nov. 16, 2010 Hearing

Dunn testified that she did not review the e-mail she received from Wojeski on July 21 and that she did not discuss the terms of the private annuity with her client prior to the phone call with the SEC on the afternoon of July 22, 2010. Hrg. Tr. at 72. Dunn further testified that Wojeski did not even mention receiving the e-mail from David Smith. Hrg. Tr. at 77. Wojeski's time records, however, undermine these assertions. In fact, as the redactions on his time records appear to reflect conversations between Dunn and Wojeski, it appears that they discussed the terms of the contract reflected in the email from David Smith on July 20, 21 and 22. Mehraban Decl. Exh. C.

Dunn also admitted drafting the false statement in Wojeski's October 7 declaration that Wojeski did not learn of the Annuity Agreement until July 27. At the evidentiary hearing on

November 16, Dunn conceded that that Wojeski's affidavit was "not accurate." Hrg. Tr. at 80.

Dunn's testimony regarding the "Indemnity and Hold Harmless Agreement" she drafted, which David and Lynn Smith signed on July 22, 2010, also was not credible. Dunn claimed that it was a "coincidence" that this indemnity agreement, in which the Smiths released Wojeski from liability for all claims, was drafted days after Wojeski and Dunn received documents concerning the "Annuity Contract" and Wojeski spent time researching private annuities. Hrg. Tr. at 75-76. Dunn also testified that she essentially copied the language from a 2008 release given to Urbelis (*Id.*), but the earlier release was far narrower in scope. The Wojeski release dated July 22, 2010, is broader and covers claims regarding "obligations or distributions, and the potential tax consequences thereof, relating to said Trust, its donors and its beneficiaries, and any and all financial institutions, third parties and government and quasi government authorities." *Compare* Mehraban Decl. Exhs. D and I. Contrary to Dunn's testimony at the November 16 hearing, the broader language appears specifically directed to issues that might arise related to discovery of the Annuity Agreement.

Dunn's and Wojeski's November 15 and 17, 2010 Declarations

The fax to Wojeski on July 20 containing the annuity documents, and his email of those documents to Dunn on July 21, proves that the earlier declarations filed by Dunn and Wojeski were intentionally false. Wojeski's time records also reveal that he spent portions of three days reviewing the documents, conducting research and, apparently, discussing these issues with Dunn.

Rather than withdraw their false declarations, they both sought to downplay the significance of the documents Wojeski received from David Smith. Dunn claims that she did not read the e-mail at the time and that Wojeski never mentioned it to her, even though they were

communicating over the course of those three days when Wojeski received the fax, sent it to Dunn, and conducted his research. Dkt. 188 ¶ 3; Hrg. Tr. at 68-73. Such testimony lacks credibility.

Wojeski's declaration merely states that he seeks "to clarify a statement made in my [October Declaration]," and argues unconvincingly that he somehow believed that the fax from D. Smith on July 20 and the production of the Annuity Agreement by Urbelis on July 27 "had occurred at the same time." Dkt. 191.

The Trust's Distribution of Funds After July 7, 2010

According to an accounting provided to the SEC on August 16, 2010 and a related email from Dunn (Mehraban Decl. Exh. G), approximately $944,848 was disbursed from the Trust account from July 7, 2010, when the Court released the Trust from the asset freeze, through August 3, 2010, when the Court again temporarily froze the Trust's assets. The following persons received funds from the Trust during this period:

- Dunn Law Firm received $101,096;
- Wojeski received $13,874.00, including $5,775.50 reimbursement for fees paid to title company and $8,098.50 for trustee fees;
- L. Smith directly received $449,878.00, and $150,000 indirectly through Geoffrey and Lauren Smith (for camp property) and L. Smith appears to have paid $115,000 from these funds to Featherstonhaugh (*see* Dkt. 146-2, ¶ 5);
- Geoffrey Smith received $96,500, including $75,000 that he gave to L. Smith as a down payment on the purchase of camp property, and $200,000 for a company he created, Capacity One Management LLC;

- Lauren Smith received $83,500.00, including $75,000.00 that she gave to L. Smith as a down payment on purchase of camp property.

ARGUMENT

The SEC requests that the Court: (1) order that L. Smith, Wojeski, Dunn and Urbelis be jointly and severally liable to pay the SEC's reasonable fees and costs of $164,000 incurred due to the fraudulent conduct, and that these payments be directed to the Court registry fund for the benefit of victims; (2) order that all funds paid out by the Trust after July 7, 2010, be returned either to the Trust account or to the Court registry; (3) conduct an evidentiary hearing to determine whether sanctions are warranted against Featherstonhaugh, and find that the crime-fraud-exception to the attorney-client privilege applies; and (4) order such other and further relief as the Court deems appropriate.

I. The Court's Authority to Impose Sanctions

The broadest source of authority, applying to parties as well and nonparties, is the court's inherent authority to sanction bad faith conduct in litigation.[2] The United State Supreme Court, in *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991), upheld the use of a court's inherent authority to impose sanctions, and affirmed sanctions against a party for the full amount of an opposing party's attorney fees and expenses. The Supreme Court also noted with approval that the district court had imposed sanctions against non-parties including the trustee (a reprimand), the trustee's attorney (suspension of practice before the court for six months) and the current and former attorney for the party (suspension of practice before the court for five years, and disbarment and prohibition from seeking readmission for three years, respectively). 501 U.S. at 41 n.5. The

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[2] Local Rule 1.1(d) provides: "Failure of an attorney or of a party to comply with any provision of these Rules, General Orders of this District, Orders of the Court, or the Federal Rules of Civil or Criminal Procedures shall be a ground for imposition of sanctions."

court's inherent power to sanction stems from "the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases." *Chambers*, 501 U.S. at 43; *Zlotnick v. Hubbard*, 572 F. Supp. 2d 258, 272 (N.D.N.Y. 2008) (denying reconsideration of ruling imposing sanctions on party's attorney); *see also Roadway Express, Inc. v. Piper*, 447 U.S. 752, 764-65 (1980) (discussing court's inherent power to impose sanctions).

To impose sanctions under the Court's inherent authority, the court must make a finding that: "(1) the offending party's claims were entirely without color, and (2) that the claims were brought in bad faith – that is, motivated by improper purposes such as harassment or delay." *Zlotnick*, 572 F. Supp. 2d at 272 (*quoting Eisemann v. Greene*, 204 F.3d 393, 396 (2d Cir. 2000)). "There must be a showing of subjective bad faith on the part of the offending attorney. However, bad faith can be inferred when the attorney's actions are so completely without merit as to require the conclusion that they must have been undertaken for some improper purpose such as delay." *Zlotnick*, 572 F. Supp. 2d at 272 (internal quotes and citations omitted).[3]

In addition, 28 U.S.C. § 1927 provides that "[a]ny attorney . . . who so multiplies the proceedings in any case unreasonably and vexatiously may be required to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred because of such conduct." Section 1927 authorizes sanctions when an attorney's "actions are so completely without merit as to require the conclusion that they must have been undertaken for some improper purpose, and

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[3] In the Second Circuit, scienter to commit fraud can be established through knowledge or through reckless disregard of the truth. Reckless disregard means conduct that "'at the least ... is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *In re Carter-Wallace, Inc. Sec. Lit.*, 220 F.3d 36, 39 (2d Cir. 2000) (citation and quotation marks omitted). "An egregious refusal to see the obvious, or to investigate the doubtful, may in some cases give rise to an inference of ... recklessness." *Chill v. General Elec. Co.*, 101 F.3d 263, 269 (2d Cir. 1996).

upon a finding of conduct constituting or akin to bad faith." *Gollomp v. Spitzer*, 568 F.3d 355, 368 (2d Cir. 2009) (internal quotation marks omitted, citing *In re 60 East 80th St. Equities, Inc.*, 218 F.3d 109, 115 (2d Cir. 2000)).

The court may also impose sanctions under Federal Rule of Civil Procedure 11, which applies to pleadings, written motions or other certified papers submitted to the Court. F.R.C.P. 11(b). Rule 11, however, provides a "safe harbor" when the claim of bad faith arises in the first instance from a party's motion. F.R.C.P. 11(c)(2); *see also ATSI Commc'ns, Inc. v. Shaar Fund, Ltd.*, 579 F.3d 143, 150 (2d Cir. 2009). In this case, the "safe harbor" provision does not apply because the Court initiated the sanction process. F.R.C.P. 11(c)(3); *see also ATSI*, 579 F.3d at 150 ("[w]hen sanctions are initiated by a court *sua sponte* . . . no such safe harbor is afforded"). Rule 11 also provides that the rule should be invoked and the Court should require the offending party to "show cause" why sanctions should not be imposed. *Id.* By giving the SEC leave to move for sanctions, however, the Court has taken the functionally equivalent step of ordering a "show cause" hearing. The sanction targets will have a full opportunity to be heard. Rule 11, therefore, is a further basis for the Court's sanctions.

The Court's inherent authority, Section 1927 and Rule 11 all provide sufficient authority to impose sanctions and the conduct at issue merits sanctions. Each of the individuals acted in bad faith in concealing the existence of the Annuity Agreement and offering false affidavits and testimony before the Court and under oath at depositions. L. Smith filed two false affidavits and a false asset statement. Wojeski and Dunn both filed false declarations and made false statements about the Trust and the Annuity. Urbelis misrepresented the nature and purpose of the Trust and failed to produce the Annuity Agreement in a timely manner although he received

a subpoena calling for its production. The uniformity of the statements of the lawyers and the witnesses also shows planning and coordination.

Such conduct is sanctionable. *See, e.g., Chambers*, 501 U.S. at 54 (sanctions imposed "for the fraud [the party] perpetrated on the court and the bad faith he displayed toward both his adversary and the court throughout the course of the litigation"); *Scholastic Inc. v. Stouffer*, 81 Fed. Appx. 396, 398 (2d Cir. 2003) (affirming sanctions against defendant for submission of false evidence); *Hargrove v. Riley*, No. 04 Civ. 4587(DGT), 2007 WL 389003, at *11 (E.D.N.Y. Jan.31, 2007) ("If a party commits a fraud on the court, the court has the inherent power to do whatever is reasonably necessary to deter abuse of the judicial process. Fraud upon the court has been defined as fraud which seriously affects the integrity of the normal process of adjudication.") (internal citations and quotation marks omitted); *McMunn v. Memorial Sloan-Cancer Kettering Ctr.*, 191 F. Supp. 2d 440, 445 (S.D.N.Y. 2002) ("[W] hen a party lies to the court and his adversary intentionally, repeatedly, and about issues that are central to the truth-finding process, it can be fairly said that he has forfeited his right to have his claim decided on the merits."); *see also Banus v. Citigroup Global Markets, Inc.*, __ F. Supp. 2d __, 2010 WL 5158642, at *5 (S.D.N.Y. Dec. 20, 2010) (imposing sanctions against plaintiff's attorney under §1927 for filing baseless action). Accordingly, sanctions are appropriate here under 28 U.S.C. § 1927 and the court's inherent authority.

The power to sanction under the court's inherent authority also reaches Urbelis, who is not a party. A number of courts have held that non-parties can be sanctioned under the court's inherent authority. *See, e.g., Manez v. Bridgestone Firestone N. Am. Tire, LLC*, 533 F.3d 578, 585 (7th Cir. 2008) ("No matter who allegedly commits a fraud on the court – a party, an attorney or a nonparty witness – the court has the inherent power to conduct proceedings to investigate

that allegation and, if it is proven, to punish that conduct."); *In re Intel Corp. Microprocessor Antitrust Litig.*, 562 F. Supp. 2d 606, 610 (D. Del. 2008) ("A court's inherent authority to sanction extends to the conduct of a nonparty") (citation omitted); *see also Chambers v. NASCO, Inc.*, 501 U.S. 32, 40 n.5 *(1991)* (noting with approval district court's sanction of non-party trustee and her attorney); *Matter of Holloway*, 884 F.2d 476, 477 & n.2 (9th Cir. 1989) (sanctioning a court reporter for "repeated and flagrant failures to meet court-imposed deadlines" that resulted in "severe prejudice to both the parties and the court"). In addition, Section 1927 on its face is not limited to attorneys representing parties in an action. As officers of the court, attorneys should be held to a higher standard than lay persons and, accordingly, Section 1927 should apply to a non-party attorney like Ubelis.

II. The Sanctioned Persons Should be Jointly and Severally Liable for the SEC's Legal Fees and Costs Caused by their Bad Faith Conduct

As a result of the scheme, the SEC expended considerable resources that would not have been necessary absent the fraud, including hiring an expert, drafting and filing the TRO papers on August 3 and other required filings, and preparing for the evidentiary hearing on November 16. Mehraban Decl. ¶ 8. Attorneys fees are the statutory sanction under 28 U.S.C. § 1927. In addition, a court may use its inherent power to "assess attorney's fees when a party has acted in bad faith, vexatiously, wantonly, or for oppressive reasons." *Chambers*, 501 U.S. at 45-46 (citation and internal quotes omitted); *see also Roadway Express*, 447 U.S. at 766 (same). In determining an appropriate amount of attorneys' fees, courts apply the "presumptively reasonable fee analysis." *Porzig v. Dresdner, Kleinwort, Benson, N. Am, LLC*, 497 F.3d 133, 141 (2d Cir. 2007). Such analysis involves determining the appropriate hourly rate for each attorney and the reasonable number of hours expended and multiplying the two numbers to obtain a "presumptively reasonable fee award." *Id.*

The SEC seeks a total of $164,000 in attorneys' fees and costs. Mehraban Decl. ¶¶ 8-13. The individuals discussed above should be jointly and severally liable for these costs and attorneys' fees. *See, e.g., Estate of Calloway v. Marvel Ent. Group*, 9 F.3d 237, 239-240 (2d Cir. 1993) (affirming application of joint and several liability to sanctions under Rule 11); *Reichmann v. Neumann*, 553 F. Supp. 2d 307, 327-28 (S.D.N.Y. 2008) (imposing sanctions jointly and severally on party and party's attorney under court's inherent power and 28 U.S.C. § 1927); *Warshay v. Guinness PLC*, 750 F. Supp. 628, 641 (S.D.N.Y. 1990) (party and counsel jointly and severally liable for attorneys' fees where party submitted misleading affidavit); *see also Arista Records, LLC v. Doe 3*, 604 F.3d 110, 117 (2d Cir. 2010) ("[T]he common law doctrine [is that] one who knowingly participates or furthers a tortious act is jointly and severally liable with the prime tortfeasor.") (quotation marks and citation omitted); *U.S. v. Klein*, 476 F.3d 111, 114 (2d Cir. 2007) ("[C]o-defendants may be proportionally or jointly and severally liable for restitution when they are all culpable.");

III. The Funds Disbursed As a Result of the Misconduct Should Be Returned

If the fraud had not taken place, and the Annuity Agreement had been properly disclosed, the Trust account would have remained frozen and the Trust never would have made the distributions it did between July 7 and August 3. The Annuity Agreement, in fact, constituted the "proverbial 'smoking gun,'" and its concealment caused the Trust to be released from the freeze. MDO III, at 6. As the Court found, absent the Annuity Agreement, the evidence was insufficient to freeze the Trust, but "[w]hen the Annuity Agreement is added to the analysis, however, the conclusion is compelled that David Smith possesses an equitable and beneficial interest in the Trust through the Annuity Agreement," which justified maintaining the freeze over the Trust. MDO II, at 21. This relief merely puts the parties in the same position that they

would have been had the sanctionable conduct of the parties not occurred. This sanction is appropriate under the Court's inherent authority. But for the fraud, the Court never would have released the Trust from the asset freeze and the approximately $1 million dissipated by the Trust would have remained frozen.

In particular, at least with respect to the individuals listed above who received funds directly or indirectly from the Trust during the period from July 7 to August 3, 2010 -- Dunn, Wojeski, Featherstonhaugh, L. Smith, Geoffrey Smith and Lauren Smith -- the Court's action would be akin to disgorgement of a defendant's ill-gotten gains. *See, e.g., SEC v. Cavanagh*, 445 F.3d 105, 117 (2d Cir. 2006) (disgorgement is an equitable remedy designed to "force[] a defendant to give up the amount to which he was unjustly enriched") (citation omitted).

IV. The Court Should Hold an Evidentiary Hearing

A. The Need for an Evidentiary Hearing

Plaintiff believes that there is more than sufficient evidence before the Court to impose sanctions on Dunn, L. Smith, Wojeski, and Urbelis. An evidentiary hearing may be needed, however, with regard to Featherstonhaugh, and there are sufficient red flags regarding Featherstonhaugh to justify an evidentiary hearing. Featherstonhaugh filed false affidavits on behalf of L. Smith, and he had direct communications with each of the participants in the scheme. In addition, Featherstonhaugh retained D'Aleo, the accountant who prepared the false statement of net assets for L. Smith, analyzed every transaction the Trust undertook, determined that all taxes had been paid, and knew or recklessly disregarded the fact that the stock was sold to the Trust, not donated. Featherstonhaugh also communicated with Urbelis in late April or early May 2010. Dkt. 46-1, Exh. 11, at 47 (Urbelis dep.). Featherstonhaugh, who shares office space with Dunn, also had a financial motive in the success of the scheme, and he received

$115,000 when the freeze was removed. To summarize, numerous individuals with a common interest and in close contact with Featherstonhaugh – including his own client, D'Aleo, Dunn, D. Smith, Wojeski and Urbelis – knew of or recklessly disregarded the Annuity Agreement. Unless all these individuals perpetrated this fraud behind his back, Featherstonhaugh must have known of the scheme.

B. The Crime-Fraud Exception

At an evidentiary hearing, and with regard to document discovery, the attorney-client privilege should not apply to protect from disclosure communications between Featherstonhaugh and L. Smith and between Dunn and Wojeski. Communications that would otherwise be protected from disclosure by the attorney-client privilege are excluded from the privilege where they "relate to client communications in furtherance of contemplated or ongoing criminal or fraudulent conduct." *U.S. v. Jacobs*, 117 F.3d 82, 87 (2d Cir. 1997) (quoting *In re John Doe, Inc.*, 13 F.3d 633, 636 (2d Cir. 1994)). "It is the purpose of the crime-fraud exception to the attorney-client privilege to assure that the 'seal of secrecy' between lawyer and client does not extend to communications 'made for the purpose of getting advice for the commission of a fraud' or crime." *Id.* (*quoting U.S. v. Zolin*, 491 U.S. 554, 563 (1989) (citations omitted)).

For the crime-fraud exception to apply, the SEC must show that there is probable cause to believe that: (1) a fraud or crime has been committed; and (2) the communications in question were in furtherance of the fraud or crime. *Jacobs,* 117 F.3d at 87. Probable cause means "that a prudent person have a reasonable basis to suspect the perpetration or attempted perpetration of a crime or fraud, and that the communications were in furtherance thereof." *In re John Doe*, 13 F.3d 633, 637 (2d Cir. 1994) (*quoting In re Grand Jury subpoena Duces Tecum Dated September 15, 1983*, 731 F.2d 1032, 1037 (2d Cir. 1984)).

The evidence outlined above shows a well-thought out scheme to defraud the Court by concealing the existence of the Annuity Agreement. Communications with attorneys were integral to the scheme. Indeed, the scheme could not have occurred without the participation of attorneys who drafted the false affidavits, and who stood in Court and presented false evidence through witnesses and argument. L. Smith knew that her communications with Featherstonhaugh would be used to prepare false affidavits and briefs, and would be a basis for the false testimony presented at the preliminary injunction hearing, as did Dunn and Wojeski. Accordingly, the crime-fraud exception should apply to communications between Featherstonhaugh and L. Smith, and between Dunn and Wojeski. The SEC should also be allowed to serve document discovery prior to such hearing to obtain relevant communications.

CONCLUSION

For the foregoing reasons, plaintiff respectfully requests that the Court grant its motion for sanctions and order: (1) that L. Smith, Dunn, Urbelis and Wojeski are jointly and severally liable for payment of the SEC's attorney fees and costs of $164,000 reasonably incurred in responding to the bad faith conduct; (2) that all funds transferred from the Trust account between July 7, 2010 and August 3, 2010, should be returned within 14 business days to the Court registry or to the Trust account; (3) that an evidentiary hearing be held to hear evidence regarding the conduct of Featherstonhaugh, and the crime-fraud exception to the attorney-client privilege apply so the testimony can be heard regarding communications between L. Smith and Featherstonhaugh, and Dunn and Wojeski; and (4) such other and further relief as the Court deems appropriate.[4]

Dated: New York, NY
January 31, 2011

Respectfully submitted,

s/David Stoelting
Attorney Bar Number: 516163
Attorney for Plaintiff
Securities and Exchange Commission
3 World Financial Center, Room 400
New York, NY 10281
Telephone: (212) 336-0174
Fax: (212) 336-1324
E-mail: stoeltingd@sec.gov

Of Counsel:
Kevin McGrath
Lara Shalov Mehraban
Haimavathi V. Marlier
Joshua Newville

[4] *See, e.g.*, Local Rule 83.4(g).

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	
Plaintiff,	
v.	**10 Civ. 457 (GLS/DRH)**
McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC, McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, FIRST INDEPENDENT INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, TIMOTHY M. MCGINN, DAVID L. SMITH, LYNN A. SMITH, DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY MCGINN,	
Defendants,	
LYNN A. SMITH, and NANCY MCGINN,	
Relief Defendants, and	
DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,	
Intervenor.	

DECLARATION OF LARA SHALOV MEHRABAN

I, Lara Shalov Mehraban, pursuant to 28 U.S.C. § 1746, declare as follows:

1. I am an attorney in the Enforcement Division of the New York Regional Office of the Securities and Exchange Commission. I have been employed with the SEC since September 2007. I make this declaration in support of the SEC's motion for sanctions.

2. Attached hereto are true and accurate copies of the following documents:

EXHIBIT NO.	DESCRIPTION
A	Excerpt of Transcript of Evidentiary Hearing Held on November 16, 2010 (Jill Dunn direct and cross)
B	Plaintiff's Exhibit 13 introduced at November 16, 2010 Hearing (documents from Piaker & Lyons, produced by Trust to SEC on November 13, 2010)
C	Three-page document containing Wojeski's time records produced by the Trust to the SEC on November 13, 2010 (redactions in original)
D	Plaintiff's Exhibit 10 introduced at November 16, 2010 Hearing (Indemnity and Hold Harmless Agreement produced by Trust to SEC on November 13, 2010)
E	Plaintiff's Exhibit 16 introduced at November 16, 2010 Hearing (July 17, 2010 document request from David Stoelting)
F	Document Request Dated September 17, 2010 to Wojeski, as Trustee
G	Email from Jill Dunn dated August 16, 2010 containing Trustee's accounting and Email from Jill Dunn dated August 18, 2010 containing further information regarding Trustee's accounting
H	Letter from James Featherstonhaugh to David Stoelting dated May 5, 2010 enclosing Lynn Smith's Statement of Net Assets (marked at L. Smith deposition; redacted version filed as Dkt. 19)
I	Plaintiff's Exhibit 98 introduced at the PI Hearing (Indemnity Agreement regarding Urbelis; marked at Urbelis deposition)

The SEC's Calculation of Reasonable Attorneys' Fees

Reasonable Rates

3. To determine the rates "prevailing in the community for similar services by lawyers of reasonably comparable skill, experience and reputation" (*Blum v. Stenson*, 465 U.S. 886, 896 n. 11 (1984)), the SEC looks to the rates proposed by Iseman, Cunningham, Reister & Hyde LLP in its motion for attorneys' fees (Dkt. 229-1, at p. 12 of 24).

4. David Stoelting is a senior trial attorney with over 18 years of experience. He clerked on the U.S Court of Appeals for the Sixth Circuit. His experience also includes civil litigation in private practice. He joined the SEC as senior counsel in 2005 and he became a senior trial attorney in 2006. His level of experience appears commensurate with that of a seasoned partner like Robert H. Iseman, whose billing rate is $500/hour.

5. Kevin McGrath is a senior trial attorney with over 30 years of experience. His experience includes 14 years as an Assistant United States Attorney and civil and criminal litigation as an associate, counsel and partner in private practice. He joined the SEC as a senior trial attorney in January 2010. His level of experience also appears commensurate with that of a seasoned partner like Robert H. Iseman, whose billing rate is $500/hour.

6. Jack Kaufman is a senior trial attorney with over 20 years of experience. He clerked at the Supreme Court of New Hampshire and in the District Court for the District of New Hampshire, and then worked in the Civil Division at the DOJ as a trial attorney in the commercial litigation branch for almost 10 years. He joined the SEC as senior counsel in 2000 and became a senior trial attorney in 2001. His level of experience also appears commensurate with that of a seasoned partner like Robert H. Iseman, whose billing rate is $500/hour.

7. I am a senior counsel with over 10 years of experience. I clerked on the U.S. Court of

Appeals for the Ninth Circuit, and worked as an associate doing civil and criminal litigation in private practice for approximately seven years before joining the SEC as senior counsel in 2007. My level of experience appears commensurate with a junior partner like James Lagios, whose billing rate is $325/hour.

Time Billed

8. SEC attorneys do not maintain contemporaneous billing records. The figures contained in the below chart are based on each attorney's estimate of the amount of hours spent performing the specific tasks outlined below for each time period. The figures are intended to be conservative estimates:

July 7 to July 22: discussions re: tax implications of donation of property; meetings with tax experts, including Geiger; research on Charter One stock; review documents regarding loans of stock; drafting internal papers regarding amending complaint; editing amended complaint

July 22: communications with Dinosaur Securities; telephone conference with Court; telephone conversation with Dunn; discussions with Geiger; internal discussions

July 23 to Aug. 3: discussions with Geiger; telephone conversations with Urbelis; research and drafting brief re motion for reconsideration based on new evidence; editing amended complaint with new evidence; draft and edits to Stoelting declaration and accompanying TRO papers.

Aug. 16: Court conference in Albany re motion for reconsideration

Sept. 3 to 14: reviewing briefs and affidavits filed in opposition to motion for reconsideration; drafting reply brief and declaration filed Sept. 14

Oct. 7 to Nov. 16: review affidavits file by Wojeski and Geoffrey Smith and brief; review Court's Order re evidentiary hearing; internal discussions re same; tel conf with Court re: evid hrg. (10/15); conduct discovery regarding PAA including subpoenas for documents and testimony; review of documents at USAO; discussions regarding stipulation; negotiation of strategy and prep for hearing; witness prep; discussions with Iseman firm re stipulating to Annuity Agreement and other issues

Nov. 16: Evidentiary hearing in Albany

Dec. 6 to Jan. 3: Review Dunn's motion for reconsideration and draft opposition

	7/7-7/22	7/22	7/23-8/3	8/16	9/3-9/14	10/7-11/16	11/16	12/6-1/3	**TOTAL**
Kaufman	0	0	0	0	0	30	4	0	34
McGrath	6	4	20	8	16	12	4	12	82
Mehraban	40	0	35	0	10	85	4	2	176
Stoelting	15	4	20	8	0	20	4	5	76
TOTAL	61	8	75	16	26	147	16	19	368

9. The total hours of Kaufman, McGrath and Stoelting (192) multiplied by a rate of $500/ hour equals $96,000. The total hours for Mehraban (176) multiplied by a rate of $325/hour equals $57,200. The total attorneys' fees therefore equal $153,200.

10. This estimate does not include the time spent by a number of additional SEC attorneys who were consulted or provided assistance in preparing the amended complaint, the motion for reconsideration and in preparation for the hearing. The estimate also does not include travel time to Albany for discovery related to the Annuity Agreement or for the November 16, 2010 hearing.

Costs

11. In addition to attorneys' fees, the SEC engaged a tax law expert, Brit Geiger, in connection with preparing the amended complaint and motion for reconsideration. Geiger's fees totaled $10,800.

12. Because the case law regarding attorneys' fees suggests a billing rate for a local attorney, the SEC has not included travel costs from New York City to Albany.

13. The total amount of attorneys' fees and costs is $164,000.

I declare under penalty of perjury that the foregoing is true and correct.

Executed: New York, New York
January 31, 2011

Lara Shalov Mehraban

Exhibit A

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF NEW YORK

- -

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-versus- 10-CV-457

(EVIDENTIARY HEARING)

McGINN, SMITH & CO., INC., et al.,

Defendants.

- -

TRANSCRIPT OF PROCEEDINGS held in and for the United States District Court, Northern District of New York, at the James T. Foley United States Courthouse, 445 Broadway, Albany, NY 12207, on **TUESDAY, NOVEMBER 16, 2010**, before the **HON. DAVID R. HOMER**, United States District Court Magistrate Judge.

APPEARANCES:

FOR THE PLAINTIFF:
U.S Securities & Exchange Commission
BY: LARA SHALOV MEHRABAN, ESQ.; JACK KAUFMAN, ESQ; KEVIN P. McGRATH, ESQ.; and DAVID P. STOELTING, ESQ.

FOR THE DEFENDANTS:
ISEMAN, CUNNINGHAM, RIESTER & HYDE, LLP
BY: ROBERT H. ISEMAN, ESQ., and JAMES P. LAGIOS, ESQ.

JILL DUNN, ESQ.
WILLIAM J. BROWN, ESQ.
MARTIN RUSSO, ESQ.
ALISON COHEN, ESQ.

MS. MEHRABAN: No, your Honor.

THE COURT: Thank you. You may step down.

(Witness was excused.)

THE COURT: I take it that's all your witnesses?

MS. MEHRABAN: We were gonna call Miss Dunn.

THE COURT: Oh, you're calling Miss Dunn?

MS. MEHRABAN: Yes.

THE COURT: All right.

THE CLERK: Miss Dunn, raise your right hand.

J I L L D U N N,

having been duly sworn by the Clerk of the Court, was examined and testified as follows:

DIRECT EXAMINATION

BY MS. MEHRABAN:

Q Miss Dunn, on the afternoon of July 22, 2010, you took part in a telephone conference with the Court, correct?

A Yes.

Q On this telephone conference, the SEC stated that gift taxes and capital gains taxes should have been paid with respect to the transfer of the Charter One stock to the trust, correct?

A Their characterization to the judge and their argument to the judge was to the effect that Lynn Smith had testified at the hearing that she had created a trust for tax and estate planning purposes and that they believed that

gift tax returns should have been filed or capital gains paid. That's my recollection.

Q Okay. And you stated on the telephone conference that no gift taxes were due, correct?

A Yes, I did.

Q Okay. Shortly after the conference, you received a call from Mr. Stoelting and Mr. McGrath, correct?

A Almost immediately after the phone conference.

Q Okay. And Mr. Stoelting asked you why no gift taxes were due, correct?

A I thought it was Mr. McGrath speaking, but if it was Mr. Stoelting, then perhaps it was Mr. Stoelting.

Q Okay. And you stated that the reason no gift taxes were owed was because this was a private annuity trust, correct?

A I believe I stated no gift tax returns were filed because no gift tax was due.

Q Okay. Did you also state that no gift tax return was filed and no gift taxes were due because this was a private annuity trust?

A Yes, I did.

Q Okay. At the time of your call, what was your understanding of why no gift taxes would be due if it was a private annuity trust?

A It was my understanding that the characterization

of a private annuity trust was such that the tax implications were such -- I'm sorry, let me start that again. My understanding was that there was no capital gains realized and no gift tax required because it was a private annuity trust. That was the explanation that had been provided to me.

Q What about a private annuity trust made it that no gift taxes were due or no capital gains were due?

A I understood it to be a tax -- an estate planning vehicle that deferred the payment of tax and the realization of gain until money was paid out of the trust.

Q On the call, you also informed Mr. Stoelting and Mr. McGrath that you consulted with accountants on the gift tax issue, correct?

A Correct.

Q How many accountants did you speak to?

A Two.

Q Was one of those accountants Mr. D'Aleo?

A Yes.

Q When did you speak with him?

A I first met him, I believe --

MR. ISEMAN: Your Honor, we are getting outside of the call and I object.

THE COURT: Sustained.

BY MS. MEHRABAN:

Q When did you first speak with Mr. D'Aleo concerning the gift tax issue?

MR. ISEMAN: Same objection.

THE COURT: Same ruling.

BY MS. MEHRABAN:

Q Okay. You said -- at the time of the call with Mr. Stoelting and Mr. McGrath, you said you didn't know of the existence of any private annuity agreement, correct?

A That's correct.

Q Okay. You said you didn't know of the existence of any private annuity agreement until July 27, 2010, when you received it from Mr. Urbelis, correct?

A That's correct.

Q Okay. By July 22, 2010, you knew that it was a private annuity trust, correct?

A I knew it was a private annuity trust well before July 22nd.

Q Okay. When did you learn that it was a private annuity trust?

A I would say the end of April or early May.

THE COURT: All right. You're using the word "it" to refer to a private annuity trust. Are you talking about the declaration of trust or the annuity agreement?

Q Let me ask you that question. When you say it's a

private annuity trust, what do you mean?

A I knew that it had been characterized as a private --

THE COURT: You knew that what had been characterized?

THE WITNESS: The trust vehicle, the letter --

THE COURT: Is that the declaration of trust or the annuity agreement or both?

THE WITNESS: I think they're two -- I think that the declaration --

THE COURT: When you say "it," what are you referring to?

THE WITNESS: I'm talking globally about the concept of the trust. The first time I heard the trust mentioned, it was characterized as a private annuity trust. When I subsequently received what I requested as trust documents, I received a declaration of trust. There was no private annuity agreement provided to me and the first time I ever saw this private annuity agreement that was apparently executed by David and Lynn Smith was on July 27th when I received it from Tom Urbelis. They're two separate documents and I saw them at two separate points in time.

THE COURT: When you refer to "the vehicle," are you referring to the declaration of trust then?

THE WITNESS: The concept of the estate and tax

plan was to utilize something known as a private annuity trust. It had been characterized to me as a private annuity trust early on, in late April or early May. I did not know whether or not all of the steps that would be necessary to truly make it a private annuity trust had been undertaken. I received in May, from Tom Urbelis, a declaration of trust. I think I also received that declaration from Mr. Featherstonhaugh. That declaration of trust, that document that I was working from, did not have a Schedule A attached, it did not have a private annuity agreement attached. I wondered in my mind what form, if there was an annuity affiliated with it, what form that annuity would take. In my mind, I didn't know if it would take the form of some type of external document, such as something purchased from like a Metropolitan Life, some external annuity company, or if it would just be a certificate issued or if it would be a letter or an agreement. I had no idea. And the thought crossed my mind that all of the steps might not have been taken to effectuate the entire plan, step one, step two, step three. I was working from a declaration of trust.

BY MS. MEHRABAN:

Q Just to be clear, Miss Dunn, at the time you received the documents from Mr. Urbelis, you had no reason to think that the document production from Mr. Urbelis did

not contain all of the documents related to the trust, correct?

A The production I received from him in May? Yes, that's correct.

Q Okay. You understood that the declaration of trust did not create a private annuity trust, correct?

A I understood that the declaration of trust created an irrevocable inter-vivose trust.

Q You understood that the declaration of trust did not create a private annuity trust, correct?

A That's correct.

Q Okay. You knew that there had to be a separate agreement in connection with the private annuity, correct?

A I expected that there had to be some other form or document. I didn't know whether it would take the form of an agreement, of a certificate, of a letter or some other written obligation, or if it would take the form of a purchase of an annuity from an external source.

Q Okay. As part of your due diligence in representing the trust, you looked on the website of the National Association of Private Annuity Trusts, correct?

A I did briefly look at it, yes.

Q Okay. And you looked at the documents on the website?

MR. ISEMAN: I am gonna object to it as being

outside the scope of the call.

THE COURT: Overruled.

A I looked at some of them.

Q Okay. And the documents that you looked at were helpful to you in understanding the basic nature of a private annuity trust, correct?

A Yes.

Q All right. The website for that National Association of Private Annuity Trusts is in your declaration, it's www.NAPAT.org, correct?

A That's correct.

Q Okay. The website says that "A private annuity is a contractual" --

MR. ISEMAN: I am gonna object as to the characterization of what the website says.

THE COURT: Sustained.

BY MS. MEHRABAN:

Q Okay. Let me show you a document. Oh, it's document 8, Exhibit 8. So I'm showing you a printout from the website www.NAPAT.org. This is the address of the website that you looked at, correct?

THE COURT: What's the exhibit number?

THE WITNESS: 8.

MS. MEHRABAN: Plaintiff's 8.

A This is the address of the website I viewed.

MS. MEHRABAN: Okay. I am gonna offer this into evidence.

THE COURT: Any objection?

MR. ISEMAN: I have no objection.

THE COURT: Plaintiff's Exhibit 8 is received in evidence.

(Plaintiff's Exhibit 8 received.)

BY MS. MEHRABAN:

A Miss Mehraban, this is dated 11/15/2010 and I don't know whether the content is the same as it was when I reviewed it.

Q Okay. Well, let me direct your attention to the last page of the document. The last page of the document is a link, "What is a PAT," private annuity trust, correct?

A Um-hum, yes.

Q And it says, "A private annuity is a contractual agreement of sale between two private parties, usually the seller, the annuitant, the parent, of an asset transfers property to a family member, the obligor, the children or heirs, in exchange for a special payment contract, an annuity of substantially equal value. The obligor is then responsible for making annuity payments to the annuitant during his or her lifetime." Did I read that correctly?

A Yes.

Q Okay. You remember generally that the website

informed you that a private annuity trust involved a contractual agreement of sale of an asset, correct?

MR. ISEMAN: Object to the form of the question.

A No, that's not correct.

THE COURT: Overruled.

Q What do you remember?

A I -- at what point in time?

Q When you looked at the website.

A At which point in time?

Q The first time.

A I reviewed portions of the website. As I testified earlier, I don't know whether this is the same. I know that I read descriptions of the distinction between a private annuity and a private annuity trust. And as indicated on the page you're referring to, there is a distinction between the trust and the annuity. And I understood there would be a distinction.

Q Do you have any reason to think that this document is different from what you saw when you looked at it the first time?

A I have no reason to think that it's the same or different. I don't -- I don't know. And I don't believe that I printed it the first time that I looked at it.

Q And did you look at it more than once?

A I believe I looked at it, at the website, once in

May and again probably in August.

Q Okay. You said that the website drew a distinction between private annuity and private annuity trust, okay?

A I said this draws a distinction between it, what I'm looking at right now, yes (indicating).

Q Okay. So the next paragraph reads, "What is a private annuity trust? A private annuity trust is a specialized and sophisticated trust designed to give structure and convention to the private annuity contract. The trust may sell and use the proceeds to provide an income stream for the life of the annuitant." Did I read that correctly?

A Yes, you did.

Q Was that your understanding at the time?

A That's my understanding of the intention behind a private annuity trust and what it allows individuals to do.

Q So, after consulting with this website, you understood, did you not, that the only way to avoid gift and capital gains taxes that would have been due on the transfer of the Charter One stock from the Smiths to the trust was if the Smiths had sold the stock to the trust in exchange for an asset of substantially equal value, correct?

A I don't know that my understanding was as succinct or sophisticated as your characterization or that my

understanding was achieved all at one point in time.

Q Okay. Well, after consulting the website, what was your understanding?

A My understanding was that a private annuity trust is a term of art or a tax and estate planning vehicle, that it's highly specialized. That it is -- it allows individuals to place assets into a trust for the purpose of deferring capital gains and that there are several steps that would need to be taken from start to finish in order to achieve the intention or benefits of the concept behind this vehicle that was allowed by the IRS.

Q Okay. And I believe you stated earlier you understood at the time that the declaration of trust was not sufficient in and of itself to do all of those things?

A I think that's correct, the declaration of trust created the trust itself, it created the entity or the trust that was necessary as point one in a multi-step process.

Q Okay. In addition to doing this research, in fact, you had a document showing all of the terms of the private annuity agreement before the July 22, 2010, call with Mr. Stoelting and Mr. McGrath, correct?

A I do not believe that I saw any such document prior to that conversation.

Q It was in your possession, correct?

A I believe it was in my in box. I have since

learned that it was in my in box on July 21st. I do not believe I read it prior to the conversation.

Q Okay. And this was an e-mail that you received from your client, Mr. Wojeski?

A That's correct.

Q Okay. I am gonna show you a document that we've marked as Plaintiff's Exhibit 22.

MS. MEHRABAN: Your Honor, I know this was filed last night, but the copy that I have was from Miss Dunn's e-mail and so it doesn't have the ECF number on it. But I am sure I can get that for you if you want it.

THE COURT: Thanks, I have it. It's 188.

MS. MEHRABAN: All right, thank you.

BY MS. MEHRABAN:

Q This document attaches as Exhibit A the e-mail you received from your client, Mr. Wojeski, correct?

A Yes, it does.

Q Okay. And if you turn to the next page, it contains an e-mail from someone named Nanci Pipo at South Towns Financial Group to David Smith, or a fax or an e-mail?

A It appears to.

Q The next page of the document, which is page 205 of the fax, it's entitled "private annuity contract," correct?

A That's correct.

Q Okay. This document was signed, it looks like, by David Smith, correct?

A I can't read the handwriting, but that's what it appears likely to be.

Q Okay. When did you first see this document?

A I saw it -- I know that I saw it on -- do you mean the document in terms of the entire document with the e-mail from Mr. Wojeski?

Q No.

A Or are you talking about just that one page?

Q Just Exhibit A, just this page.

A Just Exhibit A or just this page?

Q Just this page.

A I don't recall specifically when I saw it, I believe it was -- I don't recall specifically the first time I saw it.

Q Okay. The next page of the document is also entitled private annuity contract, correct?

A Yes.

Q And this contains the terms of the agreement, correct?

A It contains the words contract terms.

Q Okay. And it shows that the periodic payments for the contract are $489,932?

A Well, it contains references, but it doesn't

contain any kind of contract.

Q It states that the contract terms -- the periodic payment under the contract terms are $489,932, for example, correct?

A Those are the words on this page. As I said, it doesn't -- this document doesn't contain a contract.

Q Well, what is this document?

A I don't know.

Q And you received this from Mr. Wojeski, correct?

A Yes.

Q Okay. And you discussed it with Mr. Wojeski at the time?

A My discussions with my client are privileged and I don't know what time you're referring to.

Q I'm referring to --

A You say "at the time."

Q Prior to July 22, 2010.

A No, I did not.

Q Okay. Did you discuss with Mr. Wojeski at any time prior to July 22, 2010, your conversation with Mr. Stoelting and Mr. McGrath, the terms of the private annuity contract?

A I'm sorry, could you repeat that question?

MR. ISEMAN: Can we have that read back?

(Record read back.)

MR. ISEMAN: Object to the form of the question. I don't understand it.

THE COURT: Do you understand the question?

THE WITNESS: No, I don't, because --

THE COURT: All right.

THE WITNESS: Okay.

THE COURT: Objection is sustained.

BY MS. MEHRABAN:

Q Okay. I'll ask it again. At any time prior to your call with Mr. Stoelting and Mr. McGrath on July 22, 2010, did you discuss with Mr. Wojeski the terms of the private annuity agreement?

A I did not know that a private agreement -- private annuity agreement existed prior to that time and no, I did not discuss the terms of a private annuity agreement with Mr. Wojeski prior to that date.

Q Did you discuss with him the terms of the private annuity trust?

A Again, I have to state that my communications with my client are confidential, but we had several communications regarding the trust and the declaration of trust.

Q Well, did you discuss with Mr. Wojeski that the periodic payments under the private annuity trust were $489,932 a year?

A I don't believe I did.

Q Did you discuss with Mr. Wojeski that the first payment date for -- under this agreement is September 26, 2015?

A At what point in time?

Q Prior to your call with Mr. McGrath and Mr. Stoelting.

A No.

Q At the same time that you received this e-mail, you were working on an indemnity agreement for Mr. Wojeski, correct?

A I prepared an indemnification agreement for Mr. Wojeski, I believe, on July 22, 2010.

Q Okay. And this agreement -- this is been marked as Plaintiff's Exhibit 10.

MS. MEHRABAN: And I am gonna offer it into evidence.

THE COURT: What is it?

MS. MEHRABAN: This is the -- an indemnity and hold harmless agreement signed by David Smith and Lynn Smith on July 22, 2010.

THE WITNESS: Are you asking me if this is the document I prepared?

MS. MEHRABAN: No, I'm offering it into evidence. There's no question yet.

THE WITNESS: Oh, okay.

MR. ISEMAN: We have no objection.

THE COURT: Plaintiff's Exhibit 10 is received in evidence.

MS. MEHRABAN: Thank you.

(Plaintiff's Exhibit 10 received.)

BY MS. MEHRABAN:

Q In this agreement, David and Lynn Smith agree to indemnify and hold harmless Mr. Wojeski for all claims arising out of the trust, okay?

MR. ISEMAN: I am gonna object because the agreement will speak for itself.

THE COURT: This is a foundation question. Overruled.

A That's correct.

Q Okay. David and Lynn Smith are not the beneficiaries of the trust, correct?

A Correct.

Q So the only circumstances in which they would hold Mr. Wojeski harmless is if there was something in the trust that gave them an interest in the trust, correct?

A No, that's not correct.

Q Okay. Why would they sign an indemnity and hold harmless with Mr. Wojeski?

A Mr. Wojeski had become the trustee of this trust

in the midst of very significant litigation and following the lifting of the asset freeze as to the trust, the beneficiaries had communicated with him and requested some financial assistance from the trust and they had requested that he -- that the trust purchase the family vacation home, I believe to avoid their mother having to sell it to raise money, and he asked for a general assurance that he was not going to have complaints or inter-family disputes concerning those different transactions. And I advised him that at some point in time while Mr. Urbelis was the trustee of this trust, he had prepared an indemnification and hold harmless agreement that David and Lynn Smith signed during his -- to give him protection and indemnification as a result of his performance of his duties as trustee and that I could do the same in these circumstances. And I pulled the indemnification agreement that had been prepared by Mr. Urbelis several years earlier and which had been offered into evidence at the hearing, and I, in essence, retyped it, changed the names, maybe cleaned up a few words and presented it to Mr. Wojeski and I said, "Does this give you what you want?" He said, "Yeah, that's great." And it was done in the context of the real estate closing for the purchase of the property and the Smiths signed this agreement at the time that Mrs. Smith signed all of the closing documents.

Q Okay. So it's just a coincidence that it was signed the day after Mr. Wojeski e-mailed you the terms of the private annuity contract?

A The real estate closing or the real estate transaction had been underway more than a week at that point and we were scheduled to close on it on July 22nd. And as I testified earlier, the e-mail from Mr. Wojeski on July 21st is not something that I believe I saw on that day. I had many other client matters and personal matters going on, I had spent a considerable amount of time working on this case and, frankly, once Judge Homer's decision came in, I put this matter aside and was working on other issues and I didn't look at that document until at least probably a week or more after I apparently received it.

Q So it was a coincidence, correct?

A I think, Miss Mehraban, that you can characterize things as you characterize them and I'll characterize them as I characterize them.

Q So you don't agree with the statement that it's a coincidence?

MR. ISEMAN: It's asked and answered and argumentative.

THE COURT: I don't think it's answered. Overruled.

A It's a fact that the real estate closing was

underway and the indemnification agreement was prepared and signed in conjunction with the real estate closing. That an e-mail was sent to me the day before that I didn't see at that time is of no moment, and if you want to call it a coincidence, I have no quibble with that.

Q You spoke to Mr. Wojeski about the real estate deal, correct?

A Yes.

Q Okay. And the real estate deal closed on July 22, 2010, correct?

A Yes.

Q For the purchase by the trust of the camp house --

A Yes.

Q -- from Lynn Smith? Okay.

During your conversations with Mr. Wojeski prior to July 22, 2010, he did not mention to you that he had received an e-mail or a fax from David Smith containing the terms of the private annuity contract?

A I don't believe he did, no.

Q On July 27, 2010, the same day you received the private annuity agreement from Mr. Urbelis, you received a document request in the form of a letter from the SEC, correct?

A I received a letter from the SEC.

Q In that letter was contained a document request,

correct?

A I think that Mr. Stoelting was requesting information from me, yes.

Q Mr. Stoelting, in fact, asked you for all documents related to the private annuity agreement, correct?

A Yes, he did.

Q And you had the e-mail from Mr. Wojeski by the time you received that letter, correct?

A I now know that I had it at that time, yes.

Q And in response to the letter, you didn't look at your e-mails?

A No, I didn't. Because the letter was -- at the time that the letter was received, this litigation had concluded as to this trust. The intervention was granted for the specific purpose of addressing the preliminary injunction motion, it was limited to that. I had never received any kind of discovery demands, the case was closed, in my mind, and I don't believe there was any basis for making a discovery demand and I didn't undertake any search for any documents.

Q Just to be clear, we are talking about -- I'm showing you Plaintiff's 16, which has already been admitted into evidence. This is the letter requesting documents?

A Yes.

Q And the first sentence of the second paragraph

says, "Please produce all documents concerning the private annuity agreement and any other agreements between David Smith and/or Lynn Smith and the irrevocable trust, including, but not limited to, all correspondence, drafts, revisions and amendments on or before July 29, 2010," correct?

A That's what -- yes, that's what the letter says.

Q Okay. And you did not provide any documents in response to this letter?

A That's correct. And the second sentence after that says, "Such documents are responsive to the documents' request search done on Lynn Smith." This letter was addressed to two attorneys.

Q That's correct. Okay. In the affidavit you submitted last night, you retracted the statement you made in your declaration about having no document regarding the private annuity agreement before July 27, 2010, correct?

A I corrected my prior statement, yes.

Q And that's because of the e-mail sent to you by Mr. Wojeski?

A That's correct.

Q You also submitted a declaration by Mr. Wojeski in connection with the trust certified to the SEC's motion, correct?

A That's correct.

Q Did you draft that declaration?

A I did.

MS. MEHRABAN: Can I have Exhibit 21? 20.

Q I am gonna show you what has been marked as Plaintiff's Exhibit 20. It was e-filed and it's document 147.

Paragraph 2 of this declaration, the last sentence, says, "The first I learned of the existence of an annuity agreement was in late July, when my attorney informed me that the former trustee had just produced the agreement simultaneously to her and to the SEC's counsel." Is that correct?

A That's correct.

Q Okay. And you now know that that statement's not accurate, right?

A That's correct.

Q Okay. I'm gonna show you...

(Pause in proceedings.)

Q Exhibit 13 is Bates stamped TR0000520 through 548. These are documents produced by the trustee to the SEC in response to the SEC's document request, correct?

A That's correct.

Q And these are from the trust files?

A No. This is not from the trust -- you mean the trustee's file?

Q Sorry, the trustee's file.

A No, it's not.

Q Where is it from?

A This is a document which John D'Aleo gave to me at the end of September.

Q 2010?

A 2010.

Q Under what circumstances did he give you the document?

A He was in -- I saw him in the office and he said that he had been given this document by Dave Smith, who had just recently gotten it from Ron Simons, and he said this, you know, describes what the -- might explain this annuity.

Q Why was he giving it to you?

A Why was he giving it to me?

Q Yes.

A Because I am representing the trust and he thought I might be interested in it.

MS. MEHRABAN: Okay. I am gonna offer this into evidence.

MR. ISEMAN: No objection.

THE COURT: Plaintiff's Exhibit 13 is received in evidence.

(Plaintiff's Exhibit 13 received.)

THE COURT: What's the date of the document

production to the SEC?

MS. MEHRABAN: The document request was September 17, 2010. The document production was, I believe, delivered this past Saturday, which is November 13th.

THE WITNESS: The original response was November 2nd, and then the document production occurred Friday or Saturday, I believe.

BY MS. MEHRABAN:

Q Mr. Urbelis sent you documents on May 21, 2010, correct?

A Correct.

Q Okay. And he sent a copy of those documents to the SEC on May 29, 2010, correct?

A That is my understanding, yes.

Q Okay. And you had asked Mr. Urbelis to send you all documents related to the trust, correct?

A I did.

Q Okay. And you reviewed the documents he sent you?

A I did.

Q Okay. Included in the documents you received was the declaration of trust, correct?

A Yes.

Q As well as the cover letter from Mr. Smith, correct?

A Yes.

Q Okay. And this is the cover letter that used the phrase "private annuity trust"?

A Yes.

Q Okay. And at the time you received those documents from Mr. Urbelis, you had no reason to think that the document production from him did not contain all of the documents related to the trust, correct?

A No reason whatsoever.

Q Okay.

MS. MEHRABAN: One minute, your Honor.

(Pause in proceedings.)

MS. MEHRABAN: No further questions, your Honor.

MR. McGRATH: One minute, your Honor?

MS. MEHRABAN: Sorry.

THE COURT: Yes.

(Pause in proceedings.)

MS. MEHRABAN: No further questions, your Honor.

THE COURT: Thank you.

MR. ISEMAN: May I?

THE COURT: Yes.

CROSS-EXAMINATION

BY MR. ISEMAN:

Q Ms. Dunn, at any time during the telephone conversation between you and Mr. Stoelting and Mr. McGrath of the SEC on July 22nd following the call with the Court,

did you use the term "private annuity agreement"?

A Absolutely not. And that's why Mr. McGrath did not hear those words during the conversation, because I didn't use them.

MS. MEHRABAN: Objection.

THE COURT: Sustained as to what Mr. McGrath may have heard.

BY MR. ISEMAN:

Q And had you ever seen a private annuity agreement --

A Absolutely not.

Q -- as of the date of that call?

A Absolutely not.

MR. ISEMAN: Nothing further.

THE COURT: Anything further?

MS. MEHRABAN: No, your Honor.

THE COURT: You may step down.

(Witness was excused.)

THE COURT: Anything further, Mr. Iseman?

MR. ISEMAN: No, your Honor.

THE COURT: All right. I take it there's nothing further from the SEC?

MS. MEHRABAN: No, your Honor.

THE COURT: Is there anything further today?

MR. ISEMAN: No, your Honor.

MS. MEHRABAN: No, your Honor.

THE COURT: All right. Decision is reserved. Thank you.

(This matter adjourned at 11:12 AM.)

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C E R T I F I C A T I O N

I, THERESA J. CASAL, RPR, CRR, CSR, Official Court Reporter in and for the United States District Court, Northern District of New York, do hereby certify that I attended at the time and place set forth in the heading hereof; that I did make a stenographic record of the proceedings held in this matter and caused the same to be transcribed; that the foregoing is a true and correct transcript of the same and whole thereof.

s/Theresa J. Casal

THERESA J. CASAL, RPR, CRR, CSR

USDC Court Reporter - NDNY

DATED: November 26, 2010

Exhibit B

Piaker & Lyons
Certified Public Accountants

FACSIMILE COVER SHEET

TO: David Smith / McGinn Smith
FROM: Ron Simons

FAX: 1-518-449-4894
DATE: 8/10/04

TEL: 1-518-449-5131
NO. PAGES 3
(Including cover sheet)

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RE: Private Annuity

- When trust sells stock ⇒ Proceeds = Basis; Thus NO Gain or Loss.
- Subsequently – Trust makes annuity payments. If total annuity payments exceed stock proceeds, excess payments are capital losses to trust. If annuitant dies early, stock proceeds in excess of actual annuity payments – are capital gain to trust.
- I will call you to discuss.

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EXHIBIT
PL 10cv457

electing to report the annuity under the installment sales rules of § 453, subjecting themselves to imputed interest under § 483.[765] The taxpayer/buyer argued that the private annuity qualified as a contingent payment installment sale and that he should be allowed to deduct the imputed interest.[766] The Claims Court disagreed, holding that the 1980 ISRA did not create an alternative method of reporting a private annuity to that prescribed by § 72. The court noted that § 453 was a general statute that covers various types of property, while § 72 specifically deals with annuities. The court then cited the well-established principle that a specific statute nullifies a general statute to the extent both statutes overlap.

C. Transferee (Trust)

1. General

The primary income tax problem of the transferee is the determination of the basis for the property before the transferee dies (that is, before the total actually paid for the property is finally determined). With depreciable property, this problem arises immediately after the transfer, because the transferee must determine the basis to compute depreciation deductions. With nondepreciable property, the problem arises only if the transferee sells the property before the transferor dies. If the transferor exchanges property that is not depreciable and is not sold before the transferor's death, there should be no need to determine the transferee's basis.

The rules governing the transferee's basis for the property are reasonably well-settled, but before 1955 this was an area of some controversy. Some cases applied the "capital expenditure" theory to determine the transferee's basis: the basis generally equaled the payments actually made to date.[767] Other cases applied the "annuity venture" theory: the basis generally equaled the value of the annuity as of the date of the agreement.[768]

The IRS resolved the controversy over the proper method for determining the transferee's adjusted basis in 1955 when it issued Rev. Rul. 55-119,[769] which combined elements of both the capital expenditure theory and the annuity venture theory. However, Rev. Rul. 55-119 is not without its critics.[770]

Comment: Rev. Rul. 69-74, discussed above,[771] relates only to the transferor. Consequently, that ruling should have no effect on the application of Rev. Rul. 55-119 to transferees.

2. *Basis for Depreciable Property*

a. *Before Transferor's Death*

If a portion of the private annuity transaction constitutes a gift, then the transferee makes appropriate adjustments to the transferor's income tax basis relating to the gift portion.[772]

Under Rev. Rul. 55-119, the transferee's unadjusted basis equals the present value of the annuity[773] as of the date of the transaction, absent any donative intent. This value serves as the basis for computing the transferee's depreciation deductions until the total payments made equal the present value of the annuity. After this break-even point, each additional annuity payment increases the transferee's current adjusted basis, and the transferee computes a new depreciation deduction each year until the transferee dies.

N/A

Example: On July 31, year 1, P, age 66, transfers land appraised at $50,000 and a commercial building built thereon in 1987 and appraised at $250,000 to a child (C) in exchange for C's promise to pay P $36,695 on each July 31 for the rest of P's life. C's depreciation deduction under the Modified Accelerated Cost Recovery System (MACRS)[774] for the first year is $2,943 ($250,000 × 1.177%).[775] For the subsequent years, the factor is 2.564%[776] ($250,000 × 2.564% = $6,410 per year). Thus, at the end of the ninth year, the entire property will have an adjusted basis of $245,777 ($300,000 original basis minus $54,223 depreciation deductions for nine years). The transferee's depreciation deduction for the 10th year would normally have been $6,410. However, the total payments made at the end of the 10th year would be $330,255 (nine payments × $36,695 = $330,255), or $30,255 more than the value of the annuity at the outset. The additional $30,255 would be added to the transferee's original basis

---

[765] The seller was not actually a party to this claim for refund. The buyer tried to argue that since the seller had reported the transaction under § 453(b) and paid his tax accordingly, that § 453 controlled all of the subsequent tax consequences, including the buyer's. The Claims Court noted that there would be practical problems if the tax treatment of both parties to a private annuity transaction were tied together by the seller's/transferor's election to have to report the transaction and held that the tax treatment of an individual taxpayer is determined only by the tax laws applicable to that taxpayer's situation.

[766] The taxpayer cited Regs. § 1.483-2(a)(1), which provides that "[s]uch unstated interest shall constitute interest for all purposes of the Code."

[767] *See, e.g., Citizens Nat'l Bank v. Comm.*, 122 F.2d 1011 (8th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942); *Forrester v. Comm.*, 4 T.C. 907 (1945), *acq.*, 1945 C.B. 3.

[768] *See, e.g., Comm. v. John C. Moore Corp.*, 42 F.2d 186 (2d Cir. 1930), *aff'g* 15 B.T.A. 1140 (1929).

[769] 1955-1 C.B. 352.

[770] *See* Manning & Hersh, "Private Annuities After the Installment Sales Revision Act of 1980," 6 *Rev. of Tax'n Individuals* 20 (1982). A serious distortion of income will result if the annuity payment period is prolonged. If the transferor is living at the end of the property's useful life, a huge depreciation deduction is generated. It has been suggested that the obligor should be allowed to deduct excess payments from his or her yearly income. This was the approach adopted by the Tax Court in one case decided under the 1939 Code. *See Sheridan v. Comm.*, 18 T.C. 381 (1952), *acq.*, 1952-2 C.B. 3.

[771] See VI, A, 2, above.

[772] *See* § 1015; Regs. § 1.1015-4.

[773] The value would be determined, in the usual case, under the estate and gift tax tables in Pub. 1457, *Actuarial Tables, Book Aleph* (1999).

[774] Effective for property placed in service after 1986, there is no accelerated method for real property; the recovery period is 27.5 years for residential real property and 31.5 years for nonresidential real property. However, the taxpayer may elect to recover the cost of residential and nonresidential real property using the straight-line method (and a mid-month convention) over a 40-year period. Section 13151(a) of the 1993 Act amended § 168(c) to provide that the recovery period for nonresidential real property generally placed in service on or after May 13, 1993, is 39 years. This provision does not apply to property a taxpayer placed in service before Jan. 1, 1994, if (1) the taxpayer or a qualified person entered into a binding written contract to purchase or construct the property before May 13, 1993; or (2) construction of the property was commenced by or for the taxpayer or a qualified person before May 13, 1993. A qualified person is any person who transfers his rights in such a contract or such property to the taxpayer, but only if the property is not placed in service by such person before such rights are transferred to the taxpayer.

[775] *See* Pub. 946, *How to Depreciate Property*, Appendix A, Table 7A.

[776] 250,000 (fair market value of property placed in service) divided by 39 years (the applicable recovery period for nonresidential real property) equals $6,410.25 or 2.564%.

for the depreciable portion of the property ($250,000),[777] giving him an adjusted original depreciable basis of $280,255 at the end of the 10th year. When the adjusted original depreciable basis, $280,255, is multiplied by the appropriate depreciation factor (2.564%) for that year, a depreciation deduction of $7,186 is obtained for the 10th year. As each payment is made thereafter, this same process is continued until the transferor dies.

Comment: In *Associated Patentees, Inc. v. Comr.*,[778] the Tax Court permitted the transferee of a patent to deduct each annual payment as depreciation because the total amount to be paid depended upon the transferee's profits and so was highly uncertain. This method is much simpler than Rev. Rul. 55-119's approach. Also, under Rev. Rul. 55-119, once the actual payments exceed the value of the annuity, the depreciation deductions will grow progressively larger after the break-even point. It is also possible the transferee may outlive the useful life of the property, in which case it is hard to conceptualize how the transferee will obtain a deduction for the payments made in subsequent years. The *Associated Patentees* approach would avoid these problems and more accurately reflect the transferee's annual cost for the property. However, it is questionable whether the rationale of *Associated Patentees* applies to a private annuity.

b. After Transferor's Death

At the transferor's death, the transferee's adjusted basis equals the sum total of payments made minus all depreciation deducted.

Example: Under the same facts as in the preceding example, if the transferor dies on Feb. 1, Year 10, the transferee would have taken a total of $61,409 for depreciation. The transferee would have paid $330,255, which, subtracting the depreciation, leaves an adjusted basis of $268,846. Had the transferor died on Feb. 1, Year 3, the transferee's adjusted basis would have been only $64,037 ($73,390 annuity payments minus $9,353 depreciation).

3. Sale of Property Transferred

Rev. Rul. 69-74 treats the transferee as the purchaser of annuity property. Thus, the transferee realizes no immediate gain or loss at the time of purchase. Section 61 does, however, impose a tax when the transferee realizes income from the transferred property; the transferee faces two different sets of tax problems, depending on whether the sale takes place before or after the transferor's death. Rev. Rul. 55-119[779] sets forth the rules and procedures for sales of transferred property in both situations.

a. Before Transferor's Death

(1) Gain

Under Rev. Rul. 55-119, if the transferee sells the annuity property before the transferor's death, then the transferee's basis equals the sum total of (1) the total payments actually made at the time of the sale, plus (2) the present actuarial value of the future annuity payments at the time of the sale, minus (3) all prior depreciation allowed for depreciable property.

Example: The transferor, age 65, transfers stock worth $100,000 to his daughter (*D*) in exchange for her promise to pay him $13,195 per year for life. After making the fifth annual payment, D sells the stock for $200,000. Although five years apart, the §7520 rate for both the month in which the stock was transferred to D and the month in which she sold the stock was 9.4%. D realizes gain as illustrated below.

Step One: Calculate transferee's adjusted basis for gain.

$65,975 (Total payments actually made)[780]
+ $89,945 (Actuarial value of the annuity payments)[781]
$155,920 (Transferee's adjusted basis for gain)

Step Two: Subtract the transferee's adjusted basis from the amount realized.

$200,000 (Amount realized)
− $155,920 (Transferee's adjusted basis)
$44,080 (Transferee's recognized capital gain)

(2) Loss

The transferee's basis for determining the loss realized on the sale of the transferred property equals the total payments actually made at the time of the sale minus depreciation allowed. In a loss situation, all subsequent payments result in a recognized loss.

Example: If D in the example above sold the stock for $65,000, then she would realize a loss of $9757[782] because her adjusted basis equals the sum of the total payments actually made at the time of the sale. D would realize no gain or loss if she sold the stock for an amount between the basis for loss ($65,975) and the basis for gain ($155,920).

If the transferee sells the property while the transferor is living, the transferee must nevertheless continue to make payments under the private annuity agreement and the character of these payments still must be determined. If the transferee recognized gain on the sale, his or her adjusted basis includes the actuarial value of the annuity payments.[783] Consequently, the continuation of the annuity payment after the sale of the property does not affect the transferee's income tax situation until the total of annuity payments made exceeds the transferee's adjusted basis. After that point, the transferee may deduct the excess loss in the year paid.

Example: Assume the same facts as in the previous two examples above, except that the transferor lives 17 years after the sale. D thus made 12 annual payments of $13,195 for a total of $158,340 in the 12th year D would report a

[777] Planners may also add only the amount of payments after the break-even point that correspond to the ratio of depreciable property to nondepreciable property at the time of the transaction. In this example, planners would add 26,548 or 83.358% of the annuity payments after the break-even point to the basis in the building. The same ratio would apply to each subsequent payment.

[778] 4 TC. 979 (1945), *acq.*, 1950-2 C.B. 3.

[779] 1955-1 C.B. 352.

[780] The total annuity payments made at the time of sale, i.e., $13,195 multiplied by five years.

[781] The annual payment of $13,195 multiplied by the annuity factor of 6.8166 for a transferor age 70 at a § 7520 rate of 9.4%.

[782] $65,975 - $65,000 = $975.

[783] $89,945 in the example above.

capital loss of $2,420 (the difference between her adjusted basis for gain of $155,920 and the total payments made of $158,340). If the transferor lived 14 years after the sale, then D would recognize a loss of $2,420 in Year 12 and a loss of $13,195 in each of Year 13 and Year 14. If D recognized a loss on the sale of the annuity property before the transferor's death, then she would be able to deduct each annuity payment of $13,195 as a loss in the year paid.[784]

(3) No Gain or Loss

If the transferee recognized neither gain nor loss on the sale, then the transferee recognizes no loss until the total payments, before and after the sale, exceed the amount realized from the sale.

Example: Assume the facts are as in the previous three examples above, except that after making eight annuity payments, D sold the stock for $100,000, an amount between the basis for loss ($65,975) and the basis for gain ($155,920). D will have made total payments of $105,560 to the transferor both before and after the sale. She therefore can deduct a loss of $5,560[785] in the year of sale and every dollar of each subsequent $13,195 annuity payment.

In the year of the transferor's death, the transferee includes in gross income only the amount, if any, equal to the difference between the amount realized and the total annuity payments actually made at the time of the sale.

Example: The facts are the same as in examples above, except that the transferor died two years after D sold the stock. D will have made total payments of $92,365 (7 x $13,195). In the year of the transferor's death, D will include $7,635 in gross income: the difference between the total annuity payments of $92,365 and the amount realized of $100,000.

b. After Transferor's Death

If the transferee sells the property after the transferor's death, then the basis for determining gain or loss is simply the total payments made minus the total depreciation deductions.

4. Payments After Sale of Property

a. General

If the property is sold before the transferor's death, the transferee will nevertheless continue to make the payments called for by the annuity contract. Consequently, the transferee is faced with the problem of characterizing those payments for income tax purposes.

b. Gain Recognized on Sale

If gain was recognized on the sale then, as discussed above, the transferee would have used the actuarial value of the annuity in determining the basis. From the tax standpoint, consequently, the transferee has in effect already been given credit for the future payments. Therefore, the annuity payments after the sale have no tax effect on the transferee until their total exceeds the actuarial annuity value used to compute the gain. After that point, each payment is a deductible loss.

If the transferor dies before the post-sale payments equal the actuarial value of the annuity, then the transferee will have income in the year of the transferor's death equal to the difference between the actuarial value of the annuity used in computing the gain and the total payments made after the sale.

c. Loss Recognized on Sale

If the transferee recognized a loss on the sale of the property then, as discussed above, the basis for computing the loss was simply the total of annuity payments made before the sale. Thus, for taxes the transferee has not received any credit for payments made after the sale. Consequently, each annuity payment the transferee makes after the sale is a deductible loss.[786]

d. No Gain or Loss Recognized

If, under the rules discussed above, the transferee recognized neither gain nor loss on the sale of the property then no loss is recognized on further payments until the total of all post-annuity payments made, before and after the sale, minus all depreciation deductions, equals the amount realized from the sale. After that, each annuity payment is a deductible loss.

After the transferor's death, if the total of all payments, minus depreciation deducted, is less than the amount realized on the sale, the difference is taxable income to the transferee in the year of the transferor's death.

e. Character of Subsequent Income or Loss

Rev. Rul. 55-119 requires that any income or loss recognized under the foregoing rules be characterized under the principle of *Arrowsmith v. Comm'r*,[787] in which the Supreme Court held that losses arising out of payments made after completion of a particular transaction are characterized by reference to the underlying transaction. Thus, the taxpayers in *Arrowsmith* were required to treat payments to judgment creditors of a liquidated corporation as capital losses because the taxpayers' liability arose out of their status as former shareholders of the corporation and their gain on the liquidation had been taxed as capital gain.

Applying *Arrowsmith* to payments made later by the transferee of a private annuity, or to income recognized later, would usually require that such payments or income be treated as capital gains or losses because the property received and sold by the transferee would normally have been capital assets or § 1231 assets. Also, before the repeal of the capital gains deduction, the *Arrowsmith* rules made it very important that the property be held by the transferee long enough to qualify for long-term capital gain, as the early death of the transferor would otherwise trigger substantial short-term capital gain.

f. Planning to Avoid Gain

The transferee contemplating a sale of the property before the transferor's death should consider transferring the property to a partnership and then having the partnership sell the prop-

[784] Assuming the underlying annuity property is a capital asset under § 1231.

[785] Excess of basis (8 x $13,195) over amount realized from the sale.

[786] Rev. Rul. 55-119, 1955-1 C.B. 352.

[787] 344 U.S. 6 (1952), *aff'g* 193 F.2d 734 (2d Cir.), *rev'g* 15 T.C. 876 (1951).

Federal Taxes - Primary Sources - Rulings & Other Docs.

REV-RUL, Adjusted basis., Rev. Rul. 55-119, 1955-1 CB 352, (Jan. 01, 1955)

Rev. Rul. 55-119, 1955-1 CB 352

SECTION 113(b).--ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS: ADJUSTED BASIS

REGULATIONS 118, SECTION 39.113(b)(1)-1: Adjusted basis.
(Also Sections 113, 114; Regulations 118, Sections 39.113(a)(2)-1, 39.114-1.)
Basis for computing the depreciation allowance and for determining gain or loss upon the disposition of property acquired in exchange for an annuity contract.
O. D. 945, C. B. 4, 44 (1921), and S. M. 3141A, C. B. IV-2, 183 (1925), modified.

[Text]

Advice has been requested relative to the basis for (1) computing depreciation and (2) determining gain or loss upon the subsequent sale or exchange of property received by a taxpayer in exchange for an agreement to make annuity payments to the annuitant (transferor of the property) for the remainder of the annuitant's life.

In O. D. 945, C. B. 4, 44 (1921), the taxpayer received certain land in exchange for a cash payment and his promise to support his mother for the remainder of her life. O. D. 945, as modified by I. T. 2689, C. B. XII-1, 160 (1933), pursuant to the recommendation to that effect in G. C. M. 11655, C. B. XII-1, 159 (1933), holds that the basis for determining gain or loss on the sale of such land is the sum of the cash payment plus the discounted value of the support to be furnished. In S. M. 3141A, C. B. IV-2, 183 (1925), the taxpayer purchased her mother's life interest in property, giving as the consideration therefor her agreement to contribute to the support of her mother for the remainder of her mother's life. S. M. 3141A holds that the total of the payments made and to be made by the taxpayer under the contract will represent the cost of the property acquired.

Under the provisions of section 23(e) of the Internal Revenue Code of 1939, one of the requisites of a deductible loss is that such loss must actually be sustained during the taxable period for which the deduction therefor is sought and evidenced by a closed and completed transaction. See section 39.23(e)-1 of Regulations 118. A transaction in which a taxpayer who is not engaged in the business of writing annuity contracts receives property in exchange for his promise to make annuity payments to the transferor is not a closed and completed transaction until the death of the annuitant. It is not until the death of the annuitant that the fixed cost of the property so acquired may be determined. The annuitant having died and payments under the contract having terminated, the cost of the property, for Federal income tax purposes, is the total of the annuity payments made. See *Thomas H. Mastin* v. *Commissioner*, 28 Fed. (2d) 748; *Citizens National Bank of Kirksville, Mo.* v. *Commissioner*, 122 Fed. (2d) 1011, certiorari denied, 315 U. S. 822; and *D. Bruce Forrester* v. *Commissioner*, 4 T. C. 907. Of course, if the property acquired in exchange for an annuity contract is depreciable property, or if the property is sold prior to termination of the annuity payments, it is necessary to determine a basis upon which to compute a reasonable allowance for depreciation and upon which the gain or loss from the sale or exchange of the property may be determined.

In view of the foregoing and assuming an arm's-length transaction with no intent of a gift on the part of either party, where a taxpayer who is not engaged in the business of writing annuities receives property in exchange for his contract to make annuity payments, the following Federal income tax consequences will result, subject, however, to the provisions of section 24(b) of the Code of 1939, relating to the nondeductibility of certain losses from sales or exchanges of property:

1. The basis (unadjusted) of the property for the purpose of computing the allowance for depreciation prior to the death of the annuitant shall be the value of the prospective payments under the annuity contract (computed as of the date of the transaction in accordance with Table I, section 86.19(f) of Regulations 108 with reference to the life expectancy of the annuitant) until such time as the annuity payments equal the value of the annuity contract at the date of the transaction. Any annuity payments made in excess of the value of the annuity contract at the date of the transaction should be added to the basis of the property for depreciation purposes. However, upon the death of the annuitant, the basis (unadjusted) for computing any subsequent allowance for depreciation becomes the total of the annuity payments made under the contract. In the event

depreciable and nondepreciable property is received, an allocation, for the purpose of computing the basis for the depreciable portion of the property, must be made on the basis of the ratio of the respective fair market values of the depreciable and nondepreciable properties at the time acquired.

2. Should disposition of the property occur after the death of the annuitant, the basis (unadjusted) for determining gain or loss shall be the total of the annuity payments made under the contract. See *D. Bruce Forrester* v. *Commissioner, supra.*

3. Should disposition of the property occur prior to the death of the annuitant, the basis (unadjusted) for determining gain shall be the total of the annuity payments made under the contract up to the date of disposition plus the value of the prospective payments remaining to be paid at the date of such disposition (computed in accordance with Table I, section 86.19(f) of Regulations 118 with reference to the life expectancy of the annuitant as of the date of disposition of the property). The basis (unadjusted) for determining loss shall be the total of the annuity payments actually made at the time of disposition. Compare section 39.23(e)-1, Regulations 118; *Thomas H. Maslin* v. *Commissioner, supra*; and *Citizens National Bank of Knoxville, Mo.* v. *Commissioner, supra*. Of course, a situation may arise where the selling price is less than the adjusted basis for gain and greater than the adjusted basis for loss, in such a case, neither gain nor loss would be recognized at the time of the sale.

Where disposition of property acquired in exchange for a promise to make annuity payments has occurred prior to the death of the annuitant, the taxpayer may realize a gain or loss, for Federal income tax purposes, as a result of events occurring subsequent to such disposition. Whether such events result in a recognized gain or a recognized loss is dependent upon the circumstances in each individual case. If the total of the annuity payments made under the contract (total of payments made before and after disposition of the property) exceeds the basis (unadjusted) of the property used in determining the gain or loss on the disposition, such excess is a loss in the year or years in which paid. In the case of a recognized loss, this will include all payments made after the date of disposition of the property. Where the selling price is such that neither gain nor loss is recognized upon disposition of the property, no loss is sustained until the total of the payments made under the annuity contract (total of payments made before and after disposition of the property) when decreased by depreciation allowed or allowable exceeds the selling price, at which time such excess is a loss in the year in which paid.

On the other hand, in the case of a recognized gain upon disposition of the property prior to the death of the annuitant, if the total of the annuity payments ultimately made is less than the basis (unadjusted) for computing such gain, the excess of such basis over the total of the annuity payments will constitute income in the year the annuitant dies. In the case of a recognized loss, there will be no gain as a result of the annuitant's death. In case neither gain nor loss was recognized upon the disposition of the property, if the total annuity payments ultimately made (decreased by depreciation allowed or allowable during the period the property was held and adjusted for capital additions or subtractions) is less than the selling price, the excess of the selling price constitutes income in the year the annuitant dies.

The nature of any gain or loss, whether capital or ordinary, which is recognized as a result of events occurring subsequent to the sale of the property involved will depend upon the purpose for which the property was held. Compare *F. Donald Arrowsmith et al., executors of the last will and testament of Frederick R. Bauer, deceased, and Ruth R. Bauer et al.* v. *Commissioner*, 344 U. S. 6, Ct. D. 1752, C. B. 1952-2, 136.

The principles outlined above may be illustrated by the following examples:

(a) Assume the fair market value of the property received is $95,000 (land $15,000 and building $80,000) and the property is used in the taxpayer's trade or business or for the production of income. The remaining life of the building is 50 years and the estimated salvage value of the building at the end of that time is $15,000. The annuity contract provides for annual payments of $10,000 to the annuitant (transferor) for the remainder of his life. At the time of transaction the present value of the annuity contract is $94,785 (at age 69).

The annual depreciation would be computed for the period up to the date of the annuitant's death as follows:

$80,000/$95,000x$94,785-$15,000/50=$1,296.38

(b) If the annuitant should die at the end of the eighth year, the annual depreciation for subsequent taxable

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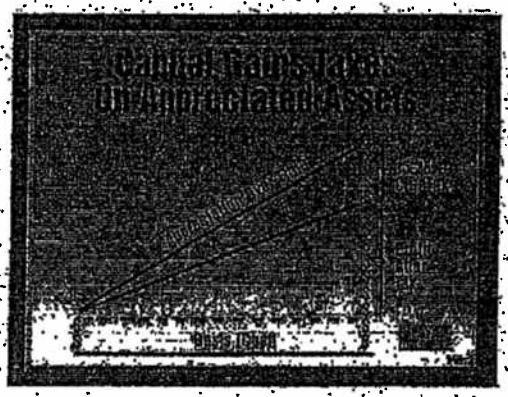

McGinnSmith & Company, Inc.
David L. Smith
President
99 Pine Street
Albany, NY 12207
Telephone 518-449-5131
Fax 518-449-4894
www.mcginnsmith.com

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Revision 4

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DEFERRAL OF CAPITAL GAINS AND DEPRECIATION RECAPTURE TAXES

The Capital Gains Tax Problem. Capital gains taxes are a tax on the profit we make when we sell assets. The asset may be real estate, personal property, investments and securities, a business, an art collection, etc. Any long term asset sold at a profit is subject to a capital gains tax of some rate. Figure 1 illustrates this concept. The left side represents the price paid or the cost of the asset. This cost is called the "Basis". Moving to the right side of the graph is a progression thru time. Over time the asset grows in value or appreciates. The right side of the graph represents the point of time at which the owner wants to sell the asset. Unfortunately the seller does not get to keep all the profit, the capital gains, and is taxed at some rate.

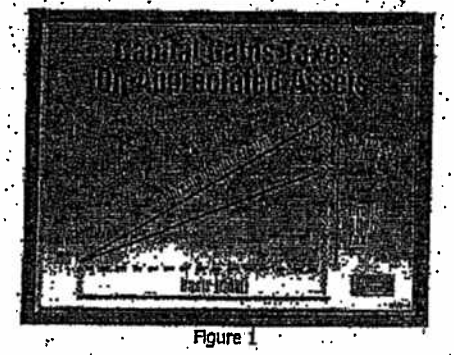

Figure 1

The rate for a significantly sized sale of an asset owned for one year or longer (referred to as long term gains) will be 15% for federal taxes. Most states charge 5% to 10% on top of that, making the total tax run as high as 25%. If there is depreciation recapture in the asset sale, that is taxed at 25% federal rate, making the tax on recapture higher than the capital gains tax.

That isn't the end of the story for the total tax effect though. Capital gains must be added to the taxpayer's adjusted gross income (AGI). This means that capital gains or profits will raise the "floor" above which one can take a number of itemized deductions. This often results in a large decrease or total loss of those deductions. Also the higher AGI from adding in the capital gains is taken into account in computing the phase out of personal exemptions. Again, for many taxpayers this results in a large loss of deductions. This makes the effective, but hidden, capital gains rate much larger than the stated federal and state rates. As a result of the hidden and the recapture taxes the total tax effect on a capital gains sale can easily exceed 25%. To make matters worse the capital gains and depreciation recapture taxes must be paid within ninety days of the sale of the asset. With that background we will begin our overview of the Premier VI Private Annuity.

Step 1, Selling the Property To a Trust. The process starts with a property owner depicted on the left of Figure 2. We will refer to this property owner as the "annuitant" in the rest of this discussion. We are assuming that the annuitant owns property worth $1,000,000, as illustrated in the lower part of the diagram. We know that 1,000,000 is the fair market value because the annuitant previously located a buyer who offered that amount for the property. Before the annuitant completes a sale to that buyer the annuitant transfers ownership to a dedicated family trust. This transfer isn't a gift, but is a special type sale, as explained later.

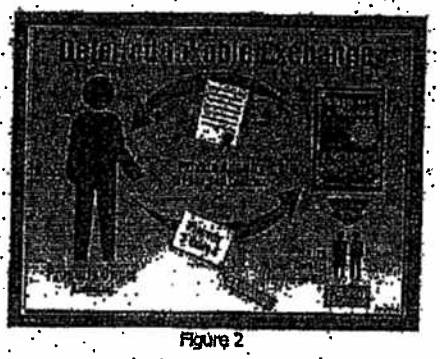

Figure 2

The trust is represented by the bank safe. The owners of the trust are the heirs of the annuitant, probably his

children. They are the beneficiaries of the trust. The trust, representing the beneficiaries, becomes the owner of the property once it is transferred to the trust.

Step 2, Paying Annuitant for the Property. Next, the trust "pays" the annuitant for the property (Figure 2). The payment isn't in cash, but with a special payment contract called a "private annuity". A private annuity is not an annuity issued by an insurance company. It is strictly a private arrangement between the trust and the annuitant. It is very important in understanding this entire program that this is a buy-sale transaction, not a gift to the trust by the annuitant. The form of payment is not outright cash, but is a life annuity. The payment amount is the property's fair market value, also known in tax law as "full and adequate consideration".

A private annuity is something like an installment sale. Instead of specifying an exact number of payments as in an installment sale, the private annuity promises to make payments to the annuitant for the rest of his life. Since the property was worth $1,000,000, the face value of the annuity contract is also $1,000,000. The amount of the life time annuity payments will be in direct proportion to this face value. The annuity payments may begin immediately or they may be deferred for some period of months or years. The amount of the annuity payments in this example are detailed in a later topic.

Step 3, Liquidation of the Property. The next step in the private annuity process (Figure 3) is liquidation of the private annuity property. The trust, as the new owner, sells the property to the previously identified buyer. In the example we are following, the outside buyer pays the trust $1,000,000 cash for the property.

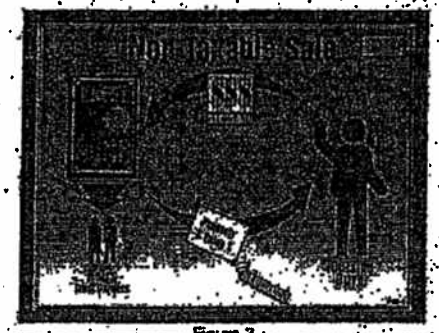

Figure 3

Taxation for Annuitant. The tax ramification to the annuitant is that the exchange is not immediately taxable. Under IRS rules the annuitant is taxed only on payments actually received, as they are received, and not all up-front on the entire amount. This is similar to making an installment sale, then paying taxes only on the installment payments as they are received. If the annuitant chooses to defer his annuity, that is wait for some period of time before payments begin, there will be no taxes during the deferral period because no money is received. Once payments begin, whether immediately or at some deferred period, there will be a proportionate amount of taxes owed on each year's payment. For details of how the payments are taxed, see the later topic, *Taxation of Annuity Payments* (Figure 8).

Figure 4

Taxation When Trust Liquidates Property. The tax ramification to the trust's liquidation of the property is: Zero taxes. That is due to the fact that, in this example, the trust sold the asset for $1,000,000 to the outside buyer, and the trust paid $1,000,000 to the annuitant, by means of the private annuity contract. That leaves zero gain to the trust, and zero taxes.

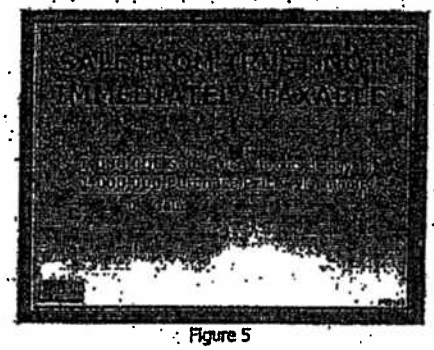

Figure 5

Deferral of Payments. Often annuitants will choose deferral because they have other income and don't need the payments right away. Of course, annuity payments

may begin immediately too; deferral is strictly an option. The deferral can be any amount of time, though payments must begin by age 70-½ . For the annuitant there are no capital gains taxes owed on the asset sale at any time during the deferral period.

Figure 6 provides a time line illustration of what happens when there is a deferral. This annuitant is 45 years old at the time of the creation of the private annuity transaction, doesn't need the payment and he chose a 20 year deferral. He receives no payments during the 20 year deferral and pays no taxes. At age 65 the payment period begins for the annuitant. At that age the annuitant has a 20 year life expectancy according to IRS tables. During the annuity payment period the annuitant will receive taxable annuity payments for as long as he lives, regardless of whether that is longer than, shorter, or exactly 20 years.

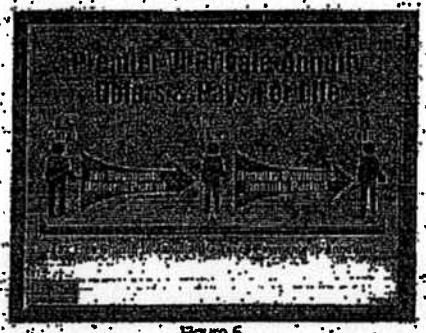

Figure 6

Comparison With a Taxed Sale. It is important to understand that payment of the capital gains tax to the IRS is done with an "easy installment plan". There is no interest or penalty on these deferred payments of the tax. On top of that the tax payments will be made with depreciated dollars. The tax dollars will be worth far less than they are today due to inflation. Yet the underlying investment will grow in value, probably at more than the rate of inflation.

In our example, the $1,000,000 property placed in the trust was sold for cash by the trust. The trust accrues interest to the annuitant on the $1,000,000. (The interest rate is dictated by the IRS under Section 7520 of the Tax Code.) So the annuitant has the entire untaxed value of the sale, $1,000,000, growing and earning interest for him. He may earn much more money than he would if he sold the property and paid the tax up-front. This is due to both the twenty year deferral to age 65 and the spreading of the tax payments over an additional twenty year period.

Let's examine actual numbers and compare the annuity transaction to a straight-forward, taxed sale (see Figure 7). We start with the $1,000,000 property value. The annuitant's basis is 200,000 leaving a profit or gain of 800,000. We are estimating combined federal and state capital gains taxes at 160,000 which is 20% of the profit (assuming 15% federal and 5% state tax rates). This leaves net cash of 840,000 in a direct sale vs. 1,000,000 in the annuity deferral sale. We are assuming that the net investment cash earns 6.0% before income taxes for the next 20 years. The property owner or annuitant is age 45 at the beginning, so he will be 65 when he starts to take payments from either of these plans. Under the direct and taxed sale the property owner receives annual payments of 277,300 vs. 330,119 under the annuity plan. This yields an estimated life payout of 5,546,000 under the taxed plan vs. 6,602,380 with the annuity strategy. That is an advantage of 1,056,380 more money to the annuitant. This advantage is due to the larger amount of net cash that was initially available to invest for the annuitant.

Figure 7

Fixed Nature of Annuity Payments. It is important to understand that the annuitant's income is locked in to a fixed payment amount that is determined by three factors: Private annuity face value, annuitant's age and the IRS stipulated interest rate. No matter how much the trust earns the annuitant *cannot receive more than his fixed payments*. Any excess that the trust earns must be held for or paid to the trust beneficiaries. This should not be viewed as a negative feature however. The annuitant will receive all his principal over time and all the accrued interest on the unpaid balance of his principal. And, he is receiving it in a tax advantaged manner. The annuitant's chief consideration should not be on what may be left behind in the trust. It should be on whether or not he is benefiting more from the private annuity than he would from a taxed sale (and that assumes he is self disciplined enough to invest and manage his own money from the taxed sale).

Taxation of Annuity Payments. With Figure 8 we explain how the annuitant's private annuity payments are taxed. First, this annuitant has a cost basis in his property, and a proportionate share of that basis is returned to the annuitant each year. The basis portion is tax-free to the annuitant. Another part of each year's payment will be a proportionate share of the capital gains, and that portion will be taxed at capital gains rates. The last part of the payment is ordinary income, and is taxed accordingly. The reason the annuitant receives ordinary income is that the private annuity always earns interest on the unpaid balance, and interest is paid out each year on top of the basis and capital gains portions.

The proportionate share of tax free return of basis and capital gains is determined by the annuitant's life expectancy at the time that the payments begin. If the annuitant has a 15 year life expectancy, he will receive 1/15th of his basis and 1/15th of the capital gains each year. With a 20 year life expectancy the annuitant will receive 1/20th of basis and 1/20th of capital gains each year. If the annuitant lives longer than life expectancy, he will have received a 100% return of his basis and capital gains at full life expectancy. So all further payments will be treated as 100% ordinary income to him.

Figure 8

Depreciation Recapture. While we have primarily focused on the capital gains tax, depreciation recapture taxes are also deferred with a private annuity. But in either a cash sale or an installment sale the depreciation recapture is taxed immediately. While an installment sale can spread the capital gains out over a number of years, it cannot do the same with depreciation recapture. Furthermore, installment sales have "related party rules" that prevent an arrangement such as the private annuity trust described above. The related party rules only permit an installment sale with an outsider. This prevents the selling family from using a trust to make a cash sale, with the trust making installment payments to the original property owner.

Trust Investments. There is substantial flexibility in making investments with the trust's funds. The money may be invested in securities, real estate, or even in a new or existing business. Many investment advisors recommend using the trust funds to purchase a commercial variable annuity as the best tax advantaged investment vehicle, while other advisors may recommend mutual funds or individual stocks for the trust. The primary requirement of the trust's investment program is simply to produce the cash flow necessary for the private annuity payments to the annuitant.

Trustees. Annuitants cannot be the trustee nor have any direct control over the trust. The trustee may be any adult trust beneficiary or any person who is independent of the annuitants. For example, an adult child who is also a beneficiary may be the trustee. The annuitants' accountant, attorney, financial advisor, family friend or a relative who is not in the immediate family are all possible choices. There may be either one trustee, or two co-trustees.

Another trustee option is to use a corporate trustee. The National Association of Financial and Estate Planning (NAFEP) can assist with corporate trustee choices, or the annuitant may use a local trust company.

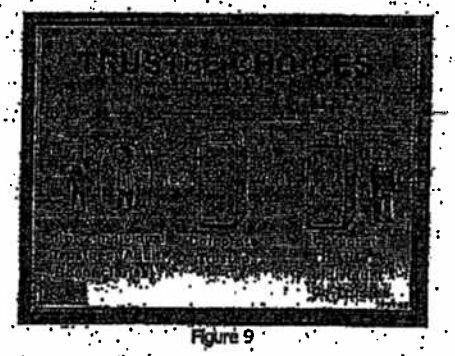

Figure 9

Benefits for Original Property. There are certain benefits for the property which the annuitant transfers to the trust. They are:

1. The entire value of the property is removed from the taxable estate of the annuitant. When the annuitant dies the payments to him cease and the annuity becomes null and void. This leaves nothing in the estate. Whatever is left in the trust will pass to the beneficiaries completely free of estate and gift taxes. (If the annuitant dies before receiving all the payments from an installment sale, the balance of the unpaid payments will be in his taxable estate.)

2. This arrangement does not trigger any gift tax consequences no matter how much the property is worth. The private annuity is treated by federal tax laws as an arms length, buy-sell transaction for full and adequate consideration.

3. The property will not need to go through probate when the annuitant dies. The property is removed from the annuitant's estate by the buy-sell annuity transaction.

Added Benefits to Annuitant and Family. The deferral of capital gains taxes can produce a dramatic increase of cash in your pocket. But that is far from being the only benefit from using a Premier VI Private Annuity. Let's discuss some of these other benefits:

1. The family of the annuitant controls the trust and all the money. Everything from the sale proceeds and all trust earnings either goes to the annuitant or to his heirs. When the annuitant dies everything left in the trust will go to his heirs.

2. The trust can make a cash sale. It is not forced to make an installment sale to the outside buyer in order to spread out the capital gains tax. This is an advantage because you never know whether the outside buyer will make all the payments on an installment sale.

3. The private annuity is the equivalent of receiving a tax free loan from Uncle Sam. The $160,000 of deferred taxes in our example above was used to benefit the annuitant for a period that covered 40 years.

4. The formal mechanics of the trust arrangement provide the discipline that some find helpful in providing for their own retirement. The private annuity works equally well for single or married annuitants. Married couples can have the private annuity written as a joint, last to die contract.

Private Annuity vs. Charitable Remainder Trust. A competing strategy to the private annuity is a program known as a "charitable remainder trust" or CRT. The private annuity has several advantages over the CRT, and virtually no disadvantages:

1. Private annuity payments are often higher, due to the fact the annuity returns all principal, with interest, whereas the CRT pays income (interest) only.

2. The private annuity allows much greater flexibility in investment choices. This is due to the fact the annuity is not "qualified", not regulated by the IRS, whereas the CRT is.

3. A large advantage the private annuity has is that all the benefits stay in the family, where a charity will receive some of the benefits of a CRT. For example, if the private annuity trust earns more money than it needs to make the private annuity payment, that excess may be paid to the beneficiaries. In a CRT there is no such thing as "excess". Further, when the annuitant dies the family receives all the remainder in the private annuity. With the CRT the remainder goes to the selected charity.

4. Mortgaged property cannot be transferred to a CRT program, but it can be with the private annuity.

One problem with the CRT approach is that the annuitant could die early, leaving the family with no further benefits. If the annuitant died right away, as sometimes happens, the entire asset would be lost to the family. To solve this problem, most CRT's are sold with a life insurance policy on the life of the annuitant. Of course that further reduces the amount of money the annuitant gets from the CRT.

Finally, if in spite of the private annuity advantages the annuitant is charitably inclined, the private annuity may still be the strategy chosen, using a charity as the beneficiary of the private annuity trust. Then there really is *no* advantage to the CRT.

The Private Annuity As A Gift & Estate Tax Strategy. An important use of a Premier VI Private Annuity is in the transfer of large estates to the next generation free of gift and estate taxes. Many people think the Tax Act of 2001 eliminated gift and estate taxes. But federal estate taxes are scheduled to remain in place through 2009, and then be somewhat replaced by a partial loss of step-up in basis. Gift tax exemptions are scheduled to increase, but the actual gift tax was not eliminated by the 2001 Tax Act. (For complete info on estate and gift taxes, see www.nafep.com, "Estate Planning Under 2001 Tax Act".) Further, most states have their own estate or inheritance taxes. These were not eliminated and they can be quite substantial.

The private annuity process results in an exchange of the annuitant's property for a lifetime annuity income, with that income being based on the full value of the property. The annuitant will receive all the principal and all the accrued interest under actuarial assumptions. In other words, the annuitant is given "full and adequate consideration" for the property. Therefore, the property transfer to the trust is not a gift, not subject to gift taxation. Likewise, when the annuitant dies there are no estate taxes because the property was sold, and the annuity expires null and void at that point. So the private annuity arrangement is a type of insurance policy for the annuitant's gift and estate tax planning. As long as the annuitant is alive he will continue to receive his payments

to help with living expenses, but the balance of the annuity property is out of his estate immediately when he dies.

QUESTIONS AND ANSWERS

Q. How can I know the amount of my payments?

A. NAFER or one of its Associates can provide that answer quickly from three facts: (1) Annuitant(s) age, (2) Selling price of the property minus any mortgages, fees or commissions that must be paid off, (3) The length of deferral, if any, until payments begin. There is no charge or obligation for an illustration of your private annuity interest.

Q. What happens if I live longer or less than life expectancy?

A. Payments go on until you (or the surviving spouse with a married couple) die, no matter whether that is sooner or later than life expectancy. Life expectancy is just the number used to calculate the size of the payments. After your death (or the surviving spouse's) the annuity becomes null and void.

Q. What if I want to change the payment amounts?

A. The payments are locked in to a fixed amount and paid either monthly, quarterly or annually for the rest of your life. The payment will not increase or decrease. The amount is based on IRS dictated interest rates at the time the annuity is created, your age and the fair market value of the exchange property. The amount cannot be changed after the contract is issued, however read the questions below for other possibilities.

Q. What if I need some money before annuity payments begin, or what if I need more than the payments?

A. The trust can lend money to the annuitant, but the loan should not be substantially all the trust's assets, probably no more than 10% of its assets. The loan should be structured the same way a bank would: Fully secured, market interest rates, formal loan documents with a realistic repayment schedule, and repayments are enforced.

Q. Are there any flexibilities or variability's in the annuity payment stream, such as increasing the payments over time?

A. The trust may issue more than one annuity to the annuitant at the outset. For example, maybe the annuitant needs an extra $1,000 a month until retirement, and then needs more. In that case the trust could issue two annuities. The first would be immediate and would be based on just enough exchange property value to pay $1,000 per month. The second annuity would be deferred to retirement age, and would be based on the balance of the value of the exchange property.

Another flexibility is that the annuitant might go to a bank or other lender, and pledge his annuity payment stream to receive a loan in the needed amount.

Q. Could I cancel the whole deal after a few years and get my money?

A. If the trustee agrees, you may terminate the trust and get the cash out. However, this invalidates the deferral you received up to that point, so you would owe all the taxes, plus penalty and interest, on the full amount of cash you received. Also, the trustee should seek legal counsel or NAFER assistance before agreeing to the liquidation.

Q. How much interest will I earn on the unpaid balance?

A. Every month the IRS issues the "Annual Federal Mid Term Rate" (AFMR). This rate is calculated from an arbitrary formula created by the IRS. It fluctuates each month with the normal ups and downs of the credit markets. Your annuity will use the AFMR rate that was current in the month the annuity was created. That rate is fixed for the life of your annuity payments and won't change.

Q. What happens if capital gains tax rates are lowered after I set up the private annuity?

A. Politicians frequently advocate lowering capital gains rates further, as they did in 1997, so this could happen. In that case you would get the benefit of the lowered rate on the capital gains portion of your annuity payments.

Q. How long can the deferral period be?

A. Deferral can be for any amount of time up to age 70-1/2 years old. If you are already older than that a deferral of one year can be arranged by setting up annual payments for the annuity with the first payment scheduled to begin in one year.

Q. Can the deferral period be shortened once the private annuity is setup?

A. Prior to 1998 the answer was yes. But a 1998 U.S. Treasury Decision (TD-8754) seems to have eliminated this type provision, though that result is not certain. TD-8754 also identified other provisions which were no longer allowable. However, the Decision did reaffirm that deferrals of private annuities are legal.

Q. What guarantee do I have that the annuity payments will be made?

A. One important feature of the private annuity is that it must be unsecured. That means that the trust cannot pledge its assets to the annuitant as a guarantee of the annuity. If the annuity is secured the tax strategy is not allowed by the IRS. This is not actually a problem though. The trustee's only role is to make sure your payments are made and that the beneficiaries get whatever is left. The trustee has no legal way to personally benefit from the property. That makes the annuity as secure as the investment of the trust funds. Part of the trustee's job is to make sure that the investments are prudent and reasonable. If the investment is in mutual funds the annuity payments are as safe as the stocks held in that fund. There really is no other variable that affects the security of your payments.

Q. What happens if the trust goes broke before I die?

A. With bad luck or poor investment guidance that could happen, In that case there would be no further taxes, nor penalty or interest owed by either the trust or the annuitant to the IRS. You cannot be taxed on money you have not and will not earn.

Q. How does this compare to an installment sale?

A. An installment sale will spread the capital gains tax over the life of the note. But, there are three problems:

First, an installment sale won't defer depreciation recapture.

Second, when you make the sale to an outsider there is always a chance the deal will go bad, that the payments won't be made, or that the property will be allowed to degrade in value. With the annuity you can get tax deferral without the trust being forced to make an installment sale. The trust can sell for cash if it chooses.

Third, with an installment sale the unpaid balance of the note will be included in your estate when you die, which makes that balance subject to estate taxes. But when the annuitant dies there is nothing left in his taxable estate from the entire annuity transaction. The beneficiaries own whatever is left.

Q. Who serves as trustee?

A. Annuitants cannot be the trustee nor have direct control of any kind over the trust. The trustee may be any adult trust beneficiary or any person who is independent of the annuitants. For example, an adult child who is also a beneficiary may be the trustee. The annuitants' accountant, attorney, financial advisor, family friend or a relative who is not in the immediate family are all possible choices. Another option is a NAFEP corporate trustee furnished by a NAFEP Associate member. No matter who the trustee is a co-trustee can be appointed as an extra measure of security or comfort to the annuitants and beneficiaries. When a co-trustee is used all trust transactions require the signature of both the trustee and co-trustee. In all cases the beneficiaries have the ability to fire and replace the trustee.

Q. Can my spouse be either trustee or the beneficiary of the trust?

A. No in both cases. But, your spouse can be a joint annuitant, even though he/she is not a co or joint owner of the exchange property. With joint annuitants, payments would be made until the death of the second spouse.

Q. How do I manage the trust's investments?

A. The annuitant(s) absolutely cannot manage the investments or any other aspect of the trust. Only the trustee can do that, though the annuitant can make recommendations. Most trustees would go along with those recommendations as long as they were generally prudent investments.

Q. Do I sell the property and put the cash in the trust? May I keep some of the cash from the sale?

A. It is imperative that the property be placed in trust before it is sold. The annuitant may be paid some of the cash when the trust liquidates the property. In that case the annuitant must pay, by the end of the tax quarter, a proportionate share of capital gains taxes on the cash he/she received.

Q. If the annuity payment is fixed, what happens if the trust makes more money than that? What happens to the money left in the trust after my death?

A. Any excess earnings in the trust belong to the beneficiaries, the annuitant's heirs. It may be paid to them at any time, or held until the annuitant's death. Everything left in the trust at the annuitant's death goes to the beneficiaries. It may be paid out to them immediately, or paid over some pre-specified time frame.

Q. How can I have my tax advisor or attorney analyze the private annuity idea?

A. NAFEP or one of its Associates will gladly provide your tax advisor with the technical and legal information he/she needs to properly advise you. This is done routinely by using a NAFEP publication entitled. *Private Annuity Legal Package*. Most CPAs and tax advisors are enthusiastic about the strategy after they understand it.

Q. My attorney (or CPA) has never heard of a private annuity, or doesn't think it is legal. What "proof" is there that this strategy is legitimate?

A. For the best and most complete information refer to the previous answer. For a quick answer have your tax advisor review: IRS Revenue Rulings 55-119 and 69-74, plus the IRS' GCM39503 of 5/19/86 and Treasury Decision TD-8754 issued in 1998, and the Ninth Circuit U.S. Court of Appeals decision "LaFargue v Commissioner, 689 F.2d 845 (1982)". (These rulings and decisions are included or summarized in the above mentioned *Legal Package*).

Q. What risks or other negative factors are there?

A. The only risk to your money is from the stability of the investment. But you have that same concern even if you make a cash, taxed sale because you still need to invest the money. Prudent investment strategies make that risk negligible, though.

There is an unrelated negative factor. The annuity face amount should be something less than the fair market value of your property, by 5% to 10%. This provides the trust with some backup or reserve capital. Without a reserve in the trust the value of the property that went into it and the obligation to make the annuity payments are theoretically equal. The net worth of the trust would be zero, its assets and liabilities would be equal. That could lead to a disallowance of the transaction by the IRS on the grounds that the trust lacks economic substance. Reserve capital needs may be handled by a gift of some additional property to the trust (from either the annuitant or beneficiaries). But the most common way to provide the reserve is by decreasing the face value of the annuity by some amount. NAFEP recommends writing the private annuity for 93% of the fair market value of the property.

Q. I am interested in having one of these plans put together, what should I do next?

A. Your next step is to contact NAFEP or one of its members directly. They will communicate with your tax advisors if necessary. They will also provide an illustration of your annuity payments. To get the program put together they will help you fill out an application. Then an attorney who is an expert with the private annuity will review the information and put the documentation together. Finally, NAFEP or one of its Associate members will assist you and your advisor with implementation.

www.nafep.com

A member of: The National Association of Financial and Estate Planning

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TO: Dave Smith FROM: Ron Simon

FAX: 1-518-449-5131 DATE: 7/30/04

TEL: 1-518-449-4894 NO. PAGES 5 (Including cover sheet)

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RE: Private Annuity

Attached are Trust Tax Return for 2004

Attached is additional info on a Private Annuity. Most items confirm what you had - but there may be additional information such as last page of disadvantages.

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APPENDIX 5C

Comparison of Self-canceling Installment Notes (SCINs) and Private Annuities (See sections 502 and 503)

SCINs	Private Annuities
PAYMENT TERM	
Maximum period of payments does not exceed the life expectancy of transferor.[a]	Payments to be made for the remainder of the transferor's life with no stated maximum or for a period in excess of actuarial life expectancy[a] (e.g., based on joint and survivor life expectancies).
PURCHASE PRICE	
Risk premium for cancellation feature must be included in purchase price or reflected in a higher interest rate. Length of payments must be reasonable. Do not state the premium separately.	Present value of annuity payments to be received over actuarial life expectancy should equal FMV of the property.
CASH FLOW BENEFITS	
Provide liquidity in retirement.	Provide liquidity in retirement.
GIFT TAX TREATMENT	
None if purchase price includes risk premium or higher than normal interest rate is used to create risk premium.[b] Special valuation rules of Chapter 14 do not apply.	No gift if present value of payments over actuarial life expectancy = FMV.[b] Special valuation rules of Chapter 14 do not apply. If joint and survivor annuity with spouse as survivor, no gift tax consequences.
ESTATE PLANNING BENEFITS AND TAX TREATMENT	
1. Not includable in transferor's gross estate since the transferor's right to receive payments ends with his death.[a,c] However, note canceled by executor or by will is included in decedent's gross estate.[d] 2. Remove future appreciation and income from the estate.	1. Not includable in transferor's gross estate since the transferor's right to receive payments ends with his death.[a,c] 2. Remove future appreciation and the property's income from the estate. 3. If a joint and survivor annuity exists, the discounted value of the future payments to be made to the survivor are includable in the first to die's taxable estate unless offset by the marital deduction.
INCOME TAX RECOGNITION BY TRANSFEROR	
1. Deferral of gain.[e] Each payment includes interest income, gain, and return of basis. 2. Loss is recognized in year of sale. However, related party rules apply to prevent loss recognition [IRC Secs. 267(b) and 318(a)]. 3. Deferred gain remaining at death of transferor is recognized as *income in respect of decedent (IRD)* on estate's income tax return.[g,h]	1. Deferral of gain through IRC Sec. 72 (annuity treatment).[b] Return of basis, gain, and interest income are the three components of each payment until transferor attains life expectancy.[b] If transferor lives beyond life expectancy: capital gain changes to ordinary income,[b] and the amount of each payment that had been non-taxable return of basis is taxable ordinary income.[i] 2. Loss is not recognized in year of transfer. If transferor dies before basis is recovered, remaining basis is itemized deduction on final Form 1040 (not subject to 2% floor).[i] Unrecognized deferred gain is ignored. 3. Unrecognized deferred gain remaining at transferor's death is never subject to income tax. 4. If the private annuity is secured, gain may be taxed immediately.[e,j]
INCOME TAX TREATMENT OF PURCHASER	
Deductibility of interest expense is subject to Section 163 rules. Unstated interest is subject to IRC Secs. 483 and 1274.	Interest expense is capitalized to cost of property.[k]

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SCINs	Private Annuities
BASIS TO TRANSFEREE	
Sales price, regardless of whether the obligor (transferor) dies before all payments are made.[e,f]	Beginning depreciable basis is present value of annuity over life expectancy. It increases if payments extend beyond life expectancy and decreases if transferor (annuitant) dies before all scheduled payments are made (based on life expectancy). Basis at time of sale depends on timing of sale.[k]
RISK OF CHALLENGE BY IRS	
Yes—sales price (including risk premium) and length of payment term.	Yes—fair market value.
ADVANTAGES	
1. See gift and estate tax treatment. 2. Provide cash flow to transferor. 3. Deferred payments allow the seller (transferor) to spread the taxable gain over the payment period. 4. As proceeds are received, they are (theoretically) available to pay the tax on the gain. 5. A sale of certain property might allow the seller to restructure his estate to qualify for tax benefits available only if the estate meets certain percentage tests (e.g., IRC Secs. 303, 2032A, and 6166). Each of these benefits pertains to a business interest owned by the decedent at the date of death. 6. Flexibility is greater than private annuity (sales price, interest rate, and length of payments). 7. Purchaser has basis equal to sales price regardless of whether all payments are made. 8. Purchaser may be able to deduct interest payments under IRC Sec. 163. 9. If property sells at a loss, entire loss is recognized in year of sale. However, related party rules apply to prevent loss recognition [IRC Sec. 267(b)]. 10. Note can be secured. 11. Purchaser knows the maximum number of payments that must be made. 12. Prepayments are allowed. 13. Deferred payments make purchase possible for buyers otherwise unable to finance the purchase.	1. If annuitant dies before actuarial life expectancy expires, the unrecognized deferred gain never has to be recognized for income tax. 2. See gift and estate tax treatment. 3. Provides cash flow to transferor (and to survivor if joint and survivor annuity is used). 4. Annuity payments allow the seller (transferor) to spread the taxable gain over the payment period. 5. As annuity payments are received, they are (theoretically) available to pay the tax on the gain. 6. A sale of certain property might allow the seller to restructure his estate to qualify for tax benefits available only if the estate meets certain percentage tests (e.g., IRC Secs. 303, 2032A, and 6166). Each of these benefits pertains to a business interest owned by the decedent at the date of death. 7. If annuitant dies well before end of actuarial life expectancy, the purchaser acquires the property for little cost, and transferor and his estate escapes transfer taxes. Caution: If annuitant is terminally ill at time of sale actual life expectancy is used.[m] 8. Related party is not restricted as to dispositions [i.e., dispositions do not trigger gain to transferor as in IRC Sec. 453(e)]. 9. Deferred payments make purchase possible for buyers otherwise unable to finance the purchase.

Appendix 5C
(Continued)

GEP 8/00

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SCINs

Private Annuities

DISADVANTAGES

1. Unrecognized deferred gain must be recognized as IRD on estate's income tax return.
2. If installment sale was between related parties and transferee disposes of property within two years, gain is accelerated.[a]

1. Flexibility is lesser than SCIN (sales price and length of payments).
2. Buyer's basis is not fixed until annuitant dies (amount actually paid determines basis). (Trust)
3. Interest expense must be capitalized. — Not Deductible
4. Gain deferral can be lost if the annuity is secured.[a]
5. Purchaser does not know the ultimate number of payments because they continue until death of annuitant.
6. If transferor (annuitant) lives beyond life expectancy, payments in the aggregate may be greater than the appreciated value of the asset at date of death. Thus, taxable estate could be greater than if the transfer had never been made.
7. Loss on transfer is not recognized in the year of the transfer. Rather, remaining basis at transferor's death is itemized deduction on transferor's final Form 1040 (not subject to 2%).

CRITERIA

1. Self-canceling provision should be in sales agreement and note.[a]
2. The transferor must not have the power to revoke the cancellation provision.[c]
3. Purchase price must be at arm's length and must include risk premium for the terminating provision, or interest rate should be higher than market rate to reflect risk premium and to avoid IRC Secs. 483 and 1274.[a] (Do not state risk premium separately.)
4. Term of payments should be reasonable considering facts and circumstances.[a] Term should not exceed actuarial life expectancy of transferor.
5. Seller (transferor) should not retain extensive control over the property.[d]

1. Must be unsecured.[a]
2. Payments to be made for the remainder of the transferor's life with no stated maximum or for a period in excess of actuarial life expectancy[e] (e.g., based on joint and survivor life expectancies).
3. Transferor should retain no control over the property, including no voting rights.[g]
4. Present value of annuity payments to be received over actuarial life expectancy should equal FMV of the property. Appraisal is critical.
5. To value the annuity, use life expectancy found in Reg. 1.72-9 and 120% federal midterm AFR. Annuity factors are in IRS Pub. No. 1457.
6. Do not tie life or disability insurance to private annuity agreement.

Notes:

a GCM 39503.
b Rev. Rul. 69-74.
c *Estate of Moss.*
d *Estate of Buckwalter.*
e Rev. Rul. 86-72.
f IRC Sec. 72(b)(2).
g *Estate of Frane.*
h IRC Sec. 453.
i IRC Sec. 72(b)(3).
j *Estate of Bell.*
k Rev. Rul. 55-119.
l IRC Sec. 453(f)(3).
m Reg. 1.7520-3(b)(3).
n IRC Sec. 453(e).
o IRC Sec. 2033.

Appendix 5C
(Continued)

REV-RUL, Introduction., Rev. Rul. 69-74, 1969-1 CB 43, (Jan. 01, 1969)

Rev. Rul. 69-74, 1969-1 CB 43

Section 72.--Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

26 CFR 1.72-1: Introduction.
(Also Sections 101, 2511; 1.101-2, 25.2511-1.)

Principles to be applied in determining the tax consequences of the transfer of appreciated property for a private annuity contract in an intra-family exchange.

[Text]

Advice has been requested relative to the treatment for Federal income and gift tax purposes of monthly payments received under the circumstances outlined below.

In the instant case, the taxpayer, age 74, transferred property (a capital asset) having an adjusted basis of $20,000, and a fair market value of $60,000, to his son in 1966, in exchange for the legally enforceable promise of the latter to pay him a life annuity of $7,200 per annum payable in equal monthly installments of $600.

Section 72(b) of the Internal Revenue Code of 1954 provides that gross income does not include that part of any amount received as an annuity which bears the same ratio to such amount as the investment in the contract bears to the expected return under the contract. Further, section 1.72-3 of the Income Tax Regulations states that amounts received under annuity contracts are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 of the 1954 Code and the regulations thereunder.

Accordingly, the tax consequences of the private annuity transaction in this case are determined by applying the following principles:

(1) The gain realized on the transaction is determined by comparing the transferor's basis in the property with the present value of the annuity. Section 1.101-2(e)(1)(iii)(b)(3) of the regulations prescribes the appropriate table to be used for valuing a private annuity contract. (U.S. Life Table 38 contained in paragraph (f) of section 20.2031-7 of the Estate Tax Regulations.) The gain realized will be capital gain if the transferred property constitutes a capital asset.

(2) The excess of the fair market value of the property transferred over the present value of the annuity acquired constitutes a gift for Federal gift tax purposes where the transaction is not an ordinary business transaction within the meaning of sections 25.2511-1(g)(1) and 25.2512-8 of the Gift Tax Regulations.

(3) The gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includible in gross income by virtue of the application of section 72 of the 1954 Code. This will enable the annuitant to realize his gain on the same basis that he realizes the return of his capital investment.

(4) The investment in the contract for purposes of section 72 of the 1954 Code is the transferor's basis in the property transferred. Since the amount of the gain is not taxed in full at the time of the transaction, such amount does not represent a part of the "premiums or other consideration paid" for the annuity contract. Applying the foregoing principles, the transaction in the instant case is taxable as follows:

(1) Based on U.S. Life Table 38, with interest at 31/2 percent, the present value of the right of a person age 74 to receive a life annuity of $7,200 per annum is $47,713.08.

(2) The excess of the fair market value of the property transferred over the value of the annuity received as a

addition, a transfer of property in exchange for a SCIN will not be subject to gift taxes. Thus, individuals can use it as a vehicle for making lifetime transfers in excess of the applicable exclusion amount ($1 million) for gift tax purposes.

502.37 Note: If the sale involves an interest in a pass-through entity (e.g., S corporation stock), the purchaser will be able to deduct (for income tax purposes) the interest portion of the installment payments (Temp. Reg. 1.163-8T). This may be classified as business or investment interest depending on the activities of the S corporation. See Ltr. Rul. 9215013, where the IRS allocated the interest of business assets and investment assets. A similar rule should apply when the sale is of a partnership interest (Ltr. Ruls. 9031022, 9037027, and 9040066; IRS Notices 88-20 and 89-35).

502.38 Appendix 5C compares self-canceling installment notes and private annuities, which are alternate planning techniques for transferring property to family members. Private annuities are discussed in section 503. Also, see section 509 for a discussion of intrafamily loans (as opposed to sales), including developments dealing with forgiveness of intrafamily debt.

503 SALE OF PROPERTY FOR A PRIVATE ANNUITY

503.1 Generally, the value of an annuity in which payments were being received by a decedent at the date-of-death is included in his gross estate (IRC Sec. 2039). However, if all rights to receive payments terminate upon the annuitant's death, no "transfer at death" occurs, and, accordingly, nothing is included in the gross estate.

503.2 A private annuity involves a transfer of property in exchange for an unsecured promise to receive a stream of fixed payments for life. It is distinguished from a commercial annuity involving a contract between an individual and an insurance company. A private annuity is a valuable estate planning tool in many family transfer situations. Typically, an older-generation family member transfers an appreciating asset (e.g., closely held business or real estate) to a younger-generation family member or to a trust in exchange for the transferee's promise to make fixed, periodic payments for the remainder of the transferor's life.

503.3 Structured properly, such a transfer removes the asset from the transferor's gross estate, as long as the payments terminate upon his death. The transferor receives a steady cash flow stream, and the property can be retained within the family unit. For this reason, private annuities may be appropriate in family business succession planning situations. In addition, the transferor is relieved of whatever burdens might be associated with the ownership and management of the property, and his estate will be relieved of the related administration of the property.

503.4 Another opportunity to use a private annuity is for a surviving spouse to transfer all or a portion of marital trust property to either a bypass trust or the heirs, in exchange for a private annuity, when estate tax would otherwise be due upon his or her death. (See Chapter 12 for a discussion of marital trusts and bypass trusts.)

Example 5-8: Exchange of marital trust assets for a private annuity.

Tom Brown died in 2009, leaving his entire $1 million estate to a marital trust for the benefit of his wife, Stella, who was 72 years old. Under the terms of the trust instrument, Stella had a general power of appointment over the trust assets. Absent further estate planning, the assets would be included in Stella's gross estate upon her death, along with any assets that Stella owned herself.

To avoid gross estate inclusion of the $1 million of assets Stella inherited from Tom, she could exchange the assets with her adult children for a private annuity that would pay her a fixed amount for life. Thereafter, Stella has a steady income stream that she can count on, and the $1 million and any future appreciation are removed from her gross estate for estate tax purposes.

503.5 Downsides to private annuities include (a) the possibility that the seller will outlive his actuarial life expectancy, which could cause the buyer to pay more for the asset than he or she otherwise would, (b) the difficulty of determining the income tax basis of the transferred assets (see discussion at

paragraph 503.18), and (c) the nondeductibility of the interest element in the annuity payment (see discussion at paragraph 503.25).

503.6 The estate and generation-skipping transfer taxes are scheduled for repeal effective for decedents dying after December 31, 2009. If repeal becomes permanent (note that Congress must act to permanently repeal the estate tax), this will limit the estate planning benefits of a private annuity for individuals who are alive when repeal is scheduled to take effect in 2010. However, if the seller desires to transfer the asset prior to death and needs to receive some consideration in return, the private annuity is an attractive technique to meet these objectives. In addition, a transfer of property in exchange for a private annuity will not be subject to gift taxes. Thus, individuals can use it as a vehicle for making lifetime transfers in excess of the applicable exclusion amount ($1,000,000) for gift tax purposes.

Cash Flow Considerations

503.7 The payments from a private annuity are generally based on the transferor's life expectancy. Thus, this arrangement can provide liquidity over the life of the annuitant.

503.8 Planning Tip: If income for a surviving spouse is an issue, the annuity could be established as a joint and survivor annuity (i.e., over the lives of both spouses). This would decrease the annuity payments because of the increased probability of a longer payment schedule.

503.9 Planning Tip: The transferor might consider obtaining life insurance and/or disability insurance on the transferee because a private annuity must be an unsecured agreement. However, the insurance should not be mentioned or tied to the private annuity in any way, since securing the annuity would cause the entire capital gain from the sale to be recognized in the year of transfer. (See paragraph 503.20.)

Income Tax Considerations

503.10 The transfer of property in exchange for an annuity typically generates a gain that is recognized ratably as the annuity payments are received over the transferor's life (Rev. Rul. 69-74). The overall gain to be recognized is determined by subtracting the transferor's basis in the property from the present value of the annuity, which is to be determined by using IRS actuarial tables (IRC Sec. 7520). The overall gain is reported ratably (i.e., on a straight-line basis) over the transferor's life expectancy as of the annuity starting date. See Appendix B for the life expectancy table used to determine the amount of gain to be reported each year.

503.11 If the property was a capital asset, the gain will be a capital gain. If the private annuity sale involves related parties, no loss will be recognized on the initial transfer because of the related party loss limitations of IRC Sec. 267. See section 502 for a discussion of these limitations.

503.12 In addition to the gain component, each annuity payment will include an interest, or ordinary income component, to the extent the annuity payment exceeds the sum of the gain component and the return of investment (i.e., basis) component. Rev. Rul. 69-74 requires that from each payment received, the return of investment (i.e., basis) portion and the capital gain portion are subtracted, and the remaining portion is ordinary income. While the ordinary income portion is similar to an interest payment, it cannot be deducted by the payor of the annuity. However, the ordinary income portion is included in the calculation of the buyer's adjusted basis in the property.

503.13 Note that the "simplified general rule" used for commercial annuities is not available to calculate the taxability of the annuity payments received from a private annuity. Instead, the "general rule," as described in IRS Pub. 939, "Pension General Rule," must be used. This involves the calculation of an exclusion ratio that is used to determine the nontaxable return of investment portion of each annuity payment. The exclusion ratio is the transferor's investment in the contract (i.e., basis in the transferred property) divided by the expected return under the contract as of the annuity starting date [IRC Sec. 72(b)(1)]. The expected return is determined by multiplying the transferor's life expectancy times the amount of the periodic payment to be received. The exclusion ratio is applied to each annuity payment received to determine the portion of the payment that is nontaxable (i.e., the return of investment component). It is applicable throughout the life of the contract.

503.14 Note: If the annuity starting date is after 1986, the exclusion ratio is applied only to payments received that include recovery of the annuitant's investment (i.e., until the anticipated life of the contract is reached based on the annuitant's life expectancy). After the investment is recovered, the amount that would have been excluded based on the exclusion ratio is converted to ordinary income.

Example 5-9: Income tax effects of a private annuity.

John Ware transferred stock in his closely held business to his son, Fred, for the unsecured promise to receive $60,000 annually for life. John was 70 years old at the time of the transfer, and his basis in his stock was $100,000.

The overall gain to be reported over John's life expectancy is determined by subtracting his basis in the stock ($100,000) from the present value of the annuity payments. The present value is determined by applying an annuity factor from Table S (IRS Pub. 1457) to the annual annuity payment of $60,000. The annuity factor is a function of John's age (70) and the Section 7520 rate for the month of the transfer, which is assumed to be 7.4% in this example. Accordingly, the annuity factor is 7.7270. [See Table S (7.4%) at Appendix 8L; recent Section 7520 rates are included in Appendix 8F.] Therefore, the present value of the annuity payments is $463,620 ($60,000 × 7.7270), and the overall gain is $363,620 ($463,620 − $100,000).

According to the life expectancy table (see Appendix 5D), John's life expectancy at the time of the transfer was 16 years. Therefore, the gain to be recognized each year is $22,726 ($363,620 ÷ 16).

The nontaxable return of basis portion of the annuity payments is determined by applying the exclusion ratio to the annual payments received. The exclusion ratio is determined by dividing John's basis ($100,000) by his expected return ($60,000 per year × 16 years or $960,000). Thus, 10.4167% of the annuity payments received will be a nontaxable return of basis.

Therefore, following the guidance of Rev. Rul. 69-74, the $60,000 received each year will consist of the following components:

Gain	$ 22,726	($363,620 ÷ 16)
Nontaxable return of investment	6,250	($60,000 × 10.4167%)
Ordinary income	31,024	[$60,000 − (22,726 + 6,250)]
Total annuity payment	$ 60,000	

503.15 Planning Tip: When a private annuity is used as part of an intrafamily transfer the usual goal is for the annuity payments to be as low as possible so that the junior family member will pay as little as possible for the asset and the transferor will have as little as possible added back to his estate. The most recent mortality tables (issued in 1999) are based on a longer life expectancy, which produces a larger annuity factor and a correspondingly smaller annuity payment.

503.16 Caution: For income tax purposes, the mortality tables under IRC Sec. 72 apply, not IRC Sec. 7520. The tables under IRC Sec. 72 have not been amended, so if a private annuity transaction results in capital gain, that capital gain is recognized (and the cost is recovered) using the same expected return multiples previously found in the regulations under IRC Sec. 72.

503.17 If the transferor dies before the end of his life expectancy, his unrecovered basis (i.e., investment in the annuity contract) is deductible as a miscellaneous itemized deduction not subject to the 2% of AGI limit on his final individual income tax return [IRC Sec. 72(b)(3)]. If the transferor lives beyond his life expectancy so that his basis has been fully recovered, all additional payments are considered ordinary income.

503.18 The transferee's basis in the property is generally the present value of the annuity (i.e., the same amount used to determine the seller's overall gain). However, if the transferor dies prematurely, the transferee's basis is limited to the annuity payments actually made. Conversely, if the transferor outlives his actuarial life expectancy, the transferee's basis is increased by the additional payments made. Unlike the result with

self-canceling installment obligations where the death of the transferor before the note is paid results in income in respect of a decedent to the transferor's estate (*Estate of Frane*; paragraph 502.35), the dissent in *Frané* stated that the cancellation of the private annuity at death would not result in income in respect of a decedent to the transferor's estate.

503.19 Planning Tip: The loss of the step-up in basis that would have occurred if the property owner had held the property until death must be weighed against the benefits of the annuity plan.

503.20 Caution: If the annuity is secured, the entire capital gain portion is recognized in the year of the transfer (*Self Estate*). Thus, for planning purposes, it is essential that private annuities be structured as unsecured obligations.

503.21 In addition to private annuity contracts between two individuals (e.g., senior generation business owner and junior generation successor), a private annuity may also be structured between an individual seller and a corporation, trust, or any other party. A private annuity can be used to fund a stock redemption whereby an individual shareholder transfers stock back to the corporation in exchange for an annuity. In such situations, it is usually preferable to structure the annuity as a private annuity for a term of years (PATY), as opposed to a lifetime annuity.

503.22 Generally, one of the requirements of a stock redemption (when other family members own stock after the redemption) being treated as a sale rather than as a dividend is that the redeemed shareholder cannot hold an interest, other than as a creditor, in the corporation for at least 10 years following the redemption [IRC Sec. 302]. Thus, the key when using a private annuity to fund a redemption is for the redeemed shareholder to be considered a creditor and not an equity interest owner. If the annuity contract is for life, the IRS may contend that the redeemed shareholder actually retained an equity interest instead of an interest as a creditor. However, if the term of the interest is less than 15 years, the IRS may (but is not obligated to) issue a favorable advance ruling on the issue if there is no chance the stock would be returned to the shareholder if the corporation defaulted and the payments are not contingent (Rev. Proc. 2002-3; Ltr. Ruls. 8319073 and 8503058).

503.23 Note: Since private annuities are technically not installment sales, the requirement that all recapture income be recognized in the year of an installment sale may not apply. However, there are no rulings or cases directly on point, and the IRS could assert that a literal reading of language in IRC Secs. 1245(a)(1) and 1250(a)(1) requires ordinary income recognition in the year of sale.

503.24 If income-producing property is transferred via a private annuity, income taxes may be saved by the family unit if the transferee is in a lower income tax bracket than the transferor. If the property is depreciable, the depreciation deductions can shelter income received by the transferee. Depreciation deductions can be especially attractive if the property was fully depreciated in the hands of the transferor prior to the sale.

503.25 No portion of the transferee's payments are deductible as interest. This may be a disadvantage when compared to a self-canceling installment note (SCIN) when the property sold is an interest in a pass-through entity. In those situations, the interest is deductible by the purchaser.

503.26 See Appendix 5C for a table comparing the advantages, disadvantages, and features of private annuities and SCINs, which are discussed in section 502.

Gift Tax Considerations

503.27 In addition to the income tax considerations of private annuities, the estate planner must consider the gift and estate tax ramifications as well.

503.28 If the fair market value of the transferred property exceeds the present value of the annuity payments, such excess is a taxable gift for gift tax purposes. However, up to $11,000 (indexed for inflation) of the excess can be sheltered from gift tax by the transferor's annual gift tax exclusion. (See section 304 for additional information on the annual exclusion.) Therefore, to avoid creating a taxable gift, the annuity payments should be set so that the present value of the payments, based on the life expectancy of the

transferor, equals the fair market value of the property. If the buyer has difficulty meeting the payment obligations, the seller can use his annual gift tax exclusion to forgive up to $11,000 per year of annuity payments, although it is important to be able to demonstrate that a bona fide debtor-creditor relationship exists. It is important to avoid the situation where the IRS could claim there was an implied understanding regarding the systematic forgiveness of the debt. In such cases, the IRS could claim that the entire transaction was a gift or that the seller retained the income from the property, causing inclusion of the property in the seller's gross estate under IRC Sec. 2036. See section 509 for a discussion of a court case that involved the systematic forgiveness of $11,000 of intrafamily debt per year.

503.29 When the fair market value is not readily determinable, an appraisal of the property transferred is essential to document the valuation used for gift tax purposes.

Example 5-10: Taxable gift generated by a private annuity.

Assume the same facts as in Example 5-9. If the fair market value of the stock was $500,000, the transfer would generate a gift to Fred of $36,380 ($500,000 – $463,620 value of annuity received), of which $11,000 could be sheltered by John's annual gift tax exclusion.

503.30 **Planning Tip:** If one of the objectives is to minimize the periodic payment, the best time to structure a private annuity is when interest rates are at their lowest. Lower interest rates cause the present value of the annuity to be higher than in a period of higher interest rates. Thus, it takes a lower periodic payment to equalize the present value of the annuity and the fair market value of the property.

503.31 **Planning Tip:** If the transferor is in poor health and is expected to die before the end of his actuarial life expectancy (Appendix 5D) but death is not clearly imminent at the time of the transfer, a private annuity will transfer out of the estate much more than the transferor receives back in the form of annuity payments.

503.32 If an individual is terminally ill (i.e., known to have an incurable illness or deteriorating physical condition and has at least a 50% probability of death within one year), the IRS actuarial tables cannot be used. Actual life expectancy must be used instead. However, if the individual survives for 18 months or longer after the transfer, he is presumed not to have been terminally ill on the date of the transfer (and presumably the tables can be used to value the gift on an amended gift tax return) [Reg. 1.7520-3(b)(3)].

Estate Tax Considerations

503.33 Generally, the value of an annuity in which payments were being received by a decedent at the date of death is included in his gross estate (IRC Sec. 2039). However, if all rights to receive payments terminate upon the annuitant's death, no "transfer at death" occurs, and, accordingly, nothing is included in the gross estate.

503.34 **Note:** If the private annuity is a joint and survivor annuity, the discounted present value of the payments to be received by the survivor is included in the estate of the first to die (IRC Sec. 2039). However, if the joint annuitants were married, the inclusion in the estate of the first to die is offset by the unlimited marital deduction (IRC Sec. 2056). See Chapter 12 for a discussion of the marital deduction.

503.35 Since one of the overriding objectives of a private annuity is to remove the property from the transferor's gross estate, it is essential that the transfer not be construed as a transfer with a retained life estate. The IRS has frequently attacked private annuities and installment sales using a Section 2036 argument when the sale was made to a trust. Thus, the authors recommend avoiding such sales to a trust when possible. Such transfers are included in the transferor's gross estate under IRC Sec. 2036 and are covered in depth in Chapter 4.

503.36 To ensure that IRC Sec. 2036 does not apply, the annuity payments should not be tied to the income generated by the property. In addition, the transferor should not retain control over the property, including voting rights in the case of shares of stock in a closely held corporation.

503.37 IRC Sec. 2036 does not apply to a bona fide sale of property for adequate and full consideration, even if the purchaser is related. Therefore, the authors strongly recommend establishing the fair market value of the property via an appraisal, and structuring the present value of the annuity payments to equal such fair market value, thus meeting the requirement for adequate and full consideration and avoiding the possibility of IRC Sec. 2036 being invoked. However, if IRC Sec. 2039 applies, the "adequate and full" consideration rule does not apply, and thus the full value of the property would be includable in the transferor's gross estate. See paragraph 501.7 for a discussion of this issue.

503.38 If the sale of a remainder interest is to a family member, the annuity payments must meet the IRC Sec. 2702(b) requirements of either (a) fixed amounts payable at least annually or (b) at least annual payments based upon a fixed percentage of the fair market value of the property, valued annually. Of course, if the sale of the remainder interest is to other than a member of the transferor's family (e.g., a niece or nephew), in return for the private annuity, then the annuity payments can be structured in any manner the parties desire, as long as the actuarial value of the private annuity equals the value of the remainder interest.

503.39 **Planning Tip:** In addition to the traditional use of a private annuity discussed above (i.e., to transfer the assets at a reduced transfer tax cost), an additional opportunity may arise after the business owner's death. The first spouse to die (assume husband) often leaves his entire estate, or his estate reduced by the applicable exclusion amount ($1 million in 2003 and $1.5 million in 2004), to the surviving spouse, either outright or in trust. In such situations, the assets will be included in the surviving spouse's gross estate, along with her own assets. To minimize her potential estate tax, the surviving spouse could sell her interest in the decedent's assets to her heirs (or even to a bypass trust created under the husband's will) for a private annuity. This technique would remove the husband's assets from the surviving spouse's gross estate and provide her with a cash flow stream for the rest of her life. (See Example 5-8).

503.40 **Caution:** The technique mentioned in paragraph 503.39 will not work with a qualified terminal interest property (QTIP) trust without triggering a gift. QTIP trusts are discussed in Chapter 12.

Generation-skipping Transfer Tax Considerations

503.41 A private annuity may be a useful technique with which to transfer property to a grandchild. As discussed in Chapter 9, the generation-skipping transfer tax applies to transfers of property to "skip persons," who are individuals more than one generation below that of the transferor. However, the GST tax applies only to gratuitous transfers (either during life or at death). If the transfer is structured as a sale for adequate consideration, as in a private annuity, there is no gratuitous transfer, and the GST tax will not apply.

504 PROS AND CONS OF JOINT OWNERSHIP OF PROPERTY

504.1 Property can be collectively owned by two or more individuals in the following ways:

a. Joint tenancy with right of survivorship.

b. Tenancy in common.

c. Community property.

d. Tenancy by the entirety.

504.2 *Joint tenancy with right of survivorship* (JTWROS) is a form of property ownership in which multiple owners each share an undivided interest in the property. Upon the death of one of the joint tenants, his property interest passes automatically to the surviving joint tenant(s). Thus the key feature of joint tenancy is the "right of survivorship." In approximately half the states, a special form of JTWROS between spouses referred to as tenancy by the entirety exists. It is similar to JTWROS in many ways. However, the interests of the tenants by the entirety are not severable. Furthermore, creditors of one tenant by the entirety cannot reach the property, only creditors of both spouses can do so. However, the IRS can attach a lien even if only one spouse owns the debt. (*Craft*)

Exhibit C

Employee: DV

Wojeski & Company CPAs, P.C.

Inquiry - Client: 4028 Eng: 001

Tran Date	Emp	W/C	Hours	Rate (Adj)	Amount (Adj)	Invoice #	Invoice Description
5/11/2010	DW	404	1.00	225.0000	$225.00	00122429	[redacted]
5/11/2010	DW	404	2.00	225.0000	$450.00	00122429	Smith Trusts
5/18/2010	DW	404	2.10	225.0000	$472.50	00122429	[redacted]
5/25/2010	SR	112	0.50	50.0000	$25.00	00122429	Set up binder in engagement, Scan in 2004, 2005, 2006, 2007, 2008 tr's into engagement
5/25/2010	DW	404	2.00	225.0000	$450.00	00122429	there
6/8/2010	DW	404	1.20	225.0000	$270.00	00122429	nys and irs getting transcripts
6/8/2010	DW	404	3.10	225.0000	$697.50	00122429	get eady for hearing - review affidavits, tax returns, statements
6/9/2010	DW	404	7.00	225.0000	$1,575.00	00122429	trial
6/10/2010	DW	404	8.00	225.0000	$1,800.00	00122429	
6/10/2010	DW	X06	0.00	0.0000	$31.00	00122429	parking
6/11/2010	DW	404	4.10	225.0000	$922.50	00122429	trial
6/11/2010	DW	X12	0.00	0.0000	$10.00	00122429	trial
6/23/2010	DW	404	0.60	225.0000	$135.00	00122429	[redacted]
6/25/2010	DW	404	1.00	225.0000	$225.00	00122429	geoff conf call & initial review of deal
6/29/2010	DW	300	0.40	225.0000	$90.00	00122429	[redacted]
6/30/2010	DW	404	3.20	225.0000	$720.00	00122429	t/cs, review trust and P&I act - discretionary if life interest
7/6/2010	DW	404	0.70	225.0000	$157.50	00122694	letter to inv firm and calls
7/6/2010	DW	300	0.40	225.0000	$90.00	00122694	
7/7/2010	DW	404	1.20	225.0000	$270.00	00122694	with phil and more forms
7/8/2010	DW	404	0.70	225.0000	$157.50	00122694	read decision
7/8/2010	DW	300	0.30	225.0000	$67.50	00122694	
7/9/2010	DW	404	2.80	225.0000	$630.00	00122694	nfs letter, [redacted], tc with phil, e mail to phil, rmr trustee form, nfs talk and clearing trust
7/12/2010	DW	404	1.40	225.0000	$315.00	00122694	new acct req, wires, pine st money, geoff & lauren t/c
7/13/2010	DW	404	0.60	225.0000	$135.00	00122694	kid wires [redacted]
7/14/2010	DW	404	0.50	225.0000	$112.50	00122694	wire stuff with phil
7/15/2010	DW	404	0.50	225.0000	$112.50	00122694	wire problems still
7/19/2010	DW	404	0.40	225.0000	$90.00	00122694	real estate and appraisal issue - got realtor
7/20/2010	DW	404	1.10	225.0000	$247.50	00122694	hugh j conf call, property appraisal
7/20/2010	DW	404	1.60	225.0000	$360.00	00122694	[redacted] pvt ann tr, nubk ck acct

Wojeski & Company CPAs, P.C.

Inquiry - Client: 4028 Eng: 001

Tran Date	Emp	W/C	Hours	Rate (Adj)	Amount (Adj)	Invoice #	Invoice Description
7/20/2010	DW	404	1.00	225.0000	$225.00	00122694	read/research pvt ann trust
7/21/2010	DW	404	1.60	225.0000	$360.00	00122694	[redacted], at nubk open acct
7/21/2010	DW	404	0.50	225.0000	$112.50	00122694	pvt annuity, phil wire
7/22/2010	DW	404	1.00	225.0000	$225.00	00122694	wire to kind issue, phil tal[redacted]
7/22/2010	DW	404	2.00	225.0000	$450.00	00122694	meet with geoff smith here
7/23/2010	DW	404	0.70	225.0000	$157.50	00122694	
7/26/2010	DW	404	1.20	225.0000	$270.00	00122694	[redacted] and wire issues, money not arriving
			4.70	225.0000	$1,057.50	00122694	recording all activity for 2010 and reconciling stmt - filing all documents.
8/2/2010	DW	404	1.00	225.0000	$225.00	00122997	new complaint
8/3/2010	DW	404	0.40	225.0000	$90.00	00122997	new acct and trying to get tax docs
8/4/2010	DW	404	0.50	225.0000	$112.50	00122997	rec bank acct
8/4/2010	DW	404	1.90	225.0000	$427.50	00122997	list of transactions and support since asset freezing
8/10/2010	DW	404	1.50	225.0000	$337.50	00122997	equity agreement
8/11/2010	DW	404	0.50	225.0000	$112.50	00122997	reconcile july rmr stmnt
8/16/2010	DW	404	0.70	225.0000	$157.50	00122997	affidavit and transaction detail
8/16/2010	DW	404	0.40	225.0000	$90.00	00122997	memorialize terms of capacity one investment
8/17/2010	DW	404	0.30	225.0000	$67.50	00122997	t/c and final changes with geoff
8/18/2010	DW	404	0.20	225.0000	$45.00	00122997	property lake permit
8/25/2010	DW	404	0.90	225.0000	$202.50	00122997	[redacted] pvt annuity
9/1/2010	DW	404	0.20	225.0000	$45.00	00123292	phone call with geoff
9/13/2010	DW	404	1.00	225.0000	$225.00	00123292	2010 tax projections
9/16/2010	DW	404	0.80	225.0000	$180.00	00123292	reconcile august
9/17/2010	DW	404	1.00	225.0000	$225.00	00123292	verified acctng, beach rights
9/24/2010	DW	404	1.20	225.0000	$270.00	00123292	
9/27/2010	SB	404	1.50	50.0000	$75.00	00123292	Beach Rights Transfer
9/28/2010	DW	404	0.60	225.0000	$135.00	00123292	reply papers
10/1/2010	SB	404	0.50	50.0000	$25.00		Beach Rights Wrap-up
10/4/2010	DW	404	0.90	225.0000	$202.50		pine street capital and rec
10/9/2010	DW	404	1.20	225.0000	$270.00		review dunn filings
10/13/2010	DW	404	0.60	225.0000	$135.00		capacity one bus plan and [redacted]
10/19/2010	DW	500	0.80	225.0000	$180.00		rmr sept activity
10/20/2010	DW	404	1.40	225.0000	$315.00		subpoena
10/25/2010	DW	112	1.00	225.0000	$225.00		2007 and 2008, transcripts and start

Wojeski & Company CPAs, P.C.

Inquiry - Client: 4028 Eng: 001

Tran Date	Emp	W/C	Hours	Rate (Adj)	Amount (Adj)	Invoice #	Invoice Description
10/29/2010	CHT	110	1.50	40.0000	$60.00		2009
10/29/2010	DW	404	0.80	225.0000	$180.00		Printed documents requested
10/29/2010	DW	404	1.30	225.0000	$292.50		[redacted] & tax impact of annuity
11/1/2010	DW	404	1.10	225.0000	$247.50		go thru and print all document for subpoena
11/1/2010	DW	112	1.30	225.0000	$292.50		[redacted]
11/2/2010	DW	404	0.80	225.0000	$180.00		
11/3/2010	DW	404	2.10	225.0000	$472.50		isetnan talk and jill
11/3/2010	DW	404	1.00	225.0000	$225.00		iseman retainer, curran issue, ac email
11/3/2010	DW	404	0.60	225.0000	$135.00		trust - im welles
11/8/2010	DW	404	2.10	225.0000	$472.50		
11/9/2010	DW	404	0.70	225.0000	$157.50		t/c with [redacted] print time records
11/11/2010	DW	404	13.10	225.0000	$2,947.50		for subpoena
			108.50		$23,738.50		rec oct stmts, [redacted] discovery demand and e mails

Exhibit D

Indemnity and Hold Harmless Agreement

For valuable consideration, the receipt of which is hereby acknowledged, we, David L. Smith and Lynn A. Smith of 2 Rolling Brook Drive, Saratoga Springs, New York, on behalf of ourselves and our heirs, devisees and assigns, jointly and severally hereby agree to release, indemnify, defend and hold harmless David Wojeski of 75 Troy Road, East Greenbush, New York, individually and as Trustee of the David L. Smith and Lynn A. Smith Irrevocable Trust dated August 4, 2004, of and from any and all claims, actions, compensation, obligations, tax assessments, liabilities, demands, contracts, agreements, judgments, at law and in equity, whether in existence now or which may accrue in the future, arising out of or related to the David L. Smith and Lynn A. Smith Irrevocable Trust dated August 2, 2004, including but not limited to, any financial transactions, investments, obligations or distributions, and the potential tax consequences thereof, relating to said Trust, its Donors and its beneficiaries, and any and all financial institutions, third parties and government or quasi-government authorities.

David L. Smith 7/22/10 Date

Lynn A. Smith 7/22/10 Date

EXHIBIT

TR0000242

Exhibit E

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
New York Regional Office
Three World Financial Center
New York, NY 10281

DIVISION OF
ENFORCEMENT

David Stoelting
Senior Trial Counsel
(212) 336-0174 (direct)
(212) 336-1324 (fax)

July 27, 2010

BY EMAIL/US MAIL

James D. Featherstonhaugh
Featherstonhaugh, Wiley & Clyne, LLP
99 Pine Street
Albany, New York 12207

Jill Dunn
99 Pine Street
Albany, New York 12207

Re: ***SEC v. McGinn, Smith & Co., Inc., et al.*, 10-CV-457 (GLS/RFT)**

Dear Jim and Jill:

We received today from Mr. Urbelis certain documents pursuant to Subpoena, including a Private Annuity Agreement dated as of August 31, 2004, between David Smith and Lynn Smith, and the David L. and Lynn A. Smith Irrevocable Trust, and other documents concerning a David Smith life insurance policy.

Please produce all documents concerning the Private Annuity Agreement and any other agreements between David Smith and/or Lynn Smith and the Irrevocable Trust, including but not limited to all correspondence, drafts, revisions and amendments, on or before July 29, 2010. Such documents are responsive to the documents request served on Lynn Smith.

Very truly yours,

David Stoelting

Exhibit F

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,	
Plaintiff,	
v.	
McGINN, SMITH & CO., INC., McGINN, SMITH ADVISORS, LLC, McGINN, SMITH CAPITAL HOLDINGS CORP., FIRST ADVISORY INCOME NOTES, LLC, FIRST EXCELSIOR INCOME NOTES, LLC, FIRST INDEPENDENT INCOME NOTES, LLC, THIRD ALBANY INCOME NOTES, LLC, TIMOTHY M. MCGINN, DAVID L. SMITH, LYNN A. SMITH, DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, GEOFFREY R. SMITH, LAUREN T. SMITH, and NANCY MCGINN,	**10 Civ. 457 (GLS/DRH)**
Defendants,	
LYNN A. SMITH, and NANCY MCGINN,	
Relief Defendants, and	
DAVID M. WOJESKI, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04,	
Intervenor.	

PLAINTIFF'S FIRST REQUEST FOR PRODUCTION OF DOCUMENTS TO DEFENDANT DAVID M. WOJESKI, TRUSTEE OF THE DAVID L. AND LYNN A. SMITH IRREVOCABLE TRUST U/A 8/04/04

Pursuant to Rule 34 of the Federal Rules of Civil Procedure, plaintiff Securities and Exchange Commission requests that defendant David M. Wojeski, Trustee of the David L. and Lynn A. Smith Irrevocable Trust U/A 8/04/04, produce the following documents at the

Commission's offices at 3 World Financial Center, Suite 400, New York, N.Y. 10281, on or before October 17, 2010.

INSTRUCTIONS

1. Each Request requires the production of each responsive document in its entirety, including all non-identical copies, drafts, and identical copies containing different handwritten notations, without abbreviation, expurgation, or redaction.

2. Claims of privilege with respect to any document, or portion of any document, shall be made pursuant to Rule 26(b)(5) of the Federal Rules of Civil Procedure.

3. If any document sought by this Request once was, but no longer is, within a responding party's possession, control or custody, please identify each such document and its present or last known custodian, and state: (a) the reason why the document is not being produced; and (b) the date of the loss, destruction, discarding, theft or other disposal of the document.

4. No part of the document request shall be left unanswered merely because an objection is interposed to another part of the document request.

5. Unless otherwise indicated, this Request seeks documents from January 1, 2003 onward.

6. This Request is ongoing in nature, and the responding party should continue to produce responsive documents as they are found or created on an ongoing basis.

DEFINITIONS

1. "And" as well as "or" shall be construed in either the disjunctive or conjunctive form as necessary to bring within the scope of the request any information which may otherwise be construed to be outside its scope.

2. "Communication" means any transmittal of information (in the form of facts, ideas, inquiries, or otherwise). Communication includes but is not limited to, e-mail, instant messages, faxes, text messages, notes of meetings, phone logs, and letters.

3. "Concerning" means relating to, referring to, describing, evidencing, or constituting.

4. "Document" is defined to be synonymous in meaning and equal in scope to the usage of this term in Federal Rule of Civil Procedure 34(a), including without limitation audio files, voicemail messages, electronic spreadsheets and drafts of electronic spreadsheets or other computerized data, including email messages (deleted or otherwise, and whether located at your offices or at your employees' residences or property, or on central or official databases, your servers and backup servers, local databases, internet-based e-mail servers, individual employees' hard drives, discs or personal digital assistants), notes, memoranda, work papers, paper files, desk files, draft workpapers). A draft or non-identical copy is a separate document within the meaning of this

term.

5. "G. Smith" shall mean Geoffrey R. Smith and any person or entity acting on his behalf.

6. "LT. Smith" shall mean Lauren T. Smith and any person or entity acting on her behalf.

7. "Lynn Smith" shall mean Lynn A. Smith and any person or entity acting on her behalf.

8. "Piaker & Lyons" shall mean Piaker & Lyons Certified Public Accounts, any current or former employee of Piaker & Lyons, and any person or entity acting on its behalf.

9. "Smith" shall mean David L. Smith and any person or entity acting on his behalf.

10. "Trust" shall mean the David L. & Lynn A. Smith Irrevocable Trust U/A, dated August 4, 2004.

11. "Urbelis" shall mean to Thomas J. Urbelis and any person or entity acting on his behalf.

12. "You" or "yours" shall mean to David M. Wojeski and any person or entity acting on his behalf.

DOCUMENTS REQUESTED

1. All documents concerning the Trust, including but not limited to documents concerning the private annuity agreement (the "Annuity Agreement") between Smith and Lynn Smith and the Trust.

2. All documents concerning transfers of money or other assets from the Trust.

3. All documents concerning the purchase of securities, real property or other assets by the Trust.

4. All documents concerning banking, brokerage or other accounts held by or for the benefit of the Trust, including but not limited to account opening documents and monthly statements.

5. All documents concerning taxes due, owing and paid by the Trust.

6. All documents concerning communications with the following persons and entities concerning the Trust, including but not limited to, the Annuity Agreement:

a. Smith;

b. G. Smith;

c. LT. Smith;

d. Lynn Smith;

e. Piaker & Lyons; and

f. Urbelis.

Dated: New York, New York
September 17, 2010

s/David Stoelting
Attorney Bar Number 516163
Attorney for Plaintiff
SECURITIES AND EXCHANGE COMMISSION
New York Regional Office
3 World Financial Center, Suite 400
New York, New York 10281-1022
Telephone: (212) 336-0174
Fax: (212) 336-1324
E-mail: StoeltingD @sec.gov

Of Counsel:
Michael Paley
Kevin McGrath
Lara Mehraban
Linda Arnold

Exhibit G

Stoelting, David

From: Jill Dunn [jdunn708@nycap.rr.com]
Sent: Monday, August 16, 2010 6:01 PM
To: Stoelting, David; jdf@fwc-law.com; mkaplan@gkblaw.com; 'William J. Brown'
Subject: Trustee's Verified Accounting
Attachments: ltr to SEC providing trustee's verified accounting 8-16-10.pdf; Trustee's Verified Accounting 8-16-10.pdf

Please see attached.

Jill A. Dunn, Esq.
The Dunn Law Firm PLLC
99 Pine Street, Suite 210
Albany, NY 12207
(518) 694-8380 phone
(518) 935-9353 fax

The Dunn Law Firm PLLC
99 Pine Street, Suite 210
Albany, New York 12207
(518) 694-8380 telephone
(518) 935-9353 facsimile

Jill A. Dunn

Admitted in New York
and the District of Columbia

August 16, 2010

VIA ELECTRONIC MAIL ONLY

David Stoelting, Esq.
Senior Trial Counsel
Securities and Exchange Commission
Three World Financial Center
New York, NY 10281

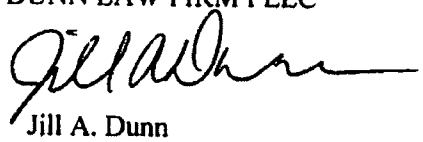
Re: SEC v. McGinn, Smith & Co., Inc., et al.
Civil Action No. 10-CV-457 (GLS/DRH)

Dear Mr. Stoelting:

Enclosed please find the verified accounting required by the present Order to Show Cause.

Very truly yours,

THE DUNN LAW FIRM PLLC

By: 
Jill A. Dunn

JAD/jc

Cc: James D. Featherstonhaugh, Esq.
Martin Kaplan, Esq.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

vs.

McGINN, SMITH & CO., INC.,
McGINN, SMITH ADVISORS, LLC,
McGINN, SMITH CAPITAL HOLDINGS CORP.,
FIRST ADVISORY INCOME NOTES, LLC,
FIRST EXCELSIOR INCOME NOTES, LLC
FIRST INDEPENDENT INCOME NOTES, LLC,
THIRD ALBANY INCOME NOTES, LLC,
TIMOTHY M. McGINN, DAVID L. SMITH,
LYNN A. SMITH, DAVID M. WOJESKI, Trustee of
The David L. and Lynn A. Smith Irrevocable Trust
U/A 8/04/04, GEOFFREY R. SMITH,
LAUREN T. SMITH, and NANCY McGINN,

Defendants, and

Case No.: 1:10-CV-457 (GLS/DRH)

LYNN A. SMITH, and
NANCY McGINN

Relief Defendant, and

DAVID M. WOJESKI, Trustee of the
David L. and Lynn A. Smith Irrevocable
Trust U/A 8/04/04,

Intervenor.

VERIFIED ACCOUNTING

I, David Wojeski, hereby verify, under penalties of perjury, that the attached document sets forth all distributions, payments or transfers from the David L. and Lynn A. Smith Irrevocable Trust since July 7, 2010.

TRUSTEE

DAVID WOJESKI

Sworn to before me this 16th day of August, 2010.

Notary Public

JILL A. DUNN
Notary Public, State of New York
No. 02DU5024316
Qualified in Albany County
Commission Expires ~~March 7, 20~~ April 10, 2014

All transactions since July 7, 2010

Account name	Date	Transaction type	Name	Amount
Kinderhook checking	7/23/2010	wire in	internal transfer	50,000.00
	7/26/2010	check	Wojeski & Company CPA's	(5,775.50)
	7/26/2010	check	Wojeski & Company CPA's	(8,098.50)
	7/31/2010	check	The Dunn Law Firm	(5,355.00)
Kinderhook Savings	7/22/2010	deposit	transfer	2,000,000.00
	7/23/2010	wire out	internal transfer	(50,000.00)
	7/23/2010	wire out	Lynn Smith	(449,878.00)
	7/31/2010	withdrawal	bank & wire fees	(25.00)
	7/31/2010	deposit	interest income	522.85
RMR Cash account				
	7/9/2010	wire out	The Dunn Law Firm	(95,741.40)
	7/12/2010	wire out	Geoffrey Smith	(96,500.00)
	7/12/2010	wire out	Lauren Smith	(83,500.00)
	7/16/2010	wire out	Geoffrey Smith	(200,000.00)
	7/22/2010	wire out	Kinderhook Bank	(2,000,000.00)

Description
transfer from Kinderhook savings
reimbursement for title company charges paid by Wojeski & Company
trustee fees
legal fees
transfer from RMR to get interest on idle cash
transfer to Kinderhook checking
closing proceeds on property purchase
July fees
July interest
legal fees
$75,000 down payment on property, $15,160 credit card debt, $3,055 for health insurance, $3,285 living expenses
$75,000 down payment on property, $1,800 new apt lease deposit, $6,200 credit card debt
Investment in Capacity One Management, LLC - (RMR would not wire directly to the LLC)
to move money to interest bearing account

Mehraban, Lara

From: Jill Dunn [jdunn708@nycap.rr.com]
Sent: Wednesday, August 18, 2010 3:16 PM
To: Stoelting, David; jdf@fwc-law.com; mkaplan@gkblaw.com; 'William J. Brown'; mrusso@gkblaw.com; 'Alison Cohen'; Mehraban, Lara; McGrath, Kevin
Subject: RE: Trustee's Verified Accounting

David,
The verified accounting comports with the clear language of the August 3rd Order. We provided you with a spreadsheet, prepared and verified by the Trustee, which shows "all distributions, payments and transfers out of the Trust account on or after July 7, 2010." There was and is no requirement to provide information regarding acquisitions or purchases by the Trust. The accounting demonstrates that the Trustee invested $600,000 plus closing costs to purchase property from Lynn Smith. A down payment of $150,000 was made to Mrs. Smith by the two beneficiaries through equal distributions from the Trust of $75,000 each. The $449,878 proceeds of sale were paid directly from the purchaser (the Trustee) to the seller (Lynn Smith), which is the customary practice in real estate transactions in this region. Neither the Trust account nor the property acquired was subject to any asset freeze order at the time of the transaction, and there is no requirement in the Order to Show Cause, nor any basis to infer a requirement, that we supply documents related to transactions undertaken by the Trustee. Your queries are in the nature of discovery requests, and are premature at best. As I indicated during the Rule 26(f) conference on Monday, I did not consent and do not intend to commence discovery prior to the Rule 16 scheduling conference on September 2. To the extent that you and Mr. Russo and/or Mr. Featherstonhaugh choose to do so on behalf of your respective clients, that is entirely your option.

If you have any questions, feel free to contact me.

Jill Dunn

From: Stoelting, David [mailto:StoeltingD@SEC.GOV]
Sent: Tuesday, August 17, 2010 5:45 PM
To: Jill Dunn; jdf@fwc-law.com; mkaplan@gkblaw.com; William J. Brown; mrusso@gkblaw.com; Alison Cohen; Mehraban, Lara; McGrath, Kevin
Subject: RE: Trustee's Verified Accounting

Jill –

Thank you for your email.

The Court's 8/3/10 Order requires "a verified accounting of all distributions, payments or transfers from the Smith Trust on or after July 7, 2010." This calls for more than simply a list of transfers accompanied by vague and incomplete descriptions. Accordingly, we request that you provide us with the following information by this Thursday, August 19.

First, the 7/23/10 transfer of $449,878 to Lynn Smith is described as "closing proceeds on property purchase." This is ambiguous. Please explain the nature of this transaction and the property that was purchased. Please also explain the circumstances of this transfer, including who directed the payment of Trust funds directly to Mrs. Smith's account, and why the Trustee permitted the transfer to be made directly to Mrs. Smith's account. This transfer appears inconsistent with Mr. Wojeski's testimony during the PI hearing that he would not allow funds transfers directly to Mrs. Smith's account but rather would require that all transfers go through the beneficiaries' accounts. Tr. at 560.

Second, there are two transfers on July 12, 2010, to Geoffrey Smith and Lauren Smith of, respectively, $96,5000 and 83,500, and $75,000 of each transfer was for "down payment on property." Please identify the location of the "property" and the purpose of each "down payment."

Finally, please provide any documents pertaining to the above-referenced transactions, including contracts of sale.

We are available to discuss any of these issues.

Regards.

David Stoelting

From: Jill Dunn [mailto:jdunn708@nycap.rr.com]
Sent: Monday, August 16, 2010 6:01 PM
To: Stoelting, David; jdf@fwc-law.com; mkaplan@gkblaw.com; 'William J. Brown'
Subject: Trustee's Verified Accounting

Please see attached.

Jill A. Dunn, Esq.
The Dunn Law Firm PLLC
99 Pine Street, Suite 210
Albany, NY 12207
(518) 694-8380 phone
(518) 935-9353 fax

Exhibit H

FEATHERSTONHAUGH, WILEY & CLYNE, LLP
ATTORNEYS AND COUNSELLORS AT LAW

99 PINE STREET
ALBANY, NEW YORK 12207

WEBSITE: FWC-LAW.COM

PHONE: (518) 436-
FAX: (518) 427-

FACSIMILE LEAD SHEET

TO: David Stoelting

FAX NO.: (212) 336-1324

FROM: James D. Featherstonhaugh

DATE: May 5, 2010

RE: Securities and Exchange Commission v. McGinn, Smith & Co., Inc. et al.
Case No: 1:10-CV-457 (GLS/DRH)

NO. OF PAGES TO FOLLOW: 3

CALL Christine at (518) 436-0786 IF MATERIAL IS NOT LEGIBLE

FEATHERSTONHAUGH,
WILEY & CLYNE, LLP
ATTORNEYS AND COUNSELLORS AT LAW

99 PINE STREET
ALBANY, NEW YORK 12207
WEBSITE: FWC-LAW.COM

JAMES D. FEATHERSTONHAUGH
jdf@fwc-law.com

PHONE: (518) 436-0786
FAX: (518) 427-0452

May 5, 2010

Via Facsimile Transmission (212) 336-1324

David Stoelting
Senior Trial Counsel
U.S. Securities and Exchange Commission
Three World Financial Center
New York, New York 10281

RE: SEC v. McGinn, Smith & Co., Inc., et al., 10-CV-447 (GLS/DRH)
Case No: 1-CV-457

Dear Mr. Stoelting:

Attached is the individual accounting requested in paragraph III of the current Consent Order. Please note that the statement does not detail current miscellaneous bills which had been received by Mrs. Smith since the imposition of the asset freeze which she currently estimates to total $20,000.

Very Truly Yours,

Featherstonhaugh, Wiley & Clyne, LLP

James D. Featherstonhaugh

JDF:cr
Enclosure

cc: Michael Koenig, Esquire

(WD029619.1)

Lynn A. Smith
Statement of Net Assets
As of March 31, 2010

	Market Value	
Cash		
Checking (BOA #[redacted]5287) (as of 3/25/10)	$ 1,678	
Individual Retirement Account		
RMR Wealth Management, LLC (#[redacted]) (account held at Dinosaur Securities, LLC)	$ 29,279	(3)
Investment Accounts		
RMR Wealth Management, LLC (#[redacted])	$ 2,118,511	
CMET Financial Holdings, Inc	$ 600,000	(1) (3)
First Virtual Communications, Inc	0	(1) (3)
Loans Receivable		
T. McGinn ($900,000 face value)	$ 0	(2)
T. McGinn ($15,000 face value)	$ 0	(2)
Unpriced Investments/Loans Receivable		
Coventry Carelink	$ 150,000	(3)
Mobil Security	$ 25,000	(3)
Benchmark Trust	$ 150,000	(3)
Real Property		
Primary Residence (held jointly-50% value shown): [redacted] Saratoga Springs, New York 12866	$ 306,000	(3) (4)
Residence: [redacted] Vero Beach, Florida 32963	$ 829,000	(3) (5)
Camp: Betor Road Broadalbin, New York	$ 600,000	(3)
Personal Property		
Furniture ($50,000), jewelry ($150,000), artwork ($15,000)	$ 215,000	(3)
Total Estimated Value of Net Assets	***$ 5,024,468***	

Notes:
(1) Held at Dinosaur Securities LLC, but not priced within statement
(2) Assumed worthless as of 3/31/10
(3) Estimated fair market values provided by owner
(4) Net of 50% of mortgage debt totalling $388,000 or $194,000
(5) Net of mortgage debt of $871,000

VERIFICATION

I, Lynn A. Smith have reviewed a document dated as of March 31, 2010 prepared as a compilation by John D'Aleo, CPA as noted in his attached letter dated May 3, 2010. I provided the information to Mr. D'Aleo to assist him in his preparation of this document and I have personally reviewed the document and believe that it fairly represents my own personal assets, liabilities and general financial condition as of March 31, 2010.

LYNN A. SMITH

Sworn to before me this 5th day of May, 2010.

Christine E Reed
Notary Public - State of New York
No. 01RE6117531
Qualified in Schenectady County
My Commission Expires October 25, 2012

Exhibit I

INDEMNITY AGREEMENT

For valuable consideration, the receipt of which is hereby acknowledged, we, David L. Smith and Lynn A. Smith of [redacted], Saratoga Springs, New York, on behalf of ourselves and our heirs, devisees and assigns, jointly and severally hereby agree to release, indemnify, defend and hold harmless Thomas J. Urbelis of 6 Eastman Road, Andover, Massachusetts individually and as Trustee of the David L. Smith and Lynn A. Smith Irrevocable Trust dated August 4, 2004, of and from any and all claims, actions, compensation, obligations, tax assessments, liabilities, demands, contracts, agreements, judgments, at law and in equity, whether in existence now or which may accrue in the future, arising out of or related to the David L. Smith & Lynn A. Smith Irrevocable Trust dated August 4, 2004 with Thomas J. Urbelis, Trustee, including but not limited to, financial transactions and obligations with National Financial Services LLC, McGinn Smith & Co., Inc., and any and all other financial institutions and government authorities.

David L. Smith — Date 4/6/08 — Lynn A. Smith — Date 4/6/08

PLAINTIFF'S EXHIBIT 31 For ID 6-1-10

Thomas J. Urbelis

From: System Administrator
To: gsmith@rmrwm.com
Sent: Thursday, April 22, 2010 8:57 AM
Subject: Undeliverable: David and Lynn Smith Trust

Your message did not reach some or all of the intended recipients.

Subject: David and Lynn Smith Trust
Sent: 4/22/2010 8:56 AM

The following recipient(s) could not be reached:

gsmith@rmrwm.com on 4/22/2010 8:57 AM
There was a SMTP communication problem with the recipient's email server. Please contact your system administrator.
<uf-fs.uf-law.int #5.5.0 smtp;550 invalid mailbox>