
Heckerling Musings 2014 and Current Developments

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Steve R. Akers

Senior Fiduciary Counsel — Southwest Region, Bessemer Trust
300 Crescent Court, Suite 800
Dallas, TX 75201
214-981-9407
akers@bessemer.com
www.bessemer.com

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TABLE OF CONTENTS

Introduction.....	1
1. Legislative Developments.....	1
2. Treasury-IRS Priority Guidance Plan; “BDITs”.....	6
3. General Approaches to Estate Planning Following ATRA; The “New Normal”.....	7
4. Planning for Couples Having Under \$10 Million.....	9
5. Portability.....	18
6. Estate and Income Tax Intersection—Basis Planning for Larger Estates.....	31
7. Basis Adjustment Flexibility Planning.....	36
8. Joint Spousal Trusts (To Facilitate Funding Credit Shelter Trusts and for Basis Adjustment); Section 2038 Marital Trust.....	46
9. Trust and Estate Planning Considerations for 3.8% Tax on Net Investment Income and Income Taxation of Trusts.....	50
10. Drafting for Maximum Flexibility (and “Dead Hand Control”); But Can It Go Too Far?	68
11. Gift Planning Issues for 2014 and Beyond.....	77
12. Defined Value Clause Updates.....	81
13. Sale to Grantor Trust Transaction (Including Note with Defined Value Feature) Under Attack, <i>Estate of Donald Woelbing v. Commissioner</i> and <i>Estate of Marion Woelbing v. Commissioner</i>	84
14. Grantor Trust Miscellaneous Issues.....	88
15. Self-Canceling Installment Notes (SCINs); CCA 201330033 and <i>Estate of William Davidson</i>	89
16. Same-Sex Marriage Issues.....	94
17. Life Insurance Developments—Right to Dividends, Shark-Fin CLATs, Intergenerational Split Dollar Insurance.....	97
18. Life Insurance Management, Particularly for Life Insurance Trusts.....	98
19. Business Life Insurance.....	101
20. Charitable Planning Reminders, Strategies and Creative Ideas.....	103
21. Planning for Surviving Spouse Who is Beneficiary of QTIP Trust; Sale of Assets for Deferred Private Annuity, <i>Estate of Kite v. Commissioner</i> , T.C. Memo. 2013-43 and Rule 155 Order.....	109
22. IRS Appeals.....	112
23. Generation Skipping Transfer Tax: Post-ATRA Planning and Practical Pointers.....	116
24. Fixing Trusts—Modifying Irrevocable Trusts.....	125
25. Residence and Domicile Issues—State Income Tax Issues.....	128
26. Power to Adjust or Unitrust Election.....	130

27. Funding Unfunded Testamentary Bypass Trusts	132
28. Practical Tips in Dealing With Aging Clients (and Diminished Capacity Issues)	135
29. Gifts of Fractional Interests in Art	137
30. Mandatory Income Requirement For Marital Trust	138
31. Malpractice Issues From Reviewing Documents Prepared by Others	139
32. Recent Cases Addressing Asset Protection Planning and Domestic Asset Protection Trusts	139
33. IRS Valuation Art Panel	142
34. Interest on Graegin Loan Not Deductible; Majority Interest in LLC Valued With Low Marketability Discount, <i>Estate of Koons v. Commissioner</i> , T.C. Memo. 2013-94	142
35. Net Gift Offset by Donee's Assumption of Potential §2035(b) Estate Tax Liability if Donor Dies Within Three Years, <i>Steinberg v. Commissioner</i>	143
36. Reciprocal Powers, PLRs 201345004, 201345026, 201345027, 201345028.	144
37. Valuation of Investment Holding Company; Valuation Method, Built-In Gains Tax Adjustment, Lack of Control and Marketability Discounts, and Undervaluation Penalty, <i>Estate of Richmond v. Commissioner</i> , T.C. Memo 2014-26.....	144
38. New York Estate, Gift, GST, and Trust Income Tax Issues.....	153
39. Family Limited Partnership Attack for Estate Inclusion Without Any Discounts, <i>Estate of Williams</i>	154
40. Valuation of Real Property in 2009 (When Comparables Were Not Available Reflecting Depressed Values Following the 2008 "Crash" Because Properties Were Not Selling), <i>Estate of Lovins</i>	155
41. Appraiser Failed to Testify; Estate Arguing Lower Value Than on Form 706, <i>Estate of Tanenblatt</i>	155
42. Early Termination of Charitable Remainder Trusts	156
43. Garnishment from Discretionary Spendthrift Trusts.....	156
44. Material Participation by Trustee , <i>Frank Aragona Trust</i>	157
45. Interesting Quotations	167
APPENDIX A.....	176
APPENDIX B	178

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Important Information Regarding This Summary

This summary is for your general information. The discussion of any estate planning alternatives and other observations herein are not intended as legal or tax advice and do not take into account the particular estate planning objectives, financial situation or needs of individual clients. This summary is based upon information obtained from various sources that Bessemer believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.

INTRODUCTION

The 48th Annual Philip E. Heckerling Institute on Estate Planning was again held in Orlando during the week of January 13, 2014. I have summarized some of my observations from the week, as well as other observations from various current developments and interesting estate planning issues. My goal is not to provide a general summary of the presentations. The summaries provided on the American Bar Association Real Property, Trust & Estate Law Section website, http://www.americanbar.org/groups/real_property_trust_estate/events_cle/heckerling_reports.html, that are prepared by a number of reporters, and coordinated by Joe Hodges, do an excellent job of that. Rather, this is a summary of observations of selected items during the week as well as a discussion of other items. I sometimes identify speakers, but often do not. I take no credit for any of the outstanding ideas discussed at the Institute — I am instead relaying the ideas of others that were discussed during the week.

1. LEGISLATIVE DEVELOPMENTS

- a. **Overview of Administration's Fiscal Year 2015 Revenue Proposals.** The Treasury on March 4, 2014 released the General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (often referred to as the "Greenbook") to provide the details of the administration's budget proposals. For a discussion of the proposals impacting estate planning in the 2014 Fiscal Revenue Proposals, see Item 2 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor. A few summary comments about particular proposals in the Greenbook are included below.
- b. **Transfer Tax Legislation Unlikely in 2014.** The various transfer tax proposals will likely proceed only as part of a general tax reform package, and not as a package of separate transfer tax legislation. There have been some indications, however, that transfer taxes are not being considered in the reform measures.

"There are two chances of tax reform in 2014—slim and none." Congressional tax-writing committees have spent a lot of time over the last year laying the groundwork for comprehensive tax reform. The House Ways and Means Committee and the Senate Finance Committee both held hearings in 2013 about various issues related to tax reform. There is a broad consensus of an aspiration for tax reform (both business as well as individual tax reform) but strong disagreement over details of reform and whether the overall reform would be revenue neutral. It is very unlikely that we will see general tax reform in 2014—it would require a factious Congress coming to agreement on highly charged political issues in an election year; furthermore, Senator Baucus, Past Chair of the Senate Finance Committee, has left the Senate (having been appointed as the ambassador to China) and the new Chair of the Senate Finance Committee (Senator Ron Wyden, Democrat from Oregon) will be starting over with his own plan for general tax reform. Any serious tax reform effort will probably start with corporate tax reform and bleed over into individual reform measures.

The likelihood of transfer tax legislation (which itself is always politically charged) this year is almost nil. Inclusion of some of the specific transfer tax measures that would

raise some revenue is always possible, however, as an add-on to other legislation that needs revenue offsets to help pay for the legislation.

c. ***Summary of Specific Proposals.***

- *Restore 2009 estate, gift and GST Tax parameters, beginning in 2018.* This proposal is not taken seriously. (Estimated 10-year revenue: \$118.282 billion.)
- *Require consistency of basis for transfer and income tax purposes.* This proposal has generally been well received. However, Carol Harrington observes that this provision is unfair because the beneficiary may have had no input in the estate tax audit negotiations, and the executor may have “traded off” on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries. (Estimated ten-year revenue: \$2.501 billion, up from \$1.896 billion that was estimated in the 2014 Fiscal Year plan and from \$2.014 billion that was estimated in the 2013 Fiscal Year plan.)
- *New GRAT requirements.* Requirements include (i) a 10-year minimum term, (ii) a maximum term of life expectancy plus 10 years, (iii) a remainder value greater than zero, and (iv) no decrease in the annuity amount in any year. Several years ago, this was included in various bills that needed revenue offset, but it has not been included in any bills over the last year. The proposal applies to GRATs created after date of enactment; it is extremely unlikely that this will be retroactive to the beginning of the year (as was done—probably inadvertently as to this provision—in the “Trade Adjustment Assistance Extension Act of 2011” legislative proposal). (Estimated ten-year revenue: \$5.711 billion, up from \$3.894 billion in the 2014 Fiscal Year plan and \$3.334 billion in 2013 Fiscal Year plan.)
- *Limit duration of GST exemption to 90 years.* This proposal has not generated a groundswell of criticism. The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date (subject to rules substantially similar to the grandfather rules). (Estimated ten-year revenue impact: Negligible.)
- *Sales to grantor trusts.* This proposal has been substantially narrowed from the proposal in the 2013 Fiscal Year Plan to include all grantor trusts in the settlor’s gross estate. Nevertheless, it is still a huge change and passage seems unlikely. The proposal applies to trusts that engage in a “sale, exchange or similar transaction” on or after the date of enactment. Carol Harrington’s observation: “The government created the grantor trust rules and did not coordinate them with the wealth transfer tax... Now they are shocked and appalled to find that we have used the law to our advantage. The government’s answer is to layer an even more complex system on top of the transfer tax.”

The 2015 Fiscal Year proposal clarifies that it would not apply “to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor’s spouse.”

Estimated ten-year revenue: \$1.644 billion, up from \$1.087 billion in the 2014 Fiscal Year plan; interestingly this is less than the consistency of basis provision [\$2.501 billion] and the GRAT provision [\$5.711 billion].)

- *Section 6166 estate tax lien.* The special estate tax lien under §6324(a)(1) would last for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after the date of death. (Estimated ten-year revenue: \$213 million, up from \$160 million in the 2014 Fiscal Year plan.) This almost certainly will be included in any transfer tax legislation that passes.
- *Health and Education Exclusion Trusts.* “HEET” trusts are a seldom used strategy to create a long term trust out of which tuition and medical payments could be made for future generations without any GST tax. Unfortunately, the proposal is Draconian in approach. It would eliminate the current exclusion under §2503(e) for payments from a trust for the health or tuition payments for second generation (and more remote) beneficiaries. Furthermore, the proposal has a seldom used—very harsh effective date provision—applying to trusts created after and transfers after the date of the introduction of this bill. Carol Harrington’s reaction (joking): “HEETs are not great anyway...But based on this proposal, I may have to rethink this. They must be a lot better than I thought.” (Estimated ten-year revenue: Negative \$218 million)
- *Simplify Gift Tax Annual Exclusion.* Referencing the complexity of administering *Crummey* trusts and the potential abuse of having multiple beneficiaries with withdrawal powers “most of whom would never receive a distribution from the trust,” the administration proposes deleting the present interest requirement for annual exclusion gifts, allowing \$14,000 per donee exclusion for most outright transfers, and adding a new category of gifts to which a \$50,000 *per donor* annual limit would apply. The proposal applies to gifts made after the year of enactment.

The Greenbook describes the proposal in very brief terms as follows:

The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights), and would impose an annual limit of \$50,000 per donor on the donor’s transfers of property within this new category that will qualify for the gift tax annual exclusion. Thus, a donor’s transfers in the new category in a single year in excess of a total amount of \$50,000 would be taxable, even if the total gifts to each individual donee did not exceed \$14,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The reference to “transfers of interests in passthrough entities probably relates to the complexities of whether interests in partnerships or LLC constitute present

interests (which the IRS has had success in attacking, as reflected in the *Hackl*, *Price*, and *Fisher* cases).

The effect of the proposal is to allow gift tax annual exclusions for:

- Gifts paid directly for tuition or medical expenses, §2503(e);
- Gifts of \$14,000 per year (in 2014, indexed amount) (but not including gifts to trusts [other than “vested” trusts, as discussed immediately below], passthrough entity interest gifts, transfers subject to sale prohibitions, and transfers that cannot immediately be liquidated by the donee) for (i) outright gifts (other than gifts to trusts other than “vested” trusts, passthrough entity interest gifts, transfers subject to sale prohibitions, and transfers that cannot immediately be liquidated by the donee) and (ii) gifts to “vested” trusts (described in §2642(c)(2), which has the effect of allowing a trust similar to §2503(c) trusts but without the requirement of terminating at age 21); and
- Gifts of up to \$50,000 annually in the aggregate (regardless how many donees enjoy such gifts) for (i) trust transfers (other than transfers to “vested” trusts, for which the \$14,000 per donee exclusion would apply), (ii) passthrough entity interest gifts, (iii) transfers subject to sale prohibitions, and (iv) transfers that cannot immediately be liquidated by the donee.

(Estimated ten-year revenue: \$2.924 billion)

- *Expand Applicability of Definition of Executor.* The definition of “executor” in the Internal Revenue Code applies only for purposes of the estate tax. There is no one with explicit authority to act on behalf of the decedent with regard to a tax liability that arose prior to the decedent’s death. This includes actions such as extending the statute of limitations, claim a refund, agreeing to a compromise or assessment, or pursuing judicial relief regarding a tax liability. The proposal would make the Code’s definition of “executor” applicable for all tax purposes “and authorize such executor to do anything on behalf of the decedent in connection with the decedent’s pre-death tax liabilities or obligations that the decedent could have done if still living. Regulations could provide rules to resolve conflicts among multiple executors. The proposal would be effective upon enactment, regardless of a decedent’s date of death. (Estimate ten-year revenue: Zero)
- *Omission of Section 2704 proposal.* In prior years the Obama administration has proposed revising §2704 to add an additional category of applicable restrictions (to be provided in regulations) that would be disregarded in valuing transferred assets. That proposal was dropped in the 2013 Fiscal Year plan. (This prior proposal had an estimated 10-year revenue impact of \$18.079 billion in 2013 Fiscal Year plan, which is significantly more than all the estate and gift tax proposals combined in the 2014 Fiscal Year Plan other than the proposal to return rates and exemptions to the 2009 parameters. The Congressional Budget Office and Joint Committee on Taxation refused to score this proposal because it

depends entirely on positions taken in regulations, and the IRS cannot consult with them about its thinking on provisions that might be in proposed regulations.) While the IRS has previously worked on a §2704 regulation project “regarding restrictions on the liquidation of an interest in certain corporations and partnerships,” this does not appear to be a Treasury priority.

- *Reporting requirement for sale of life insurance policies and eliminate transfer for value exceptions.* Hopefully, the legislation would be limited to purchases of policies by third-party investors as opposed to transfers of policies among the policy owner and related persons, trusts or entities.
- *Payment to non-spouse beneficiaries of inherited IRAs and retirement plans over five years.* The 2014 Fiscal Year Plan added a new proposal requiring that non-spouse beneficiaries of inherited retirement plans and IRAs generally must take distributions over no more than five years. Exceptions are provided for disabled beneficiaries, chronically ill beneficiaries, individuals not more than 10 years younger than the participant, and minor beneficiaries. The 2014 Fiscal Year plan did *not* specifically make this requirement applicable to Roth IRAs. The 2015 Fiscal Year plan provides that all of the minimum distribution rules would apply to Roth IRAs the same as other IRAs (applicable for taxpayers reaching age 70 ½ after 2014). Therefore, Roth IRAs would be subject to the 5-year distribution requirement. The proposal would be effective for plan participants or IRA owners dying after 2014, the proposal appears to apply to Roth IRAs only if the owner reached age 70 ½ after 2014 and died after 2014. This proposal, while a dramatic change, has significant acceptance on a policy basis (of requiring that retirement plans be used for retirement). (Estimated 10-year revenue: \$5.159 billion)
- *Limit total accrual of tax favored retirement benefits.* This proposal, also added in the 2014 Fiscal Year Plan, generally would limit the deduction for contributions to retirement plans or IRAs with total balances under all such plans that are sufficient to provide an annual benefit of an indexed amount, representing plan amounts of about \$3.2 million for a 62-year old individual in 2014. Commentators have observed that this provision can be complex to administer because individuals would have to disclose the value of all of their retirement plans to employers, who would then have to monitor the value of all such plans. (Estimated 10-year revenue: \$9.342 billion)
- *Eliminate MRD requirements for qualified plans and IRAs under aggregate amount of \$100,000 (indexed).* The minimum distribution rules would not apply if the aggregate value of the individual's IRA and qualified plan accumulations does not exceed \$100,000 (indexed for inflation). The proposal applies to individuals reaching age 70 ½ after 2014 or who die after 2014 before attaining age 70 ½.
- *60-Day Rollover for Inherited Retirement Benefits.* Surviving spouses may receive benefits from an IRA outright and roll them over to another IRA (a “60-

day rollover”), but beneficiaries other than spouses may only make a trustee-to-trustee transfer from the decedent’s IRA to an inherited IRA. The 2015 Fiscal Year plan for the first time acknowledges that the trustee-to-trustee transfer requirement “creates traps for the unwary” for non-spouse beneficiaries, and allows non-spouse beneficiaries to make 60-day rollovers to another IRA. The proposal applies to distributions after 2014. (Estimated 10-year revenue: Zero)

- *Enhance administrability of appraiser penalty.* Section 6694 imposes a preparer penalty for unreasonable positions and for willful or reckless conduct. Section 6695A imposes an appraiser penalty if the claimed value of property based on an appraiser results in a substantial or gross valuation misstatement. There is an exception if the appraisal is “more likely than not” the proper value. The proposal states that this “is not an administrable standard for an exception to the appraisal penalty,” and replaces with a reasonable cause exception. In addition, the appraiser penalty would not apply if the appraiser is also subject to the prepare penalty. The proposal would apply to returns filed after 2014. (Estimate 10-year revenue: Zero).

2. TREASURY-IRS PRIORITY GUIDANCE PLAN; “BDITs”

The 2013-2014 Treasury-IRS Priority Guidance Plan (for the 12 months beginning July 1, 2013) was released on August 9, 2013. It includes all ten projects that were included in last year’s Plan under the heading “Gifts and Estates and Trusts” and also includes one additional item dealing with the application of Rev. Proc. 2001-38 “regarding the validity of a QTIP election on an estate tax return filed only to elect portability.”

Like last year’s plan, there is no decanting project. (After receiving many comments about decanting in response to Notice 2011-101, the IRS says informally that it is working on guidance regarding the tax effects of decanting, but no guidance will be issued this year [or I suspect for a long time thereafter]). For a detailed discussion of the 2013-2014 Priority Guidance Plan, see Aucutt, ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated (Aug. 12, 2013).

- a. ***Unbundling Requirement Under §67(e).*** One of the items on the Priority Guidance Plan is the issuance of regulations regarding the application of §67(e) to trusts, following the Supreme Court’s decision in *Knight v. Commissioner*. Proposed regulations impose an unbundling requirement on trusts to identify the portion of trustee fees and professional fees that are subject to the 2% haircut rule for the deduction of miscellaneous itemized deductions by trusts under §67(e). The IRS had issued proposed regulations prior to the *Knight* decision and in 2011 issued a new set of proposed regulations after the *Knight* case. The IRS continued its approach of imposing the unbundling requirement despite substantial criticism of those provisions in the initial proposed regulations. The IRS has committed that it will not impose an unbundling requirement until the trust tax year that begins after the final regulations are issued. Notice 2011-37. The IRS did not issue final regulations in 2013, so the unbundling requirement will not apply to calendar-year trusts (and most trusts are on a calendar-year) until tax years beginning (at the earliest) on January 1, 2015 (returns being due in April 2016).

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- b. **BDITs.** The “Beneficiary Defective Inheritor’s Trust” is not on the Priority Guidance Plan, but the IRS has expressed concern with the “BDIT.” The BDIT is a trust created by a “nominal” third party with a nominal amount (typically \$5,000) that is designed to be a grantor trust as to the beneficiary under §678 based on the beneficiary’s withdrawal power. The withdrawal power typically lapses gift and estate tax free under §§2514(e) and 2041(a)(2). The beneficiary might later sell assets to the trust to build its value. Because the beneficiary never makes any gifts to the trust, the beneficiary could be the trustee and a beneficiary of the trust (subject to a HEMS standard). See generally Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013). Does it work? The IRS has expressed its concern in two ways.

- The IRS added the “sale to a BDIT” transaction to its “no-ruling” list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to §§678, 2035, 2036, 2037, 2038, and 2042).
- In addition, the sale to grantor trust legislative proposal specifically refers to the “deemed owner under the grantor trust rules,” which undoubtedly is a reference to trusts treated as being owned by the beneficiary under §678.

This is the IRS’s “shot across the bow” suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work.

3. GENERAL APPROACHES TO ESTATE PLANNING FOLLOWING ATRA; THE “NEW NORMAL”

- a. **The “New Normal.”** There is a “new normal” of estate planning in light of the (i) transfer tax certainty, (ii) large indexed transfer tax exemptions (which is, by far, the most important change), and (iii) portability provided by ATRA. (In 2001, 120,000 estate tax returns were filed, of which 60,000 were for taxable estates. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that only about 0.14% of decedents will be subject to the federal estate tax.) Income tax changes may significantly impact trusts.

The “new normal” will also include planning for a growing number of elderly clients. Many clients are baby boomers (now 50-68) moving into retirement years. They will be having more and more of the issues related to aging, including taking care of elderly parents and accumulating assets to support themselves for the rest of their lives. The U.S. Census Bureau predicts that by 2050 there will be 86.7 million citizens age 65 and older in the U.S., comprising 21% of the population. The number of people in the age 65 and older group will grow by 147% between 2000 and 2050, compared to 49% growth in the general population.

- b. **Planning for Married Couples Under \$5 Million.** The major focus for estate planning for couples having assets under \$5.34 million will be (i) core dispositive planning, (ii) income tax planning (for example, achieving basis step up at death), and (iii) preservation and management of assets (including asset protection planning and traditional elder law planning issues). Trusts may continue to be important for these clients for purposes other than saving federal estate tax (distribution management,

investment management, controlling where assets ultimately pass, creditor protection, “divorce protection,” etc.).

Federal transfer taxes are generally irrelevant. Traditional planning concepts need to be re-examined in light of the large federal exclusion. For example, steps that are taken to assure qualification for the annual exclusion, to avoid retained interests in trusts, etc. may no longer be necessary. Putting up with owning life insurance in an irrevocable life insurance trust and the complexity of funding the trust to pay premiums would seem irrelevant for most of these clients for federal estate tax purposes (but having assets paid to trusts for the traditional non-tax advantages of trusts will still be important). An issue that planners may increasingly face in the future is the situation of surviving spouses who are named as executors who refuse to fund traditional bypass trusts (thinking that transfer taxes will never be an issue and the spouse would prefer to utilize the basis step-up at the second spouse’s death).

State transfer tax planning may still be relevant for states with a state estate tax having an exemption level that is less than the federal exclusion amount. (The state income and transfer tax planning strategies discussed in Items 4.h, 5.k and 25 may also be appropriate for clients with under \$5 million.) Ironically, it might seem that smaller estates do not need complicated planning, but these are the families that can least afford to be paying tens or hundreds of thousands of dollars in state estate taxes. (If \$2 million could be sheltered from the gross estate for state estate tax purposes at the surviving spouse’s death, this would result in state estate tax savings of over \$100,000-based on the state death tax credit table in §2011(b) that is still used by many states that have state estate taxes.)

Clients will continue to need estate planning documents disposing of their assets among their desired beneficiaries and coordinating beneficiary designations to achieve the desired result. Existing estate planning documents should be reviewed from a new perspective. How will formula clauses operate in light of state estate taxes, higher exclusions and lifetime gifts? Will much (or all) of the estate be left to a credit shelter trust that no longer will generate federal estate tax savings (and may generate state estate taxes at the first spouse’s death)? Existing trusts should be reviewed in terms of their purposes and whether administration modifications may be appropriate.

Beneficiary designations should be reviewed. Designating certain types of trusts (designed for federal estate tax savings) as beneficiaries may no longer be appropriate.

For further discussion of planning issues for couples with under \$5 million, see Item 7.b of the Hot Topics and Current Developments Summary (December 2013) available at www.Bessemer.com/Advisor.

- c. ***Planning for Couples in \$5-10 Million Range.*** In addition to the planning issues discussed above, a primary estate planning decision for clients in this range will be whether to use a credit shelter trust or rely on portability at the first spouse’s death. A wide variety of issues may impact that decision, but a central decision point is whether to focus on saving federal or state estate taxes or maximizing the benefits of basis-step-up at the surviving spouse’s subsequent death. A more detailed discussion of

planning for clients with under \$10 million is discussed in Item 4 below, and portability is discussed in Item 5 below.

- d. ***Planning for Couples Above \$10 Million.*** Traditional planning strategies for large estates will continue to apply. A new wrinkle is that the gift exemption amount will increase each year with indexing (it increased by \$130,000 in 2013 from \$5,120,000 to \$5,250,000 and increased by \$90,000 in 2014 to \$5,340,000) and the decision will have to be made how to best use the increased gift exemption amount each year (if at all).

4. PLANNING FOR COUPLES HAVING UNDER \$10 MILLION

- a. ***Overview.*** Planning for couples having under \$10 million has changed dramatically in light of the indexed \$5 million gift, estate and GST exemptions, and with portability. Only the estates of the wealthiest 0.14 percent of Americans — fewer than 2 out of every 1,000 people who die — will owe any federal estate tax. While federal estate tax planning will be less important, Dennis Belcher and Carol Harrington conclude that “planning is more difficult for the \$5-10 million client than the \$100 million client.” They emphasize that “it is hard work; we must talk with clients” and dig deeper into their particular situations. Jeff Pennell adds that “because the planning is more difficult, preserving flexibility is even more important.”

Planning will change dramatically; previously, planning for these clients defaulted to a credit shelter trust plan and the only major issue was who would serve as trustees. A paradigm shift in estate planning practices is that there may be longer conference time learning issues that are important to clients. A question will be—can planners charge for that extra time? (Carol Harrington’s response: It’s like the man who fell out of a building, and on passing the 10th floor said “so far, so good.”) Other planners have noted that attorneys will need to continue to be more efficient in document production as the emphasis shifts to consulting and planning issues rather than document production.

Estate planning for these clients will focus on:

- traditional non-tax planning issues (including core dispositive and management planning [as an aside—the average investor earned 2.1% per year over the twenty year period ended December 31, 2011, compared to the S&P 500 annualized return of 7.8%];
- trusts may continue to be important (distribution and investment management, asset protection, controlling where assets ultimately pass);
- portability as to federal estate tax concerns;
- state estate tax planning issues (for clients who live *or who may move to* decoupled states);

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- income tax concerns (including basis adjustment planning and addressing the increased income tax costs of using trusts) (the income tax concerns will surface as clients pay their 2013 income taxes);
 - blended family issues; and
 - a myriad of other issues that can arise in particular situations.

While planning has changed dramatically for couples having under \$10 million, we must remember that a \$10 million estate is a very large estate (and the size of estate for which planners have done a wide variety of sophisticated strategies in the past for reducing estate taxes as well as achieving other goals).

- b. ***Traditional Non-Tax Planning.*** Following the passage of ATRA, Lou Mezzullo, President of the American College of Trust and Estate Counsel, sent a letter to ACTEC Fellows reminding them of the many services that professionals provide to clients other than federal transfer tax planning. He provides the following list, not meant to be exhaustive, of some of those items (quoted with his permission).

1. Planning for the disposition of the client's assets at his or her death.
2. Asset protection planning.
3. Planning for disability and incompetency.
4. Business succession planning (without the estate tax to blame for failure of a business).
5. Planning for marital and other dissolutions.
6. Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, would not be affected at all).
7. Life insurance planning (other than to provide funds to pay taxes).
8. Fiduciary litigation (enhanced because more to fight over).
9. Retirement planning.
10. Planning to pay state death taxes (in many states).
11. Planning to avoid or minimize gift taxes (and client desires to gift more than the \$5 million indexed applicable exclusion amount for gift tax purposes).
12. Using business entities to accomplish nontax objectives.
13. Planning for children with disabilities.
14. Planning for spendthrift children.

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15. Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax).
 16. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.
 17. Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.
 18. Planning for citizens who intend to change their citizenship.
 19. Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates.
 20. Planning to pay education expenses, including contributing to I.R.C. §529 plans.
 21. Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPAA, and charitable governance reform.
 22. Identifying guardians for minor children, if and when needed.
- c. **Portability.** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:
- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii do recognize portability for their state estate taxes]);
 - Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
 - Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client);
 - Blended family concerns—use the credit shelter trust approach (see Item 5.f regarding blended family planning complexities);
 - If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning);
 - Overall fixed income portfolio allocation—if the credit shelter trust could be funded with the fixed income portion of the overall portfolio, there are minimal concerns of losing basis step-up at the second spouse's death because there will likely be few unrealized gains in the trust;

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- Asset protection significance—assets that are protected from creditor claims under state law (such as tenants by the entireties, retirement accounts, homestead property and life insurance) can be left in those forms with portability to maintain the asset protected status of the assets; and
 - Basis issues—cannot be ignored (but ways of obtaining basis step up even with credit shelter trust planning may be possible);

See Item 5 for a more detailed discussion of portability issues.

- d. **Blended Families.** Over 29 million parents (13 percent) are also stepparents to other children. Forty percent of married couples with children (*i.e.*, families) in the U.S. are step-couples (at least one partner has a child from a previous relationship; this includes full and part-time residential stepfamilies and those with children under and/or over the age of 18). A very large block of clients will have blended family issues. (And some planners have noted that every family is just one death and remarriage away from being a dysfunctional family.)
- e. **Titling of Assets.** If clients rely on portability to take advantage of both spouses' exemption amounts, re-titling of assets to assure that each spouse has sufficient assets to fund a credit shelter trust is no longer necessary. (That may still be a consideration, though, for clients living in decoupled states that have relatively low state exemption amounts.) Tenancy by the entireties designations may be more widely used than in the past to take advantage of the asset protection features of that designation. Also give consideration to creditor concerns—be wary of leaving the bulk of the marital assets in the name of the spouse with the greatest liability exposure. Clients feel more comfortable seeing both of their names on the trust property.
- f. **Domicile and Residence.** Domicile (which controls for estate tax purposes and depends on the client's intent) and residence (which controls for income tax purposes) concerns may become relatively more important in the overall planning to avoid state estate taxes and state income taxes. Especially if a client lives in one state and works in another state, be wary of owning a vacation home or condo in the employment-state; that might help avoid double taxation.
- g. **Review and Repurpose Pre-existing Planning.** Existing estate planning documents should be reviewed from a new perspective. How will formula clauses operate in light of state estate taxes, higher exclusions and lifetime gifts? Will much (or all) of the estate be left to a credit shelter trust that no longer will generate federal estate tax savings? If so, substantial state estate taxes may be generated at the first spouse's death. If clients have made large gifts in the past, trusts should be reviewed to determine the operation of those trusts. Is the trustee structure and are other provisions of the trusts working appropriately, or should modifications be made? Should adjustments be made to the estate plan in light of the prior gifts and now larger federal exemptions? Should expectations regarding future gifts be clarified with family members?

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- *Irrevocable Trusts.* Existing irrevocable trusts may need to be modified in light of the changing circumstances. (See Item 24 below regarding trust modifications.)
 - *Grantor Trusts.* The client may want to take steps to “turn off” grantor trust status to avoid paying income taxes on the income of existing trusts if that achieves no wealth transfer benefit. However, keeping grantor trust status may be very helpful if the client wishes to substitute illiquid assets into the trust in return for liquid assets for living expenses.
 - *Crummey Trusts; “One-Time” Withdrawal Notice.* If the trust includes a Crummey clause, the client may no longer be concerned with using up estate exclusion (thinking that the indexed increases in the exclusion amount will readily cover whatever increases there are in the couple’s estates); the trustee might give a “one-time notice” to beneficiaries of the withdrawal rights for any trust contributions, and not bother with giving notices of additions to the trust in the future.
 - *FLP/LLCs or Other Entities.* If entities have been created largely for estate discounting purposes (the IRS believes that is the primary reason clients create entities), steps might be taken to avoid the discounts (so that a greater basis step-up would be available at the owner’s death). One possible idea might be to revise the entity’s documents to provide that the entity would make a distribution to the owner equal to the amount of estate tax attributable to the owner’s interest (which the IRS argues would trigger §2036 to cause the entity’s assets to be included in the gross estate). That may be sufficient to cause the entity’s assets to be included in the grantor’s gross estate but leave the entity in existence for other non-tax purposes of the entity. Other entity changes could revise state law limitations regarding transfers of interests at the owner’s death. Pesky provisions added to assist in qualifying transfers of interests in the entity for the annual exclusion might be dropped. FLPs may continue to have income shifting advantages if the partnership passes muster under §704(e).
 - *Fractionalized Interests.* If the ownership of some assets has been intentionally fractionalized in the past (e.g., to obtain fractionalization discounts for fractional interests in real estate), consider consolidating those interests with interspousal transfers or by transfers between grantor trusts.
 - *QPRTs.* If QPRTs no longer serve a federal estate tax advantage, consider whether the client might repurchase the residence (perhaps despite a prohibition in the trust agreement that was inserted merely to meet tax requirements). Consider having the grantors continue to live in the residence past the QPRT term for no or nominal rent (perhaps with remaindermen giving consents), to raise an argument of inclusion of the residence in the gross estate under §2036 as a transfer with an implied agreement of retained enjoyment.

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- *Existing Bypass Trusts.* Even though there may be no federal estate tax advantages of existing bypass trusts, the trust may be helpful as an income shifting tool by making distributions not to the surviving spouse but to descendants (as well as being helpful for non-tax purposes).
- h. **State Estate Tax Planning.** There is significant planning complexity in decoupled states. About 20 states have “decoupled” from the federal estate tax. In most decoupled states, the maximum rate is 16% (in Washington state, it is 19%). Many states have exemption amounts much lower than the federal exclusion amount. The exemption is currently \$1 million in the District of Columbia, Maryland, Massachusetts, Minnesota, New York and Oregon (and is just \$675,000 in New Jersey).

Even if a “state bypass trust” is used, the goal may not be to shift as much appreciation into the trust as possible during the surviving spouse’s subsequent lifetime—that would avoid a possible 16% state estate tax on the estate appreciation but might incur a possible 23.8% federal combined capital gains/NIIT tax (plus state capital gains taxes, if applicable) on the appreciation if the assets are sold soon after the spouse’s subsequent death. The income tax resulting from not getting a basis step-up may be lower than this, however; for example, this could happen due to turnover in the portfolio after the first spouse’s death so that gains have already been recognized on some portion of the appreciation occurring after the first spouse’s death.

- *Outright to Spouse Plan.* The clients may prefer the simplicity of an “outright to spouse” plan even though doing so will cost some state estate tax at the second spouse’s death; at least the rate is significantly less than the federal estate tax rate. The disadvantages are the added state estate tax (which can still be considerable) and giving up the non-tax advantages of trust planning.
- *Outright to Spouse With Disclaimed Assets Passing to Bypass Trust.* This still uses the simple plan as the starting point. Following the first spouse’s death, the decision can be made as to how much the surviving spouse would disclaim, to pass into a bypass trust that would not be subject to state estate tax at the surviving spouse’s subsequent death. This decision may be made using a more granular approach by disclaiming assets that will either be held for a very long time period after the surviving spouse’s life expectancy, or which are not likely to have significant appreciation potential (again keeping in mind that the income tax cost of not getting a basis step-up at the second spouse’s death may outweigh the potential 16% state testate tax).
- *Emphasize “Asset Location Decisions.”* Bypass trusts are typically funded following the first spouse’s death when the couple is already in their 70s. At least half of the portfolio may be in fixed income investments at that point. The fixed income investments could be funded to the state bypass trust. That amount would escape state estate taxes at the second spouse’s subsequent death, and there would likely be little capital appreciation to worry about losing basis step-up at the second spouse’s death.

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- *Formula State Exemption Bypass Trust, Balance Outright to Spouse.* Because disclaimers sometimes don't happen as a practical matter, the clients may want to mandate that the bypass trust will be funded with the state exemption amount at the first spouse's death.
 - *Formula State Exemption Bypass Trust, Balance Up To Federal Exemption to State QTIP Trust.* If the state allows a "state-only QTIP election," the estate could first fund the state exemption amount into a bypass trust, next fund an amount up to the federal exemption amount in a trust for which the QTIP election is made only for state purposes (this is sometime referred to as a "gap trust"), and the balance (if any) could pass to a trust for which a state and federal QTIP election is made. This has the advantage of effectively having a federal bypass trust for an amount up to the full federal credit. However, the loss of the basis step-up together with the added incremental income tax costs of the gap trust may outweigh the federal estate tax benefits (probably non-existent for the under \$10 million couple). There is also an obvious loss of distribution flexibility since all of the net income of a QTIP trust must be distributed annually to the surviving spouse.
 - *Formula State Exemption Bypass Trust, Balance to QTIP Trust.* Some states (like New York and New Jersey) provide that the federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Leaving the balance above the state exemption amount to a QTIP trust would have the advantage of using trust planning for non-tax purposes for all of the estate at the first spouse's death. Potential concerns have been raised in light of Rev. Proc. 2001-38, but the IRS will likely give favorable guidance allowing the use of QTIP trusts with portability, even though there is no requirement to file the federal estate tax return other than to make the portability election. See Item 5.g for further discussion about Rev. Proc. 2001-38.
 - *Outright Bequest to Spouse Followed by Gift to Heirs Using DSUE.* The gift by the surviving spouse would assure being able to take advantage of the first spouse's DSUE amount in case the surviving spouse remarries and survives the new spouse who leave no DSUE amount. (If a bequest had been made directly to the children to use the federal exemption amount, substantial state estate taxes might be generated at the first spouse's death.)
 - *Outright Bequest to Spouse Followed by Gift to Grantor Trust Using DSUE.* This is a possible strategy for mega-estates to achieve the transfer planning advantages of the spouse having a grantor trust (permitting sales of assets to the trust by the spouse, and the spouse pays the income taxes of the trust [the "grantor trust burn"]). The swap power could be used to achieve a basis step-up on appreciated assets. However, couples with \$10 million are unlikely to use this strategy.
 - *Outright Bequest to Spouse Followed by Gift to Trust in DAPT State.* For couples with under \$10 million, the surviving spouse will likely want to be a

potential discretionary beneficiary of the gift amount (if the spouse is willing to make a gift at all). A gift to a trust under the laws of a domestic asset protection trust (DAPT) would allow that as a possible strategy. (There is uncertainty as to whether or not a domiciliary in a non-DAPT state can establish such a trust in a DAPT jurisdiction and have it respected so that his or her claimants cannot reach the trust assets. See Shenkman & Rothschild , *Self-Settled Trust Planning in the Aftermath of the Rush University Case*, Leimberg Asset Protection Planning Newsletter (Dec. 6, 2012).

- *Outright Bequest to Spouse Followed by Non-Qualified Disclaimer to Use DSUE.* The surviving spouse could make a non-qualified disclaimer of a portion of the estate, with the assets passing to a trust for children (or if in a DAPT state, to a trust with the spouse as a discretionary beneficiary). Because the disclaimer is non-qualified, it would not disqualify the state estate tax marital deduction.

i. ***Changing Drafting Considerations.***

- *Powers of Attorney.* Carefully consider with the client whether to include gift provisions. Because there are no federal estate tax advantages for couples under \$10 million, should agents be authorized to make any gifts at all? Does that open up the potential for elder abuse? Gifts might still be helpful, however, to avoid state estate taxes for clients living in a decoupled state.
- *Revocable Trusts.* Similarly, re-consider gift provisions in revocable trusts.
- *Health Proxies.* Consider whether some reminder should be made of exercising “swaps” to achieve a basis increase before “pulling the plug.”
- *Wills.* If bypass trusts are included in Wills, consider including descendants as discretionary beneficiaries for income shifting purposes.
- Consider investment provisions. If the bypass trust is funded predominantly with fixed income assets, there may be no disadvantage of not having a basis increase on the bypass trust assets at the second spouse’s death. That may require a revision to the standard investment provisions so that the trustee is authorized to invest solely in fixed income assets.
- Consider including in bypass trusts flexible measures that may allow causing estate inclusion at the surviving spouse’s (or other beneficiary’s death) to allow a basis step-up at that time. See Item 7.
- *Trusts.* Consider providing that capital gains are allocated to income (so that capital gains will be included in DNI and distributions will carry out capital gains to beneficiaries for income tax purposes). If capital gains are allocated to principal, give the trustee discretion to take the position that distributions include gains realized during the year. See Item 9.l-m for a discussion of income shifting concerns for capital gains in trusts.

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- j. ***GST Exemption Allocation Still Important*** . Even though the couple perceives that they have no federal estate tax concerns, it is still important to consider the GST tax implications of trust transfers. If a trust terminates at a child's death and passes to skip person beneficiaries, a GST tax is imposed if the trust is not GST-exempt. It makes no difference if the beneficiary has plenty of excess estate tax exclusion amount. In making transfers to trusts that will last for many years, consider whether to affirmatively allocate GST exemption (or make sure that automatic allocation applies).

For non-exempt trusts, if a taxable termination occurs as a result of the death of a beneficiary, a basis adjustment is allowed for the trust assets. §2654(a)(2). See Item 23.h.

k. ***Asset Protection Planning.***

- *Inter Vivos QTIP Trusts.* The clients may want to consider having one spouse create an inter vivos QTIP trust for the other spouse with spendthrift provisions. After the trust has been created, the assets should not be reachable by the creditors of either spouse. If the donee-spouse predeceases and the assets pass back into a trust for the original donor-spouse (either directly or by the exercise of a power of appointment by the donee-spouse) the assets may still be protected from the original donor-spouse's creditors. (Statutes in Arizona, Delaware, Florida, Michigan, Ohio, North Carolina, Texas, Virginia and Wyoming — and perhaps other states — make that clear. See Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.)
- *Lifetime Credit Shelter Trusts.* If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouses' creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.) both trusts may be protected from claims of the spouses' creditors (but that is a state law issue, not necessarily governed by the Grace reciprocal trust federal tax doctrine). If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets may still be protected from creditors of the donor spouse (depending on application of the "relation back" doctrine.) Statutes in Arizona, Ohio and Texas—and perhaps other states—make clear that creditors could not reach the assets of the appointee trust in that situation. *E.g.*, TEX. PROP. CODE §112.035(d)(2)(effective Sept. 1, 2013). See Item 15.d of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor for a detailed discussion of this issue. Making transfers to a lifetime credit shelter trust also removes the assets from the gross estates of the individuals for estate tax purposes in case the exemption should later be reduced.
- *Tenancy by the Entireties.* Almost half of the states provide asset protection for assets held by the spouses in a tenancy by the entireties.

- *Homestead.* A number of states provide creditor protection for the personal residence claimed as a homestead.
 - *Qualified Retirement Plans.* Assets in qualified retirement plans are generally exempt from creditors' claims.
 - *Domestic Asset Protection Trusts.* For a discussion of self-settled trust states, the §2036 issues regarding the creation of domestic asset protection trusts (DAPTs) in which the settlor is a discretionary beneficiary, and the incomplete gift issues for DAPTs, see Item 17 of the Hot Topics and Current Developments Summary (December 2013) found [here](http://www.Bessemer.com/Advisor) and available at www.Bessemer.com/Advisor. Recent cases regarding domestic asset protection trusts and asset protection planning are discussed at Item 32.
- I. ***Intra-Family Loans.*** Couples with under \$10 million are likely to make more use of loans to assist family members than outright gifts. The loans must be structured as a bona fide loan (e.g., note, expectation of repayment, etc.).

There are income tax consequences to loans (the interest is income to the parent-lender but likely non-deductible to the descendant-borrower) that can be avoided if the loan is made to a grantor trust. Also, the original issue discount rules likely require the lender to recognize interest income each year even if the interest is accrued and paid at the end of the note term; that can also be avoided if the loan is made to a grantor trust.

Loans could be used to accomplish income shifting. A client could make an AFR (very low interest rate) loan to descendants (or modest income parents). The loan proceeds may be invested in assets the client would have otherwise acquired; income on those assets will be shifted to the lower tax brackets of the borrower.

5. PORTABILITY

- a. ***Brief Background.*** Section 303(a) of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 ("the 2010 Tax Act") allows portability of any unused "basic" exclusion amount (changed to "applicable" exclusion amount in ATRA) for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount" (referred to as the "DSUE amount.") The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse."

Highlights of some of the more important provisions of the regulations (§§ 20.2010-1T, 20.2010-2T, and 20.2010-3T) include:

- The portability election is made by the executor's filing a timely and complete Form 706 (if the estate tax return is not timely filed and if the estate is small enough that no return would otherwise be required, Rev. Proc. 2014-18

(issued January 27, 2014) allows a relief procedure for certain estates, described in paragraph b below);

- In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the “timely and complete” Form 706 if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity);
- The surviving spouse’s DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;
- The regulations adopt the “Example 3” approach of the Joint Committee Technical Explanation, negating any “privity” requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;
- The surviving spouse can use the DSUE amount any time after the decedent’s death, assuming the portability election is eventually made by the executor;
- Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse’s own exclusion amount to cover later transfers;
- DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse’s death).

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the December 2012 summary, “Estate Planning Current Developments and Hot Topics” found [here](#) and available at www.bessemer.com/advisor.

For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

b. Relief For Late Filing of Portability Election Returns in Some Cases.

Background. Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse, and for the election to be effective the return must be filed within the time prescribed by law (including extensions) for filing the estate tax return. For estates having a gross estate and adjusted taxable gifts under the basic exclusion amount, no return is required to be filed under §6018(a) (so there is no prescribed filing date). The portability regulations add that for those estates under the

filing threshold limit, if the estate makes the portability election it will be considered to be required to file a return under §6018(a), so the due date is 9 months after the decedent's date of death (or 15 months if the return is extended). Because there is no statutory filing deadline for estates under the filing threshold, the IRS has the authority to grant extensions of time for filing the return under §301.9100-3 to make the portability election. The IRS has granted various such extensions for estates under the filing threshold who have made formal letter ruling requests for extensions pursuant to §301.9100-3.

Overview of Rev. Proc. 2014-18. Rev. Proc. 2014-18 (issued January 27, 2014) allows a simplified relief procedure (with no user fee being required), generally adopting one of the recommendations made by the Section of Real Property, Trust and Estate Law of the American Bar Association in comments filed with the IRS on September 27, 2013 (the ABA RPTE Section Comments are described in Item 8.I of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor). The relief measure assists those estates below the filing threshold who did not file the election return timely because they were unaware of the need to file the return in light of the newness of the regulations and also those same-sex couples who were retroactively recognized as spouses in Rev. Rul. 2013-17, 2013-38 I.R.B. 201.

Extension to December 31, 2014. Rev. Proc. 2014-18 grants an automatic extension for filing the estate tax return making the portability election until December 31, 2014 (without filing a letter ruling for relief under §301.9100-3) if the following conditions of the procedure are satisfied.

Conditions to Qualify for Automatic Extension. The requirements to qualify for the automatic extension under the Revenue Procedure are:-

- The decedent of the estate
 - has a surviving spouse,
 - died after 2010 [portability first became available for decedents dying after 2010] and on or before December 31, 2013, and
 - was a citizen or resident of the United States on the date of death;
 - The estate was not otherwise required to file an estate tax return because the value of the gross estate and adjusted taxable gifts was less than the basic exclusion amount [\$5 million in 2011, \$5.12 million in 2012, and \$5.25 million in 2013];
 - The estate did not file an estate tax return within the time specified in Reg. §20.2010-2T(a)(1) for filing the estate tax return to elect portability [i.e., the 9 month (or 15-month, if extended) period for filing the estate tax return; if a timely return was filed, that return either automatically made (or affirmatively declined to make) the portability election, Reg. §20.2010-2T(a)(3)(i)]; and
 - The estate satisfies the following procedural requirements—
 - The executor (or other person permitted to make the election) filed a “complete and properly-prepared Form 706” (i.e., meeting the requirements

of Reg. §20.2010-2T(a)(7) [which allows simplified reporting procedures for estates that are below the filing threshold]) on or before December 31, 2014; and

- The return must state at the top of Form 706 “FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(c)(5)(a).”
- The IRS will send an estate tax closing letter acknowledging receipt of the Form 706; but if it is subsequently determined that the estate was over the filing threshold the automatic grant of extension is “deemed null and void.”

Limitations on Refund Claims by Surviving Spouse's Estates. If the surviving spouse has subsequently died after the decedent who is making the late election, Rev. Proc. 2014-18 addresses the limitations period for requesting a credit or refund. The surviving spouse must file a claim for refund before the general refund limitation period. For example, assume S1 died on January 1, 2011, S2 died January 14, 2011, and the Form 706 for S2 was filed and tax was paid on October 14, 2011 (without taking advantage of unused exclusion amount from S1, which would have eliminated the estate tax totally for S2). The estate of S2 must file a claim for refund 3 years after filing the Form 706 (*i.e.*, by October 14, 2014), even if the estate of S1 does not file the return making the portability election or receive a closing letter regarding such election before that date. The claim will be a protective claim for refund pending the determination that the estate of S1 is ultimately determined to have elected portability pursuant to the extension measures under the new procedure.

Effective Date; Pending Requests. The procedure is effective January 27, 2014. Any estate that has a ruling request pending may withdraw the ruling request and receive a refund of its user fee if it does so by March 10, 2014. (The next sentence in the Rev. Proc. is confusing—it says the national office will process ruling requests pending on January 27, 2014 unless the executor withdraws the request prior to the *earlier* of March 10 or the issuance of the letter ruling. By implication, this may suggest that the IRS could issue a letter ruling before March 10 and avoid having to return the user fee as long as the executor has not notified the IRS to withdraw the ruling request before the letter ruling is issued.)

Observations:

- *Welcome Relief.* This procedure is quite welcome. It will prevent estates who meet the requirements of the procedure from having to pay the \$10,000 filing fee (which can be reduced for certain taxpayers) for making the letter ruling request for extension pursuant to §301.9100-3.
- *Key Dates.* Two important due dates are specified: (1) the Form 706 making the portability election must be filed by December 31, 2014; and (2) estates with any pending ruling requests for extending the date to file the return must do so by March 10, 2014 to receive a refund of its user fee (and perhaps even before that date—so file the notification to withdraw the ruling request as soon as possible). Another date is specified if the surviving spouse has died and paid estate tax—the refund claim (based on having the first decedent's DSUE

amount, which would reduce the surviving spouse's estate tax) must be filed within the normal 3-year date of filing the surviving spouse's return.

- *Procrastination Pays!!!* Estates that realized they had not timely filed the return to make the portability election and that filed a ruling request (and paid the user fee) and received the ruling apparently will not get their money back. (Shame on them for being responsible and proactively filing for relief under §301.9100-3 as soon as reasonably possible.)
 - *Estates That Filed Returns After Due Date But Have Not Filed Ruling Request.* In light of the uncertainty surrounding the filing date issue, some estates may have simply filed the estate tax return late making the portability election, but have not yet filed a ruling request for an extension of time to file late. Those returns obviously would not have included the required notice at the top of the return. Those estates are not prohibited under the procedure from using the extended due date by reason of the earlier-filed return, because it was not timely filed. To be conservative, any estate in this situation should re-file the estate tax return, with the required notice added at the top of the return.
- c. **Portability Decision is Complex.** Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple “all to spouse” will planning, relying on portability to take advantage of both spouses’ estate exemptions, rather than using more complicated bypass trust planning. From the planner’s perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse’s death (including the surviving spouse’s age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse’s lifetime, whether assets will be held long-term even after the surviving spouse’s death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether there will likely be net consumption of the estate, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

Clients living in states with state estate taxes may use a combination of a credit shelter trust (up to the state exemption amount) and portability.

The issue is not just trust vs. non-trust because portability can also be used in connection with QTIP trusts.

Although the purpose of portability is to facilitate simplicity for clients, the possibility of relying on portability may in some cases makes the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives.

- d. **Credit Shelter Trust Approach Primary Advantages.** Major advantages of the credit shelter approach include: (i) desirability of omitting future appreciation from the estate, (ii) being able to take advantage of state estate tax exemptions (perhaps using a credit shelter trust only up to the amount of the state exemption [Delaware and Hawaii recognize portability for state estate tax purposes]), (iii) maximizing use of the GST exemption, (iv) being able to include the spouse and other persons as trust

beneficiaries, (v) avoiding (or minimizing) inequities in a blended family situation (including the inherent possibility of the creation of a blended family by the surviving spouse's remarriage), and (vi) non-tax advantages of trusts (if a client wants to use a trust for non-tax advantages in any event, and will not have the simplicity of outright transfers, the client might decide to use the credit shelter trust for its advantages rather than using a QTIP trust).

A prime tax advantage of using portability is the second basis step-up at the second spouse's subsequent death. However, using credit shelter trusts may not cause a loss of basis step-up if the amount in the credit shelter trust is about the amount that the client would allocate to fixed income assets in the overall asset allocation for the combined portfolio of marital assets. The credit shelter trust could hold the fixed income assets and the surviving spouse could hold the equity portion of the overall portfolio (and there would be a basis step-up for the appreciation that would be included in the surviving spouse's gross estate at his or her subsequent death); there would not be substantial capital gain appreciation in the credit shelter trust. Marty Shenkman (Paramus, New Jersey) refers to this as "asset location" planning.

Also, even with the credit shelter trust, a second basis step-up may be available using the "Delaware tax trap" (discussed in Item 7.f below). Furthermore, the second basis step-up may not be important if assets likely will be sold during the spouse's lifetime so that there will not be substantial unrealized appreciation (although there will be income tax benefits to a basis step-up if the asset is a depreciable or depletable asset). Other strategies for achieving a basis step-up at the surviving spouse's death are discussed at Item 7.c-g below.

- e. ***Portability Approach Primary Advantages.*** The effects of the portability approach can vary depending on whether the "outright to spouse" or "QTIP trust" approach is used in connection with portability. Portability advantages include: (i) administrative simplicity of outright ownership if a trust will not be used at all (forgoing asset management/preservation, the ability of the first spouse to control the ultimate disposition of the assets, and creditor protection advantages), (ii) desirability of a second basis step-up at the second spouse's death, (iii) administrative simplicity to avoid re-titling or re-balancing structures with certain types of assets such as retirement plans and residences, and (iv) ability to leave the assets in a trust for descendants of which the surviving spouse is treated as the owner under the grantor trust rules.

That last advantage--the ability of the surviving spouse to create a trust using the first-decedent spouse's exclusion amount that is a grantor trust as to the surviving spouse—can maximize wealth transfer (and it assures that the DSUE amount can be used even if the surviving spouse remarries and is predeceased by the new spouse), but it would only be workable for very large estates. It raises the issue of whether making a gift using gift exclusion is preferable to keeping the DSUE amount until the surviving spouse dies so that more assets can in the gross estate to receive a basis step-up (as discussed in Items 4.h and 6.b).

For couples with approximately \$7 million, it is highly likely that with portability, there will be no federal estate tax at the second spouse's death; planning to be able to take

advantage of the second basis step-up comes without giving up any federal estate tax savings. (Some planners jokingly would call this “free-basing.”)

Even if a couple is inclined to use portability, leaving the state exemption amount into a credit shelter trust for state estate tax purposes is still important. (For example, if a credit shelter trust avoids a state estate tax on \$2 million, that will result in a state estate tax savings of over \$100,000 in many states.)

- f. ***Blended Family Situation.*** In a “non-standard” family situation (“not Ward, June, Wally and the ‘Beav’- but the Brady bunch”) situation, substantial inequities may result if the credit shelter approach is not used. The following observations and examples are based on observations from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting. Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent’s prior marriage) and the surviving spouse’s family. The executor may try to “extort” consideration for making the portability election. Or the executor may be unwilling to bear the expense of filing an estate tax return to make the election. (The will could be drafted to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse’s descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). Even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse’s descendants—even though the assets are “protected” in a QTIP trust.

QTIP Trust “overpaying” estate tax in blended family situation. The assets of the QTIP trust will be included in the surviving spouse’s gross estate, and the surviving spouse’s estate is entitled to reimbursement under §2207A for estate taxes attributable to the QTIP trust (determined on a marginal basis: the amount of estate taxes with the QTIP trust included in the gross estate minus the amount of federal estate tax if the QTIP trusts were not included in the gross estate). This could occur if the surviving spouse makes gifts utilizing the DSUE amount or even if the spouse makes no gifts but has his or her own assets that are large enough to cause the payment of estate taxes even if the QTIP trusts were not included in the estate.

For example, assume W dies with \$2 million passing to a QTIP trust. H later dies with his own \$12 million estate. H’s gross estate is \$14 million. H’s estate exemption is \$5.25 million DSUE from W + H’s \$5.25 million (assuming no indexed increase in the exemption), or \$10.5 million. The federal estate tax is (\$14 million - \$10.5 million) x 40%, or \$1.4 million. If there were no QTIP trust, H’s estate tax would have been (\$12 million - \$10.5 million) x 40%, or \$600,000. The difference (\$1.4 million - \$600,000) or \$800,000 must be borne by the QTIP trust (unless H waives his reimbursement right under §2207A). W’s children have to bear \$800,000 of the estate tax even though her estate was well under her \$5.25 million exemption amount.

Possible planning alternatives to avoid this situation are (i) use a premarital or post-nuptial agreement in which the parties agree that a decedent-spouse’s executor will make the portability election only if the surviving spouse agrees to waive the §2207A reimbursement right from the decedent-spouse’s QTIP trust, or (ii) if a marital

agreement is not possible, the decedent-spouse's executor might agree to make the portability election only if the surviving spouse agreed to waive the §2207A reimbursement right (perhaps a capped waiver, as described below, in case the QTIP trust grows to more than the DSUE amount). (Agreeing to make the QTIP election only if the surviving spouse agreed to waive the reimbursement right might conceivably create concerns as to whether the QTIP election was valid, and using the conditional portability election is preferable to a conditional QTIP election.)

QTIP Trust “underpaying” estate tax in blended family situation. Reverse fact scenarios could arise in which the surviving spouse's family would be disadvantaged and pay more than their fair share of the estate tax due at the surviving spouse's death if the surviving spouse waives the reimbursement right.

For example, assume W dies with \$12 million passing to a QTIP trust. H later dies with his own \$8.5 million estate. H's gross estate is \$20.5 million. H's estate exemption is \$5.25 million DSUE from W + H's \$5.25 million (assuming no indexed increase in the exemption), or \$10.5 million. H's federal estate tax is $(\$20.5 \text{ million} - \$10.5 \text{ million}) \times 40\%$, or \$4 million. If there were no QTIP trust, H's estate tax would have been $(\$8.5 \text{ million} - \$10.5 \text{ million}) \times 40\%$, or \$0. H's agreement to waive his §2207A reimbursement right means that his estate bears \$4 million of the estate tax—and his family only receives \$4.5 million of his \$8.5 million estate. If the \$4 million of estate tax were prorated between the QTIP trust and H's estate, the QTIP portion would be \$2.34 million $(\$4 \text{ million} \times 12/20.5)$ and H's estate portion would be \$1.66 million $(\$4 \text{ million} \times 8/20.5)$.

Accordingly, in a complex blended family situation, having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids those complexities. Alternatively, if the family wishes to use the portability approach, fund the first decedent-spouse's exempt amount into a separate QTIP trust and have the surviving spouse agree to waive reimbursement rights with respect to that trust only (perhaps a capped waiver, as described in the following paragraph, in case the QTIP trust grows to more than the DSUE amount).

Planning Cap on Waiver of Reimbursement Right. If the surviving spouse waives the reimbursement right with respect to a QTIP trust, the spouse may want to place a maximum cap on the reimbursement right that is waived. For example, assume the QTIP is funded with \$2 million of land that happens to be in an “oil play” that ends up being worth \$60 million when the surviving spouse dies. The \$60 million would be in the spouse's gross estate and if the spouse has waived all reimbursement rights with respect to that trust, the surviving spouse's family might pay many millions of dollars of estate tax with respect to assets that will pass to the first decedent-spouse's family (possibly even wiping out the surviving spouse's estate). For example, a clause similar to the following might be used:

I, Mary Doe, in exchange for the Executor making a portability election in the Estate of John Doe, hereby waive any right of reimbursement under Section 2207A of the Internal Revenue Code with respect to the Mary Doe Marital Trust (the “Marital Trust”), but only to the extent of the federal estate tax assessed against my estate attributable to the value of the Marital Trust assets equal to an amount up to but not exceeding the amount of the deceased spousal unused exclusion amount (the “DSUE amount”) as finally determined from the estate of John Doe (whether or not such DSUE amount is available to my estate at the time of my death). The amount of the reimbursement right from the Marital Trust that is waived shall be determined by the following calculation process. (1) First, determine the amount of reimbursement that would be due to my estate from the Marital Trust under Section 2207A but for this waiver (the “Section 2207A reimbursement amount”). (2) If the value of the Marital Trust assets for

estate tax purposes at my death is equal to or less than the DSUE amount, the full Section 2207A reimbursement right is waived. (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, the amount of the reimbursement right that is waived is the Section 2207A reimbursement right multiplied by a fraction, the numerator of which is the DSUE amount and the denominator of which is the value of the Marital Trust for estates purposes at my death. **[ALTERNATE APPROACH FOR CLAUSE (3):** (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, enough of the Section 2207A reimbursement amount is waived such that my estate will bear no more federal estate tax than if (i) the Marital Trust assets were not included in my gross estate for federal estate tax purposes, and (ii) only my applicable exclusion were used not including the DSUE amount.]

In light of the fact that §2207A requires that any waiver of the reimbursement right be in "his will (or revocable trust)," the spouse would contractually agree to waive the reimbursement right, but the actual legal waiver of the reimbursement right from the QTIP would need to be in the surviving spouse's will or revocable trust.

Strong Reasons to Use Credit Shelter Trusts In Blended Families. In a complex blended family situation, having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids all of the complexities discussed above if QTIP trusts are used for blended families.

- g. **Revenue Procedure 2001-38.** Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of QTIP trusts in connection with a portability election if the estate tax return was filed only to elect portability. It provides that the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." However, for various reasons Rev. Proc. 2001-38 does not appear to preclude making a QTIP election even though the estate is relying on portability. See generally Franklin, Law & Karibjanian, Portability — The Game Changer (January 2013), available [here](#) and on the American Bar Association Real Property Trust & Estate Law Section website.

Several PLRs issued in 2013 involving taxpayers invoking the protection of Rev. Proc. 2001-38 do not suggest that the IRS will use the "null and void" argument to assert that the QTIP elections for estates that are not subject to estate tax are invalid and cannot be used to leave unused exclusion amount available to a surviving spouse under portability. PLRs 201345006 & 201338003.

The IRS has added "the validity of QTIP elections on an estate tax return filed only to elect portability" as an item on the IRS/Treasury Priority Guidance Plan for 2013-2014. Ron Aucutt believes that the inclusion of this item on the Priority Guidance Plan makes clear that the IRS will grant relief from Rev. Proc. 2001-38 in the context of estates making the portability election. Aucutt, *ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated* (Aug. 12, 2013) ("It is not always the case that the appearance of a project on the Priority Guidance Plan makes it clear what the outcome of the project will be, but it is clear in this case.").

- h. **Optimal Approach for Flexibility.** An optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to rely on portability. Alternatives are:

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- (1) Disclaimer approach - rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or
 - (2) QTIPable trust approach - portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3)), and a bypass trust approach would be used if a partial QTIP election is made with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single-beneficiary mandatory income interest trust for the surviving spouse).

As between those two approaches, the disclaimer approach seems simpler, but the QTIP approach may be preferable in many situations.

Disclaimer Approach Disadvantages. There are several significant disadvantages of relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation. However, that is much more of a concern where property passes outright to a spouse, and where the spouse may not want to give up full ownership of the asset. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. See generally Zaritsky, *Disclaimer-Based Estate Planning—A Question of Suitability*, 28 EST. PL. 400 (Aug. 2001). Also, under the laws of some states, disclaimers may not be recognized for fraudulent transfer purposes with respect to the disclaimant's creditors (e.g., FL. STAT. §739.402(d)) and may be treated as disallowed transfers for Medicaid qualification purposes.

QTIPable Trust Approach Additional Flexibilities. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.

- The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death.
- If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exemption amount without paying any state estate taxes at the first spouse's death.

- Any unelected portion could pass to a standard bypass trust under a “Clayton” provision. (Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Panelists take the position that there *should* be no gift tax consequences; this should be no different than other post-death tax elections [such as where to deduct administrative expenses] that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse [or QTIP trust]). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years as to whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust.) (As an aside, Jeff Pennell thinks the preferable plan is generally to structure the credit shelter so that it has “QTIPable terms”—mandatory income interest for spouse as the exclusive beneficiary. That would, for example, facilitate getting a PTP credit if the surviving spouse were to die shortly after the first spouse to die. Other panelists observe that clients like being able to make transfers to children and the use of the children for income shifting purposes.)
- The surviving spouse can have a testamentary limited power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).

QTIPable Trust With Delayed Power of Withdrawal. If the clients want to have the flexibilities afforded by using QTIPS (*i.e.*, to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still wants the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust but including a delayed withdrawal power. The trust is a general power of appointment trust qualifying for the marital deduction only if the surviving spouse’s power of appointment exists immediately following the decedent’s death. Reg. §§20.2056-5(a)(4)(“must be exercisable in all events”); 20.2056-5(g)(1). For example, provide that the power of withdrawal arises sometime after estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (*e.g.*, up to 20% each year). Jeff Pennell suggests that this perhaps should be the default approach for QTIP trusts, to be removed if the clients don’t want the provision. (Jeff observes that most attorneys trust their own spouses after they are dead but think their clients do not trust their spouses.)

If the QTIP approach is used, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, consider using a “trust director” or “trust protector” to make the decision about how much of the QTIPable trust will be covered by the QTIP election or provide broad exculpation to the fiduciary who must make the QTIP election.

i. ***Creative Flexible Approaches Using Both Disclaimers and QTIP Trusts.***

Approach Starting With Outright Bequest. The plan could start with an outright bequest to the surviving spouse, with provisions that if the spouse disclaimed, the assets would pass to a QTIPable trust, and that if the spouse disclaimed his or her

interest in the QTIP trust, the assets would pass to a bypass trust. This affords a great deal of flexibility.

- The spouse could decide not to make any disclaimers and keep the assets, and the executor would then make the portability election.
- Alternatively, the spouse could disclaim some or all of the outright bequest and the disclaimed assets would pass to the QTIPable trust. The executor would have up to 15 months after the date of death (if the estate tax return is extended) to decide whether to make the QTIP election (or whether to make a partial QTIP election). If the QTIP election is not made, the unelected portion could pass to the bypass trust. If the QTIP election is made, the executor could make the reverse-QTIP election and allocate the decedent's GST exemption to the trust.
- If there is a state estate tax and if the state has a "state only QTIP election," the state QTIP election could be made as to all of the assets in the trust other than the state exemption amount (to avoid paying any state estate tax at the first spouse's death), but that excess portion would not be subject to federal estate tax at the surviving spouse's death. The effect is that all of the first decedent's federal exemption would be used, but no state estate tax would be paid at the first spouse's death.
- If there is a state estate tax, the spouse could disclaim the state exemption amount from both the outright bequest and from the QTIP trust, so that the state exemption amount would pass to the bypass trust. The portability election could be made with respect to the balance of the decedent's unused exemption amount. The balance of the estate could remain with the spouse (under the outright bequest) or the spouse could disclaim to the QTIPable trust. The alternative choices described above for the QTIPable trust would apply, including the possibility of making the "state only" QTIP election if that is permitted in the state.
- The spouse could disclaim an amount equal to the federal exemption both for the outright bequest and the interest in the QTIP trust so that the federal exemption amount would pass to a bypass trust (which might result in having to pay some state estate tax at the first spouse's death).
- A disadvantage of these approaches, relying on disclaimers, is that the surviving spouse could not have a limited power of appointment over either the QTIP trust or the bypass trust.

Approach Starting With QTIPable Trust. An alternative approach might operate in a somewhat reverse fashion.

- The decedent's will might make a bequest first to a QTIP trust.
- The executor would have 15 months to decide whether to make the QTIP election over all or a portion of the QTIP trust. Any unelected portion could pass to a bypass trust under a "Clayton" provision. If the QTIP election were

made, the portability election would be made for the decedent's unused exemption amount. This "reverse-disclaimer" approach has the significant advantage of allowing the surviving spouse to have a testamentary limited power of appointment over both the QTIP trust and the bypass trust.

- If the spouse disclaims an interest in the QTIP trust, the disclaimed assets would pass outright to the surviving spouse.
 - This is a twist from the typical operation of a disclaimer, but the disclaimer rules do not seem to preclude this sort of approach in which the disclaimant receives a greater interest in the property than under the bequest that was disclaimed. Under §2518(b)(4)(A), the disclaimed assets can pass to the surviving spouse.
 - Potential concerns are (1) that the disclaimer would not be "qualified" because the spouse would own the assets and direct who receives them, and (2) the spouse might be treated as making a gift if the spouse does not disclaim. These concerns and possible responses are discussed at Item 8.h of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.
 - An alternate approach is to provide that disclaimed assets would pass to a credit shelter trust.
- j. ***Should the Portability Election be Mandated? Who Pays the Filing Expense?*** This is particularly important for second or (or third) marriages. If clients are asked if the surviving spouse should be able to use any excess exclusion, most will say yes. If clients are asked whether the surviving spouse should have to pay the first-decedent's family to be able to use the unused exclusion amount, most will say no. The planner may discuss with the clients whether the spouse of the decedent's estate should bear the expense of filing the estate tax return to make the election.

Similarly, consider these issues in pre-marital agreements.

- k. ***State Estate Tax Planning Implications of Portability.*** The following observations are based on comments and examples from a presentation by Thomas Abendroth and Barbara Sloan at the ACTEC 2013 Fall Meeting. The detailed examples and analysis are discussed at Item 8.j of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.
- *Avoiding state estate tax at first spouse's death.* Using a credit shelter trust for the full amount of the federal exemption amount at the first spouse's death might generate significant state estate taxes, which could be avoided by using portability. For example, fully funding a bypass trust in New York, with its \$1 million exemption amount, would cost about \$431,000 in New York state estate tax at the first spouse's death. Perhaps a bypass trust would be funded with only the amount of the state exemption.
 - *Few states have state gift taxes.* If bequests are made outright to the surviving spouse, the surviving spouse could make gifts, which are not subject to state

estate or gift taxes in most states. Only two states (Connecticut and Minnesota) have a gift tax, and a few more have “contemplation of death” state estate tax provisions for transfers within a certain period of time prior to death.

- *State death tax portability.* Delaware and Hawaii have adopted a portability concept for their state estate taxes. Their tax provisions make reference to the federal “applicable exclusion amount” (which includes the DSUE amount).
- *State estate tax implications for clients who have made substantial prior gifts.* If an individual has made significant lifetime gifts, the amount that can be funded into a bypass trust at the individual’s death without imposing a state estate tax may be relatively insignificant. For example, if an individual has previously made \$5.0 million of gifts and died in 2013 in a state with a “pick-up tax” based on the table in §2011 when the federal exclusion amount had increased to \$5.25 million, an amount equal to \$100,000 would pass to the credit shelter trust under a standard formula that leaves as much as possible to the credit shelter trust without generating a state or federal estate tax. To avoid the creation of such small trusts, removing the formula credit shelter bequest from the will may be prudent, and allow any unused applicable exclusion amount to pass to the surviving spouse with a portability election.
- *Clients in non-tax states owning real estate in decoupled states.* Clients living in states without state estate taxes may nevertheless have to pay state estate tax if they own real estate in states that have a state estate tax. This may be the case even if the real estate in the other state does not exceed the exemption for that state; many states calculate the state estate tax that would apply on the entire estate, wherever located, and impose a tax that is proportionate to the amount of the estate represented by the in-state real property.
- For further discussion of planning alternatives to address state estate taxes, see Item 4.h.

6. ESTATE AND INCOME TAX INTERSECTION—BASIS PLANNING FOR LARGER ESTATES

Paul Lee (New York) highlights the increasingly large significance that income tax planning has in estate planning (and in particular, planning to take advantage of the step-up in basis at death for assets that are in the decedent’s gross estate). He concludes “the future of estate planning will be pro active tax basis management and getting basis step-up for free.”

- a. **Historical Approach.** Planning approaches in 2001 included: (1) use the applicable exclusion amount as quickly as possible during life, (ii) avoid estate tax inclusion at every generation, (iii) the basis step-up at death was less important because of low capital gain rates, (iv) income tax considerations were secondary in estate planning, and (v) the state of one’s residence had no significant effect on the estate plan (there was an enormous amount of uniformity in state estate tax costs).
- b. **New Math.** The differential between income tax costs of selling assets and the combined federal and state estate tax rates is small (and sometimes non-existent). For

a state with no state estate tax or state income tax, the differential is 16.2% (*i.e.*, 40% - 23.8% [20% capital gains rate + 3.8% net investment income surtax]). For California, the combined federal, state and local capital gains tax is 37.1%, only 3.0% less than the federal estate tax (there is no state estate tax). For some assets that generate tax at ordinary income rates upon their sale, the differential is actually negative. There must be an increased emphasis on giving consideration to planning that can take advantage of the basis step-up while still minimizing transfer taxes.

The indexing of the applicable exclusion amount creates the significant likelihood that aside from very large estates, the estate tax exclusions may shelter most (even large) estates from the federal estate tax. Estimates are that the current \$5.34 million exclusion will grow to about \$7 million in 10 years, and to about \$9 million in 20 years. At that point, a couple could have \$18 million in their combined estate without federal estate tax—and generate very substantial income tax savings with a stepped-up basis on the \$18 million of assets (but only if the client dies with the right kind of assets [highly appreciated assets] and if the applicable exclusion amount has not been used at the person's death).

In California, the advantages of retaining assets to obtain basis step-up often outweigh the estate tax savings from transfer planning. California has the trifecta of the highest state income tax, no state estate tax, and community property so that all assets get a basis step-up at the first spouse's death. "Just die with your assets."

c. ***Summary of Planning Approaches With the New Estate Planning Math.***

- Estate planning is infinitely more complicated than in the past, depending on a wide variety of variables such as how long the client lives, spending, the size of the estate, investment return expectations, income tax character of assets, the expected timing of the sale of assets, investment and non-investment income relative amounts, the state of the residence of the grantor and beneficiaries, expected inflation, etc.)
- Keep the applicable exclusion amount as much as possible, using zeroed out transfer strategies instead of gifts. "Don't ever ever ever use the applicable exclusion amount during the lifetime of your client" (though Paul Lee backs off of that and says that lifetime giving can make sense in some situations, for example with high basis assets near one's death in order to save state estate taxes; "you must convince yourself that this is a good use of the applicable exclusion; don't throw it away as quickly as we have done before").
- Tax basis management will be a crucial part of estate planning and should be considered in tandem with potential transfer taxes in making planning decisions.
- Estate tax *inclusion* can save more in income taxes if a decedent has excess exclusion amount that would otherwise be unused.
- The state of residence of the grantor and beneficiaries becomes very important, giving rise to different types of planning. Planners must ask their clients where

they will likely live when they die and where their children and grandchildren likely will live.

- d. **Use Zeroed Out Transfer Planning.** Estate tax savings from transfer planning occurs only with respect to the future income or appreciation that is removed from the client's estate. Sales to grantor trusts have basically the same advantage, except that it is only the future income and appreciation above the very low AFR interest rate threshold that is transferred. If an asset grows at 10%, making a \$5 million gift will remove \$500,000 from the estate in the following year. The same \$500,000 amount can be removed from the estate by selling an asset for \$7 million, which would grow to \$700,000, or a net of \$500,000 after paying \$200,000 of interest. Two advantages result: (1) The applicable exclusion amount is retained to be able to shelter appreciated assets that are in the gross estate at death; and (2) the applicable exclusion remains in the unlikely event that the transferred assets goes down in value instead of appreciating.
- e. **Consider Tax Nature of Assets.** Some assets do not benefit from a basis step-up, including cash and income in respect of a decedent assets (e.g., retirement plan assets). At the other end of the spectrum, the sale of some assets generates a tax at ordinary income rates (e.g., creator-owned copyrights, trademarks, patents and artwork). Another type of high-tax asset is a "negative basis" commercial real property limited partnership interest (where the real estate has been fully depreciated and the developer has withdrawn cash from the partnership). The calculations also differ depending on the state where the individual lives. Measuring the transfer tax against the potential income tax savings will vary for these different types of assets.

Paul Lee's general listing of the types of income that benefit from a basis step-up, from highest to lowest is as follows: creator-owned intellectual property; negative capital account commercial real property/limited partnership interests; investor/collector-owned artwork, gold and collectables; low basis stock or other capital assets; Roth IRA assets (the recipients do not recognize income on receipt of distributions so effectively receive the benefit of a basis step-up); high basis stock; cash; capital assets with unrealized loss; variable annuities; and traditional IRA and qualified plan assets.

Furthermore, the analysis is not just a quantitative analysis depending on tax rates. The income tax savings occur generally only if the asset is sold; however, savings (at ordinary rates) can also result for depreciable assets (generally over 39 ½ years) or depletable assets (example, minerals, with generally highly accelerated depletion deductions).

- f. **Forcing Estate Inclusion.** If a beneficiary has excess exclusion amount that would be unused, including an appreciated asset in the beneficiary's estate will result in a basis step-up without any estate tax cost. One way of achieving this would be to have a formula general power of appointment, but Paul Lee advises not to use formula general powers of appointment. He thinks it cannot be written with precision to get the basis step up on the "right" assets. Furthermore, arguments could be made that the formula general power of appointment is subject to conditions that would cause the power not to exist under §2041 (citing to PLR 8516011, TAM 8551001, and *Estate of Kurz v. Commissioner*, 68 F.3d 1027 (7th Cir. 1995)). "Don't waste your nonbillable time trying to write this formula." (Other planners believe that defining the amount of the

formula general power of appointment can be achieved. One alternative might be to use a formula to determine which particular assets would receive the basis step up in a general manner even if that does not result in precisely the optimal income tax advantage. For further more detailed discussion about formula general powers of appointment see Item 7.e and Appendices A & B below.)

Another approach is to give a trust protector the power to grant a general power of appointment to beneficiaries. This would need to be considered every year if the grant of the power of appointment will be made with precision to the “right” assets. Fiduciary issues could also arise regarding the manner in which a third party exercises the authority to grant a general power of appointment, suggesting an extremely broad exculpatory clause for the third party. See Item 7.d below.

Another possible approach for planning between spouses to achieve a full basis step-up on all marital assets at the first spouse’s death (mirroring what happens with community property) is to create a joint spousal trust with the first decedent-spouse having a general power of appointment over all of the trust assets (which the IRS maintains does not permit a basis step-up) or a “Section 2038 Marital Trust.” See Item 8.c-d below.

- g. **Reverse Estate Planning.** Consider using the exclusions available to the modest parent of a client. The client would make gifts (or modest gifts with sales of assets) to the client’s grantor trust that also grants a testamentary general power of appointment to the client’s parent. The parent would either exercise the power (hopefully leaving the assets into a trust for the client) or allow the general power to lapse. At the parent’s death, the assets subject to the general power would be in the parent’s gross estate and would achieve a stepped-up basis (although issues could arise under §1014(e) if the parent dies within one year of the client’s transfer to the trust). Melissa Willms (Houston) has referred to the planning as the creation of the “Accidentally Perfect Grantor Trust,” with this example:

Jenny owns the stock in a closely held business that she thinks is about to explode in value. Her mom Mary’s net worth is perhaps \$10,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. She then sets up an IDGT for Mary’s benefit, and sells the non-voting stock to the trust for its current appraised value of \$1 million. She uses a combination of seed money and a guarantee by Mary to make sure that the sale is respected for tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (Just in case, the IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment.) When Mary dies four years later, the stock has appreciated to \$2 million in value. Because the trust assets are included in Mary’s estate, the stock gets a new cost basis of \$2 million. The trust assets, when added to Mary’s other assets, are well below the estate tax exemption of \$5 million. Mary’s executor uses some of Mary’s \$5 million GST exemption to shelter the trust assets from estate tax when Jenny dies. Despite the fact that Jenny has the lifetime use of the trust property, (i) it can’t be attached by her creditors, (ii) it can pass to Jenny’s children, or whomever Jenny wishes to leave it to, without estate tax, (iii) principal from the trust can be sprinkled, at Jenny’s discretion, among herself and her descendants without gift tax, and (iv) if the trust isn’t a grantor trust as to Jenny, income from the trust can be sprinkled, at Jenny’s discretion, among herself and her descendants, thereby providing the ability to shift the trust’s income to taxpayers in low income tax brackets. Mickey R. Davis and Melissa J. Willms, *Trust and Estate Planning in a High-Exemption World and the 3.8% ‘Medicare’ Tax: What Estate and Trust Professional Need to Know*, Univ. of Texas School of Law 61st Annual Tax Conference (December 2013).

Having a “permanent” \$5 million indexed estate tax exclusion amount makes this type of planning realistic.

- h. **Income Splitting.** Income splitting will become more important, in light of the increased tax rates for high bracket taxpayers and the 3.8% tax on net investment income that applies to taxpayers with adjusted gross income above a certain (non-indexed) threshold. This can be particularly important for trusts, which become subject to the high brackets at only \$12,150 of taxable income (in 2014). Over a period of years, the tax savings can be substantial; however, income splitting that involves direct splitting with beneficiaries must be viewed under a prism of reality—as a practical matter the younger generations may consume the assets and there will not be a dramatic increase in wealth available to the family decades later. That may be avoided by using distributions of interests in partnerships or S corporations that cannot be converted into ready cash flow by the younger generation beneficiaries.
- i. **Asset Swapping.** Planners may recommend that clients annually consider whether high basis assets should be “swapped” into a grantor trust (using the substitution power) in return for low basis assets that the client could own at death to receive a stepped-up basis at death.
- j. **Using Partnerships to Change the Basis of Non-Depreciable Assets Without Death or a Taxable Event.** Using partnerships is the only way proactively to change the tax basis of non-depreciable assets without death or a taxable event. (Paul Lee calls Subchapter K “Subchapter Kryptonite.”) Assume a partnership has older and younger partners and high-basis and low-basis assets. A passive approach is to allow the older partner to die and make a §754 election to get an inside basis adjustment on the partnership assets attributable to the basis step-up in the deceased partner’s interest in the partnership. Merely relying on §754 in this manner, however, is not optimal—it might result in only a marginal step-up after considering discounting of the decedent’s partnership interest and the adjustment applies to every asset in the partnership, possibly resulting in a “step-down” in basis for some assets. The preferred approach is to make a liquidating distribution of the high basis asset to the older partner. The distribution results in the older partner receiving the asset with a zero basis (assuming his outside basis in his partnership interest was zero). He will die with the zero-basis asset and get a full basis step-up, not impacted by discounting of the partnership interest. As long as a §754 election is in place, the stripped basis that was lost (when the high-basis asset was distributed, converting it into a zero basis asset) is moved to the low-basis asset remaining in the partnership for the benefit of the younger partners. (Paul Lee calls this “maximizing the free-base without having a taxable event.”) The estate could contribute its high-basis asset (after the basis step-up at death) back into the partnership. There are no mixing bowl or disguised sales issues with this approach. Achieving this result involves a complex partnership tax structuring strategy.

The following example is based on an example by Jerry Deener (Roseland, New Jersey) (based on Paul Lee’s analysis).

A partnership is owned by parent and two children, 1/3 each. The partnership has assets valued at \$12 million. Assume there are no mixing bowl rules (i.e., assets were contributed more than 7 years ago, so that a distribution to one partner will not trigger a taxable event to another partnership would contributed the distributed asset). Assume the “outside” basis in

parent's partnership interest is zero. The partnership owns three assets, one of which has a built-in loss:

Property 1: Basis \$250,000, FMV \$5M

Property 2: Basis \$250,000, FMV \$5M

Property 3: Basis \$3M, FMV \$2M (the built-in loss asset)

If parent dies with this partnership structure, parent's partnership interest is worth \$4M (assume no partnership discounts), and parent's outside basis is stepped up from zero to \$4M. If a §754 election is in effect, this increases the inside basis of the two appreciated partnership assets, so:

Property 1: Basis \$2,250,000, FMV \$5M

Property 2: Basis \$2,250,000, FMV \$5M

Property 3: Basis \$3M, FMV \$2M

Alternatively, if the partnership had distributed the built-in loss assets (Property 3) to parent in a partial liquidation, parent would receive the \$2M asset, which parent would receive with a basis of zero and parent's outside basis in the remaining partnership interest would be zero. §732(a). The partnership would be left with \$10M of assets, and parent would own his remaining \$2M value / \$10M or 20%. Each child would own 40%. If the §754 election is in effect, the \$3M of "stripped" basis in Property 3 is reallocated to the remaining partnership assets, so the inside basis and values of the partnership assets would be:

Property 1: Basis \$250,000 + \$1.5M = 1.75M, FMV \$5M

Property 2: Basis \$250,000 + \$1.5M = 1.75M, FMV \$5M

At parent's death, Property 3 (owned by parent) would receive a basis step-up under §1014 to its FMV of \$2M. Parent's outside basis in the partnership interest would be stepped-up to its FMV, or \$2M. IF the §754 election is in effect, parent's \$2M outside basis step-up further increases the basis in Property 1 and Property 2 by \$1M each, so:

Property 1: Basis \$2.75M, FMV \$5M

Property 2: Basis \$2.75M, FMV \$5M

In effect, this strategy has augmented the inside basis of the appreciated property (the appreciated assets would have had a basis of \$2.25M each if the partial liquidating distribution had not been made, as illustrated above; the effect is to allocate an additional \$1M of basis to the appreciated assets).

7. BASIS ADJUSTMENT FLEXIBILITY PLANNING

Basis adjustment strategies at a donor/settlor's death are discussed in paragraph a below. The balance of this Item discusses basis adjustment strategies for beneficiaries of trusts. The concept is to cause estate inclusion for the donor or beneficiary (for example, possibly the surviving spouse) if that individual has no estate tax concerns (which might occur, for example, because of indexing of the federal estate tax exclusion amount over the individual's subsequent lifetime). The assets would then receive a basis adjustment at the individual's death under §1014(b).

- a. ***Preserving Basis Adjustment Upon Death of Donor/Settlor.*** For a detailed discussion of basis adjustment planning for donors, see Item 10 of the Hot Topics and Current Developments Summary (December 2013) found [here](http://www.Bessemer.com/Advisor) and available at www.Bessemer.com/Advisor. Primary strategies include the following:

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- Repurchase from a grantor trust of appreciated assets for cash or other high basis property by the donor;
 - Independent third party exercise of authority to grant the donor a testamentary limited power of appointment, which would cause estate inclusion under §§2036(a)(2) and 2038 and result in a basis adjustment under §1014(b)(9);
 - Donor use of the property in some way that would reflect an implied agreement of retained enjoyment to cause estate inclusion under §2036 (such as using property without paying adequate rent); or
 - If the donor is a discretionary beneficiary of the trust, move to the trust situs to a state that does not have domestic asset protection provisions.
- b. **GST Impact.** Basis adjustment planning considerations for trusts is important particularly for GST-exempt trusts. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed as long as the taxable termination is occurring as a result of the death of an individual. §2654(a)(2). See Item 23.h.

Even for non-exempt trusts, though, there may still be reasons to cause estate inclusion for a beneficiary who is not the last surviving non-skip person. For example, if the settlor has two children, a taxable termination will not occur until both children have died. When the first child dies, if that child has excess estate exclusion amount, causing estate inclusion for that child may result in a basis adjustment of the trust assets.

- c. **Broad Distribution Powers.** Give the independent trustee broad authority to make distributions to the surviving spouse (or other beneficiary) in the absolute discretion of the trustee. (Even a "best interests" standard for a particular beneficiary might limit distributions for the purpose of allowing the beneficiary to make gifts.) An advantage of this approach is its simplicity, but possible fiduciary concerns in exercising the authority to make outright distributions of all or most of the trust assets to the beneficiary might frustrate this planning. Consider providing a broad exculpatory provision for the fiduciary, and express in the trust agreement client's intentions as to whether the settlor is comfortable with the trustee distributing a large portion of all of the assets to the beneficiary if the trustee, in its sole discretion, determines that to be appropriate.

An example of the fiduciary issues that arise in making these broad distribution powers is illustrated by *Smith v. First Community Bancshares, Inc.*, 575 S.E.2d 419 (Sup. Ct. W. Va. 2002)(Dennis Belcher was an attorney in the case). A QTIP trust contained this distribution provision:

I direct the said Trustee to pay to my said wife, out of the principal of the aforesaid trust estate, upon her request therefor in writing, such sum or sums as may be required to meet any need or condition which may arise or develop and which in the judgment of the Trustee justifies invading the corpus of the trust estate.

The surviving spouse, with the approval of the trustee, transferred over \$2 million of stock to a CRUT, which resulted in substantial estate tax savings at her death. After

her death, the remainder beneficiaries of the marital trust sued the trustee and the spouse's estate planning attorney who assisted with the CRUT structuring. The court concluded that the language of the trust did not require the trustee to consider other financial resources of the spouse to provide for her own needs.

In sum, we find that whether the corpus of the marital trust could be invaded for the purpose of avoiding excessive estate taxation depends on the terms of the trust as set forth in Mr. Tierney's will [T]he language used by Mr. Tierney is very broad. First, "any need" is indicated. The word "need" is not expressly limited to the comfort, support, maintenance, or welfare of the beneficiary. Also, "need" is not limited by any specific exigency of the beneficiary such as a health, medical, or financial crises. In addition, the will provides that the trust corpus may be used to meet not only a "need" but also a "condition." ... Moreover, it is remarkable that the phrase "any need or condition" is not limited by the phrase "of the beneficiary." By its express terms, the corpus of the trust may be used for "any need or condition" perceived by Mrs. Tierney with the approval of the trustee, apparently including a "need or condition" of the corpus of the trust itself. Finally, we believe that the appellees adduced sufficient evidence below that the distribution from the principal of the marital trust was necessary in order to mitigate estate tax consequences upon the death of Mrs. Tierney.

The court's detailed construction analysis to reach the conclusion that the trustee was authorized to make the distribution suggests the wisdom of including extremely broad authority of the trustee to make distributions (e.g., "any purpose the trustee determines appropriate") if that is the testator/settlor's intent.

If a trustee makes distributions beyond what is authorized in the instrument, the IRS may take the position that it can ignore the distribution. See *Estate of Lillian L. Halpern v. Commissioner*, T.C. Memo. 1995-352 (distributions made from "general power of appointment marital trust" to descendants while surviving spouse was competent and consented were recognized even though instrument did not authorize the distributions; distributions made after spouse was incompetent and when neither she nor a guardian for her consented were not recognized because the Pennsylvania court would likely have allowed her to set aside those distributions, so those distributed assets were included in the surviving spouse's gross estate under §2041).

- d. ***Independent Party With Power to Grant General Power of Appointment.*** The trust agreement could give an independent party the power to grant a general power of appointment to the surviving spouse. It could be a power exercisable only with the consent of a non-adverse party if the settlor wishes to place some controls over the surviving spouse's unbridled ability to redirect where the assets will pass. The power could be limited to the ability to appoint the assets to the surviving spouse's creditors. Advantages of this approach (as pointed out by Howard Zaritsky) compared to making distributions to the beneficiary are (1) the mechanics may be much easier by merely having the independent party sign a one-page document granting the spouse a general power of appointment rather than distributing and re-titling assets, and (2) the individual may be elderly and have management issues with respect to outright ownership of the assets, or may be susceptible to pressure to make transfers to family members or caregivers. A basis adjustment would result under §1014(b)(9).

If there are concerns as to how the power holder might exercise a general power of appointment, it might be limited to an appointment in favor of the power holder's creditors, or it might be exercisable only with the consent of a non-adverse party (that is still a general power of appointment, §2041(b)(1)(C)(ii)). To protect the third party

from an argument that the party must continually monitor whether to grant or change powers of appointment, the trust could provide that the third party has no authority to grant a general power of appointment until requested by one of various specified family members to do so. In addition, in light of the fiduciary issues that could arise in granting such a general power of appointment, consider using an extremely broad exculpatory clause for the third party. (As Paul Lee puts it—“Why didn’t you realize that giving a \$9 million general power of appointment to my dad, notwithstanding the income tax savings, actually increased the value of the estate for purposes of determining the elective share? You actually caused \$3 million to pass to the step-monster.”)

- e. **Formula General Power of Appointment.** To avoid the risk that the third party never “gets around” to granting the general power of appointment, could it be granted by formula in the trust from the outset under a formula approach? The fact that the general power comes into existence only at the beneficiary’s death clearly does not preclude it from being a general power of appointment, Reg. §20.2041-3(a)(2), and a basis adjustment is triggered under §1014(b)(9).

For one planner’s caveat about using formula general powers of appointment, see Item 6.f.

- (1) *Validity of Conditional General Power of Appointment Equal to Beneficiary’s Remaining Exclusion Amount Less Beneficiary’s Taxable Estate.* A formula based on the individual’s remaining federal estate tax exclusion amount would seem straightforward, but potential issues could arise as to its validity for tax purposes. Arguably the beneficiary may have a general power of appointment over the full amount of the gift exemption amount at the time the formula power of appointment is granted even if the beneficiary later makes gifts “using up” the gift exemption amount—if it were determined that making a gift was not an act of independent significance. Furthermore, if the formula is the beneficiary’s remaining exemption amount less the value of the beneficiary’s taxable estate, the beneficiary has a great deal of control to increase the amount subject to the general power of appointment by reducing the size of his taxable estate—for example by consuming assets, by making terrible investment decisions, or by leaving assets to a spouse or charity—which would increase the amount of the formula general power of appointment. However, those would all seem to be acts of independent significance. (The significance of “acts of independent significance” is summarized in the discussion below of the Kurz case.)

Several private letter rulings have concluded that formula general powers of appointment equal to a beneficiary’s remaining estate exclusion less the value of the beneficiary’s other estate assets were effective in causing estate inclusion of the trust assets up to that amount. PLRs 200403094 (“having a value equal to (i) the amount of my wife’s remaining applicable exclusion amount less (ii) the value of my wife’s taxable estate determined by excluding the amount of those assets subject to this power”); 200604028 (“equal to the amount of Husband’s remaining applicable exclusion amount set forth in § 2010 of the Internal Revenue Code (‘Code’) minus the value of Husband’s taxable estate (determined

by excluding the amount of those assets subject to this power)"). Those rulings addressed other issues as well, but the rulings clearly reasoned that the assets were included in the deceased beneficiary's gross estate.

- (2) *Sample Formula General Power of Appointment of Amount That Will Not Increase Beneficiary's Estate Tax.* The following sample clause is by Richard Franklin (Washington D.C.) and Lester Law (Naples, Florida) and is included with their consent.

By-Pass Trust - Spousal Testamentary General Power of Appointment.

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

Fractional Share. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.

How Exercised. My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.

[For the sake of brevity, the sample GPOA language provided herein does not include all of the forms language needed to address other matters such as the permissible scope of a power of appointment granted to an object of the power, the allowable effect of an exercise on an S election, whether the last will and testament exercising the testamentary power of appointment must be probated, etc.]

- (3) *Acts of Independent Significance.* If the surviving spouse (or other beneficiary) has the power to impact the amount that would be subject to the general power of appointment under the formula, the IRS might argue that the beneficiary has a general power of appointment to that maximum extent. *See Kurz v. Commissioner*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995). In *Kurz*, the decedent was a beneficiary of both a marital trust and a family trust. The decedent was entitled to all income and the right to withdraw principal of the marital trust. She could request distributions from the family trust subject to two conditions: (1) the principal of the marital trust must have been exhausted; and (2) she could withdraw no more than 5% per year from the family trust. In fact, the decedent did not withdraw the entire principal from the marital trust, so could not withdraw any principal from the family trust at her death. However, the IRS argued that she had a general power of appointment over 5% of the family trust because the contingency to be able to exercise that power was within the decedent's control (*i.e.*, she could have withdrawn all of the principal from the marital trust so that contingency would have been satisfied). The estate argued that the decedent's access to the principal of the family trust was subject to a contingency that did not occur, so she did not have a general power of appointment under Reg. §20.2041-3(b) ("However, a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death. For example, if a

decedent was given a general power of appointment exercisable only after he reached a certain age, only if he survived another person, or only if he died without descendants, the power would not be in existence on the date of the decedent's death if the condition precedent to its exercise had not occurred.”). The Tax Court interpreted this regulation to conclude that the decedent could have some control over the contingency and still not have a general power of appointment, but the contingency must not be “illusory” and must have independent significant non-tax consequences:

“...the event or contingency must not be illusory and must have some significant non-tax consequence independent of the decedent's ability to exercise the power.... We think any illusory or sham restriction placed on a power of appointment should be ignored. An event or condition that has no significant non-tax consequence independent of a decedent's power to appoint the property for his own benefit is illusory.”

The Tax Court analogized to the contingency provisions under §2038, and gave two examples of situations involving independent consequences:

“For example, for purposes of section 2038, a power is disregarded if it becomes operational as a mere by-product of an event, the non-tax consequences of which greatly overshadow its significance for tax purposes. See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, par. 126.5.4, at 126-64 (2d ed. 1984). If the power involves acts of “independent significance”, whose effect on the trust is “incidental and collateral”, such acts are also deemed to be beyond the decedent's control. See Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of “independent significance”, whose effect on a trust that included after-born and after-adopted children was “incidental and collateral”); see also *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F.2d 1401, 1406 [AFTR2d 76-1529] (1976) (“In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd.”). Thus, if a power is contingent upon an event of substantial independent consequence that the decedent could, but did not, bring about, the event is deemed to be beyond the decedent's control for purposes of section 2038.”

The Seventh Circuit affirmed, agreeing with the reasoning of the Tax Court that merely stacking or ordering withdrawal powers does not exclude the powers that come later in the list.

“By contrast, the sequence in which a beneficiary withdraws the principal of a series of trusts barely comes within the common understanding of “event or...contingency”. No one could say of a single account: “You cannot withdraw the second dollar from this account until you have withdrawn the first.” The existence of this sequence is tautological, but a check for \$2 removes that sum without satisfying a contingency in ordinary, or legal, parlance...

No matter how the second sentence of sec. 20.2041-3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have withdrawn all of the Marital Trust and 5 percent of the Family Trust by notifying the Trustee of her wish to do so.”

As an example of how this doctrine might apply in the context of formula general powers of appointment for basis optimization purposes, the power to make marital or charitable bequests is within the decedent's control, and if the formula

refers to the maximum amount that could pass without estate tax at the decedent's death, the formula could be interpreted to assume that the decedent would leave all of his estate to a surviving spouse or charity and therefore give the decedent a general power of appointment over all of the trust (up to the decedent's exemption amount) even if the decedent in fact did not leave his estate to a surviving spouse or charity. The contingency to have a general power of appointment over the trust up to the maximum amount is within the decedent's control.

However, *Kurz* makes clear that contingencies that would have independent significant non-tax consequences are to be ignored. Those contingencies prevent the decedent from having realistic unfettered control to access the trust assets. Indeed, the contingency in *Kurz* was as non-independent as could be imagined. It involved a mere sequencing of withdrawal powers. The assets of trust 2 could not be withdrawn before the assets of trust 1 were withdrawn. The decedent still had clear authority to withdraw all of the assets from both trusts. The Tax Court questioned whether this was even a contingency at all. Compared to that, the decision to make large lifetime gifts or to leave a bequest to a spouse or charity has much greater independent non-tax consequences. In any event, *Kurz* raises uncertainties about such formulas.

As to the possibility of a marital or charitable bequest increasing the amount of the general power of appointment under the formula, such bequests would seem to be acts of independent significance. However, to avoid that argument, the formula could refer to

“the largest portion of the assets of the Bypass Trust which would not increase any federal estate tax payable by the estate of the Surviving Trustor without taking into consideration any charitable or marital gift by the Surviving Trustor that would be deductible by the estate of the Surviving Trustor pursuant to Section 2055 or Section 2056 of the Internal Revenue Code.” See Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, State Bar of Texas Advanced Estate Planning Course at p.17 (2013)(excerpt from formula general power of appointment form suggested by Mr. Golden).

Other commentators have made the same observation regarding the impact of possible marital or charitable bequests on the operation of formula general powers of appointment.

“Making charitable or spousal bequests should logically be deemed to be acts of independent significance, such that they would not be deemed to control the grant of a general power of appointment, but it is not certain that a court would so hold, and it is very possible that the IRS would assert this position and the taxpayer would need to litigate.

One could minimize this risk by drafting the formula clause granting a general power of appointment based on the surviving spouse's taxable estate, determined without regard to marital or charitable deductible transfers. This approach significantly reduces the likelihood that a court would conclude that the surviving spouse holds a general power of appointment over a greater share of the trust assets than his or her available applicable exclusion amount. If it is known that the surviving spouse will make certain charitable bequests, these can be expressly excluded from the calculation, with the same result.” Howard Zaritsky, *Practical Estate Planning* in 2011 and 2012.

For various form suggestions, see Ed Morrow, *The Optimal Basis Increase and Income Tax Efficiency Trust* (2013)(available from author); Al Golden, *Back to the Future – The Marital Deduction from Before ERTA to After ATRA*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING COURSE at p.17 (2013); Howard Zaritsky, *PRACTICAL ESTATE PLANNING IN 2011 AND 2012* (various forms and excellent analysis); James Blase, *Drafting Tips That Minimize the Income Tax on Trusts—Part 2*, ESTATE PLANNING (Aug. 2013).

- (4) *Identifying Specific Assets Subject to General Power of Appointment.* A power of appointment over part of a trust is probably generally considered as being over some fractional part of trust. As long as the amount of the general power of appointment is determined objectively by a formula, perhaps a third party (such as an trustee) could be given the authority to determine which particular assets would be subject to the general power. (Query whether that would be recognized for tax purposes?) Alternatively, the formula could specify objectively which particular assets are subject to the general power of appointment formula amount. Richard Franklin and Lester Law suggest a sample formula provision, designed to apply the general power of appointment, in order, to the assets that if sold immediately prior the beneficiary's death would generate the greatest aggregate amount of federal and state income tax. The clause is included as Appendix A. A formula clause taking a different approach, provided by the Day Pitney law firm (West Hartford, Connecticut), allocates the formula general power of appointment to the assets with the greatest appreciation, is attached as Appendix B (with the permission of Day Pitney).

- f. ***Basis Step Up Flexibility; Delaware Tax Trap.*** Another alternative to leave the flexibility to cause inclusion in the beneficiary's estate is to use the "Delaware tax trap." Delaware law at one time (perhaps still) provided that if someone exercises a power of appointment to grant a presently exercisable power of appointment to another person, even a limited power of appointment, that grant of the new power is treated as a vesting of property for purposes of the rule against perpetuities. The original power could be exercised to appoint the assets in further trust, with a new perpetuities period running from the date of exercise, which means that the trust could be extended indefinitely without having the assets subjected to estate tax. Sections 2041(a)(3) and 2514(d) were enacted to prevent avoiding the estate tax indefinitely by successive exercises of limited powers of appointment and creating new powers in other persons of new presently exercisable limited powers of appointment. Section 2041(a)(3) provides that property subject to a non-general power of appointment (which would generally not cause inclusion under § 2041) will cause estate inclusion under that section if the power holder exercises the power of appointment "by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power."

Under the law of most states, exercising a power of appointment by creating a new presently exercisable general power of appointment in another person is treating as vesting the property in the new power holder because he or she could exercise the

power to appoint the property immediately to him or herself. If the new power holder were to appoint the property in further trust, the perpetuities period on the new trust would run from the time of the exercise creating the new trust. Therefore, at the time the original power holder granted a new presently exercisable general power of appointment, § 2041(a)(3) would be triggered because the new power could be exercised in a way that the vesting of the property in anyone else could be postponed for a period longer than the perpetuities period that applied originally (*i.e.*, “for a period ascertainable without regard to the date of the creation of the first power.”). For an excellent discussion of the Delaware tax trap and ways of using the concept to cause estate inclusion in a trust beneficiary (in order to avoid the GST tax), see Jonathan Blattmachr and Jeffrey Pennell, *Using “Delaware Tax Trap” to Avoid Generation-Skipping Taxes*, 68 J. TAX’N 242 (April 1988). For a discussion of using the Delaware Tax Trap in connection with basis adjustment planning, see Les Raatz, *“Delaware Tax Trap” Opens Door to Higher Basis for Trust Assets*, 41 EST. PL. 3 (Feb. 2014). For an outstanding 50-state summary of state law regarding the rule against perpetuities and whether exercising a limited power of appointment to create a presently exercisable general power of appointment causes a new perpetuities period to begin see Zaritsky, *The Rule Against Perpetuities: A Survey of State (and D.C.) Law* (2012), available on the ACTEC public website (search for “Rule Against Perpetuities”).

Accordingly, using the Delaware tax trap is one way to cause inclusion in the surviving spouse’s (or any other beneficiary’s) gross estate, if the beneficiary would not owe estate tax in any event because of the estate tax exemption and the beneficiary would like to obtain a step up in basis on the trust assets at his or her death. **All that must be done to leave open the flexibility of using the Delaware tax trap is for the trust to give the beneficiary a limited power of appointment that includes the power to grant new presently exercisable powers of appointment (the power to appointment in further trust would generally include this authority) and confirm that the perpetuities savings clause is worded in terms of requiring that the interests of beneficiaries must “vest” within the prescribed perpetuities time frame rather than requiring that they be distributed during that time frame.** The decision of whether to trigger estate inclusion in the beneficiary’s gross estate is then totally up to the beneficiary. If the beneficiary wants to trigger estate inclusion, the beneficiary would exercise the original power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the original power holder’s gross estate under § 2041(a)(3).

In the context of planning for basis adjustment purposes, the power would be granted only over assets with significant appreciation and that are not income in respect of decedent assets (for which no basis adjustment is available).

A negative aspect of causing estate inclusion in that manner is that the assets would also have to be included in the successor power holder’s gross estate as well (because the second power holder would hold a general power of appointment). A possible strategy that might avoid negative consequences of estate inclusion for the recipient of the power is if the power can be granted to a beneficiary whose estate is well below the exemption amount and for whom the estate inclusion will not likely be enough to impose estate taxation at the individual’s death. For example, if the beneficiary’s

parent or parents have nominal assets, they may be possible appointees (assuming they survive the beneficiary). Other successor potential recipients of the power would be listed in case the parent did not survive the beneficiary.

Using the Delaware tax trap in states that have abolished their rule against perpetuities is more complicated. In that situation, a possible strategy suggested by some planners is to provide that the original trust lasts for 1,000 years, but that the power can be exercised to create a trust that could last for 1,000 years after the power is exercised. In this manner, the vesting of the property could be postponed for a period “ascertainable without regard to the date of the creation of the first power.” As an example, Steve Gorin (St. Louis, Missouri), suggests using the following clause in a state that has abolished its rule against perpetuities:

Notwithstanding the foregoing, if a power to Appoint that is not a general power of appointment (within the meaning of Code section 2041) is exercised by creating another power of appointment which under the applicable local law could be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, then any trust created by such exercise shall terminate no later than one thousand (1,000) years after this Agreement becomes irrevocable; provided however, that the limitations of this sentence shall not apply if the exercise specifically states an intent to create a general power of appointment or specifically refers to Code section 2041(a)(3) in a manner which demonstrates such an intent.

To exercise the Delaware tax trap under that clause, the surviving spouse would “create another power of appointment that postpones the vesting of any estate or interest in such property, or suspends the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the first spouse’s death (or creation of an inter vivos irrevocable trust) that also happens to be more than 1,000 years after the first spouse’s death” (quoting Steve Gorin). Steve cautions that the use of this approach would depend on particular state law, and there may be limitations if a state has a 360- or 1,000-year rule against perpetuities.

At the 2014 Heckerling Institute, one panelist cautioned that she would not want to rely on the “Delaware tax trap” to cause estate inclusion in the context of obtaining a basis increase because there have been no cases addressing the application of §2041(a)(3) in order to affirmatively cause estate inclusion.

- g. ***Asset Protection Impact of Triggering Basis Adjustment.*** The mere existence of the structured flexibility for triggering estate inclusion does not of itself create creditor concerns. However, the actual exercise of the adjustment powers may in some cases subject assets to the beneficiary’s creditors. If the assets are distributed to the beneficiary, obviously they can be reached by the beneficiary’s creditors. If the beneficiary is granted a general power of appointment (either by a third party or by formula at the beneficiary’s death), the general rule is that would not by itself allow creditors to reach the assets; however, the beneficiary’s creditors could reach the assets if the beneficiary actually *exercised* the general power of appointment. That traditional rule was the position of the Restatement (Second) of Property (Donative Transfers) (§13.2, 13.4, 13.5). The Restatement (Third) of Property, however, takes the position that property subject to an *unexercised* general power of appointment can be reached by the power holder’s creditors if his or her property or estate cannot satisfy all of the

power holder's creditors. Restatement (Third) of Property (Donative Transfers) §22.3 (2011). Some states (such as California, Michigan and New York) have specific statutory measures adopting the position of the Third Restatement. The Uniform Trust Code applies the Restatement (Third) position to inter vivos general powers of withdrawal in §505(b)(1) (presumably that would also apply to general powers of appointment); it does not address property subject to a testamentary general power of appointment, but refers to the Restatement *Second* position—suggesting that creditors could not reach property subject to an unexercised testamentary general power of appointment. A possible solution is to require the consent of a third person (who would need to be a nonadverse party in order for the power of appointment to cause estate inclusion under §2041). See Bove, *Using the Power of Appointment to Protect Assets—More Power Than You Ever Imagined*, 36 ACTEC L.J. 333, 337-38 (Fall 2010).

8. JOINT SPOUSAL TRUSTS (TO FACILITATE FUNDING CREDIT SHELTER TRUSTS AND FOR BASIS ADJUSTMENT); SECTION 2038 MARITAL TRUST

- a. **Significance.** (1) Joint spousal trusts have been used as a strategy for assuring that the first decedent's spouse has sufficient assets in his or her gross estate to fully utilize the estate exclusion amount. This is not as important now that we have portability. (2) The joint trust has also been used in the hope that it would secure a basis step-up at the first spouse's death for all of the marital assets (mirroring what happens with community property). (3) As a practical matter, many couples view their assets as joint assets, and using a joint trust coincides with that perception (even if doing so may cause complexities later on).
- b. **Gross Estate Inclusion to Allow Full Funding of Credit Shelter Trust At First Spouse's Death.** Several private letter rulings, and in particular PLR 200101021, provide that giving the first decedent-spouse a general power of appointment over all of the joint trust assets is workable to facilitate funding the credit shelter trust at the first spouse's death. This is not as important now that portability is available to avoid wasting the first decedent-spouse's unused estate exclusion. For spouses that wish to fund a credit shelter trust at the first spouse's death, however, this planning can be very helpful to facilitate having sufficient assets to fund the trust even if the "non-property" spouse dies first.

In PLR 200101021, the joint trust was funded with tenancy by the entireties property. Each spouse could terminate the trust, causing the trust property to be delivered to the grantors as tenants in common. Upon the death of the first grantor, he or she had a testamentary general power of appointment over the entire joint trust. In default of exercise of the power of appointment, a credit shelter trust was to be funded with the trust assets, with the balance of the trust assets passing to the surviving spouse.

The IRS ruled that (1) there was no completed gift on creation of joint trust, (2) all of the trust assets were included in the gross estate of the first decedent-spouse, (3) the assets passing to a credit shelter trust at the first spouse's death were not included in the surviving spouse's estate under §2036, and (4) there was a gift from the surviving spouse to the first decedent-spouse immediately before the moment of death, but the gift qualified for the gift tax marital deduction. (Some commentators have questioned

whether this deemed gift and estate tax marital deduction ruling is correct, and some planners are uncomfortable using this technique without further clarification. The IRS is not attacking them, however.) These rulings and the reasoning of the IRS is discussed more fully in Item 9.e of the ACTEC 2013 Fall Musings found [here](#) and available at www.Bessemer.com/Advisor.

- c. ***General Power of Appointment Over All Joint Trust Assets to Obtain Basis Step-Up on All Joint Trust Assets.*** Another goal of the joint spousal trust is to achieve the result that applies to community property—to obtain a basis step-up on all assets in the trust, regardless which spouse contributed assets to the trust and regardless which spouse dies first.

Section 1014(e) provides that the basis of property received from a decedent will be equal to the decedent's basis immediately prior to death, rather than its estate tax value, if the property had been given to the decedent within one year before the date of death and if the property passes back to the original donor (or his or her spouse). For an excellent analysis of §1014(e) and planning ramifications, see Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning*, LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014); Mark Siegel, 27 ACTEC. The IRS ruled in PLR 200101021 that §1014(e) applied to the joint trust that gave the first decedent-spouse a general power of appointment over all of the trust assets. The IRS reasoned that assets are given from the surviving spouse to the decedent-spouse and then returned to the surviving spouse within one year of the gift, therefore no basis adjustment is permitted under §1014(a). See also PLRs 200604028, 200413011, 200403094, 200210051. Arguably, §1014(e) does not apply if the assets do not return "to" the donor (*i.e.*, the surviving spouse) but remain in trust for the benefit of the surviving spouse. Also, some commentators question the IRS's reasoning that the surviving spouse makes a gift at the instant of the first spouse's death as a result of relinquishing control to the decedent-spouse. See John H. Martin, *The Joint Trust: Estate Planning in a New Environment*, 39 REAL PROP. PROB. & TR. J. 275 (2004). In any event, the IRS position is clear that a basis adjustment is allowed only for the portion of the joint trust assets attributable to the first decedent-spouse's contributions to the trust, and most planners are not claiming the full basis step-up for all property in the joint trust in light of the IRS's position in these PLRs.

This planning strategy has been referred to as the "Joint Exempt Step-Up Trust (JEST)". See Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 1*, 40 EST. PLAN. 3 (Oct. 2013); Alan S. Gassman, Christopher J. Denicolo, and Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses-Part 2*, 40 EST. PLAN. _ (Nov. 2013).

Whether the assets pass to a QTIP trust or a credit shelter trust for the surviving spouse, arguably §1014(e) would not apply on the theory that the asset did not pass back to the donor for purposes of this income tax statute but into a trust for the benefit of the donor (even if the assets pass to a QTIP trust that is included in the surviving spouse's gross estate for estate tax purposes). Letter Ruling 9026036 (reversed as to other issues and reissued as PLR 9321050) may provide some support for this argument. Letter Ruling 9026036 addressed a situation in which property

transferred by a wife to a QTIP trust for her husband would return to a QTIPable trust for wife if husband predeceased her. The IRS ruled that only the portion of the trust allocable to the life income interest would be affected by §1014(e), and the remainder interest would not be deemed to pass back to the donor spouse and thus would qualify for a basis step-up.

The legislative history to §1014(e), which was passed in 1981 as a part of ERTA, discusses that §1014(e) applies if the property passes to the donor directly or indirectly. It applies if the inclusion of the gift property in the decedent's estate "affected the amount that the donor receives under a pecuniary bequest." H.R. Rep. No. 97-201, at 188-89 (July 24, 1981). Therefore, if the gift property passes to a credit shelter trust but other property passes to the donor, this suggests that §1014(e) would apply. But if the entire estate passed to a credit shelter trust, this indirect argument in the legislative history might not apply.

Professor Mark Siegel points out that the legislative history to ERTA also states that the rules under §1014(e) apply on a pro-rata basis if the donor-heir is only entitled to a portion of the property, and the portion of the property that does not pass back to donor receives a stepped up basis. He suggests that this pro rata rule should apply to trust interests:

As applied to dispositions in trust, the pro-rata rule should recognize the split interests between income beneficiary and remainder beneficiary. The trust agreement may direct the trustee to pay all the income to the donor. If that is the case, the donor possesses the right to the income and would be entitled to receive only the value of that portion of the property. Actuarial principles would be used to determine the value of the income interest and § 1014(e) would apply to that portion to prevent a step up in basis. However, the income beneficiary is not entitled to receive the value of the trust remainder so that the remainder portion should receive a step up in basis under § 1014(a). The portion attributable to the remainder interest should be valued according to actuarial principles. The terms of the trust income interest must be examined to ascertain whether the donor-income beneficiary is entitled only to a portion of the property. For example, if the trustee were authorized to pay the income or accumulate it, the discretionary nature of the income interest would prevent the donor from having the right to the income and being entitled to receive the value of that portion of the property. Therefore, the valuation tables would not apply to value the discretionary income interest. As a result, there is no portion of the trust property the donor is entitled to and section 1014(e) would not apply. Consequently, the entire property would receive a section 1014(a) step up. Mark R. Siegel, *I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust*, 27 AKRON L.J. 33, 49 (2012).

If the taxpayer loses the argument that all of the trust assets receive a new basis, using the joint trust may create a difficult administrative problem. Some portion of the assets in the trust have a new basis (*i.e.*, those assets attributable to contributions from the deceased spouse when the trust was created—and more than one year before death), and some assets have the same basis.

This rather extended discussion of the §1014(e) issue is included in light of the increased emphasis that basis planning is receiving in the current planning environment. This kind of planning to achieve a basis adjustment for all of the marital assets at the first spouse's death is not recognized by the IRS, but there may be arguments to avoid the IRS position.

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- d. **Section 2038 Marital Trust.** Another possible strategy to achieve a basis step-up for all marital assets at the death of the first spouse is a “Section 2038 Marital Trust.” This is a trust created by one spouse for the other that is neither a QTIP nor a general power of appointment trust. Assume that H is creating the inter vivos trust for W. H could serve as the trustee and have the discretion to distribute income and principal to W for her life (W does not have to have a mandatory income interest). On W’s death, the trust assets would pass to her estate. H retains the right to terminate the trust prior to W’s death; if the trust is terminated, the assets would be distributed to W.

The transfer is a completed gift. Even though H can change the time of enjoyment, the gift is still complete because H has no ability to change the beneficiary. Reg. §25.2511-2(d). The transfer will qualify for the marital deduction, even without a mandatory income requirement; because W is the only possible beneficiary, her interest is not a “nondeductible terminable interest” under §2523(b). See Reg. §25.2523(b)-1(a)(2).

The trust should be a grantor trust under §677(a). (If there is any concern the trust would not be completely a grantor trust under §677(a), H could choose not to serve as trustee but retain a “swap” power to substitute assets of equivalent value in a nonfiduciary capacity. That would also give H the power to “swap” low-basis assets into the trust prior to the death of a spouse.)

If H dies first, the trust assets should be included in his gross estate under §2038 because of his power to terminate the trust early. (Section 2038 clearly applies even though the power is merely affects the time of enjoyment “even though the identity of the beneficiary is not affected.” Reg. §20.2038-1.) If W dies first, the trust assets will be included in her estate under §2031 because the assets are paid to her estate. Therefore, a basis step-up should be allowed whichever spouse dies first. Even if W dies first and her will leaves the assets to H or to a trust for him, §1014(e) should not apply as long as the trust was created more than a year before W’s death. This strategy differs from the joint spousal trust considered in PLR 200101021, because with this strategy, a completed gift occurs when the trust is created.

- e. **General Power of Appointment Trust Funded With Cash Followed by Sale.** An idea attributed to Jonathan Blattmachr is for the donor to fund a grantor trust with *cash* for the donee-spouse, in which the donee-spouse has a testamentary general power of appointment. The donor would subsequently *sell* appreciated property to the grantor trust (with no income recognition under Rev. Rul. 85-13). The trust assets will be included in the donee-spouse’s estate because of the general power of appointment, and a basis step-up is generally allowed under §1014(b)(9). Even if the donee-spouse dies within one year and appoints the trust assets to the donor or to a trust for donor’s benefit, §1014(e) arguably does not apply. Section 1014(e) only applies if “*appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death.*” §1014(e)(1)(A). In this situation, *cash* was *gifted* to the trust for the donee-spouse; *appreciated property* was not *gifted* to the trust. See Jeff Scroggin, *Understanding Section 1014(e) & Tax Basis Planning*, LEIMBERG EST. PL. EMAIL NEWSLETTER #2192 (Feb. 6, 2014).

9. TRUST AND ESTATE PLANNING CONSIDERATIONS FOR 3.8% TAX ON NET INVESTMENT INCOME AND INCOME TAXATION OF TRUSTS

John Goldsbury (Charlotte, North Carolina) provided an outstanding review of the operation of and planning opportunities for minimizing the new 3.8% tax on net investment income (or NII) under §1411. The summary below is in significant detail in light of fact that planners everywhere are still struggling with understanding, applying, and planning for this new surtax.

a. **Basic Structure of 3.8% Tax on NII.** The 3.8% tax on NII became effective in 2013.

Section 1411 imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012. For individuals, the tax is 3.8% of the lesser of —

- (i) the individual's modified adjusted gross income in excess of a threshold amount (\$200,000 for individuals and \$250,000 for couples), or
- (ii) the individual's NII for the year.

For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the lesser of —

- (i) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold (\$11,950 for 2013, \$12,150 for 2014), or
- (ii) the estate's or trust's undistributed net investment income.

The threshold for individuals is not indexed. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number. Multiple estates and trusts cannot be used to avoid the §1411 tax because all of Chapter 1 of the Code is intended to apply and §643 is in Chapter 1.

Individuals, estates and trusts will report net investment income on new Form 8960.

b. **Complement to Payroll Taxes on Wages.** Payroll taxes on wages consist of 6.2% for Old-Age, Survivors and Disability Insurance (subject to a wage base limit) and 1.45% for Hospital Insurance Tax that is not subject to a cap. The employer also pays a 1.45% Hospital Insurance Tax, so the total Hospital Insurance Tax for employees is 2.9%. Beginning in 2013, the employee's portion of the Hospital Insurance Tax increases by 0.9% for wages (or self employment income) in excess of the same threshold amounts that apply to the NII tax. (\$250,000/\$200,000). Therefore, the total combined Hospital Insurance Tax for taxpayers above the threshold is $1.45\% + 1.45\% + 0.9\% = 3.8\%$. Self-employed individuals are subject to a 3.8% Hospital Insurance Tax. Therefore, the 3.8% tax, in effect, applies whether the taxpayer receives income by wages or by investment income.

Some types of income, however, escape the 3.8% tax totally. For example, executor fees paid to an individual fiduciary may escape the wage, self-employment and net

investment income tax. See New York State Bar Association Tax Section Report on the Proposed Regulations Under Section 1411, Report 1284, May 15, 2013.

- c. **Regulations Overview.** Proposed regulations were published on December 5, 2012 (with corrections on January 31, 2013). The IRS received numerous comments and released final regulations on November 26, 2013 (scheduled for official publication on December 2, 2013). In addition, the IRS released a new set of proposed regulations regarding various topics that are not covered in the final regulations. Among other issues in the final regulations:
- No “fresh start” for making the election to consistently treat distributions as including realized capital gains is permitted (in order to satisfy one of the methods of including capital gains in DNI);
 - There is no guidance regarding how a trust or estate “materially participates” in a trade or business, but the IRS is studying the issue and has sought comments as to whether it should give additional guidance regarding that topic for purposes of §469 as well as §1411;
 - Under the final regulations, charitable remainder trusts (“CRTs”) must track net investment income within each class of the trust’s income to determine the amount of undistributed net investment income, but the newly proposed regulations still permit CRTs to use the “simplified method” of tracking net investment income as described in the December 2012 proposed regulations (with a few modifications);
 - New proposed regulations provide additional detail regarding the determination of the amount of net investment income arising as a result of dispositions of certain interests in partnerships or S corporations; and
 - New proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation’s business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the section 678 owner with respect to S corporation stock held by a QSST). ACTEC has filed comments with the IRS urging a revision of the proposed regulation so that the material participation would be determined at the beneficiary level in that circumstance.
- d. **Grantor Trusts.** The §1411 tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person’s individual net investment income. Reg. §1.1411-3(b)(1)(v). The net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor’s individual threshold (\$250,000/\$200,000). Material participation (for purposes of the active business income exception, discussed below) is tested based on participation by the grantor. See General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint

Committee on Taxation, at 242, n.33. Spousal attribution of material participation, allowed generally under §469(h)(5), should be applicable.

- e. **Net Investment Income.** There are three major categories of income, which are offset by various allowed deductions, to determine NII. A common theme of all three categories is that if an item of income is not treated as income for regular tax purposes, it will not be NII for surtax purposes. The income items are--
- Category 1. Gross income from interest, dividends, annuities, royalties, and rent (but not including those items that are income derived in the ordinary course of a non-passive business [such as rents, discussed below]). Any of these items that are not in regular income are not in NII—for example, municipal bond interest income is not included in NII.
 - Rents are generally passive for purposes of the §1411 tax. There is an exception for real estate professionals that devote 500 hours annually to working in the real estate business. Reg. § 1.1411-4(g)(7). Otherwise, taxpayers must meet two tests to be for rent to be excepted from being net investment income: (i) material participation and (ii) the rental income activity is a trade or business.
 - Category 2. Gross income that is from (1) a passive activity or (2) a trade or business of trading in financial instruments or commodities is NII. (Rents would generally be considered passive income, but they are included in Category 1.) To determine whether an activity is “passive,” the passive activity loss rules of §469 apply. This category includes business income if the taxpayer does not materially participate in the business. Passive loss carryovers apply for NII purposes to offset passive NII (even passive loss carryover from years prior to 2013 can offset passive NII income).
 - Under the § 469 passive loss rules, activities may be “grouped”; an individual’s activities in several businesses that are grouped may rise to the level of being material participation, even though the individual would not meet the material participation for any separate activity. Regrouping is generally not permitted under § 469, but a one-time regrouping is allowed (which will apply for both regular and surtax purposes) on the return for the first year the individual would be subject to the surtax. Reg. §1.469-11(b)(3)(iv).
 - Working interests in oil and gas property are treated as active, not passive activities. This applies whether the taxpayer owns the working interest directly or in an entity—except that if the interest is owned in an entity that limits the liability of the taxpayer, the interest will be deemed to be a passive activity. §469(c)(3)(A).
 - Category 3. Net gain that is included in taxable income (this would include capital gains). Examples of gains that are not included in taxable income (and therefore are not NII) include gain that is excluded from gross income on the sale of a principal residence, Qualified Small Business Stock, ESOP stock,

build-up in value of life insurance policies, and tax-free like-kind exchanges and tax-free exchanges of life insurance policies. Gain on the sale of business assets used in an active business is not included in NII. Gains attributable to goodwill in the sale of an active business's are not NII. (The 2012 proposed regulations include this statement about goodwill, Prop. Reg. § 1.1411-7(c)(5)(ii)(B); the final regulations do not specifically address goodwill;) Net gain includes "recapture" income that is often recognized on the sale of investment real estate. Reg. § 1.1411-4(d), Ex. 2. Capital losses can offset gains (indeed, "net gain" is what is included as NII in Category 3), but capital losses can offset income in Categories 1 or 2 only up to \$3,000 per year.

- Gain from the sale of S corporation or partnership interests is subject to special rules designed to be taxpayer friendly. The seller can exclude from NII the amount of gain that would have been excluded from NII (*i.e.*, the gain attributable to active trade or business assets) if the entity had sold its assets immediately before the taxpayer's sale of its interest in the entity. §1411(c)(4). The 2012 proposed regulations had a complicated 4-step process, but the final regulations withdrew the 2012 prior regulations and new proposed regulations were issued adopting commentators' suggestions to simplify the reporting process. Prop. Reg. §1.1411-7.
- Excluded Income Items. Several types of income are specifically excluded from NII, including (i) distributions from IRAs and qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) income subject to self-employment tax. As discussed above, certain gains from the disposition of interests in partnerships and S corporations are excluded. The final regulations specifically address various other exclusions covered by non-recognition provisions (such as §§1031), income covered by various exclusion provisions (such as §§ 103, or 121), wages, compensation, unemployment compensation, Social Security benefits, and alimony.

The final regulations added a wide variety of deductions "properly allocable to such gross income or gain" that can be subtracted in determining the "net" investment income. Reg. §1.1411-4(f). For trusts, the final regulations added that trustee fees can be deducted for purposes of the surtax, and planning opportunities are available in allocating trustee fees against certain types of income. See Item 9.k below.

- f. ***Exception for Non-Passive Business Income; Material Participation.*** The non-passive trade or business income exception requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a non-passive activity within the meaning of §469, which requires material participation by the taxpayer. Reg. §1.1411-5(a-b). (There is no exception for business income from trading financial instruments or commodities, whether or not the activity is passive.) Thus, generally there must be *both* (1) a trade or business and (2) material participation by the taxpayer. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or

business income (unless the real estate company is in the trade or business of leasing multiple similar real properties). Also, generally any interest, dividends, capital gains, etc. earned on investment assets held by the business will constitute NII, no matter how strong the business purpose is for holding the investment assets and no matter if there is material participation so that the business is an active activity. Reg. §1.1411-6.

The material participation requirements under the §469 passive loss rules are used for determining whether an activity is passive for purposes of the exception from the surtax for business income. §1411(c)(2)(A). Section 469(h)(1) defines material participation as an activity in which the taxpayer participates on a “regular, continuous, and substantial basis.”

Individuals can use one of seven tests (one of them being the 500-hour rule) to establish material participation to avoid passive income treatment. Reg. §1.469-5T(a). In addition, there is a separate exception for real estate professionals (if the taxpayer performs more than 750 hours in real property trades or businesses). §469(c)(7)(B). The rules are not as clear regarding material participation by trusts or estates.

The section 1411 regulations indicate (in an extremely round-about way) that a **100 hour test** may generally apply, with some exceptions, for purposes of the active business interest exception. Reg. §1.1411-5(b)(2). See Richard Dees & Jeffrey Ekeberg, *Participation of 100 Hours May Be Sufficient to Generate Active Income Exempt from the 3.8 Percent Health Care Tax on Net Investment Income*, McDermott Will & Emory Website On the Subject Newsletter (April 14, 2014). Some background is necessary to understand this §1411 regulation. (The regulation is a model for being as obtuse as seemingly possible, with cross references to cross references in the §469 regulations.) The §469 rules contain provisions to prevent taxpayers from generating passive income (i.e., through “passive income generators” or “PIGs”) to offset what would otherwise be passive losses for which no deductions would be allowed. One of these “anti-PIG” rules applies to a “significant participation passive activity” in which the taxpayer participates for more than 100 hours during the taxable year but does not meet any of the seven tests for material participation. Reg. §1.469-2T(f)(2)(ii). Such income is recharacterized as “not from a passive activity.” The §1411 regulations provide that a business income that is treated as “active” under this recharacterization rule will, with a few exceptions, be treated as active business income for purposes of the active business income exception in §1411.

(b) Passive activity--(1) A passive activity is described in this section ifii

(i) such activity is a trade or business; and

(ii) Such trade or business is a passive activity with respect to the taxpayer within the meaning of section 469 and the regulations thereunder.

(2) Application of income recharacterization rules--(i) Income and gain recharacterization. To the extent that any income or gain from a trade or business is recharacterized as “not from a passive activity” by reason of §§1.469-2T(f)(2), §1.469-2(f)(5), or §1.469-2(f)(6), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain.” Reg. §1.1411-5(b)(2)(i).

That regulation refers to Reg. §1.469-2T(f)(2), which describes the significant participation passive activity rule, with a cross reference to Reg. §1.469-5T(c)(2), which is the “more than 100 hours” rule. Accordingly, business income that is recharacterized as “not from a passive activity” generally includes business income in which the taxpayer participates more than 100 hours (but less than 500 hours).

Although income from a trade or business may be recharacterized as “not from a passive activity” (as described above), the section 1411 regulations have an exception if the income is further recharacterized as “portfolio income” under certain §469 regulations (that further cross reference to other §469 regulations):

(iii) Exception for certain portfolio recharacterizations. To the extent that any income or gain from a trade or business is recharacterized as “not from a passive activity” and is further characterized as portfolio income under § 1.469-2T(f)(1) or § 1.469-2(c)(2)(iii)(F), then such trade or business income constitutes a passive activity when the meaning of paragraph (b)(1)(ii). Reg. §1.1411-5(b)(2)(iii).

Hold on—it that has not been confusing enough, here comes the really obtuse cross references to cross references.

Reg. §1.1411-5(b)(2)(iii) (quoted above) refers to Reg. §1.469-2T(f)(1), which merely refers to Reg. §1.469-2(f)(10), which in turn refers to Reg. §§ 1.469-2T(f)(3) (rental of nondepreciable property [for example, cash rental of farmland]), 1.469-2T(f)(4) (net interest income from passive equity-financed lending activity), and 1.469-2T(f)(7) (acquisition of interest in passthrough entity engaged in the trade or business of licensing intangible property). Accordingly, the more than 100 hours rule would not apply to business income from the rental of nondepreciable property, interest income from passive equity-financed lending activities, or income from the business of licensing intangible property; the regular 500 hour test would apply to those activities.

Reg. §1.1411-5(b)(2)(iii) (quoted above) also refers to Reg. §1.469-2(c)(2)(iii)(F). That regulation refers to property held as an investment activity before it was used in a passive activity. Income from that type of property is also treated as being recharacterized as portfolio income and as a passive activity even though it satisfies the 100 hours test.

In summary, income that is recharacterized includes business income in which the taxpayer participates more than 100 hours (but less than 500 hours) other than

- income from the rental of nondepreciable property,
- interest income from passive equity-financed lending activities,
- income from the business of licensing intangible property, or
- gain from the disposition from property held as an investment activity before it was used in a passive activity.

Accordingly, this “recharacterization” regulation suggests that for purposes of the active business income exception in §1411, only 101 hours of participation by the taxpayer is sufficient, except for the excepted types of income listed in the preceding sentence.

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- g. **Material Participation by Trusts or Estates.** There is no guidance regarding how a trust or estate “materially participates” in a trade or business, under either the §469 or §1411 regulations. The §1411 final regulations declined to provide any guidance regarding this issue, despite the fact that it is now of much greater importance than for just the passive activity loss rules. The Preamble to the final regulations points out that “the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date.” The IRS requested comments, including “recommendations on the scope of any such guidance and on specific approaches to the issue.”

For a detailed discussion of the application of the non-passive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1*, TAX NOTES 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2*, TAX NOTES 785 (Aug. 19, 2013).

Regulations addressing passive activity rules for trusts and estates have never been written. The IRS position is that trusts and estates are not treated as individuals for this purpose (so, for example, the 500-hour rule does not apply), and that the real estate professional exception does not apply to trusts. (The Richard Dees article cites ECC 201244017, an emailed advice, stating the IRS Office of Chief Counsel view that the real estate professional exception applies to individuals and C corporations but not trusts.) The IRS position is that the trustee must be involved directly in the operations of the business on a “regular, continuous, and substantial” basis. The IRS points to the legislative history of §469, which states very simply:

“Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating.” S. Rep. No. 99-313, at 735.

In the *Mattie Carter* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust’s behalf, including employees as well as the trustee. The court reasoned that measuring the trust’s participation by reference only to the trustee “finds no support within the plain meaning of the statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none.” The court observed that no regulations are on point, but “the absence of regulations and case law does not manufacture statutory ambiguity.” The court acknowledged that it had studied the “snippet of legislative history IRS supplied” (including the Senate Finance Committee Report) as well as a footnote in the Joint Committee on Taxation’s General Explanation of the Tax Reform Act of 1986, at 242 n.33, but the opinion concludes that “the court only resorts to legislative

history were the statutory language is unclear, ... which, ... is not the case here.”
Mattie K. Carter Trust v. United States, 256 F. Supp.2d 536 (N.D. Tex. 2003).

Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the business as a “special trustee” will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice.

Private Letter ruling 201029014 reiterates the general IRS position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity’s activities on a regular, continuous, and substantial basis. It did not mention the *Mattie K. Carter* case and did not address the issue of participation as a trustee rather than participation as an individual.

If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. However, the IRS questioned that strategy in Technical Advice Memorandum 201317010 (released April 26, 2013). The trust in that TAM had owned stock in an S corporation. The trust had a trustee and a “Special Trustee.” The trustee “did not participate in the day-to-day operations of the relevant activities” of the company. The individual who was the Special Trustee was also the president of a qualified Subchapter S subsidiary of the S corporation. The trust instrument limited the Special Trustee’s authority in selling or voting the S corporation stock. The IRS concluded that the trust did not materially participate in the activities of the company for purposes of the §469 passive loss rules. The ruling highlights two issues: (1) the Special Trustee’s authority was limited to voting and selling the S corporation stock; and (2) the Special Trustee’s activities as president were not in the role as fiduciary. As to the first issue, the ruling concluded that time spent serving as Special Trustee voting the stock of the company or considering sales of stock would count for purposes of determining the trust’s material participation in the business, but the “time spent performing those specific functions does not rise to the level of being ‘regular, continuous, and substantial.’” As to the second issue, the ruling stated in its recitation of facts that the individual serving as president and Special Trustee “is unable to differentiate time spent” as president, as Special Trustee, and as a shareholder. The ruling reasoned that under §469 the owner of a business may not look to the activities of the owner’s employees to satisfy the material participation requirement, or else an owner would invariably be treated as materially participating because most businesses involve employees or agents. The ruling concluded that the work of the individual serving as Special Trustee and president “was as an employee of Company Y and not in A’s role as a fiduciary” of the trust and therefore “does not count for purposes of determining whether [the trust] materially participated in the trade of business activities” of the company.

TAM 201317010 creates a significant distinction in the treatment of individuals vs. trusts with respect to the “employee” issue. For individual taxpayers, their activities as employees of a business will be considered for purposes of determining their material participation in the business. For trust taxpayers, the IRS position is that the activities

of a trustee as an employee of the business cannot be considered to determine the trust's material participation in the business.

Comments to the proposed regulations under §1411 by the American Bar Association Tax Section submitted on April 5, 2013 recommend that the IRS issue new proposed regulations regarding material participation for a trust or estate for purposes of §1411. The Tax Section Comments propose that such regulations recognize material participation by an estate or trust under any of three tests, one of which is that "[t]he fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity."

In addition to recognizing actions through employees or contractors, material participation of a trust could be based on direct participation of the fiduciary, and in that context, the Tax Section Comments reason that

any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.

In light of the paucity of authority, "it is difficult to establish a framework for material participation by a trust (or an estate)." Jonathan Blattmachr, Mitchell Gans & Diana Zeydel, *Imposition of the 3.8% Medicare Tax on Estates and Trusts*, 40 EST. PL. 3, at 9 (April 2013). Despite the *Mattie K. Carter* case, the IRS is continuing to press the issue and could issue a regulation adopting the position taken by the IRS in the private rulings. *Id.*

In a case of major importance, the Tax Court recently issued a case addressing the requirements for material participation by a trustee for purposes of the passive loss rules. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014). This case directly addresses the "real estate professional exception" in §469(c)(7), but one of the requirements of that exception is material participation by the taxpayer. The case states that (1) trusts can qualify for the real estate professional exception and (2) activities of three of the six co-trustees as employees of the manager of the business are counted in determining material participation by the trust. The case, which is a "regular" Tax Court decision, directly repudiates the position taken by the IRS in TAM 201317010. See Item 44 for a further discussion of this case.

- h. ***Character of Income as NII Is Made at Trust Level and Does Not Change When Item Is Distributed to Beneficiary.*** The final regulations say that the character of an item of trust income as net investment income (or not) is determined at the trust level, and that determination does not change when the income item is distributed to a beneficiary. (This position was surprising to planners.) Therefore, even if a beneficiary is clearly materially participating in a business, a distribution of business income from the trust to the beneficiary will not qualify for the "active business income" exception if the trust did not materially participate in the business to qualify for the exception at the trust level (and how a trust materially participates is subject to great uncertainty).

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- i. **Trusts-General Approach for Determining Undistributed NII.** The following approach is used to determine a trust's undistributed net investment income.

- (1) Determine the trust's distributable net income (DNI) and the items of income that comprise its DNI
- (2) Determine the items of income that comprise the trust's NII (including making subtractions as appropriate for items that are deductible in determining NII; expenses must generally be allocated between NII and non-NII items on a reasonable basis, such as proportionate to the amounts of gross income).
- (3) Items of income that are deemed to be distributed under the normal DNI distributions rules (or under §642 for charitable deductions) and that also are items of NII will be deemed to be distributed NII.
- (4) NII that is so determined to be distributed is taxed as NII to the recipient beneficiaries (based on their individual threshold levels).
- (5) NII that is not distributed is taxed at the trust level (with its very low threshold (\$12,150 in 2014)).

- j. **DNI Results Dictate the NII Distribution Amounts.** Items of income that **both** (i) are distributions of DNI under the normal DNI rules, and (ii) are items of NII, will be considered distributions of NII. An example in the regulations is helpful in illustrating how this works. Reg. §1.1411-3(e), Ex. 1 is summarized below.

Assume a trust with the following income (and no expenses) makes a \$10,000 distribution to Beneficiary A in 2013:

Dividends	\$15,000
Taxable interest	\$10,000
Capital gain	\$ 5,000
IRA distribution	<u>\$75,000</u>
Total	\$105,000

DNI: All of the income except capital gain is in DNI. (See Item 9.I below regarding whether capital gain is included in DNI. For this example, assume that capital gains are not in DNI.) Therefore the DNI is \$100,000.

NII: All of the income except the IRA distributions is in NII. Therefore, there is \$30,000 of NII.

Distributed DNI: The \$10,000 distribution is $(10,000/100,000)$, or 10% of the DNI. Accordingly, 10% of each income item included in DNI is deemed distributed under the normal DNI rules. Therefore, A receives \$1,500 of dividends, \$1,000 of interest, and \$7,500 of IRA proceeds.

Distributed NII: Only items that are distributed under the DNI rules will be deemed distributed under the NII rules, and only those items of DNI that are distributed that

constitute NII will be treated as distributions of NII. While \$7,500 of IRA proceeds are distributed under the DNI rules, they are not NII. So the only items of NII distributed are \$1,500 of dividends and \$1,000 of interest. (These items are NII of Beneficiary A. If Beneficiary A has other income that, combined with this income, results in A having adjusted gross income in excess of the individual threshold, A will be subject to the 3.8% tax.)

Undistributed NII: The remaining NII ($\$30,000 - \$1,500 - \$1,000 = \$27,500$) is undistributed NII taxed to the trust.

Trust Surtax: The trust surtax is 3.8% times the lesser of (1) the AGI threshold ($\$105,000$ [gross income] - $10,000$ [distribution] - $11,950$ [highest bracket threshold]) = $\$93,050$, or (2) the undistributed NII ($\$27,500$). The lesser amount is $\$27,500$, so the surtax is $3.8\% \times \$27,500 = \$1,045$.

The regulations contain another example that describes the similar calculation process with distributions to three separate beneficiaries and a charity. Reg. §1.1411-3(e)(5), Ex. 2.

- k. **Impact of Charitable Distributions.** Charitable distributions that are deductible under §642(c) will shift both regular taxable income and NII to the charity, where it will not be subject to either tax. Section 642(c) allows a charitable deduction for any amount of gross income (including gross income from prior years) that pursuant to the terms of the governing instrument is paid or permanently set aside during the tax year for a charitable purpose specified in §170(c). The trust agreement does not have to mandate distributions to charity; distributions of income to charities as discretionary permissible beneficiaries qualify for the §642(c) deduction. *Old Colony Trust Company v. United States*, 301 U.S. 379 (1937).

A summary by Turney Berry, Stephanie Casteel and Martin describe the procedure for applying the §642(c) deduction for purposes of the NII surtax.

The starting point is the special rule in §662(b) for characterizing income distributed to individual beneficiaries when a charitable contribution is made from the trust. Under that rule, the charitable contribution deduction is allocated proportionately among the classes of income entering into the computation of trust income before individual distributions are characterized. Consequently, the charitable distribution is treated as paid off the top, reducing DNI and the amount of taxable income in the various classes that individuals must report. However, in the case of individual beneficiaries to whom income is required to be distributed currently, the character of their distributions is determined by disregarding the charitable contribution deduction "to the extent that it [the deduction] exceeds the income of the trust for the taxable year reduced by amounts for the taxable year required to be distributed currently." Treas. Reg. §1.662(b)-2. As a result, the §642(c) deduction does not affect the DNI computation and characterization for purposes of determining the items of income distributed under a mandatory provision to an individual beneficiary.

A trust provides that income, including accumulated income, may be distributed to A, an individual, and/or XYZ Charity. In the current tax year, the trust has \$40,000 of taxable interest and \$10,000 of tax exempt interest, and DNI of \$50,000. The trustee distributes \$50,000 to XYZ Charity and \$10,000 to A. In determining the amount that A is required to take into income, the entire charitable contribution deduction is taken into account. Since the deduction equals DNI, A has no amount that is included in her gross income.

Assume the same facts, except that the trust is also required to make an income distribution to B of \$30,000. For purposes of determining the character of the distribution to B, DNI is \$30,000. The charitable contribution deduction only reduces DNI by \$20,000, the difference between the total income

of the trust (\$50,000) and the amount required to be distributed (\$30,000). The charitable contribution is allocated proportionately to the income items (\$16,000 to taxable interest and \$4,000 to tax-exempt interest). B's distribution is then characterized as \$24,000 of taxable interest and \$6,000 of tax-exempt interest. B receives no income tax benefit as a result of the charitable distribution. In determining the amount that is included in the gross income of A, however, the entire charitable contribution can still be taken into account, with the result that for A's purposes there is no DNI and therefore no amount that A has to take into income.

Comparable rules apply for determining NII in the hands of individual beneficiaries. Prop. Reg. §1.1411-3(e)(4). In the examples above, A would have no NII as a result of the trust distribution; B would have \$24,000 of NII, since the tax-exempt interest portion of her distribution would constitute excluded income. Berry, Casteel, Hall, *Charitable Planning Today*, 48TH ANN. HECKERLING INST. ON EST. PL., AT IV-A-115 (2014).

The final regulations contain a detailed example that includes distributions to individuals and distributions to a charity that are deductible under §642. Reg. §1.1411-3(e)(5), Ex. 2.

- I. ***Allocation and Deduction of Expenses.*** Expenses are first allocated directly to the income item that gave rise to the expense. For example, expenses attributable to rental property must be allocated against rental income. For indirect expenses, however, the regulations under §652 allow the fiduciary to allocate them any way desired (except that they must be allocated proportionately to tax-exempt income [for which the taxpayer receives no benefit]). Accordingly, indirect expenses can be allocated against income that would otherwise be subject to the highest rate. (Tax preparation software will not do this typically. The preparer will need to override the software output to make such special allocations of indirect expenses.)

Approach for Calculating NII Distribution With Allocated Expenses. (1) Expenses that are not directly attributed to an income item may be deducted against any item(s) of DNI. That will impact which of those items that also happen to be NII that may possibly be treated as distributed. (2) Separately, the expenses must be allocated between NII and non-NII items in a reasonable manner (generally based on the relative amounts of gross income). (3) Distributed NII is the lesser of the amounts of NII from Step 2 that are also deemed distributed under Step (1). (Unfortunately, there are no examples in the regulations for determining NII that is distributed, taking into consideration the deductions of expenses properly allocable to NII.)

Example. Assume the following.

IRA distribution (in DNI, not in NII)	\$20,000
Capital gain (not in DNI, in NII)	\$20,000
Taxable interest (in both DNI and NII)	\$20,000
Trustee fees	\$10,000
Discretionary distribution to A	\$10,000

Trustee fee allocation: The trustee fee is allocated to the IRA distribution (which is in DNI but happens to be non-NII); this should result in more NII assets being deemed distributed.

DNI: After subtracting the \$10,000 trustee fee from the IRA distribution, the DNI is:

IRA net after deduction	\$10,000
Interest	<u>\$20,000</u>
TOTAL	\$30,000

Distributed DNI: The \$10,000 distribution is $(10,000/30,000)$, or 33.3% of the DNI. 33% of each income item included in DNI is deemed distributed under the normal DNI rules. Therefore, A receives \$3,333 of IRA proceeds, and \$6,667 of interest.

NII, after subtracting deductible expenses: The \$10,000 trustee fee must be allocated between the NII items (capital gain and interest-total gross income of \$40,000) and non-NII item (IRA-gross income of \$20,000). Therefore, $2/3$ ($40,000/60,000$) of the \$10,000 trustee fee is allocated against the \$40,000 of NII items, leaving $\$40,000 - \$6,667 = \$33,333$ of NII items after the deductions. The regulations are not clear as to how the expenses must be allocated among just the NII items; conceivably they must be allocated on a gross income pro rata approach as well, meaning that the trustee fee is allocated on a pro rata gross income basis among all items of income merely for purposes of determining the “net” income (after deductions) of each item of NII. This means that the \$10,000 of trustee fees is allocated \$3,000 to the IRA (non-NII), \$3,333 to the capital gain, and \$3,333 to the interest. Therefore, the NII items, after subtracting allocable deductions on a gross income-pro rata basis of all gross income are:

Capital gain	$\$20,000 - \$3,333 = \$16,667$
Interest	$\$20,000 - \$3,333 = \$16,667$

Distributed NII: There is \$16,667 of capital gain after deduction of allocable expenses, but it was not deemed distributed under the DNI rules so it is not distributed NII. There is \$16,667 of interest after deduction of allocable expenses, and there is \$6,667 of interest in DNI that is deemed distributed. Therefore, \$6,667 of NII is distributed, leaving \$26,667 of NII after allocable expenses that is not distributed (\$16,667 of capital gain and $[\$16,667 - \$6,667, \text{ or } \$10,000]$ of interest).

Observation: Only one type of NII in DNI. In this most simplified example, only one type of NII is also in DNI (the interest). If there had also been dividends, which for regular tax purposes would be taxed at a lower rate than the interest, the trustee would also have to take into consideration the effect of different tax rates applicable to the various classes of income.

- m. **Capital Gains in DNI.** Capital gains are an item of net investment income. While distributions reduce both AGI and net investment income, capital gains cannot be distributed without authority in the trust instrument or state law for doing so. Trust instruments can either mandate how distributions are allocated against various types of taxable income, or can give the trustee discretion to allocate capital gains to income that is distributed. For an excellent discussion of various alternatives see Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32, 35-37 (Dec. 2012).

Capital gains ordinarily are excluded from DNI. Reg. §1.643(a)-3(a). However, the regulations provide the capital gains will be included in DNI if they are, (1) “pursuant to the terms of the governing instrument and applicable law” or (2) “pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)”

(1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. Reg. §1.643(a)-3(b).

Planning possibilities using each of these three exceptions are summarized below.

Exception (1). One possible approach is to provide in the trust agreement that capital gain is allocated to income (except for mandatory income trusts—so that the capital gains would not have to be distributed). If the distribution standard allows discretionary distributions of income or principal to all of the current beneficiaries, this would not seem to have any economic impact. The “consistently exercised” requirement does not apply under the § 1.643(a)-3(b)(1) regulation in which income is allocated to income if there is no unitrust provision. Example 4 of Reg. §1.643(a)-3(e) confirms this result. The example involves a trust instrument stating that “pursuant to the terms of the governing instrument (in a provision not prohibited by applicable local law), capital gains realized by Trust are allocated to income.” The example concludes that capital gains are included in DNI. As an example, of what might be “prohibited by applicable local law” see *Thorman v. Carr*, 408 S.W.2d 259, 261 (Tex. Civ. App.—San Antonio 1966), *aff'd per curiam*, 412 S.W.2d 45 (1967)(trustee abused discretionary allocation power in allocating entire proceeds from sale of stock to income).

Income From Flow-Through Entities. Another possible approach is to hold assets in a partnership or LLC. Under most state laws, distributions from the entity will be treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. The entity may have capital gains that will be reported out to the partners or owners; the entity may make distributions, but those distributions will be fiduciary accounting income—so the capital gains would be included in DNI. This planning is based on a special rule for capital gains from pass-through entities that is helpful in carrying out capital gains to beneficiaries. Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States*, 34 Fed. Cl. 112 (1995); see Carol Cantrell, *Income Tax Problems When the Estate of Trust is a Partner*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1375, 1446-47 (April 2013). Furthermore, under the Uniform Principal and Income Act (UPAIA) cash distributions from an entity are generally

allocated to fiduciary accounting income unless one of several exceptions applies (the primary exception being if cash is distributed in total or partial liquidation of the entity). Therefore, under UPAIA cash distributions from a flow-through entity with capital gains that are reported to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.)

Exception (2). Another approach is to give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a “deeming” rule. Example (1) of Reg. §1.643(a)-3(e) refers to a trust in which the trustee “is given discretionary powers to invade principal for A’s benefit and to deem discretionary distributions to be made from capital gains realized during the year.” In that example, “Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore the capital gains realized during the year are not included in distributable net income and the \$10,000 of capital gains tax to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.” In Example (2) the trustee elects “to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year,” and in Example (3) the trustee “intends to follow a regular practice of treating discretionary distributions of principal as being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of assets.” In each example, this treatment of capital gains is “a reasonable exercise of Trustee’s discretion.” In Examples (2) and (3) capital gains are included in DNI.

Trust agreements may specifically grant the trustee to allocate all or part of realized gains from the sale or exchange of trust assets to income or to principal (within the meaning of Reg. §1.643-3(b)), or to deem any discretionary distribution of principal as being made from capital gains realized during the year (within the meaning of Reg. §1.643(a)-3(e)). See generally Blattmachr & Gans, *The Final “Income” Regulations: Their Meaning and Importance*, 103 TAX NOTES 891 (2004).

The “treated consistently” requirement applies to exception (2) (*i.e.*, capital gain that is allocated to corpus but treated as part of a distribution). This is easy to meet if the issue arises in the trust’s first year or perhaps if the §1411 final regulations allow a fresh start in light of the significant tax law changes in ATRA. Otherwise, how a trust changes its position to start deeming that capital gains are included in distributions is not clear. (Historically, capital gains typically have not been treated by trustees as being included in distributions to cause them to be included in DNI.)

Exception (3). Some commentators suggest that an allocation of capital gains to corpus under Reg. §1.643(a)-3(b)(3) when “utilized by the fiduciary in determining the amount that is to be distributed” does not have to be exercised consistently from year to year. The commentator acknowledges that the IRS has not provided further guidance regarding the meaning of revised subsection (b)(3), but that subsection (b)(3) “should be applicable when the fiduciary varies the amount of a principal

distribution based upon the amount of the trust's or estate's capital gains for the year," and suggests, as a practical matter, that a trustee allocating capital gains to principal under subsection (b)(3) "make a record, before the distribution if possible, of the decision to do so." Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA*, TRUSTS & ESTATES 23 (March 2013). As an example, a trustee may study the trust income and income tax brackets of the trust and beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been "utilized by the fiduciary in determining the amount that is distributed" thus satisfying exception (3). This rationale extends beyond the examples in the regulations for exception (3). Those examples include: (i) a trust that is directed to hold an assets for 10 years and then sell it and distribute the proceeds (Ex.6); (ii) amounts distributed in a year the trust terminates when all income and principal is required to be distributed (Ex.7), and (iii) a trust requiring that one-half of the principal be distributed at a particular age, at which time the trustee sells one-half the securities and distributes the proceeds (Ex.9). However, the suggested scenario seems to meet the literal requirements stated in exception (3) because the capital gains have been "utilized by the fiduciary in determining the amount that is distributed."

- n. **Distributions.** Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. See Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32 (Dec. 2012). Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket (\$450,000/\$400,000 in 2013, \$457,600/\$406,750 in 2014). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the \$250,000/\$200,000 threshold. The total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

In making decisions about the tax impact of distributions, keep in mind that if the trust is in a state that does not have a state income tax on the trust, making the distribution to a beneficiary who lives in a state with a state income tax may generate enough state income tax to the beneficiary to more than offset the federal income tax savings to the trust by making the distribution.

This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. *Drafting Tip:* Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as

merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

These additional income tax implications may also factor into the trustee's investment decisions—for example, whether to include allocation to tax-exempt investments.

These income tax planning implications can be quite significant. As Paul Lee describes the importance of ongoing income tax planning for clients: “We spent all of our time avoiding a tax that happens once, whereas the income tax savings can happen every year.”

- o. **65 Day Rule.** Under the 65 day rule, the fiduciary may elect to treat distributions made during the first 65 days following the close of the taxable year as if they had been made on the last day of the prior year. §663(b). (For a non-leap year, this is March 6.) An estate's or trust's taxable income may not be determined by the end of the taxable year, and the 65 day rule can be helpful in planning distributions to carry out income to multiple beneficiaries, each of whom have higher thresholds, than subjecting income to taxation at the trust or estate level (with its very low \$11,950 taxable income threshold in 2013, \$12,150 for 2014, for the high rates and §1411 tax).
- p. **Kiddie Tax.** Unearned income of a person subject to the Kiddie Tax (persons under age 19 and full-time students under age 24 with unearned income over \$2,000 for 2013) will be taxed at the parent's tax rate. However, each child's AGI is viewed separately from the parent's AGI for purposes of testing whether the §1411 tax applies. Few persons under age 19 or full-time students under age 24 have AGI of \$200,000, so they will probably not be subject to the §1411 tax. To achieve this advantage, a separate income tax return should be filed for the child rather than having the child's unearned income included in the parent's AGI on the parent's return.
- q. **Funding Pecuniary Bequests.** If a pecuniary bequest is funded with appreciated property, the post-death appreciation will be taxed as capital gain to the estate or trust, subject to the 3.8% tax on net investment income as well as the 20% capital gains tax (assuming the estate or trust has taxable income in excess of \$11,950 in 2013, \$12,150 for 2014).
- r. **S Corporation Stock and Subchapter S Trusts — Grantor Trusts, QSSTs and ESBTs.** The §1411 surtax is applied at the grantor level for grantor trusts and at the individual beneficiary level for QSSTs. New 2013 proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation's business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the section 678 owner with respect to S corporation stock held by a QSST).

For Electing Small Business Trusts (ESBTs), For Electing Small Business Trusts (ESBTs), the S corporation portion of the income is taxed at the trust level regardless of distributions. The §1411 regulations have very detailed rules with a detailed example for ESBTs (designed to prevent ESBTs from claiming more than one trust

threshold for the S and non-S portions of the trust). Reg. §1.1411-3(c)(3). However, if the trust's interest in an S corporation constitutes an active trade or business of the trust and the trust meets the passive activity rules (*i.e.*, the trustee meets the material participation requirement), business income from the S corporation would not be net investment income subject to the 3.8% tax.

- s. ***Charitable Remainder Trusts.*** Charitable remainder trusts (CRTs) are tax-exempt entities. Distributions to individuals carry out income under a 4-tier system to be taxed to the individuals: Tier 1-ordinary income; Tier 2-capital gain; Tier 3-other income; and Tier 4-corpus. Within each of these first three categories there are classes of income, based on the worst to best tax treatment of items in that category. Distributions are made on a WIFO ("worst in-first out") basis so that the highest taxed items are deemed distributed first. That is for regular tax purposes; when are distributions deemed to carry out NII to individual beneficiaries?

Distributions of items of NII to beneficiaries retain their NII character, and distributions to multiple beneficiaries will have the NII prorated among them based on their proportionate distributions during that year. Reg. §1.1411-3(d)(1)(i-ii). NII that is received by a CRT for any year beginning after 2012 is cumulated and can be treated as carried out to beneficiaries in distributions. The 2012 proposed regulations adopted a harsh approach, treating any distributions as first carrying out accumulated NII that has not previously been distributed. The IRS's reasoning behind this harsh approach was that the "recordkeeping and compliance burden" of keeping track of NII vs. non-NII that is in each of the categories of the Tier system "would outweigh the benefits."

The approach of the 2012 proposed regulations could produce harsh results. For example, assume a CRT has \$50,000 of ordinary income from an IRA distribution that is not NII and has \$40,000 of capital gain. The CRT makes a \$50,000 annuity payment to an individual beneficiary. Under the Tier system, the distribution is deemed to consist of the IRA distribution (producing ordinary income). But for surtax purpose, the CRT would be treated as having distributed the \$40,000 of capital gain (which is NII) and \$10,000 of the IRA proceeds.

The IRS received many comments complaining that CRT trustees are keeping track of this information anyway and that breaking out the items of NII and non-NII in each category of income in each Tier would not be overly burdensome. The 2013 final regulations drop the "carry out NII first" approach and instead apply the Tier system to accumulated NII of the CRT. The tax rate of items of NII within each category would be treated as being subject to an additional 3.8% tax, and the normal categorization rules would be applied (meaning that the NII income within a particular category would be deemed to be distributed first for NII surtax purposes). Form 5227 (Split-Interest Trust Information Return) has been revised to incorporate these requirements. The Instructions to Form 5227 have a detailed listing of the netting and ordering rules for classes of income within the operation of the Tier system. The 2013 proposed regulations give CRTs the choice of applying the system in the 2012 proposed regulation (which is referred as the "simplified method,") or to apply the Tier approach adopted in the 2013 final regulation. (There may be situations in which the simplified

approach achieves a better tax result. For example, excess losses in a particular Tier cannot offset income in the next Tier; under the simplified method any such excess losses would enter into the calculation of the overall accumulated NII of the trust. Also, individual beneficiaries may be below the AGI threshold for paying the surtax and the simplified method may save accounting expenses. The Preamble to the 2013 proposed regulations states, however, that the IRS might discontinue use of the simplified method “if there is no significant interest” among taxpayers in using it.)

10. DRAFTING FOR MAXIMUM FLEXIBILITY (AND “DEAD HAND CONTROL”); BUT CAN IT GO TOO FAR?

a. *Evolution in Trust Law Relaxing Limitations on Trusts.*

Origin of Trusts. The concept of trusts originated the middle of the 13th century. When Franciscan friars were forbidden to own property, benefactors conveyed land to someone (called a feoffee) to hold the land for the *use* of the friar. Uses were not initially enforceable in civil courts, but the Chancellor as a matter of equity compelled feoffees to perform as they had promised. Uses became popular for other purposes as well, including to avoid the general rule of primogeniture (which required land to descend to the eldest son), and to avoid feudal death taxes. King Henry VIII, dismayed at the loss of feudal death taxes, strong-armed Parliament into passing the Statute of Uses in 1535. However, imaginative lawyers came up with ways to avoid the Statute if the feoffee had active duties to perform. That interpretation permitted chancery to reassert its equitable jurisdiction over these vehicles, which came to be called trusts.

Trust Fundamental Requirement. This origin of trusts leads to the fundamental requirements of a trust-- that one party (the trustee) holds legal title to property for the benefit of another party (the beneficiary). Trusteeship involves four overlapping functions: custodial, administrative, investment, and distribution. Trust law has been evolved by case law, and ultimately by statutes (including various Uniform Codes, culminating in the Uniform Trust Code in 2000). Fundamental duties of trustees are the duty of *loyalty* and duty of *prudence*. Subsidiary goals include the duty of *impartiality* to beneficiaries, the duty *not to commingle*, and the duty to *inform* and the duty to *account* to beneficiaries.

Importance of Freedom of Disposition. A unique aspect of the development of trust law in the United States is the commitment to the *freedom of disposition* by the trust settlor.

Evolutionary Developments. Important evolutionary developments impacting the use of trusts include: tax developments (federal estate tax in 1916, the federal gift tax in 1932, the generation-skipping transfer tax in 1976 and 1986 [“when Congress makes something a target it makes it more popular”]-long-term trusts became much more popular after enactment of the GST tax); the Uniform Prudent Investor Act; the Uniform Principal and Income Act (adopting a power to adjust between principal and income); development of the private unitrust; adoption of the Uniform Trust Code (including provisions for non-judicial settlement agreements and ratification of the role of trust advisors, protectors, and directed trustees (although those terms were not used as such in the Code)); the adoption of decanting statutes; and the relaxation of the rule against perpetuities. These developments collectively raise questions about whether settlors can

exercise such a great degree of control over trusts property that some of the basic tenants of trusts have been violated.

- b. ***Client Objectives.*** Planners must dig deeply into client intentions, and their view of life mission as acquisition, stewardship or some combination of the two. Stewardship involves values and principles. People with a stewardship outlook are generally interested in passing that sense of stewardship to future generations; they are generally more content and relaxed in disposing of their estates. Some will make minimal use of trusts, preferring to draw children into their value systems by passing property to them outright (often during life when there is an opportunity to work with the younger generations to model stewardship). Some of that can be emulated in trusts; for example, trust reporting can be in a meeting with families rather than sterile written communications.
- c. ***Core Trust Principles.*** Core principles for trusts include (1) the ability to change to adjust to changing circumstances, and (2) the ability to challenge.

The “ability to challenge” means that someone must have a fiduciary duty to beneficiaries with respect to each of the trust core functions – custodial, administration, investment, and distribution. Sometimes the fiduciary duty is divided among co-trustees, directed trustees, advisors, and protectors, but someone must have a fiduciary duty with respect to each of those functions.

Fiduciary duty requires accountability and enforceability, which depend upon (1) information, and (2) forum. The “information” concept requires that beneficiaries be informed or entitled to information about the trust. “Trustees must provide information to the beneficiaries so they are informed or they cannot enforce the trust. If they cannot enforce, there is no duty; if there is no duty, there is no trust.” The trend toward statutory recognition of “quiet trusts” on a long-term basis is troubling. The “forum” concept is that beneficiaries must have some appropriate place to enforce their rights. No contest clauses are designed to discourage beneficiaries from going to court, and they should be used with care. An evolving issue is whether trusts can mandate that disputes be resolved by binding arbitration. A 2013 Texas Supreme Court case (*Rachal v. Reitz*) recognizes the validity of an arbitration clause in a trust, but the reasoning of the case is suspect. Two states (Arizona and Florida) have passed statutes authorizing trust arbitration provisions, following the publication of a model statute by the ACTEC Arbitration Task Force. (The IRS has been wary of arbitration clauses that could affect the tax treatment of gifts or trusts. PLR 201117005, CCA 201208026.)

- d. ***Ron Aucutt's Summary About Respecting the Core Principles of Trusts.*** “What is a trust? What is the core? ... The trust—we must make ‘trusting.’ Language matters. It does matter that there is duty that the trustee has been ‘entrusted’ to discharge. And the duty must be enforceable, and that requires information and a forum. Best trusts are transitory, meaning they reflect a humble view of property ownership. They recognize that ownership doesn’t last forever; beneficiaries don’t last forever; trustees don’t last forever; and trusts in their current form are not likely to last forever (maybe any trust at all—who has the experience to judge that?). A trust must be truthful—we get back to the disclosure of information, of course. Also we must not be complacent about the aggressive terms in a trust. We must not overlook the possibility that we have not made it ‘trusting’ enough and still pretend that it’s a trust.”

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- e. ***Drafting For Maximum Flexibility and “Dead-Hand” Control—Overview.*** In light of the caution above about maintaining the core principles of trusts, Ron Aucutt and Bruce Stone discussed (with drafting examples) clauses that might directly or indirectly be used to maximize the settlor’s control over the trust. (The form clauses included below are provided by Bruce Stone (Florida) in his wonderfully easy-to-read style, and are included with his consent. “Jane” is sometimes referred to in these forms—she is the settlor’s daughter.) For discussion purposes the forms intentionally included some landmines that may be inappropriate; the forms should be used only after careful consideration by the planner.) These clauses provide helpful form language for providing a great deal of control and flexibility for changes to the trust based on changing circumstances, but consider the following caution in using these clauses:

Portions of this specimen form may be appropriate for use in some circumstances, but inappropriate in others. Some portions may be inappropriate for use in any circumstance. As with the use of any form, the estate planning attorney is solely responsible for the consequences if any part of this specimen form is used in actual documents. Absolutely no warranty or representation of any kind, whether express or implied, concerning the appropriateness or legal sufficiency of this form or any portion of it is made by Mr. Aucutt, Mr. Stone, their respective firms, or the University of Miami.

- f. ***Back-Door Access for Settlor and Keeping Control for Settlor While Settlor is Alive; Various “SLAT” Provisions.***

Spouse as Discretionary Beneficiary While Settlor Is Alive and No Pending Divorce. The settlor’s spouse is included as a discretionary beneficiary under a wide “best interest/sole and absolute discretion” standard, but only as long as the settlor is alive with no pending divorce (suggesting that the trust is structured to provide a “back-door” access for the settlor during the settlor’s lifetime).

In addition, at any time while I am alive and married (but only if no divorce proceedings with respect to my marriage are pending), the Independent Trustee may distribute to my spouse or apply for my spouse’s benefit any amounts the Independent Trustee determines to be advisable for my spouse’s best interests. The amounts distributed to or applied for the benefit of Jane or my spouse will be determined by the Independent Trustee in its sole and absolute discretion, even to the extent of exhausting the trust estate, without any duty of impartiality between Jane and my spouse, or among them and any other beneficiary under this trust instrument who is not then eligible to receive current distributions.

Daughter’s Inter Vivos or Testamentary Limited Power of Appointment (But Only After Settlor Has Died). The settlor’s daughter will have a power of appointment, broad enough to appoint the assets into a trust for the settlor’s benefit, but this power can be exercised only after the settlor’s death (in effect, meaning that the assets will remain in a trust with the settlor’s spouse as a discretionary beneficiary as long as the settlor is alive).

After my death, but only if she survives me, Jane will have the following powers to make gifts from the trust estate at any one or more times during her life or upon her death in her individual capacity and not as a fiduciary.

(a) Jane can make gifts from the trust estate to any one or more persons (including Charitable Organizations) other than herself, her estate, her creditors, or the creditors of her estate.

(b) Jane can make gifts to a trust for the benefit of one or more persons other than herself and in which she also has a beneficial interest, but only if the trust satisfies all of the following requirements.

(b)(1) The trust may permit distributions to Jane or for her benefit but only if limited for her health, education, support, or maintenance.

(b)(2) The trust must prohibit distributions in discharge of Jane's legal support obligations.

(b)(3) The trust must give Jane the continuing right (exercisable by her alone) to appoint all or any part of the trust estate to any one or more of my descendants as beneficiaries of the trust, whether or not she has the right to appoint any part of the trust estate to other persons.

(b)(4) The trust must prohibit Jane from appointing the trust assets to herself, her creditors, her estate, and the creditors of her estate.

Trust for Remote Descendants Includes Settlor's Spouse As Discretionary Beneficiary.

If the settlor's daughter predeceases the settlor, the assets pass to a trust for the daughter's descendants, and the trust includes the settlor's spouse as a discretionary beneficiary.

- g. ***Trustee Removal and Appointment Powers.*** The settlor may retain the power to remove trustees and appoint successor trustees. If the grantor could remove the trustee and appoint himself, it has long been clear that the grantor is treated as holding the powers of the trustee for purposes of §§2036 and 2038. A safe harbor provided under Rev. Rul. 95-58 makes clear that §§2036 and 2038 will not apply to a grantor who could remove a trustee, but who must appoint as a successor trustee someone who is "not related or subordinate to the decedent" within the meaning of §672(c).

The settlor could also have the ability to appoint successor trustees or to add co-trustees without causing estate inclusion under §§2036 or 2038. *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968) ("power to appoint a successor trustee or trustees"); *Durst v. U.S.*, 559 F.2d 910 (3d Cir. 1977)(power to appoint a co-trustee).

- h. ***Incentive Provisions May Be Fashioned by Trustee.*** Incentive trust provisions are very difficult to draft that will be appropriate in all future circumstances. This provision gives the Independent Trustee the ability to fashion an appropriate incentive provision.

If an Independent Trustee is serving, I authorize it to create incentive plans or programs that will reward that descendant for things such as academic achievement, working and earning income, being physically fit, engaging in philanthropic activities (including reimbursing the descendant in whole or in part for charitable gifts made by the descendant from his or her separate resources), participating in socially beneficial volunteer programs and activities, or any other purposes that the Independent Trustee believes to be in the best interests of the descendant. For example, and without limiting the discretion granted to it, the Independent Trustee may implement a plan that will reward the descendant through distributions of money or assets in kind (such as matching the descendant's salary, or purchasing an automobile for the descendant) if the descendant achieves goals set by the Independent Trustee, such as maintaining a certain grade point average as a student, earning income, quitting smoking or undergoing regular physical examinations, or serving as a volunteer for charities that benefit worthwhile causes. The Independent Trustee should consult with the descendant in the formulation of any such incentive plans or programs, and their terms and conditions should be set forth in writing. Any such plan or program will not have the status of a legally enforceable contract, and the Independent Trustee may modify the terms of or terminate any such plan or program as it may deem necessary or advisable. I would expect, however, the Independent Trustee to administer any such plan or program in a positive manner that will advance the best interests of that descendant.

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- i. ***Limiting Distributions to Married Beneficiary If Beneficiary's Spouse Has Not Waived Rights to Trust Assets.*** Another “dead-hand” control provision is to adopt a stricter distribution standard for any married beneficiary if the beneficiary’s spouse has not waived rights to the trust assets.

Restrictions Applicable to a Married Beneficiary

Despite the preceding provisions of clauses 6 and 7, the following rules will apply with respect to distributions to or for the benefit of each beneficiary of a trust held under either of those clauses who is married and who is then eligible to receive distributions.

8.1 No Trustee other than an Independent Trustee may make distributions or decisions with respect to distributions to or for the benefit of that beneficiary.

8.2 The Independent Trustee is prohibited from making outright distributions to that beneficiary for any purpose other than amounts required for the beneficiary's immediate and direct personal needs for support and health, taking into account all other available income and resources known by it to be reasonably available to that beneficiary for those purposes, so as not to allow the beneficiary to accumulate funds that would build up his or her personal net worth.

8.3 The provisions of clauses 8.1 and 8.2 will apply at all times while that beneficiary is married, whether he or she was married upon the creation of the trust for his or her benefit or becomes married at one or more times after creation of the trust. The provisions of clauses 8.1 and 8.2 will not apply during any time when that beneficiary is not married (whether never married, or whether married previously if the marriage has terminated because of the death of his or her spouse or by dissolution in legal proceedings during lifetime), except as follows. The provisions of clauses 8.1 and 8.2 will continue to apply after the dissolution of a beneficiary's marriage if rights were awarded to the beneficiary's former spouse by a court in a dissolution of marriage proceeding or by operation law in the nature of a beneficial interest in the trust, or marital property rights or other interests in the beneficial interest of that beneficiary, until the beneficiary's former spouse (or the legal representative or successor in interest of the beneficiary's former spouse) is legally barred from efforts to seek to enforce those rights, whether because of reversal of the award, death, or other reason.

8.4 Distributions to or for the benefit of a beneficiary who is married will be governed as otherwise provided in clauses 6 and 7 and without regard to the restrictions set forth in clauses 8.1 and 8.2 if the spouse of that beneficiary has executed a written instrument satisfactory to the Independent Trustee in content and form which irrevocably and permanently waives all rights of any nature in that trust which the spouse of that beneficiary might have or assert, other than rights specifically conferred upon that spouse by me under the terms of this trust instrument (such as naming the spouse as a beneficiary by specific reference to his or her name or by specific reference as the spouse of a descendant of mine, or by including the spouse as a permissible appointee under a power of appointment). The waiver must expressly state that it runs in favor of the Trustee, the beneficiary to whom that spouse is married, and all other persons having a beneficial interest in the trust estate, and it must be delivered to the Independent Trustee. The waiver may be executed before or after the marriage to that beneficiary. The Independent Trustee will not be liable to anyone for decisions to make distributions based on a waiver that is later determined to be invalid, or for refusing to make distributions if the Independent Trustee believes the waiver to be invalid, if the Independent Trustee obtains legal advice about the effectiveness of the waiver and otherwise acts in good faith.

8.5 If a beneficiary's spouse executes a waiver in accordance with the provisions of clause 8.4, and either the beneficiary or the beneficiary's spouse thereafter changes his or her residence to another jurisdiction while they are still married to each other, the restrictions set forth in clauses 8.1 and 8.2 will once again govern distributions to that beneficiary unless the spouse of that beneficiary executes another waiver in accordance with the provisions of clause 8.4 which is satisfactory to the Independent Trustee in content and form under the laws of jurisdiction in which the new residence is located.

8.6 It is my specific intention not to allow distributions for purposes beyond the immediate and direct personal needs for support and health of a beneficiary who is married which might be used to support or enhance his or her lifestyle if there is any possibility that his or her spouse could seek to assert claims for beneficial rights or interests with respect to income or principal of the trust estate, whether directly in the nature of a beneficial interest in the trust, or indirectly through the assertion of marital property rights or other interests in the beneficial interest of that beneficiary, unless the spouse of that beneficiary has irrevocably and permanently waived the right to assert all such claims and rights. I direct the Independent Trustee to enforce these provisions rigorously, and to take a narrow and conservative view of the distributions which are permitted in the absence of an irrevocable and permanent waiver by the spouse of that beneficiary, in order to prevent the distribution of the income and principal of the trust estate to anyone who is not a descendant of mine, except where I have specifically and intentionally named that person as a beneficiary in this trust instrument.

- j. ***Decanting Provision.*** A decanting provision affords a great deal of flexibility to the trustee to make adjustments to the trust by distributing the assets to a new trust with provisions to accommodate changes in conditions (but still with certain restrictions that the settlor wants to impose, such as the provision placing restrictions on married beneficiaries whose spouses have not signed waivers in any interest in the trust assets).

Distributions to Other Trusts

9. At any one or more times after my death the Independent Trustee in its sole and absolute discretion can set aside all or any part of the trust estate of a trust held under clause 6 or 7 in one or more separate trusts for the benefit of any one or more of my descendants for whose benefit that trust is held and his or her descendants.

9.1 A separate trust must contain the conditions and restrictions on distributions to married beneficiaries that are set forth in clause 8, but other than that exception the separate trust may provide for distributions of income and principal on terms that are different from those set forth in clause 6 or 7. The terms may establish beneficial interests that are limited or fixed in nature, whether in scope of permitted distributions or in duration, or that vest upon the occurrence of certain terms and conditions.

9.2 A separate trust may grant a power of appointment to a beneficiary exercisable during the beneficiary's life, upon the beneficiary's death, or both during the beneficiary's life and upon the beneficiary's death. The separate trust may permit exercise of the power in favor of any one or more persons without limit (including, for example, the beneficiary or the beneficiary's estate), or it may restrict exercise in favor of a limited class of persons (for example, any one or more of my descendants, or any one or more of my descendants and their spouses, or the beneficiary's creditors). Exercise of the power may be conditioned upon the existence of conditions (such as the marital status or net worth of the beneficiary) or limited to certain periods of time. The Independent Trustee may reserve the right to modify or terminate the power of appointment. Whether to grant a power of appointment, the determination of its nature and extent, and (if applicable) whether to modify or terminate any such power of appointment shall be determined by the Independent Trustee in its sole and absolute discretion.

9.3 The terms of a separate trust may provide for successive, contingent, or future beneficial interests provided that distributions can only be made at any time to or for the benefit of any one or more of (i) my descendant for whose benefit the trust under clause 6 or 7 is held and (ii) his or her descendants until their beneficial interests have terminated as provided in this trust instrument, or if their beneficial interests have terminated, to any one or more of my descendants, or if I have no descendant who is then living, as provided in clause 10.

9.4 A separate trust may contain provisions for the service of trustees and successor trustees that differ from the provisions set forth in clause 14 of this trust instrument.

9.5 No separate trust may be established for the benefit of anyone who is not a beneficiary under this trust instrument.

9.6 If the Trustee sets aside some but less than all of the trust estate to be held as a separate trust, the portion of the trust estate not set aside will continue to be administered under the provisions of this trust instrument.

9.7 It is my intention that this power to distribute all or any part of the trust estate in one or more separate trusts shall be exercised only when and to the least extent necessary to provide for specific needs or special situations that cannot be addressed appropriately or efficiently under the provisions of this trust instrument. If the power to distribute in further trust is exercised, it must be exercised in a manner that is consistent with my intentions as set forth in clause 6 or 7, in a manner it believes that I would exercise that power if I were the Trustee. In doing so, the Independent Trustee should take into account my values and beliefs as I have expressed them to the Trustee and to other persons, whether set forth in writing (including written communications from me to the Independent Trustee after the execution of this trust instrument) or orally. If I am disabled or deceased, the Independent Trustee may consult with members of my family, friends, and advisers as appropriate for guidance in determining whether and in what manner to exercise this power. Nevertheless, no communications from me to the Independent Trustee after the execution of this trust instrument will be binding upon the Independent Trustee. All decisions concerning the exercise of the power under this clause 9 will be made by the Independent Trustee alone and in its sole judgment.

- k. ***Substitution Power.*** The settlor retains the right to reacquire assets by substituting assets of equivalent value. This is included to cause the trust to be a grantor trust, but this is a very desirable power that settlors like to have over trust assets. The clause can now be inserted with comfort that the clause will not cause estate inclusion under §2036 in light of Rev. Rul. 2008-22. This trust form provision also gives the settlor the authority to release the substitution power.

My Right to Reacquire Assets

5. I reserve the right, exercisable by me in a nonfiduciary capacity and without the approval or consent of the Trustee or any other person in a fiduciary capacity, to acquire or reacquire by bona fide purchase the whole or any part of the trust estate at its then fair market value for adequate and full consideration payable in money or money's worth of other property, subject to the following.

5.1 The Trustee must determine that the cash or other assets transferred by me in exchange for the assets of the trust estate acquired or reacquired by me are of equivalent value. If the Trustee determines that the values are not equivalent, it shall take steps to ensure that appropriate adjustments or payments are made to ensure that the exchanges are of equivalent value.

5.2 My right cannot be exercised in a manner that can shift benefits among the beneficiaries of any trust under this trust instrument.

5.3 I can release this right at any time or times, in whole or in part, by a written instrument signed by me and delivered to the Trustee. Each such release will be irrevocable, permanent, and binding upon me. I understand that by releasing this right in whole or in part, I may be changing the classification of the trust from a "grantor trust" for federal income tax purposes to a non-grantor trust in whole or in part.

5.4 My right to acquire or reacquire assets under this clause can be exercised by a person named by me in a durable power of attorney or by a court appointed guardian.

5.5 A decision whether to release this right in whole or in part shall be made based on my personal best interests, and neither the Trustee nor any beneficiary will have any right to question or challenge any such decision, whether made by me or by a person named by me in a durable power of attorney or by a court appointed guardian.

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- l. ***Directions Regarding Distributions.*** The trust provisions give a great deal of flexibility to an Independent Trustee, including wide discretion to make distributions for the “best interests” of beneficiaries. The trust instrument later provides guidance to the trustee regarding the settlor’s intentions regarding factors that the trustee should consider in exercising that broad power.

Rules Governing Distributions

24.1 If the Trustee knows that a beneficiary has other available income and resources, it should take them into account when deciding how much to distribute to or for the benefit of the beneficiary. The Trustee does not have to get financial statements or tax returns from the beneficiary. The Trustee can make payments directly to a beneficiary or to other persons for his or her benefit (including contributing all or any of the trust assets to other trusts created by the Trustee or by other persons for the benefit of the beneficiary), but it does not have to make payments to a court appointed guardian. The Trustee’s decision on amounts to be spent will be final.

24.2 If a beneficiary is a minor or under other legal disability, the Trustee should consult with the beneficiary’s guardian to establish a budget for the beneficiary’s needs when making distributions as provided in this trust instrument. The Trustee will be responsible to determine the amounts to be distributed, and to establish procedures for disbursing funds to the guardian. The Trustee can make distributions that also provide some incidental or indirect benefit to the beneficiary’s guardian, but only if the distributions are for the primary benefit of the beneficiary.

24.3 When I have authorized the Independent Trustee to make distributions for a beneficiary’s best interests, I intend for it to be able to make funds available to the beneficiary for purposes that are unrelated to the beneficiary’s health, education, support and maintenance. The Independent Trustee should exercise its discretion in a manner it believes that I would if I were the Trustee. In doing so, the Independent Trustee should take into account my values and beliefs as I have expressed them to others, whether set forth in writing (including written communications to the Independent Trustee) or orally. The Independent Trustee may consult with members of my family, friends, and advisers as appropriate for guidance in determining whether a distribution would be in a beneficiary’s best interests, but the decision will be made by the Independent Trustee alone and in its sole judgment.

24.3(a) I do not want trust funds or assets used to support a beneficiary in a privileged lifestyle unless that beneficiary is living a productive life and functioning as a contributing member to society, as evidenced by such things as employment (including employment in low or nonpaying occupations such as being a homemaker or a volunteer worker for charity), raising a family, or enrollment in an accredited institution of learning to acquire skills and qualifications to live a productive life. These conditions can be excused by the Independent Trustee for reasons that in its judgment I would consider to be good cause (for example, mental or physical disability, or normal retirement after a career of productive employment).

24.3(b) I recognize that some of these terms may be ambiguous, incapable of precise definition, and subject to various interpretations. I also recognize that implementing my wishes may increase the costs of administering the trust, and may result in challenges to the Independent Trustee’s exercise of discretion in making (or not making) distributions. Therefore I relieve the Independent Trustee from liability for any decision it makes regarding whether a distribution would be in a beneficiary’s best interests, if it makes the decision in good faith. I further direct that the Independent Trustee be indemnified from the assets of the beneficiary’s trust for any liability, damages, attorney’s fees, expenses, and costs incurred as a result of claims or demands made by the beneficiary challenging the Independent Trustee’s decision to make or not make distributions, provided the Trustee acts in good faith.

- m. ***Broad Power Over Income; “Power to Adjust” or Adopt Unitrust.*** The trust specifically gives the trustee the power to adjust income and principal and to define income as a unitrust. This can be appropriate to assist in making investment decisions, particularly if there are different distribution standards for income vs. principal.

24.22 “Income” means money or property that the Trustee receives as current return from the principal assets of the trust estate, as determined under UPIA or other applicable state law.

24.22(a) The Independent Trustee has full and exclusive authority to define income as fiduciary accounting income (and to make discretionary adjustments to fiduciary accounting income as the Independent Trustee in its sole discretion deems advisable), to define income as a unitrust amount determined by the Independent Trustee, or to determine income based on some other method, all as authorized by governing law.

24.22(b) The Independent Trustee from time to time may adjust the percentage used to calculate the unitrust amount used to calculate the unitrust amount (provided that the percentage used is within the range of percentages authorized by UPIA), and elect to use fair market values or average fair market values in determining the unitrust amount, as the Independent Trustee determines to be necessary to administer the trust estate fairly, efficient, and impartially in a manner that is fair and reasonable to all of the beneficiaries.

24.22(c) The Independent Trustee can convert and reconvert from one method of determining income to another method from time to time (including conversions and reconversions within the same accounting period) as the Independent Trustee in its sole discretion shall determine.

- n. **Governing Law.** The trustee’s power to change the place of the trust administration and to change the governing law regarding the administration of the trust can provide very helpful flexibility. Be very wary, however, of providing for the ability to change the governing law regarding the validity or construction of the trust. Administrative provisions would include things such as income/principal allocation, notices to beneficiaries, accounting format and delivery requirements, etc. Some decanting statutes specifically provide that the decanting power is a power of administration. Things such as the applicable rule against perpetuities or the validity of the trust would be matters of the administration of the trust.

24.37 This trust instrument is executed under [Florida] law.

24.37(a) The substantive and procedural law of [Florida] will govern all aspects of this trust instrument, including, but not limited to, its validity, construction, and duties of the Trustee.

24.37(b) Subject to the other provisions of this trust instrument, the laws of the jurisdiction where a trust has its principal place of administration will govern all matters involving the administration of that trust. Each trust shall be administered at a place that the Trustee believes to be generally and reasonably appropriate to its purposes and administration. The Trustee need not choose a particular place which might be deemed more advantageous for one or more particular purposes (including, without limit, tax or creditor-protection purposes). The Trustees shall not be under a continuing duty to determine the most appropriate place for a trust to be administered or to relocate the trust to another place.

- o. **Direction Advisors.** The trust may appoint investment advisors (to control investments) distribution advisors (to direct distributions), and/or a trust protector (to make various decisions such as removing and replacing trustees or direction advisors). These can also provide substantial flexibility if the settlor would prefer to designate certain persons to make these decisions rather than an “independent trustee.” The trust instrument should make very clear whether the powers of the advisors are exercised in a fiduciary or non-fiduciary capacity. However, someone should have a fiduciary duty with respect to *all* of the core trust functions—the custodial, administrative, investment, and distribution functions.

11. GIFT PLANNING ISSUES FOR 2014 AND BEYOND

- a. **Increased Gift Exemption.** As of January 1, 2013, the gift exemption increased to be the same as the indexed estate tax basic exclusion amount (\$5.12 million in 2012, \$5.25 million in 2013, and \$5.34 million in 2014). Gifts in excess of the annual exclusion (\$14,000 in 2013 and 2014) and in excess of the tuition and medical expense tuition effectively “use up” the lifetime gift/estate tax exclusion amount. Perhaps the most important advantage of the increased gift exemption for many individuals will be the “cushion” effect — the ability to make gifts in excess of \$1 million, but considerably less than \$5 million, with a high degree of comfort that a gift tax audit will not cause gift tax to be imposed (perhaps even if “aggressive” valuations are used), which may lessen the perceived necessity to use defined value clauses to avoid paying gift taxes in making transfers.
- b. **Basis Concerns.** The differential between the 40% estate tax rate and a 20% (really 23.8% including the §1411 tax on net investment income) capital gains rate makes the basis concerns significant. The advantage of making a gift is that the appreciation is not subject to estate tax; but the disadvantage is that there is no step up in basis for that asset at death. Stated differently, there may be have to be a substantial amount of appreciation in order for the 40% estate tax savings on that appreciation to offset the loss of basis step up on the full value of the asset. Carlyn McCaffrey has suggested using formula clauses to address this issue. Carlyn McCaffrey, *Tax Tuning the Estate Plan by Formula*, 33 UNIV. MIAMI HECKERLING INST. ON EST. PL. ch. 4, ¶ 403.5 (1999).

Example: A gift is made of a \$1 million asset with a zero basis. If the asset does not appreciate, the family will lose the step up in basis, and at a 23.8% rate (if the family members are in the top tax bracket), this means the family will receive a net value of \$762,000 from the asset (after it is sold). If the asset is not gifted, the transfer tax implications are the same but the step up in basis saves \$238,000. The asset would have to appreciate to from \$1,000,000 to approximately \$2,470,000 (**147%!!**) in order for the estate tax savings on the appreciation to offset the loss of basis step up (*i.e.*, $\$1,469,135 \text{ post-death appreciation} \times 0.40 = 2,469,135 \text{ total appreciation}$ (assuming zero basis) $\times 0.238$ [assuming the donee is in the top income tax bracket]).

In making these calculations for a particular client situation, consider both federal and state income and estate taxes.

There is an example of a collectible in Mahon, *The “TEA” Factor*, TR. & ESTS. (Aug. 2011). If a zero basis collectible worth \$5 million is given, there would have to be over \$20 million of appreciation before the estate tax savings exceed the loss of basis step up (based on tax rates in 2011).

Keep in mind that the income tax is incurred only if the family sells the asset. If the family will retain the asset indefinitely, or if real estate investment changes could be made with §1031 like kind exchanges, basis step up is not as important.

Strategies are available to avoid the loss of basis step up if gifts are made to grantor trusts. The grantor can repurchase the low-basis assets before death, so that the low-basis assets would be in the gross estate at death and get a step up in basis under §1014. (This could be worthwhile even if the grantor has to borrow money to be able

to repurchase the low basis assets and get cash into the grantor trust — which does not need a stepped-up basis.) In addition, some commentators maintain that a basis step up is available under §1014 at the grantor's death for all assets in a grantor trust. *E.g.*, Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 148 (Sept. 2002). See Item 7 above for further discussion of strategies to preserve basis step up at the taxpayer's death.

- c. **Keep in Mind Downside of Depreciation.** If the gifted asset depreciates in value, the client will be worse off, from a transfer tax standpoint, than if the gift had not been made in first place.
- d. **Emphasize Strategies That Do Not Use Gift Exemption.** To the extent possible, accomplish desired lifetime transfers with strategies that minimize using the client's gift exemption (such as with GRATs or sales to grantor trusts); maximize the estate exemption remaining at death in order to retain low basis assets to receive a basis step-up at the individual's death, although there may be non-tax reasons to make gifts using gift exemptions (such as for creditor planning purposes).
- e. **Gifting Opportunities and Concerns.** General gifting opportunities and concerns in an environment of a large \$5 million indexed gift exemption include the following:
 - To the extent possible, accomplish desired lifetime transfers with strategies that minimize using the client's gift exemption;
 - Balance the loss of a stepped-up basis for gifted assets that are no longer owned by the individual at death;
 - Address the form of gifts and whether gifts should be made in trust—reasons include GST planning (if there is remaining exemption to allocate), asset protection, divorce protection, and management protection;
 - Carefully consider what assets should be transferred—for valuation discounting and leverage reasons, entities will often be used; allow time between the funding of the entity and any transfers; retain sufficient assets to provide living expenses; do not transfer personal use assets to entities; follow formalities for the entity;
 - Defined value formula clauses may be appropriate for gifts or sales if the transfer utilizes most of the remaining available gift exemption amount, see Item 12 below;
 - Large gifts combined with sales or other leveraged transactions afford the opportunity of removing huge amounts from the transfer tax base for estate and GST purposes;
 - Sales can leverage prior gift transfers to increase significantly the transfer of future appreciation; consider sales of appreciating assets to a previously funded trust in return for AFR-interest rate long term notes; the rule of thumb is that the sale amount can be 9 times the equity value of the trust from the prior gifts; allow time to pass from the date of funding the trust with gifts and

subsequent sales; See Item 13 below regarding a recent IRS attack on a sale to grantor trust transaction;

- Grantor trusts can dramatically increase the amount transferred over time by permitting tax-free compounding for the trust; if a grantor is reluctant to utilize a grantor trust because of the ongoing income tax liability, consider reducing the amount being transferred to the trust but still leaving it as a grantor trust (with someone having the flexibility to cause the trust to lose its status as a grantor trust at some point in the future);
- The gift exemption amount will increase each year with indexing (\$5.0M in 2011, \$5.12M in 2012, \$5.25M in 2013, and \$5.34M in 2014) and the decision will have to be made whether and how to use the increased gift exemption amount each year; and
- Gift splitting in order to take advantage of both spouses' large gift exemption amounts is possible if the marital assets are owned predominantly by one spouse (but there are planning complexities); for a discussion of gift splitting complexities see Item 15.e of the Hot Topics and Current Developments Summary (December 2013) found [here](http://www.Bessemer.com/Advisor) and available at www.Bessemer.com/Advisor.
- For very large estates, consider making a large gift requiring payment of gift tax, to reduce the estate tax if the donor survives three years (after exemptions have been used, giving \$100 costs \$40 of gift tax but bequeathing \$100 costs \$66.67 of estate tax; this opportunity is more realistic now that we have "permanent" transfer tax provisions and the possibility of repeal has receded; if the client wants to give particular assets in excess of the gift exemption amount but wants to minimize gift taxes payable currently, consider using financed net gifts as explained at Handler, Financed Net Gifts Compared to Sales to Grantor Trusts, 44th UNIV. MIAMI INST. ON EST. PLAN. ch. 17 (2010)).

f. ***Sample Specific Gifting Strategies.***

- Gifts to Dynasty trust to utilize \$5 million GST exemption;
- If the donor is unwilling to make further gifts, the donor may be willing to make a late allocation of GST exemption to a prior trust (and if appropriate, later do a qualified severance to have fully exempt and non-exempt GST trusts);
- Forgiveness of outstanding loans to children;
- Gifts to grantor trusts, and leveraging grantor trusts with loans or sales from the grantor;
- Equalizing gifts to children or grandchildren;
- Gifts to save state estate taxes;
- GRATs (GRATs will continue to be advantageous even with the permanent \$5 million indexed gift exemption);

- Life insurance transfers (including the ability to “roll out” of split dollar arrangements);
- Deemed §2519 transfers from QTIP trusts (for an outstanding detailed discussion of planning by a surviving spouse with QTIP trusts, see Read Moore, Neil Kawashima & Joy Miyasaki, Estate Planning for QTIP Trust Assets, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12 ¶ 1202.3 (2010)); and
- QPRTs
- These specific gift strategies are discussed in more detail in Item 5.o-aa of the “2012 Heckerling Musings and Other Current Developments” found [here](#) and available at www.bessemer.com/advisor.

g. ***Gift Strategies That Provide Some Benefit to Grantor and/or Grantor’s Spouse.***

Planning alternatives for providing some benefit to the grantor and/or the grantor’s spouse include:

- Borrowing of trust funds by grantor;
- The use of “spousal lifetime access trusts” (sometimes referred to as “SLATs”), including concerns over whether the donee-spouse can be given a testamentary limited power of appointment broad enough to appoint the assets back into a trust for the original donor-spouse if the donee predeceases, and including potential effects of creditors rights with respect to those trusts;
- “Non-reciprocal” trusts (for example, if married individuals want to include each other as potential beneficiaries of SLATs);
- Self-settled trusts established in asset protection jurisdictions;
- Sale for a note or annuity rather than making a gift of the full amount to be transferred;
- Transferring residence to trust or co-tenancies between grantor/spouse of grantor and trust;
- “Reverse defective grantor trust” transaction in which the donor purchases (including through the exercise of a substitution power) or borrows assets gifted to trust;
- A donor may choose to purchase or borrow assets from grantor trusts in return for long-term notes if the donor would like to re-acquire those assets (to be able to enjoy the income produced by those assets or to be able to achieve a basis step up at the donor’s subsequent death), see generally Clay Stevens, The Reverse Defective Grantor Trust, Tr. & Ests. 33 (Oct. 2012);
- Preferred partnership freeze;
- Turning off grantor trust status (to at least minimize the continuing cost to the grantor);
- Payment of management fees to the grantor;

- Inter vivos QTIPable trust; and
- Retained income gift trust.

Each of these alternatives is discussed in more detail in Items 14-25 of the Hot Topics and Current Developments Summary (December 2013) found [here](http://www.Bessemer.com/Advisor) and available at www.Bessemer.com/Advisor.

12. DEFINED VALUE CLAUSE UPDATES

- General Description.** In making transfers of hard-to-value assets, clients are concerned that gift taxes may result if the assumed value at the time of the transfer ends up being lower than the value that is finally determined for gift tax purposes. Two types of clauses have emerged to define what is transferred by formula in order to avoid (or diminish) the gift tax risk—(1) formula allocation clauses and (2) formula transfer clauses.
- Formula Allocation Clauses.** A “formula allocation clause” allocates the amount transferred among transferees (*i.e.*, transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees include charities, spouses, QTIP trusts, “incomplete gift trusts” (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and “zeroed-out” GRATs. With this type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values.

Four cases have previously recognized formula allocation defined value clauses, all involving clauses with the “excess” value passing to charity. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff’d*, 586 F.3d 1061 (8th Cir. 2009), *Petter v. Commissioner*, T.C. Memo. 2009-280, *aff’d*, 653 F.3d 1012 (9th Cir. 2011), and *Hendrix v. Commissioner*, T.C. Memo. 2011-133. Two of the cases relied on an agreement among the transferees as to valuation (*McCord* and *Hendrix*) and the other two cases relied on finally determined estate (*Christiansen*) or gift (*Petter*) tax values.

- Formula Transfer Clause—Wandry.** In *Wandry v. Commissioner*, T.C. Memo 2012-88, the court upheld a stated dollar value “formula transfer” clause of, in effect, “that number of units equal in value to \$x as determined for federal gift tax purposes.” The court addressed the IRS’s argument that the formula assignment was an invalid “savings clause” under the old *Procter* case. *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Judge Haines concluded that the transfers of units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to “take property back” as a condition subsequent.

As to the public policy issue, the court quoted the Supreme Court’s conclusion that public policy exceptions to the Code should be recognized only for “severe and immediate” frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause

would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter*, the court responded that the case is not “passing judgment on a moot case or issuing merely a declaratory judgment,” because the effect of the case causes a reallocation of units between the donors and the donees. The court noted in particular that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a “severe and immediate” public policy concern.

Critics of the *Wandry* opinion have focused on one of the rationales given by Judge Haines—that there are other enforcement mechanisms to ensure accurate valuation reporting. Under the *Wandry* scenario, both the donor and donee will generally wish to transfer as many units as possible within the specified dollar amount.

The IRS filed a Notice of Appeal on August 28, 2012, but the government subsequently filed a dismissal and dropped the appeal. The appeal would have been to the 10th Circuit Court of Appeals, which is the circuit that approved a formula price adjustment clause in *King v. United States*, 545 F.2d 700 (10th Cir. 1976) (formula adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price).

The IRS subsequently filed a nonacquiescence in the case. I.R.B. 2012-46 (“nonacquiescence relating to the court’s holding that taxpayers made a completed transfer of only a 1.98 percent membership interest in Norseman Capital, LLC”).

For a detailed discussion of *Wandry* and planning considerations in using defined value clauses, see Item 27 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

- d. ***Sale Transactions With Defined Value Transfers.*** Sale transactions as well as gifts can be structured with a defined value clause. *Petter* and *Hendrix* both involved combined gift/sale transactions—with formula allocation clauses allocating the “excess” value over the stated purchase price to charity. *Petter v. Commissioner*, T.C. Memo. 2009-280, *aff’d*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo. 2011-133.

Similarly, a sale could be structured with the assignment being of that number of shares equal to the specified purchase price. Recently filed companion cases involving an IRS attack on a sale to grantor trust transaction, in which the sale agreement included a *Wandry*-type provision describing the amount of units being sold in terms of the finally determined value that is equal to the specified purchase price. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13 (discussed in Item 13 below).

Alternatively, the sale could be structured with a clause similar to the approach approved in *King v. United States*, 545 F.2d 700 (10th Cir. 1976). That case upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price.

The price-adjustment approach was subsequently rejected in a sale for a private annuity in *Estate of McLendon v. Commissioner*, T.C. Memo. 1993-459, *rev'd*, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause that would adjust purchase price and amount of annuity payments; Tax Court ignored the adjustment clause, based on *Procter and Ward* [87 T.C. 78 (1986)], concluding that it would not expend “precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot”). Similarly, a “price adjustment” clause in a gift transaction was not given effect in *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986) (gift transfer of limited partnership units with a provision that if the value was finally determined to exceed \$400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the “excess value”; *Procter and King* both distinguished; adjustment provision not given effect, based on interpretation of adjustment clause).

The same defined value principles (*i.e.*, defining the amount transferred in terms of the finally determined dollar value of the assets) would also seem to apply in structuring a “swap” power under a nonfiduciary substitution power as a dollar value transfer. This could be structured with either the person holding the substitution power or the trust — whichever was transferring the hard to value asset — assigning a formula dollar value of units.

- e. **Planning Pointers.** The IRS concern with defined value types of clauses is that they may encourage taxpayers to use aggressive (and perhaps abusive) low valuations. If the IRS audits the transfer, the worse that happens is to accomplish a transfer of what should have happened in the first place-without any gift tax risk. If there is no audit, the taxpayer “gets away with murder.”

Until there is further case authority, panelists were generally not comfortable relying on *Wandry* transfers. However, they acknowledge formulas have become much more predominantly used (and even authorized by statutes and regulations in some cases) since 1944 when *Procter* was decided, and that *Procter* might be decided differently if it were being heard today.

A practical impact of the *Wandry* case is that before that case, agents would just give a very simple short one sentence response to formula clauses- “We don’t respect formulas.” That is no longer the case (although there are anecdotal indications that some agents say they cannot take a defined value clause into consideration at the agent level, but it could be considered at Appeals).

There were likely a number of *Wandry* transfers made in late 2012. Gift tax returns for many of them were likely filed in the late summer-early fall of 2013, and gift tax audits will begin emerging regarding those transfers later this year.

The IRS informally has indicated that it has not given up on its opposition to *Wandry*-type clauses and is still looking for “the right case.”

13. SALE TO GRANTOR TRUST TRANSACTION (INCLUDING NOTE WITH DEFINED VALUE FEATURE) UNDER ATTACK, *ESTATE OF DONALD WOELBING V. COMMISSIONER* AND *ESTATE OF MARION WOELBING V. COMMISSIONER*

- a. **Overview.** A very effective method of “freezing” an individual’s estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. Selling the appreciating assets to a grantor trust avoids the recognition of income on the initial sales transaction and as interest and principal payments are made on the note (at least as to payments made during the grantor’s lifetime).

While sales to grantor trusts have been widely used for several decades, there have been audits in which the IRS takes the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the “economic realities of the arrangement ... do not support a part sale,” and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (John Porter points out that this position conflicts with Treas. Reg. § 25.2512-8, which provides that transfers are treated as gifts “to the extent that the value of the property transferred by the donor exceeds the value in money or money’s worth of the consideration given therefore.”)

The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration’s Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically), as described in Item 1.c above.

In order for the sale transaction to be effective for estate tax purposes, it is important that the note that is given to the seller is recognized as “debt” rather than “equity.” If the seller transfers assets to a trust and retains a beneficial interest in those assets, as opposed to merely being recognized as a creditor of the trust, the assets transferred will be included in the seller’s gross estate for estate tax purposes. Also, the IRS takes the position that if the sale is not recognized as a “bona fide transaction,” the IRS may treat the sale transaction as a gift by the seller and afford little or no value to the note that the purchaser gives to the seller to offset the amount of the gift.

Agents on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (There are some indications that the *Karmazin* case [discussed below], which received a great deal of attention in 2003, initially arose because of the agent’s concern over use of the AFR as the interest rate on an intra-family sale transaction.)

The IRS is attacking some huge SCIN transactions in *Estate of Davidson* (discussed in Item 15.c below). The frontal assault on “standard” sale to grantor trust transactions comes to the forefront in two companion cases recently filed in the Tax Court.

- b. **Woelbing Estates Cases.** The IRS is attacking sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13.

In 2006 Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely held company located in Wisconsin) to a trust (presumably a grantor trust) in return for a promissory note having a face value of about \$59 million, bearing interest at the AFR. The purchase price was determined by an independent appraiser. The note contained a defined value provision stating that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note.

The sale was made to an "Insurance Trust" that owned three life insurance policies on the lives of Mr. and Mrs. Woelbing. (The policies were subject to an "economic benefit regime" Split-Dollar Insurance Agreement, under which Carma Laboratories was obligated to pay the annual premiums on the policies, less the annual value of the economic benefit amounts. The decedent was obligated to pay the annual economic benefit amounts. Following the deaths of both spouses, the trust was obligated under the Split-Dollar Agreement to repay Carma for its advances of premium payments.) At the time of the sale in 2006, the policies had an aggregate cash surrender value of about \$12.6 million, a portion of which could be accessed via policy loans or surrender of paid-up additions to make payments on the promissory note. Two Woelbing sons (who were beneficiaries of the trust) executed personal guarantees to the trust for 10% of the purchase price of the stock. The estate's position is that the trust-purchaser had substantial financial capability to repay the note even without considering the stock itself, and that this financial capability exceeded 10% of the face value of the promissory note. (It is not clear whether the 10% cushion included the personal guarantees or whether the trust's financial capabilities other than both the stock and the personal guarantees exceeded 10% of the note face amount.)

Mr. and Mrs. Woelbing filed gift tax returns for 2006, 2008 and 2009 making the split gift election; therefore, if the 2006 sale transaction had a gift element, the gift was treating as having been made one-half by each of the spouses for gift and GST tax purposes.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013 (interestingly, only two days after receiving the IRS's Notice of Deficiency for almost \$32 million against Mrs. Woelbing for her gift tax). In the estate tax audit of Mr. Woelbing's estate, the gift tax returns for 2006 and several other years were also audited.

Gift Tax Issues. The IRS asserts that the note should be treated as having a zero value for gift tax purposes and is contesting the underlying value of the stock in 2006 (asserting a value in 2006 of \$116.8 million compared to the \$59 million purchase price). The IRS Notice of Deficiency asserts that for gift tax purposes, "Section 2702 requires inclusion of the entire value of non voting shares ... as gifts when they were sold... in exchange for a note." Thus, the IRS position is that the note should be treated as having a zero value under §2702. Alternatively, if §2702 does not apply, the Notice of Deficiency alleges that "the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the ... Trust, and the note received in exchange." (That wording raises

the interesting issue of what shares of stock were transferred. Under the terms of the sales agreement, only that number of shares equal to the face amount of the note was transferred.)

Estate Tax Issues. For estate tax purposes, the IRS position is that the note should not be included as an asset of Mr. Woelbing's estate, but the stock that was sold should be included in the estate under both §§ 2036 and 2038 at its date of death value. The value of the stock, according to the IRS, had increased to \$162.2 million at the time of Mr. Woelbing's death.

Tax and Penalties Deficiency. The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over \$125 million and penalties over \$25 million (asserting both gift and estate tax understatement 20% penalties). There were a few other relatively minor valuation issues involved for other properties in addition to the stock sale transaction.

Gift Tax Arguments Similar to Those in Karmazin and Dallas. In *Karmazin v. Commissioner*, the IRS made similar §2702 arguments in attacking a sale of FLP units to a grantor trust. T.C. Docket No. 2127-03, filed Feb. 10, 2003. The IRS argued that the note payments should be treated as an equity interest in the trust, that the obligation of the trust to make the payments did not constitute a guaranteed annuity under the GRAT exception in §2702, and that the note should be treated as having a zero value for gift purposes. In addition, the sales agreement in that case conveyed "that number of units having an appraised value of \$x million." (The agent also claimed that the FLP was a sham and should be ignored.) The *Karmazin* case was settled later in 2003 on terms very favorable to the taxpayer. Under the settlement, the transaction was not characterized as a transfer of units followed by the reservation of an annuity from the trust, the interest payments paid by the trust were characterized as interest and not as an annuity, neither §§2701 nor 2702 applied, the valuation discount was reduced from 42% to 37%, and the defined value clause in the sales agreement was not given effect.

In *Dallas v. Commissioner*, T.C. Memo. 2006-212, the IRS agent made arguments under §§ 2701 and 2702 in the audit negotiations to disregard a sale to grantor trust transaction by treating the note as retained equity rather than debt, but the IRS dropped that argument before trial and tried the case as a valuation dispute.

- c. ***Using AFR as Interest Rate for Notes in Intra-Family Sale Transactions.*** As a practical matter, many intra-family sale transactions use notes having an interest rate equal to the AFR rather than the higher §7520 rate. Sections 1274 and 7872 were enacted soon after the *Dickman* case and address valuing gifts from below market loans. Those sections (which constitute the basis for the AFR) seem to contemplate cash loans, but there is authority that AFRs under §7872 can also be used for sale transactions. See *Frazee v. Commissioner*, 98 T.C. 554, 588 (1992) ("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply

the provision as drafted.”); *True v. Commissioner*, T.C. Memo. 2001-167 (“We concluded in *Frazee v. Commissioner*, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in *Frazee*, does not require a different result.”), *aff’d on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

Private letter rulings have also taken the position that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Private Letter Ruling 9535026 involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the § 7872 rate (*i.e.*, the AFR), with a balloon payment of principal at the end of 20 years. After summarizing the provisions of §7872 and the *Frazee* case, the ruling concludes

“that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust’s] ability to pay the notes is not otherwise in doubt.”

Private Letter Ruling 9408018 addressed whether redemption of a mother’s stock by the corporation for a note, where her son was the remaining shareholder, constituted a gift. The note had an interest rate equal to the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with “adequate stated interest” under §1274(c)(2) (which is tied to the AFR). The ruling employed reasoning similar to Private Letter Ruling 9535026, and concluded that because the interest rate on the note will be at least equal to the AFR for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation’s ability to pay the notes is not otherwise in doubt.)

d. ***Planning Implications.***

Careful Planning Required. The Woelbing cases are a reminder that sale to grantor trust transactions require careful planning (and there was detailed planning in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations.

The planner should pay particular consideration to taking steps to cause the transaction to be treated as a “bona fide transaction” so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by

courts in determining whether intra-family loan or notes transactions are respected. E.g., *Miller v. Commissioner*, T.C. Memo. 1996-3. (As an analogy, there are debt/equity principles that are applied under §385 in the context of shareholder loans.) There are no “safe harbor” regulations for intra-family sale transactions like we have for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88). Two prior cases (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which “excess value” over a stipulated amount passed to charity. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in *Wandry* (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could be the first Tax Court case addressing the validity of a “*Wandry*-type” clause in sales transactions. See Item 12 above regarding defined value clauses generally and Item 12.d regarding the use of defined value clauses in sales transactions and a summary of prior cases (*King*, *McLendon*, and *Harwood*) that have addressed the validity of “price adjustment” clauses.

Ultimately Just a Valuation Case? Is this primarily just a valuation case? (The IRS contends that the value of the transferred units was \$116.8 million compared to the \$59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin*) or drops the §§2702, 2036 and 2038 arguments (as it did in *Dallas*). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller’s estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale to grantor trust transaction.

14. GRANTOR TRUST MISCELLANEOUS ISSUES

- a. ***Basis for Gift Tax Paid.*** If the grantor makes a gift to a grantor trust requiring the payment of a gift tax, §1015 normally allows a basis adjustment for the amount of gift tax paid. However, for income tax purposes, Rev. Rul. 85-13 suggests that the grantor trust is treated as the grantor. Allowing a basis adjustment might seem inconsistent. However, the reality is that a gift tax was actually paid; treating the grantor as being the owner of the grantor trust for income tax purposes should not override that reality. Furthermore, §1015 only addresses the property and not the person to whom the property passes.
- b. ***Statute of Limitations on Grantor Trust Status.*** If an income tax return is filed for a grantor trust, does that start a statute of limitations to run on the trust being treated as a grantor trust? The panelists do not know the answer to this question. Perhaps not, if the reporting does not impact the tax liability of the trust. However, if a statement is specifically added to the return that the income is reported on the grantor’s income tax return, perhaps the statute of limitations would begin to run.

15. SELF-CANCELING INSTALLMENT NOTES (SCINs); CCA 201330033 AND *ESTATE OF WILLIAM DAVIDSON*

- a. **Brief Background.** A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling any future payments upon the death of the holder. Planning with self-canceling installment notes (SCINs) followed the seminal case of *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2. The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under §2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note." In *Moss*, the parties stipulated that the SCIN sale transactions were bona fide transactions for full and adequate consideration and that the cancellation provision was part of the bargained for consideration for the purchase price of the stock.

Mortality Premium. For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. To calculate the premium, an advisor must determine what stream of payments is required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note. There is not universal agreement as to how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. The risk premium can be structured using a higher than "normal" interest rate, a higher principal face amount of the note, or a combination of the two.

Cases. There have been few cases addressing SCINs. In *Estate of Musgrove v. United States*, 33 Fed. Cl. 657 (1995) a demand SCIN transaction was not recognized as a bona fide transaction because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds and the seller declared that he was not likely to demand payment on the note), and the SCIN was included in the decedent's gross estate. *Estate of Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo. 2001-128 recognized that a SCIN should not be ignored (the IRS argued that the sale was not a bona fide transaction) for gift tax purposes reasoning that the estate "rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness."

The income tax consequences of the cancellation of note payments were addressed in *Estate of Frane v. Commissioner*. The Tax Court agreed that gain should be recognized upon the death of the seller reportable by the seller on the seller's final return, not by the seller's estate. The Eighth Circuit changed the result, adopting the IRS's alternate position that the decedent's estate recognizes the deferred gain on its initial income

tax return as an item of IRD. 998 F.2d 567 (8th Cir. 1993), *rev'g* 98 T.C. 341, 354 (1992).

- b. **Chief Counsel Advice 201330033.** The IRS Chief Counsel Office weighed in on the treatment of SCINs in Chief Counsel Advice 201330033. While a CCA memo merely states the litigating position of the IRS for a case, this memo gives guidance regarding the IRS's position regarding SCINs. The taxpayer entered into various estate planning transactions including transfers of stock in exchange for preferred stock, stock transfers to GRATs, and sales of stock for notes. The CCA addresses the sale transactions. The sale transactions included some "standard" note transactions and some SCIN transactions. CCA 201330033 relates to the estate tax audit of the estate of William Davidson.

As to how the note should be valued, the CCA states that the SCINs were valued "based upon the § 7520 tables." Presumably that means they were valued using the § 7520 rate as the discount rate to determine the present value of the future payments, and that the mortality tables of § 7520 were used in determining the principal and interest premium amount to account for the self-canceling feature. The CCA gives the following conclusion regarding how the notes should be valued:

We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

The IRS position may be based in part on the general understanding that § 7520 applies to annuities, interests for a life or term of years, remainders and reversions—but does not govern debt instruments. (Section 1274—which refers to the applicable federal rate rather than the § 7520 rate and which makes no reference to mortality tables—specifically applies to "certain debt instruments issued for property.")

For a more detailed discussion and analysis of CCA 201330033, see Item 39.7 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

- c. **Estate of William Davidson, Tax Court Cause No. 013748-13 (filed June 14, 2013).**

General Background. William Davidson was the President, Chairman, and Chief Executive Officer of Guardian Industries Corp., one of the world's leading manufacturers of glass, automotive, and building products. Before various gift and sale transactions in December of 2008, he owned 78% of the common stock of Guardian. He is a prior owner of the Detroit Pistons NBA team. The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, including large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 (before he received any payments on the notes). The IRS Notice of Deficiency alleges gift, estate, and GST tax deficiencies of well over \$2.6 billion (although the IRS acknowledges in its answer that it "did not calculate certain deductions and credits to

which [the estate] may be entitled.”). The case involves a wide variety of issues, but the major issues are the valuation of the Guardian stock and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes.

The case was originally set for trial on April 14, 2014, but the court granted a joint motion for continuance, and the parties have been ordered to file a joint status report every three months beginning September 14, 2014. The trial judge is Judge Gustafson (Docket No. 013748-13).

Gift and Sale Transactions. There were gift, sale and substitution transactions on three dates. All of the sales were for notes providing annual interest payments and balloon principal payments due in 5 years. The SCINs were secured by more Guardian shares than just the shares transferred in return for the SCINs. These transactions included sales of stock for hundreds of millions of dollars in two different SCIN transactions. One was for a SCIN with an 88% principal premium and the other was for a SCIN with an interest rate premium (13.43% over the \$7520 rate).

Mortality Information. The mortality tables under §7520 indicate that the life expectancy was 5.8 years at the time of the sale transactions (based on Table 90CM, which applied to transactions from May 1999-April 2009 [Table 2000CM applies to transactions from May 2009 forward]). The estate and IRS disagreed over the actual life expectancy of the decedent at the time of the sale transactions. In connection with the estate tax audit the decedent’s medical records were reviewed by four medical consultants, two of whom were selected by the estate and two of whom were selected by the IRS. All four medical consultants concluded that the decedent had a greater than 50% probability of living at least one year in January 2009.

Bona Fide Transaction Issue. One possible outcome is that the court determines that the SCINs were not bona fide loan transactions (perhaps based on whether there was a reasonable expectation of repayment-and one factor in that decision will be that the SCINs are secured by more Guardian stock than just the shares transferred in return for the SCINs), and the SCINs may be valued at zero if they are determined not to represent bona fide loan transactions. The government’s answer in the case states that the burden of proof is on the estate to prove that the SCINs were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINs, and that the trusts would be able to make payments on the SCINs when due.

Applicability of §7520 in Valuing SCINs. If the court gets beyond the “bona fide transaction” issue, because all of the medical consultants agree that the decedent had a greater than 50% probability of living at least one year on the date of the sale transactions, the court presumably will be squarely faced with addressing whether §7520 applies in valuing SCINs. The IRS maintains that §7520 applies only in valuing annuities and life estates. The estate maintains that §7520 applies in valuing “any interest for life or a term of years,” and that a SCIN requires valuing an interest that involves both a term of years and an interest for life. If §7520 applies in valuing SCINs, Reg. § 1.7520-3(b)(3) indicates that the §7520 mortality tables can be used “to determine the present value of an annuity, income interest, remainder interest, or

reversionary interest” even if the individual who is a measuring life is in poor health as long as he or she is not terminally ill, defined to mean the person has a greater than 50% probability of living at least one year. The government’s position in its answer is that “whether or not the decedent was terminally ill within the meaning of Treasury Regulation §1.7520-3(b)(3) is not relevant.” That is precisely the dispute that may be squarely before the court.

For a more detailed discussion of the facts in Estate of Davidson and the legal issues that the court will address, see Item 39.g of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

d. ***Planning Implications for SCINs.***

- *SCINs Will be Scrutinized If the Seller Dies “Early.”* The CCA 201330033 is the first guidance about the IRS’s position regarding SCINs since its loss in *Costanza*. The CCA clearly indicates that the IRS continues to view SCIN transactions in a negative light, particularly if the decedent has health issues or dies soon after the SCIN transaction. We can expect to see close examination of SCIN transactions in gift and estate tax audits.
- *Backloading.* The CCA at various places highlighted that the SCINs called for interest-only payments with balloon principal payments at the end of the note term. “Backloading” SCINs in this manner appears to be a “red flag” that will draw IRS attention. Backloading SCINs raises the valuation risk—because there will be a very large payment at the end of the note term, if the discount rate or mortality assumptions are wrong, the value will be skewed significantly.
- *SCINs vs. Private Annuities.* Private annuities operate somewhat like SCINs in that no payments are required after the annuitant’s death. An early death may result in the seller receiving back far less than the value that was transferred in exchange for the private annuity. The IRS scrutinizes private annuity transactions as well if the seller dies soon after the private annuity transaction. See *Estate of Kite v. Commissioner*, T.C. Memo 2013-43 (discussed in Item 21 below). However, §7520 clearly applies in valuing private annuities, and if the client has a greater than 50% likelihood of living at least one year after the transfer and will likely live at least 18 months afterward, the actuarial tables in §7520 may be used. Treas. Reg. § 1.7520-3(b)(3). If a client is not in excellent health, but would clearly satisfy the 12-month requirement, the private annuity may be a more conservative approach (even though other tax effects of the private annuity transaction may not be as favorable as a sale for a SCIN, but the adverse income tax effects may be largely avoided if the sale is made to a grantor trust). On the other hand, the regulations require that a purchasing trust have sufficient assets to make the annuity payments if the seller lives to age 110. Treas. Reg. §20.7520-3(b)(2)(i). The mortality factor may add such a large premium (particularly for older sellers) that the purchasing trust would be unable to satisfy that requirement. See e.g., *Kite v. Commissioner*, T.C. Memo. 2013-43 (private annuity was bona fide and not illusory; individual purchasers had ability to pay annuity payments for full life

expectancy); *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (§2036 applied to a transfer of limited partnership interests to children in return for a private annuity, in part because the parties intended to ignore the agreements, and the children-purchasers did not have assets of their own to make the annuity payments). Some planners suggest avoiding the exhaustion test by having individuals or other trusts guarantee the annuity payments. Other planners suggest structuring the annuity to be payable for the shorter of life expectancy or a term of years that exceeds life expectancy by a year or so; this appears to be treated as an annuity for purposes of the valuation rules (GCM 39503), but the term of years element would eliminate the requirement of having assets to pay an annuity to age 110.

- *§7520 Application.* The CCA raises an ambiguity regarding the manner in which SCINs are valued. The commercial programs (which anecdotal evidence suggests are typically used by IRS agents in audits regarding SCINs where there are no particular health issues) generally use the §7520 discount rate and mortality tables to value SCINs. If §7520 cannot be used at all to value SCINs, those commercial programs may be suspect. What approach should be used?

As a practical matter, the IRS concern about applying §7520 to SCINs (and the same concern applies to private annuities) is that the use of the Treasury's tables by taxpayers is "self-selecting." Taxpayers who are likely to live less than the tables would otherwise suggest are the only ones who use SCINs or private annuities.

- *Using Actual Mortality Information Rather Than §7520 Tables.* The mortality tables are based on the last census, and the government waits until the census is 9 years old before releasing the next table (which they are required to do every 10 years). As life expectancies continue to improve, this means that the government's tables reflect a shorter life expectancy than actual life expectancies (which results in higher premiums being required for SCINs).
- *Actual Life Expectancy.* In light of the continuing uncertainty over whether the §7520 mortality tables apply, taxpayers may have the opportunity to value SCINs by using actual medical and life expectancy information to value a SCIN (as long as the seller is in reasonably good health). Some planners have analyzed the valuation of SCINs similar to funding the obligation with a decreasing term life insurance policy. Insurance actuaries may produce substantially different actuarial information than the government tables—resulting in significantly lower premiums built into the SCINs.
- *Ability to Repay.* The CCA at various points emphasized that the ability to repay a note is a central element of recognizing the note as a valid debt instrument rather than as a continuing equity interest of what was transferred in return for the note. In planning SCIN transactions, consider the ability of the obligors on the note to repay the note (as well as evidence suggesting that the seller may

not demand payment if payments are not made timely). If sales are made to trusts, consider the trusts' ability to make the note payments. The CCA suggests that this concern is exacerbated if there is a large principal premium to account for the cancellation feature, resulting in a note with a face value almost double the value of assets transferred. Having the SCINs secured by assets in addition to the assets transferred in return for the SCINs may be helpful in establishing the reasonable expectation of repayment and the ability to repay the note.

This is a particularly problematic issue for older clients, for whom the risk premium (especially for backloaded "balloon" payments) may result in an inordinately large principal premium or interest premium, making it unlikely that the full amount can be paid if the seller lives to a full life expectancy.

Income Tax Consequences of SCINs. If the seller dies before all payments have been made, the planner must understand that while this may result in a decrease in the amount included in the seller's gross estate, there are factors that may offset some or all of that advantage. If the seller dies before the SCIN matures, the IRS maintains that the deferred gain will be recognized for income tax purposes on the estate's first return. See *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993). (This reversed the Tax Court's holding that the deferred gain was recognized on the decedent's final return. 98 T.C. 341 (1992).) Some commentators (supported by the Tax Court dissent in *Frane*) maintain that the cancelled gain should not be recognized as income by anyone. In addition, if the sale for the SCIN was made to a grantor trust, there may be no recognition of income on the grantor's death. There are also uncertainties regarding the purchaser's basis in the purchased assets. In any event, just be aware that there are income tax issues that may offset some of the advantages of avoiding estate inclusion for the cancelled payments. See generally Akers & Hayes, *Estate Planning Issues With Intra-Family Loans and Notes*, ¶1517-4-517.6, 47th ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING (2013).

16. SAME-SEX MARRIAGE ISSUES

Same-sex marriage issues are discussed in detail in Item 29 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

- a. **Windsor.** The Supreme Court, in a 5-member majority opinion, ruled that Section 3 of DOMA (which defines marriage as the legal union of one man and one woman for purposes of federal laws and regulations) is unconstitutional. The majority opinion was rather murky on the precise constitutional reasoning, but determined that Section 3 of DOMA violates basic due process and equal protection principles under the Fifth Amendment. It made reference to the Fourteenth Amendment (but without any analysis of how the Fourteenth Amendment specifically applies and whether a "strict scrutiny," "intermediate scrutiny," or "rational basis" analysis under the Fourteenth Amendment applies in this context).

b. **Hollingsworth.** In *Hollingsworth, et al. v. Perry et al.*, 133 S. Ct. 2652 (2013), the Supreme Court let stand lower court decisions holding that California's Proposition 8 (which said that only a marriage between a man and a woman would be valid in California) was unconstitutional. (The Supreme Court did not reach the merits of the constitutional issue but held that the individual citizens who brought the case did not have standing to pursue the case.) In *Windsor*, the Supreme Court did not address Section 2 of DOMA, which allows states to refuse to recognize same-sex marriages performed under the laws of other states. Lower courts are addressing these state law issues and the Supreme Court ultimately will address the constitutionality of Section 2 of DOMA (as to whether states must recognize same-sex marriages performed in other states that allow same-sex marriages). Some predict that *Kitchen v. Herbert* (the case regarding the constitutionality of Utah's ban on same-sex marriage) is now being appealed to the 10th Circuit and is the most likely case for the Supreme Court to review Section 2 of DOMA. The district court case in *Kitchen* had a complete analysis of the constitutional law aspects.

c. **Revenue Ruling 2013-17.** Rev. Rul. 2013-17 clarifies that for federal tax purposes (1) terms relating to marriage include same-sex couples, (2) a place of celebration standard is applied if a same-sex couple moves that a state that does not recognize same-sex marriages, and (3) the ruling does not apply to domestic partnerships or civil unions. It is applied prospectively as of September 16, 2013 (the date of the ruling's publication) but taxpayers may (but need not) file back returns within the standard limitations period for refunds if the recognition of the marriage results in lower taxes.

In filing amended returns or refunds for prior years, the taxpayer must be treated as married for all purposes on a particular return, but there is no explicit requirement that the person be treated as married for all tax returns for that year (for example, apparently the taxpayer may file an amended gift tax return claiming a gift tax marital deduction but not be required to file amended income tax returns for the same year as a married individual).

If a donor paid gift tax in prior years for which the statute of limitations has closed on obtaining a refund, even though the IRS will not allow a refund will the individual's use of unified credit be restored for purposes of subsequent gifts or for estate tax purposes at the individual's death? Regulation §25.2504-2(b) provides that if the statute of limitations has run on a gift tax return, the amount of the taxable gift resulting from that return, for purposes of determining the taxable gifts in prior periods when calculating later gift taxes, can never be re-determined. That applies to all issues relating to the gift including "the interpretation of the gift tax law." Eventually, there may be a case arguing the constitutionality of this question.

d. **Place of Celebration Standard.** While the place of celebration approach applies for federal tax purposes, it does not apply for all federal purposes; some statutes are drafted based on the law of the state of domicile's recognition of the marriage. Social Security is one of those, and, interestingly, Social Security is probably the federal benefit program with spousal benefits that actually impacts most clients. A planning alternative, in order for a same-sex spouse to receive the generous spousal benefits, may be for the same-sex couple living in a state that does not recognize the marriage

to move to a state that does—primarily to be entitled to the Social Security spousal benefits.

- e. **Potential Advantages of Recognition of Same-Sex Marriage.** Professor Lee-ford Tritt provides the following list of potential advantages of having a same-sex marriage recognized:

filing joint income tax returns; claiming the marital deduction for estate and gift tax purposes under Sections 2523 and 2056 of the Code; gift splitting under Section 2513 of the Code; electing portability under Section 2010(c)(4) of the Code; same-sex spouse being automatically assigned to the same generation of his or her spouse for GST purposes under Section 2651(c) of the Code; using the reverse QTIP election; taking advantage of step-up in income tax basis under Section 1014(b)(6) of the Code on both halves of the community property at the first spouse's death, including jointly owned property in the estate under Section 2040(b) of the Code; applying grantor trust rules that are triggered by a spouse's benefits or control over a trust; not recognizing gains and losses on sales between spouses; disclaiming certain interests in property while retaining other rights in the disclaimed property under Section 2518 of the Code; naming the spouse as the beneficiary under a qualified retirement account and allowing the spouse to roll over the benefits of a deceased spouse's IRA into the surviving spouses own IRA or into an inherited IRA which provides distributions over the surviving spouse's life expectancy; possibly permitting copyright termination rights under Section 203 and 304 of the Copyright Code; availability of family protections (homestead, probate family allowances, probate personal property set asides, elective share, pretermitted spouse rules, etc.); favorable standing position for will challenges by remote heirs; heightened consideration concerning burial instructions for departed spouse; and eliminating adverse tax consequences for the transfer of property pursuant to a marriage settlement agreement. (Availability of some federal benefits will depend on whether the same-sex couple lives in a recognition state or non-recognition state.)

- f. **Potential Disadvantages of Recognition of Same-Sex Marriage.** Professor Tritt provides the following list of potential disadvantages:

filing joint income tax returns and the possibility of income tax marriage penalties; some same-sex married couples discovering that Social Security benefits that were once tax-free are taxable due to required income aggregation; same-sex married couples with children who previously could file separately as single and head of household possibly seeing increased taxes as a result of joint filing; implementing related party rules so lost opportunity to take advantage of common law GRITs, below market loans, and other such techniques; applying grantor trust rules that are triggered by a spouse's benefits or control over a trust; loss of some credits such as the adoption credit; and divorce issues. (*Unmarried same-sex clients might ask advice about whether they should marry in light of the potential tax penalties of marriage and similar concerns. In states that allow both same-sex marriage and domestic partnership benefits, there are potential strategies that should be considered.*)

- g. **Potential Planning Considerations.** Professor Tritt provides the following list of potential estate planning considerations for same-sex married clients:

revisit estate planning documents for marital deduction planning and gifting strategies; review beneficiary designation forms, retirement plans and employer provided benefits; review grantor trust status of trusts; revisit income tax issues; review and update marital agreements if necessary and possible; rethink drafting issues concerning conflict of law issues and definition of spouse for purposes of the testator/testatrix and grantor—but also for class gifts, fiduciary appointments, and permissible appointees under power of appointments for documents created by strangers to the same-sex marriage; update healthcare proxies, living wills, and durable power of appointments (and advise clients to take such instruments with them when they travel); make sure both same-sex spouses adopt children regardless of the marital presumption of any particular state; filing claims for refunds for any taxes paid that would not have been owed if the *Windsor* decision had been in effect at the time (or

requesting relief under Sections 301.9100-1 through 301.9100-3 depending on the particular circumstances); and advising fiduciaries to file claims for refunds, even if applicable period as run, or be exposed to potential liability by beneficiaries for breach of trust.

In deciding whether to revise documents to refer to one's "spouse" now that the law recognizes the same-sex marriage of a client, consider the effect if the client later moves to another state that does not recognize same-sex marriages and determines that an ambiguity applies for a bequest "to my spouse, Jon Doe."

- h. **State Tax Effects.** A huge uncertainty is how *Windsor* will affect state income taxes. There are 24 states that do not recognize same-sex marriages but require taxpayers to refer to the federal gross incomes in calculating state income taxes. For married individuals, the federal gross income is the combined income on the spouses' joint federal income tax return. It appears that many states are requiring the same-sex couple—whose marriage is now recognized for federal income tax purposes but will not be recognized in those states for state income tax purposes—to prepare "dummy" federal returns for two single taxpayers. Oregon released a directive taking this position on October 18, 2013:

Such individuals who file a federal income tax return as married filing jointly or married filing separately must each complete a separate pro forma federal return for North Carolina purposes with the filing status of single or, if qualified, head of household or a qualifying widow(er) to determine each individual's proper adjusted gross income, deductions and tax credits allowed under the Code of the filing status used for North Carolina purposes, and then attach a copy of the pro forma federal return to the North Carolina return.

States following this general approach of requiring pro forma federal returns with a filing status as separate include Arizona, Georgia, Idaho, Kansas, Louisiana, Michigan, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Utah, Virginia, and Wisconsin.

This same issue may arise for state estate tax purposes. Four of the states with a state estate tax do not recognize same-sex couples. In those states, will a dummy federal estate tax return (prepared as if the marriage was not recognized for federal tax purposes) be required to be filed with the state estate tax return?

17. LIFE INSURANCE DEVELOPMENTS—RIGHT TO DIVIDENDS, SHARK-FIN CLATs, INTERGENERATIONAL SPLIT DOLLAR INSURANCE

- a. **Right to Dividends Not an Incident of Ownership, CCA 201328030.** As part of a divorce settlement, the decedent's spouse received the ownership of insurance with the decedent being required to pay all premiums but entitled to receive all policy dividends. The CCA ruled that the right to receive the dividends is not an incident of ownership. Dividends are not an economic benefit but merely a reduction in premiums paid. Various cases have previously ruled similarly that the receipt of dividends is not an incident of ownership (*Estate of Bowers*, 23 T.C. 911 (1955); *Estate of Jordahl*, 64 T.C. 781 (1975)). What has never been addressed is whether the continuing receipt of dividends after an amount equal to the cumulative premiums paid has been withdrawn constitutes an economic benefit in the policy, and therefore an incident of ownership.
- b. **Shark Fin CLATs.** "Shark Fin CLATs" are discussed at Item 20.m below.

An advantage of using life insurance with a Shark Fin CLAT that lasts for the life of the insured is that the death proceeds will be available to pay the large termination annuity payment. Disadvantages are that additional contributions are not permitted, so exempt bonds or other assets must produce enough income to pay the minimal annual annuity payments to the charity during the early years and to pay any life insurance premiums. A potential issue is whether the life insurance is a “personal benefit contract” under §170(f)(1), which would disallow any income tax charitable deduction for contributions to trust and would subject the trust to a 100% excise tax. While technical arguments could be made that §170(f)(10) applies, that statute was designed to prevent charitable reverse split dollar arrangements under which the charity was not likely to receive any benefit.

- c. ***Intergenerational Split Dollar Life Insurance.*** A general description of an intergenerational split dollar plan is that a *grandparent* purchases life insurance on the life his *child* in trust for the benefit of *grandchildren* under a “non-equity economic benefit regime” private split dollar plan. The grandparent is entitled to be repaid the greater of the premiums paid or the policy cash value at the insured child’s death. The grandparent avoids having to make large annual taxable gifts to make the premium payment; under the split dollar arrangement, the premium “advances” are not taxable gifts. After the grandparent makes the premium “advances” for 5-10 years, the grandparent might consider forgiving the amount due with respect to the previously advanced premiums. Alternatively, the grandparent might die before the child’s death, and the value of the right to the premium repayment under the split dollar plan at the child’s subsequent death would be an asset of grandparent’s estate. In either event, arguably the value of the grandparent’s right to receive the fixed amount of premium payments many years in the future should be discounted heavily. Some commentators have raised potential arguments that the IRS might make opposing this arrangement.

There have been rumors that the IRS is unhappy with this arrangement and will be issuing guidance; those rumors have persisted, however, for 4-5 years and no guidance has been issued.

Seven cases involving intergenerational split dollar arrangements similar to that described above will be going to the Tax Court in the near future. Therefore, court guidance may be coming eventually.

18. LIFE INSURANCE MANAGEMENT, PARTICULARLY FOR LIFE INSURANCE TRUSTS

- a. ***Uniform Prudent Investor Act Application.*** Section 2 of UPIA requires the trustee to invest and manage trust assets as a prudent investor would by considering the purposes and other circumstances of the trust, exercising reasonable care, skill, and caution. One of the circumstances that trustee may consider is “an asset’s special relationship ... to the purposes of the trust” An irrevocable life insurance trust would seem to be a situation involving such a “special relationship” that would avoid the necessity of diversifying across a broad class of assets. The trust can modify the default rule of UPIA. Even so, the trustee must still act with prudence, and appropriate diversification for an ILIT may include diversification across different life insurance companies in different types of policies.

Some states have revised their statutory provisions to restrict the duty of diversification for trust-owned life insurance. Examples include Alabama, Arizona, Delaware, Florida, Maryland, North Carolina, Pennsylvania, South Carolina, Tennessee, Virginia, West Virginia, and Wyoming. However, the Office of the Comptroller, while acknowledging that some states have passed legislation, still requires rigorous due diligence with respect to trust life insurance policies (see paragraph d below).

- b. **Recent Cases.** There have been several recent cases in which trustees were sued over the management of policies in trusts. In *In re Stuart Cochran Irrevocable Trust*, 901 N.E.2d 1128 (Ind. Ct. App. 2009), the trustee (Key Bank—this case is often referred to as the “Key Bank case”) exchanged an \$8 million policy that was in danger of lapsing for a \$2.8 million policy guaranteed to age 100. Surrender charges of over \$100,000 were incurred on the termination of the old policy and a commission was payable with respect to the new policy. An independent consultant first rejected this plan but later recommended the change. Soon after the purchase of the new policy, the insured died unexpectedly at age 53. The court refused to find that the trustee breached its fiduciary duty, emphasizing that the trustee relied on guidance from “an outside, independent entity with no policy to sell or any other financial stake in the outcome.” The court noted that the trustee “examined the viability of the existing policies and at least one other option.” It observed that the UPIA prohibits the use of hindsight in determining the appropriateness of investments, and dismissed the insured’s early death and subsequent economic recovery in determining the prudence of the change.

Another case was *French v. Wachovia Bank, N.A.*, 800 F.Supp.2d 975 (E.D. Wis. 2011), in which the bank-trustee exchanged an underperforming policy for a no-lapse guaranteed policy (same death benefit and lower premium, but without benefit of accumulation of cash values). The trustee’s subsidiary received substantial commissions on the purchase. The court similarly upheld the trustee’s decision. Some of the factors in this result are that the trustee discussed and documented advantages and disadvantages of the plan, the trustee used an outside disinterested party to evaluate the policies, and the bank did not hide that its subsidiary would benefit from the insurance exchange.

- c. **ILIT Policies Are Often Not Properly Managed.** About 90% of ILIT policies are managed by nonprofessional trustees. About 40% of non-guaranteed ILIT policies are illustrated by the carrier to lapse before or within five years of estimated life expectancy.
- d. **OCC Requirements.** The Office of the Comptroller “continues to require bank fiduciaries to follow 12 CFR 9.6(c) and 12 C.F.R. 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion.” The OCC Handbook has a specific discussion about the management of trust-owned life insurance. Among the items that the OCC requires trustees to follow with respect to life insurance policies are the following.
- Understand the policy that the trustee accepts or purchases.

- Employ an independent advisor not affiliated with an insurance company to prudently manage insurance assets.
- Periodically review the financial condition and rating of the insurance company, as well as whether the policy is performing as illustrated or whether replacement should be considered.
- A bank fiduciary with discretion over the trust account must complete formal pre-acceptance, initial post-acceptance and annual reviews of insurance policies.
- Independent of these reviews, the bank must have risk management systems that address the sufficiency of premiums, suitability of a policy, carrier selection, and appropriateness of investments of any segregated account to support the cash value.
- Obtain the original policy illustration and periodically obtain in-force illustrations to measure the performance of policy against what was initially illustrated.

e. ***Policy Review Pointers.***

- ILITs may have Investment Policy Statements customized to the acquisition and management of life insurance policies in the trust.
- Policies are no longer “buy and hold” assets; they are “buy and manage” assets.
- Many agents help a trust buy a policy; few help manage it.
- Policy illustrations are improperly considered as implicit “guarantees.” They are not.
- Policy illustrations should never be used to compare different policy types or to predict future performance of the policy.
- Use conservative policy assumptions.
- Structure the policy to last for an appropriate time—beyond just standard life expectancy (when half of the average Americans will die).
- Policies should be reviewed not less than every few years. Term and no lapse guarantees should be reviewed every two years.
- After the insured has lived 5-15 years, the insured has lived through various years in which death could have occurred and the life expectancy factors should be improved (and most importantly, the policy mortality costs may be significantly lower) than when predicted for that time when the policy was originally acquired.
- Factors in the performance of policies are: (1) investment returns (most critical factor); (2) home office expenses and profit margins; and (3) policy acquisition expenses (including commissions).

- Major risk factors: (1) company insolvency; (2) actual investment returns; and (3) volatility risk. (The timing of down markets and bad returns dramatically affects the overall policy investment return.)
- Consider whether the needs for insurance change over time.
- If a policy is performing poorly (and lapse appears inevitable), remediation possibilities are (1) increasing premium funding, (2) decreasing the death benefit, (3) exchanging to a different style policy, and (4) surrendering or selling the policy in a life settlement.
- The goal is best value, not best price, considering the funding target.

19. BUSINESS LIFE INSURANCE

- a. ***Executive-Owned Insurance.*** An executive-owned life insurance arrangement is sometimes referred to as a “162 Executive Bonus Plan.” The executive owns the policy; the company pays the premium. The purpose is to provide a death benefit perk to the executive. High cash surrender value policies can also be used as a retirement substitute. (Withdrawals up to the amount of the basis in the policy are tax-free and after that time the executive could borrow from the policy.) The annual premium payments are taxed as income to the employee and the employer gets an immediate deduction under §162 if the amount constitutes reasonable compensation when considered with other compensation paid to the executive. To be conservative, the plan should be treated as a “welfare plan” under ERISA--welfare plans only have three easy-to-satisfy requirements – a written plan, a named fiduciary (usually the employer), and a claims procedure.

A “restricted access bonus plan arrangement” provides that the executive cannot surrender, borrow against, or withdraw funds from the policy without the consent of the employer for a specified period of time – say 10 years. (This provides a velvet handcuff.) The income tax consequences do not change.

A “side contract restricted executive bonus plan” includes a side contract between the employer and executive under which the executive agrees to reimburse all or part of the premium paid by the employer if the executive leaves the company within a specified time. This might cause §83 to apply-- if there is a substantial risk of forfeiture in property, there is no estate inclusion and no deduction until the property vests (unless the employee makes a §83(b) election). Arguably §83 does not apply because the executive cannot forfeit the policy itself--that is the reason for the side contract.

Some commentators are concerned that a restricted bonus plan would be a pension plan rather than a welfare plan under ERISA, and the pension plan requirements of ERISA are burdensome. Adding restrictions to an executive bonus plan adds some risk that there may be extra taxes or penalties on the arrangement.

- b. ***Joint Ownership-Split Dollar.*** There are two types of split dollar regimes-- the loan regime and the economic benefit regime.

Under the *loan regime* the employee owns the policy. The employer loans the annual premium payments, and receives a note charging at least the applicable federal rate as interest. There is typically a collateral assignment of the policy to the employer to secure the loan. The loan must be “real”—the employer cannot directly or indirectly pay the principal on the loan. If the employer pays deferred compensation or bonuses, they should not be payable at the same time or in the same amount as the interest or principal payments that are due on the split dollar loan.

A potential problem under the loan regime is if the employee is not personally liable to repay the loan (which is typical). To avoid potential tax complexities, the employer and executive should sign a statement acknowledging that a reasonable person would expect that all payments will be made. The statement must be signed by both parties before the first return is filed and attached to both tax returns for the taxable year in which the loan is made. Reg. §1.7872-15(d)(2). If loans are being made each year for the premium payments, those attachments must be attached to the tax returns each year.

Under the *economic benefit regime*, the employer owns the policy and endorses the death benefit to the executive. The one-year term premium cost on the pure insurance amount is typically included in the employee’s income. (There is also an option under which the employee could reimburse the employer for that expense, but the reimbursement would be income to the employer [Reg. §1.61-22(f)(2)(ii)], so that approach is not typically used.)

A *switch dollar* approach is sometimes used. The economic regime approach may be preferable at the beginning of the arrangement (when the employee is younger), because the annual one-year term costs may be less than the interest payments that would be due under the loan approach. However, the employer owns all of the excess cash surrender value. To avoid that result, the economic benefit regime may be used until the cash surrender value reaches the premiums paid. At that point, the arrangement would be switched to a loan regime. If the switch occurs before the appearance of cash value equity, no cash value should be taxed to the employee. The transfer of ownership of the policy is a transfer for value, so the owner after the switch must meet one of the exceptions under the transfer for value rules of §101(a)(2) (e.g., the insured or a partner of the insured).

- c. ***Employer Owned Policy.*** In the employer owns the policy, the employer gets no the deduction for the premium payments. §264(a)(1). Even if the policy is used to fund a deferred compensation contract for the executive, the executive will not be subject to income tax with respect to the policy value as long as creditors of the employer can reach the policy. Section 101(j) (added in 2006) provides that the death benefit will be included in the employer’s income to the extent that it exceeds the premium payments unless one of several exceptions applies. There are exceptions for policies on the lives of certain employees, for payments made to the insured’s family, and for payments to fund the purchase of an equity interest in the employer (e.g., under a buy sell agreement). For any of the exceptions to apply, the employee must be notified in writing of the intent to insure his or her life and the maximum amount of coverage

(as well as several other detailed items). The notice must be given before the policy is issued.

20. CHARITABLE PLANNING REMINDERS, STRATEGIES AND CREATIVE IDEAS

- a. **Charitable Intent Needed.** Do not get the “tax cart before the horse.” A client must have charitable intent for any of these alternative strategies to make sense. Turney Berry advises: “If you are dealing with someone who does not want to give something to charity, I have a tip for you—don’t talk to them about charitable gifts.”
- b. **Deduction for Contributions to Private Foundations Limited to Basis.** A frequent malpractice scenario is when planners fail to advise clients that the charitable deduction is limited to the donor’s cost basis for contributions of appreciated property to a private foundation unless the contribution is of cash or marketable securities.
- c. **Substantiation Requirements.** In *Durden v. Commissioner*, T.C. Memo. 2012-140, an income tax charitable deduction was denied for the taxpayers’ \$25,171 of contributions to their church. They received a receipt from the church and had cancelled checks, but the letter did not have the required sentence that the taxpayer did not receive any goods or services. The receipt of a letter from the church after the taxpayers received the notice of deficiency was not sufficient. The court agreed that it was a terrible result, but said that it was bound by the statute. Similarly, a deduction was denied in *Mohamed v. Commissioner*, T.C. Memo. 2012-152 in which the court said “[w]e recognize that this result is harsh – a complete denial of charitable deductions to a couple that did not overvalue, and may well have *undervalued*, their contributions – all reported on forms that even to the Court’s eyes seemed likely to mislead someone who didn’t read the instructions. But ... Congress was quite specific ... and we cannot in a single sympathetic case undermine those rules.”
- d. **Contribution of Assets With Potential Liability Concerns Can be Made to Single Member LLC.** Notice 2012-52 provides that for purposes of §170(b) (*i.e.*, for income tax purposes) a gift to a single member LLC owned by the charity is treated as a contribution to the charity. To avoid confusion, the IRS encourages the charity to disclose in its acknowledgement of the contribution that the LLC is wholly owned by the charity and is treated by the charity as a disregarded entity. This can be very helpful, for example, if someone is contributing real estate (with inherent liability for accidents occurring on the property or with a potential environment liability). The charity could form a single member LLC to hold the property to segregate any liability associated with the property from the charity’s assets. Presumably, the IRS will apply the same rule for purposes of the gift and estate tax charitable deduction.
- e. **Private Foundations Substitutes: Donor Advised Funds and Supporting Organizations.**

Donor Advised Funds. Contributions to donor advised funds (DAFs) avoid the self-dealing rules and other restrictions that apply to private foundations. The Pension Protection Act of 2006 added additional restrictions that apply to DAFs, but there are still much fewer restrictions than for private foundations.

Supporting Organizations. Additional limitations were also imposed in 2006 on what types of organizations can qualify as supporting organizations (SOs), and some

planners may think that supporting organizations are no longer workable alternatives. That is not the case. The “garden variety-easy kind” of SO still makes sense. H and W want to support three public charities. They create an SO with H, W, and a representative from each of the three charities on the board, so that the charities control the SO’s board. That clearly qualifies as a “Type I” qualified SO. For any particular decision, H and W just need to get one of the three charitable representatives to go along with them. The clients may feel comfortable with this arrangement. There is a practical limit on how many charities could be added to the board for this purpose. A board of 14 family members and 15 charitable members would not qualify, because there are too many charity representatives for any one of them to feel any real supervision responsibility. The dividing line is not objective, but the key to getting any charitable organization application through the IRS is to “be vanilla.” An application with any complications will take 2-3 years to get approved. The group that approves exempt organization application requests is just now reviewing applications filed in May 2012 that have any complexity to them. (The IRS Service Center in Cincinnati that reviews these applications receives 5,000 applications per month.)

- f. **Defined Value “Formula Allocation” Clauses With Excess Value Passing to Charity.** Four cases have approved transactions with formula clauses that allocate to charity transferred property in excess of a stated dollar value. Those types of defined value clauses are viewed more reliable than “Wandry-type” clauses. See Item 12.b above.
- g. **IRA Charitable Rollover.** The ability of a taxpayer over age 70½ to make a distribution directly from his or her IRA to a charity of up to \$100,000 was extended only through 2013. However, it has a good chance of being extended again (although perhaps not until late in 2014, or perhaps even in early 2015 retroactive back to January 1, 2014). If a client is going to make a large charitable contribution in any event, the client may want to go ahead and have the IRA make the distribution to charity (perhaps only up to the amount of the required minimum distribution that has to be made during the year). The worst that happens if the provision is not extended is the taxpayer is treated as having made a taxable withdrawal of an amount from the IRA he was going to withdraw anyway and made a charitable gift he was going to make anyway. If the IRA charitable rollover is extended, advantages of making the contribution from the IRA are that the percentage limitations on charitable deductions and the phase out of itemized deductions do not apply; furthermore the taxable income that is avoided is removed from the taxpayer’s adjusted gross income, which may result in the taxpayer being below the \$200,000/\$250,000 AGI threshold for the 3.8% tax on net investment income.
- h. **Charitable Remainder Trusts for IRAs.** Charitable remainder trusts (CRTs) may be an attractive vehicle to receive IRAs. Examples of possible uses are listed.

Older Beneficiary. A relatively old individual may prefer having the IRA paid to a CRT and the individual could receive annuity payments from the CRT for the rest of his or her lifetime. If the CRT is not used, the IRA would have to make payments designed to exhaust the fund entirely by the time the individual reached his or her life expectancy. The CRT could make distributions of only 5% per year, allowing all of the

undistributed assets to remain in a tax exempt vehicle (either in the IRA until distributed to the CRT or in the CRT).

Multi-Life CRUT to Provide for Children. Another possible use is to use a multi-life CRUT including children by a prior marriage as successor beneficiaries to assure them of receiving benefits after the second-spouse's death.

Control "Burn Rate." Another approach is if an individual wants to assure that his named beneficiaries (e.g., his children) are restricted on how much they can withdraw each year, as opposed to being able to cash in the IRA all at once if they are the direct beneficiaries of the IRA.

Non-Spouse Beneficiaries If 5-Year Rule Applies. As discussed in Item 1.c above, there is a proposal to require that qualified plan and IRA benefits be paid out in only five years for beneficiaries other than the participant or the participant's spouse (there are a few other exceptions as well). Having the IRA paid to a CRT would allow a much longer "stretch-out" of the taxable receipt of payments by individual beneficiaries.

Technical issues in using CRTs with IRAs are discussed in Christopher Hoyt, *When A Charitable Trust Beats a Stretch IRA*, TRUSTS & ESTATES (May 2002).

- i. ***Charitable Gift Annuities Are Not Dead.*** If an individual holds a low-income portfolio, one way of increasing the individual's cash flow is to contribute appreciated assets to charity in return for a charitable gift annuity. Obviously, the gift annuity is structured so that value will be left to the charity (based on normal life expectancies). Indeed, the value of the annuity cannot exceed 90% of the value of the contributed property, §514(c)(5). Various advantages can exist for gift annuities over CRTs. Advantages include: (i) simplicity (no complicated trust documents are involved); (ii) payments are due from the charity and not dependent on the performance of the limited assets of a trust; (iii) because of the annuities' simplicity they can be made available to a much broader group of donors; (iv) the charity gets to use the gift funds immediately (though state regulations may require holding a portion of contributed assets as a reserve fund); (v) the rule disallowing deductions for gifts of tangible property where there is a retained benefit does not apply (because the donor retains no interest in the gift asset); (vi) the self-dealing and other private foundation rules do not apply (in particular, the self-dealing rules do apply to gifts to CRTs); (vii) unlike with a CRT, the annuity start date can be deferred and the annuity payments can vary in amount, allowing an individual to make a charitable gift while alive (to get some current income tax deduction) but still have some assurance that the person will not run out of money in his or her older years (for example, perhaps the annuity payments would not begin until the individual is age 85). If appreciated property is contributed to charity in return for a charitable gift annuity, the transfer is treated as a bargain sale and a portion of each annuity payment will be treated as capital gain.
- j. ***Advantage of Charitable Contributions By Trusts for NII Purposes.*** Trust distributions to charity qualify for a deduction for purposes of the 3.8% tax on net investment income, whereas charitable deductions by individuals do not impact the amount of NII tax. See Item 9.j above.

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- k. **Additional Advantage for Giving Appreciated Assets—To Avoid NII Tax.** The traditional advantages of giving appreciated assets to charity (rather than selling the assets and making a charitable contribution of the sale proceeds) include that the donor gets a charitable deduction for the full value of the assets without having to recognize any of the gain. Another advantage of avoiding the capital gain income from the sale is that the capital gain would have increased the donor's AGI (perhaps putting the donor over the NII tax threshold), and even if the donor is over the NII tax threshold, the donor will have avoided receiving that capital gain income (now subject to the additional 3.8% tax on net investment income).
- l. **Non-Grantor CLATs.** CLATs structured as non-grantor trusts receive no upfront income tax deduction, but the trust income is not taxable to the grantor over the term of the trust. The trust can make the annual contributions to charity that the donor would otherwise have made. Assets in the trust that the donor would otherwise have owned can produce income that is not owned by the grantor; this achieves a better result than if the donor have received the income and made the charitable contribution because there are no percentage limitations on charitable deductions for trusts, the phase-out of itemized deductions does not apply to trusts, and the trust investment income may be offset by the charitable deduction for purposes of the 3.8% tax on net investment income. For a discussion of planning considerations with charitable lead trusts, see Item 57 of the ACETC 2013 Summer Meeting Musings found [here](http://www.Bessemer.com/Advisor) and available at www.Bessemer.com/Advisor.
- m. **Shark Fin CLATs.** "Shark Fin CLATs" are charitable lead trusts that have a very low charitable payment for most years, with dramatically increasing payments at the end of the CLT term. There is no guidance from the IRS as to whether they are acceptable. PLR 201216045 approved a charitable lead trust with an annuity that increased by 20% each year. The regulations and revenue procedures provide that CLATs may permit annuity increases, but they do not specify an acceptable amount of the increases. The GRAT regulations limit increases to 20% a year, but the GRAT regulations do not apply to CLATs. The basic advantage of Shark Fin CLATs is that the (hopefully) appreciating-high performing assets in the CLAT can remain in the CLAT longer, thus increasing the amount of assets remaining to pass the family members following the end of the CLAT term. A concern structuring the CLAT with extremely low payments for many years is that the trust income may exceed the charitable distributions, thus leaving the trust with substantial taxable income subject to annual income taxation at the trust level.

Another alternative is that the charity may decide to sell its "lead" interest to the family (and in particular to the remainder beneficiaries of the CLAT). Under the current interest rate environment, the charity's lead interest is valued assuming that it will have a yield of about 2% per year, *i.e.*, the annuity stream of payment is discounted at only 2% to arrive at the present value of the annuity stream, which produces a high present value of the income stream. The charity might run calculations assuming that it would be able to earn about 5% on the sale proceeds over the term of the CLAT, and it might be willing to sell the annuity stream using a discount rate of 5% (which would produce a significantly lower number than the value of the annuity stream produced by the Treasury tables, but may be a much more

realistic estimate of the actual value of the annuity stream to the charity over the long term of the CLAT). The charity would believe that it will have more overall receipts from the sale proceeds and growth and earnings on the sale proceeds than if it merely receives the annuity payments each year. In such a case, the charity “might be hard-pressed to refuse to sell the annuity stream.” The family may be happy to pay for the charity’s interest if it thinks the trust growth and income on the trust assets can exceed 5% per year. None of the panelists addressing CLATs have structured CLATs to last in excess of 40 years.

- n. ***Charitable Gifts by Partnerships Flow-Through to Trust-Partners.*** Rev. Rul. 2004-5 provides that a trust that is a partner is entitled to a charitable deduction for the trust’s distributive share of the charitable gift from the partnership’s gross income—even if the trust has no charitable beneficiaries. The deduction is not disallowed under §642(c) “merely because the trust’s governing instrument does not authorize the trustees to make charitable contributions.” The key to receive a charitable deduction for a trust under §642(c) is that the contribution must be from income. Similarly, the contribution from the partnership must be from partnership income in order for the trust to use the charitable deduction.

The Revenue Ruling does not address how the trust came to be a partner. Is there a limitation if the trust invests assets in an investment partnership as a way of being able to allow indirect transfers to charity with the trust receiving a charitable deduction—even though the trust instrument does not allow charitable distributions? There is no such limitation suggested in the Revenue Ruling. (A possible strategy may be to have the trust make the investment in an investment partnership and make some small charitable gifts for several years and see if the IRS objects.)

- o. ***C Corporation Redemption and Charitable Partnership.***

C Corporation Redemption. Assume the client’s children own 99% of the corporation (worth \$10 million) and the client owns 1%. The client gives the 1% interest to charity. An income tax charitable deduction is allowed for the discounted value, (with say a 40% discount), or \$60,000. The charity is not thrilled with owning the 1% interest, so it contacts the company about buying its interest. The company redeems the charity for the discounted value (\$60,000). The children’s wealth is increased by \$40,000 as a result of buying the charity’s interest at a discounted value. That seems totally allowable.

Push that. Assume the children own 51%, and the client owns 49% that is given to charity, which interest the appraiser values at \$3 million (again, reflecting a 40% discount). The charity wants cash instead of stock in the closely held company. The corporation agrees to buy the charity’s 49% interest for its appraised value of \$3 million. The corporation borrows money to buy the charity’s interest at its discounted value. The children now own all of the company with a net value of \$7 million (*i.e.*, \$10 million less the \$3 million note). The children’s wealth has increased by \$2 million (going from one-half of a \$10 million company to all of a \$7 million company).

What if the children own the 1% voting stock and the client gives its 99% non-voting interest to charity, appraised with a 30% discount. If the company buys the charity’s

stock at a 30% discount, the entire \$3 million discount amount increases the children's wealth. (Still, the client must have charitable intent for that to make sense.)

Charitable Partnership. The client does not have a \$10 million business, but owns \$10 million of a concentrated stock portfolio. The client might contribute \$10 million to a partnership for a 98% LP and 1% GP interest, and a trust for children contributes enough to own a 1% LP interest. The partnership sells the concentrated stock portfolio. The K-1 will reflect that 98% of the capital gain is allocated to the charity (on which it owes no income tax). Later, the family might buy the charity's 98% LP interest for FMV (say \$7 million, discounted by 30%). Now the family owns a \$10 million company, for which it only had to pay \$7 million. The client still must have charitable intent for this to make sense—the family is paying charity \$7 million. But if, for example, the client wants to satisfy a big charitable pledge a transaction like this could accomplish the charitable gift goal and also accomplish a wealth shift to a trust for the client's children at the same time.

The charitable partnership was examined by the IRS National Office in 1999 and it passed muster, as long as everything is done on an arm's length basis.

- p. ***Remainder Interest in Farm or Residence.*** The client might give a remainder interest in a vacation home to charity. The client receives an income tax deduction for the present value of the remainder interest, but still gets to live in the home (nothing changes from the client's perspective). The charity does not want to wait until the client dies to receive any benefit, so the charity sells the remainder interest to the client's children. At the client's death, the estate gets a charitable deduction, because the client gave the remainder interest to charity. (What the charity subsequently did with it is irrelevant.) *Blackford v. Commissioner*, 77 T.C. 1246 (1981), *acq. in result*, 1983-2 C.B. 1; Rev. Rul. 83-158.

The best approach is to wait for three years before the charity sells the remainder interest, to avoid any kind of step transaction argument. The client may be uncomfortable with waiting three years. The planner will respond—the reason this works is because you are nervous; something could go wrong. The government would then be hard pressed to make a step transaction argument.

A gift of a remainder interest in a residence is tax advantageous at very low interest rates. The retained life estate value is calculated assuming it produces an income stream equal to the low \$7520 rate, so it is valued relatively low and the charitable remainder interest is valued relatively high. If interest rates increase by the time the charity sells the remainder interest, the higher rates will tend to decrease the value of the remainder interest (and the purchase price for the sale of the remainder interest).

- q. ***Charitable Gifts by S Corporations.*** One of the extender items that expired at the end of 2013 was a provision regarding charitable contributions by S corporations. The charitable deduction flows through to the shareholders. A shareholder's basis in its S corporation stock is generally reduced by any deductions passing through to the shareholder, but this provision stated that the shareholder's basis would be reduced only by the shareholder's pro rata share of the basis of the contributed property. This is

a huge benefit to S corporation shareholders. Yet to be seen is whether this provision gets extended as part of a tax extender package at some point.

21. PLANNING FOR SURVIVING SPOUSE WHO IS BENEFICIARY OF QTIP TRUST; SALE OF ASSETS FOR DEFERRED PRIVATE ANNUITY, *ESTATE OF KITE V. COMMISSIONER*, T.C. MEMO. 2013-43 AND RULE 155 ORDER

- a. **Synopsis of “Kite I”.** Mrs. Kite (“Wife”) created a QTIP trust for Mr. Kite (“Husband”) who died a week later, and under the terms of the trust the assets remained in the QTIP trust for Wife’s benefit. The assets were included in Husband’s estate and a basis step-up was permitted despite §1014(e), which says that a basis step up is not permitted when an asset is given to someone who dies within one year if the asset passes back to the donor. Apparently, the IRS failed to raise the §1014(e) issue (perhaps because Mrs. Kite’s children ended up not having any basis in the property because of a subsequent private annuity transaction under which the children made no payments).

Subsequently, the assets of the QTIP trust as well as another QTIP trust and a general power of appointment marital trust were invested in a limited partnership. Eventually the trusts’ interest in a restructured partnership was sold for notes and the notes were contributed to a general partnership. In a three-day series of planned transactions, the trusts’ assets (*i.e.*, the interest in the general partnership) were distributed to Wife, the children contributed additional assets to the general partnership, and Wife (almost age 75) sold her partnership interests to her children for a deferred private annuity (annuity payments would not begin for 10 years). Wife died three years later before receiving any annuity payments.

The court’s initial decision (“*Kite I*”) ruled that the sale of assets for the private annuity was not a gift. T.C. Memo. 2013-43 (decision by Judge Paris). Even though the annuity payments would not begin for 10 years and Wife had only a 12 1/2 year life expectancy, using the IRS actuarial tables was appropriate because Wife was not terminally ill at the time of the sale and she had at least a 50% chance of living more than one year. The sale was not illusory and was bona fide because the annuity agreement was enforceable and the parties demonstrated their intention to comply with the annuity agreement. “The annuity transaction was a bona fide sale for adequate and full consideration.”

While the sale of assets for a deferred annuity was not a gift, the court in *Kite I* ruled that a deemed transfer occurred under §2519. The court accepted the government’s argument that (1) the distribution of QTIP assets to Wife and (2) her sale of the assets for a 10-year deferred annuity were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest that triggered §2519. The deemed transfer of the income interest was not a taxable gift under §2511 because Wife received full value. *Kite I* did not discuss what, if any, taxable gift resulted from the deemed transfer of the remainder interest.

In *Kite I*, apparently, the IRS did not argue that the contribution of QTIP assets to a limited partnership was a §2519 deemed transfer of the QTIP trust, even though some of the partnership interests were later transferred with a 34% discount. In addition,

Kite I did not address an alleged estate tax deficiency other than rejecting a rather muddled §2036 argument because of Wife's failure to sign documents admitting a new partner of the limited partnership that received the contribution of assets from the QTIP trust. A detailed discussion and analysis of *Kite I*, is summarized in the summary of *Kite I* available [here](#) or under Insights at <http://www.bessemer.com/advisor>.

- b. **Synopsis of “Kite II” (Rule 155 Order).** *Kite II* is the court's Order and Decision regarding the Rule 155 computations of the gift tax as a result of the decision in *Kite I*. (Cause No. 6772-08, unpublished op. Oct. 25, 2013). The estate argued that no gift resulted from the deemed transfer of the remainder interest under §2519 because of the court's decision in *Kite I* that the Wife's sale of assets that she received from the QTIP trust in return for a deferred private annuity was a bona fide sale for adequate and full consideration. Neither the statute nor regulations make clear whether the gift that results from a deemed transfer of the QTIP remainder interest under §2519 is the full value of the remainder interest or whether it is reduced by any amounts paid to the spouse to replace the value of the remainder interest in his or her estate. One sentence in the legislative history to §2519 suggests that the gift amount would be determined after subtracting any amounts paid to the spouse. However, the court in *Kite II* interpreted §2519 to mean that the full amount of the deemed transfer of the QTIP trust remainder interest is a gift, regardless of any consideration received by the surviving spouse. “[A] deemed transfer of a remainder interest under section 2519 cannot be made for adequate and full consideration or for any consideration.”

A detailed discussion of *Kite II* (including a hearty criticism of the reasoning in the Order), is available [here](#) or under Insights at <http://www.bessemer.com/advisor>.

- c. **Deferred Private Annuity Issue.** The court did not treat the transfer of assets in return for the private annuity as a gift; the IRS apparently did not raise whether §2036 would apply to treat the private annuity as a retained indirect beneficial interest in the assets transferred. The private annuity transaction was recognized even though there was a 10-year deferred annuity and Wife's health suggested that she might not live to receive any payments under the annuity. (In fact, Wife died about three years after the private annuity sale and she did not receive any annuity payments in return for the \$10.6 million of partnership interests that she conveyed for the private annuity.)

The overall result of the transactions in *Kite* is that the children received the very valuable estate assets with almost no estate tax. The driving factor in that result is that the surviving wife sold the estate assets in return for a deferred private annuity, and received no payments on the annuity. The court held that the spouse met the requirements of Reg. §1.7520-3(b)(3). Under that regulation, the government's actuarial tables may be used if individual who is the measuring life for the annuity is not terminally ill, and the individual is not considered terminally ill if he or she has a greater than 50% likelihood of living at least one year. The individual is presumed to meet that requirement if the individual in fact lives at least 18 months after the transaction but the IRS may rebut that presumption by clear and convincing evidence. Treas. Reg. § 1.7520-3(b)(3). In this case, Mrs. Kite had a greater than 50% likelihood of living at least one year and in fact she lived greater than 18 months (she lived three years).

While the private annuity transaction may seem abusive in this type of situation, the intent of the regulations is to provide certainty by applying rather objective tests to the government's actuarial tables. The court's ruling in *Kite I* upholding the private annuity transaction seems correct.

As a practical matter, the IRS's concern about private annuities is that the use of the Treasury's tables by taxpayers is "self-selecting." Taxpayers who are likely to live less than the tables would otherwise suggest are the only ones who use private annuities (or SCINs).

The mortality tables built into the §7520 tables are based on the last census, and the government waits until the census is 9 years old before releasing the next table (which they are required to do every 10 years). As life expectancies continue to improve, this means that the government's tables reflect a shorter life expectancy than actual life expectancies (which results in higher annuity payments).

In light of the continuing uncertainty over whether the §7520 mortality tables apply, taxpayers may have the opportunity to value SCINs by using actual medical and life expectancy information to value a SCIN (as long as the seller is in reasonably good health). Some planners have analyzed the valuation of SCINs similar to funding the obligation with a decreasing term life insurance policy. Insurance actuaries may produce substantially different actuarial information than the government tables—resulting in significantly lower premiums built into the SCINs.

- d. ***Applying §2519 to Distribution of Assets to Spouse Followed By Spouse's Sale for Private Annuity Is Wrong.*** In *Kite I*, the court accepted the government's argument that (1) the distribution of QTIP assets to Wife and (2) her sale of the assets for a 10-year deferred annuity were part of an integrated transaction that was deemed to be a disposition of her qualifying income interest that triggered §2519. A distribution to a spouse from a QTIP trust does not trigger §2519 and an investment by the trustee or spouse of QTIP assets does not trigger §2519, but the court concluded that the combination of the distribution and the reinvestment taken together violates the purposes of §2519. One of the panelists concludes "that is as wrong as it can possibly be."
- e. ***Rule 155 Order is Wrong.*** The Rule 155 Order concludes that Mrs. Kite made a gift of the full remainder value of the QTIP trust assets when she sold them, even though she received full value (*i.e.*, the private annuity) that would be in her estate for estate tax purposes. (It so happened that she made a terrible investment, and what she received ended up being worthless, but the court had already determined that she received full value in the private annuity transaction.) Furthermore, part of the court's reasoning is that the termination of a QTIP trust triggers the application of §2519 (resulting in a deemed gift by the spouse of the remainder interest in the QTIP trust). Does a surviving spouse really risk making a huge gift by merely having the QTIP assets distributed to him or her? A panelist concludes regarding the ultimate conclusion that Mrs. Kite actually made a large gift by receiving the QTIP trust assets and selling them for an annuity: "That makes no sense. It is completely wrong." (Interestingly, the Rule 155 Order is no longer available on the Tax Court website.)

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- f. **Overall Result.** Even with the Rule 155 Order (that seems totally wrong), the overall result is that the estate converted \$10.6 million of assets into an \$800,000 gift tax liability. The beneficiaries would receive basis in the assets equal to the amount of the gift tax that is attributable to the appreciation—and in this case the assets would otherwise have had a zero basis, so they would get basis for the full amount of the gift tax payment. Not a bad overall result—even if the estate does not appeal the Rule 155 determination.

The case will have minimal precedential effect. *Kite I* was a T.C. Memo. opinion so at least theoretically has no precedential effect. The Rule 155 Order is unpublished so it has no precedential effect either.

- g. **Gift Tax Apportionment Issues.** This case raises an interesting apportionment issue. This estate will owe substantial gift tax rather than estate tax. There are specific estate tax apportionment statutes—but there are no gift tax apportionment rules. The gift tax is a debt of the estate that is paid out of the residue.
- h. **Investment of QTIP Assets in FLP; Planning for Surviving Spouse's Interest in QTIP Assets; Income Tax Consequences of Private Annuity; Taxable Gift by Children by Allowing Full Distribution of QTIP Assets to Spouse.** These issues are all addressed at some length in Item 35 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

An issue that frequently arises in addressing estate planning for a surviving spouse who is the beneficiary of a QTIP trust is whether distributions can be made to the spouse so that the spouse can engage in further transfer planning strategies. See Item 7.c. for a discussion of *Estate of Lillian Halpern v. Commissioner*, T.C. Memo. 1995-352, in which the court included in the surviving spouse's estate certain assets that had been improperly distributed to other persons.

22. IRS APPEALS

Maricarmen Cuello, the IRS Appeals Team Manager, together with John Porter, discussed the IRS Appeals procedures.

- a. **Mission.** The mission of IRS Appeals is to resolve cases without litigation in a manner that is fair and impartial. Appeals strives to be independent, even though it is part of the IRS. For example, ex parte rules prohibit Appeals from talking separately with Examinations or Collections Divisions.
- b. **Location of Appeals Officers.** The nine estate and gift tax division appeals officers are located in New York (2), Philadelphia (1), Jacksonville (2), Houston (1), Dallas (1), Chicago (1), and Indianapolis (1). Some appeals conferences are conducted remotely by video-conference. Cases are typically assigned based on the location of the executor, but allocations are based on inventory loads of the appeals officers.
- c. **Getting to Appeals.** There are two basic ways of getting to Appeals. (1) Undocketed cases – The taxpayer can file a formal written Protest letter within 30 days of receiving the Revenue Agent's Report (the "30-day letter"). (2) Docketed cases – District

counsel may send a case to Appeals after the IRS has issued a 90-day letter and the taxpayer has filed a Petition with the Tax Court.

Also, Appeals may consider gift and estate tax denied claims for refund, after the taxpayer receives the Letter 105C denying the claim from the Cincinnati Service Center. The taxpayer files a protest after receiving the letter (or after it has been on file for 6 months and is deemed denied) to get to Appeals. (The two-year time frame for filing a case in the federal district court of the Court of Claims still runs during the time Appeals is considering the case.)

Appeals also handles §6166 qualification and termination cases, § 6161 extension payments, penalties from late filings or late payments in gift and estate tax cases, and late-filed Form 8939s.

Appeals normally does not handle Form 1041 issues, unless closely related to an estate tax matter.

- d. **Statute of Limitations Cut-Offs.** Appeals will only accept a case if the written protest physically arrives at Appeals prior to 180 days from when the statute of limitations runs on the case. In a gift tax case, the same 180 day limit applies, but the taxpayer can choose to extend the statute of limitations (unlike in estate tax cases).
- e. **Pre-Appeals Conference.** The Appeals officer cannot have ex parte conferences with the examining agent. But the examining agent can request a conference with Appeals before the Appeals case begins. Several years ago, the large business cases group implemented pre-conferences in their cases. Some estate tax cases are very large; some are worked by teams of examining agents. Appeals decided to extend pre-conferences to estate and gift tax cases as well. There have only been a handful of them, so far. “Exam” can pitch its case to Appeals; the taxpayer is present and gets to hear the examining agent’s arguments. The pre-appeals conference is not a mediation, but is merely the ability of Exam to present its case. The taxpayer can respond in its separate conference with the Appeals (at which the examining agent is not present).
- f. **Internal Appeals Appraiser.** Appeals has access to its own independent set of appraisers. If a case involves valuation issues in excess of \$10 million, the Appeals officer refers the valuation issue to Appeals’ in-house valuation consultants.
- g. **Protest and Presentation Best Practices.** The Protest and the presentation at the Appeals conference should address all issues in the Revenue Agent’s Report (RAR), including any factual discrepancies and interpretations of case law. These issues should be addressed in the Protest, and Exam will have the ability to respond in a rebuttal report (with a copy to the taxpayer). Ultimately, Appeals has to submit an “appeals case memorandum” describing the case and the analysis of the issue for approval by the Appeals manager. The taxpayer’s memo hopefully can be helpful to the Appeals officer in preparing the appeals case memorandum.
- h. **Referral After Case is Filed.** If a case is filed in District Court, the Department of Justice attorney handling the case generally will not agree to refer the case to Appeals. But if a petition is filed in the Tax Court, and the case has not previously been to Appeals (perhaps the statute ran on an estate tax case and there was not time to go to Appeals), district counsel will usually refer the case to Appeals—unless the IRS has

decided to designate the case as a litigating vehicle. If the case is referred to Appeals, no formal Protest letter is required. Appeals still likes to see a memorandum that provides arguments beyond what is typically in the Petition. Send the memo/position statement to the Appeals officer at least several days before the scheduled conference time so the Appeals officer has time to review the taxpayer's position to have a productive conference. The district counsel generally has no involvement in the Appeals process.

- i. **Hazards of Litigation.** Appeals can consider "hazards of litigation" in reaching its decision.
- j. **Alternative Dispute Resolution Options.** The Appeals process itself is a form of alternative dispute resolution itself, but within Appeals there are several particular ADR programs. These include Fast Track Mediation (FTM), Fast Track Settlement (FTS), Post-Appeals Mediation (PAM), and (for large business cases) the Rapid Appeals Process (RAP). They are all gaining popularity among taxpayers and Examination.

Eligibility. To be eligible for FTM or FTS, the case must be non-docketed before the 30-day letter or the statutory notice (the "90-day letter") has been issued and the case must be "fully developed" (so this usually occurs at the end of the examination process). There are several types of cases that are excluded (generally including collection cases, "whipsaw issues," cases designated for litigation, and "frivolous issues or uncooperative taxpayers").

Advantages. These are not expensive processes, and are a tool to resolve a case quickly. From the day the matter begins to ending is only 60 days. (The typical Appeals case lasts considerably longer than that.) The examining attorney does not have to prepare an "unagreed report". Some of them can be over 100 pages. Similarly, the taxpayer does not have to file a formal protest. Most of the argument will be presented and discussed orally. If an agreement is not reached, the taxpayer can still utilize the regular Appeals process (with a different Appeals officer). So there is little to lose by using this process.

Fast Track Settlement. The Fast Track Settlement Process (which applies in estate and gift tax cases) was initially a pilot program and was extended nationwide in July 2013.

Fast Track Mediation. Fast Track Mediation is a typical mediation process. Appeals officers are all trained mediators. The Appeals officer will help facilitate a settlement between the parties, but if the parties reach an impasse, the Appeals officer can suggest a settlement that he or she would propose if this were in Appeals. Either party can accept or decline. (The taxpayer can also propose a mediator, but the Appeals officers know the estate and gift tax laws and are generally preferred as the mediators.)

Examining Agent Chooses Whether to Use FTS or FTM. The examination attorney decides whether a particular case goes to FTS or FTM. Most (95%) have been choosing FTS.

How the Process Works. The FTS and FTM processes occur *before* a 30-day letter has been prepared if the taxpayer cannot reach agreement with the examining agent. The Examining Agent prepares a Form 14717 and attaches the statement of issues by both

sides and the appraisals (if valuation issues are involved). Once accepted in Appeals, an officer/mediator is assigned, and the issues are discussed in a telephone pre-conference. All decision makers must be present (or available by phone) at the pre-conference and the actual settlement/mediation session.

Failure to Reach Agreement. If the taxpayer accepts a proposed settlement but the examining manager does not, the case is then reviewed by the Area Director before the settlement can be declined. If no agreement is reached in FTS or FTM, the case can still go to Appeals and will be considered by a different Appeals officer that has not previously seen the case.

Becoming More Widely Used. The FTS or FTM processes are become more widely used. If the taxpayer is having trouble reaching an agreement with the examining agent, “plant the seed” with the examining attorney that this might be a good case to take to FTS or FTM.

Post Appeals Mediation. Post Appeals Mediation is possible if the parties do not reach agreement with Appeals. The Appeals Team Manager decides if a case is eligible for Post Appeals Mediation. If so, the case is assigned to another Appeals officer who reviews the settlement proposal. There is an opportunity to meet with the new officer and the original Appeals officer is there as well. (John Porter reports that he used this once and was able to reach a settlement.)

Conclusion of Case. While the alternative dispute options (FTS or FTM) are proceeding, Examinations retains jurisdiction and Appeals has not yet assumed jurisdiction of the case. The examining attorney prepares calculations, but the Appeals officer will want to make sure that the calculations are prepared in accordance with the settlement. The Appeals officer will prepare an agreement (Form 14000) that sets forth the agreed issues and the amounts and will usually also send the agreement forms (Form 890 [estate tax] or Form 870 [gift tax]). If the case was settled considering hazards of litigation, the Appeals officer will definitely prepare the Form 890 or Form 870.

- k. **Cases “Designated for Litigation.”** Appeals cannot consider “cases designated for litigation.” These are cases involving a legal issue that is of particular importance to the IRS national office. An example is the *McCord* case. Even though the Notice of Deficiency in *McCord* was an amount higher than if the taxpayer lost every issue in the case, there was no opportunity to settle the case before it went to trial.
- l. **Form 870/890 vs. Form 870/890-AD.** A gift tax case can be resolved at Appeals with a Form 870 or Form 870-AD, and an estate tax case can be resolved with a Form 890 or Form 890-AD.

The Form 870 or 890 waives restrictions on assessment but does not preclude the taxpayer from subsequently filing a claim for refund or the IRS from making additional assessments of tax.

The Form 870-AD or Form 890-AD precludes both the taxpayer and IRS from reopening the case (with a claim for refund or additional assessments). The IRS cannot reopen the case in the absence of fraud, malfeasance, concealment or misrepresentation. The Form 870-AD and 890-AD are typically used in settling an appeal.

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- m. **Closing Agreement.** The closing agreement is used only in limited circumstances – when the agreement involves continuing issues that may affect later years or related cases. (For example, if a formula transfer is involved, the taxpayer might want a formal Closing Agreement to make sure the formula is respected and does not cause problems in later years.) It can only be rescinded by showing fraud, malfeasance, or misrepresentation of material fact. It must be signed by the Chief of Appeals.
 - n. **Joint Committee on Taxation Review.** All cases involving a refund or credit in excess of \$2 million must be approved by the Joint Committee on Taxation. Appeals submits a report summarizing the facts and decision of Appeals. The refund can typically be approved in about a month.
 - o. **Appeals Judicial Approach and Culture (AJAC).** AJAC is a recent program attempting to strengthen the “fair and impartial” part of Appeals’ mission. Appeals has instituted various clarifications this year to strengthen its quasi-judicial approach. There are 12 clarifications, three of which apply to Examinations (and the other nine apply to Collections). More clarifications may be coming. The three applying to Examinations are as follows.
 - (1) The Appeals officers will not raise new issues or re-open issues that have already been agreed to in the examination process. Appeals is not an extension of the examinations or collections process. If Appeals thinks the examiner missed an issue, Appeals is required not to raise that issue. But district counsel can raise new issues in a docketed case. Even though Appeals does not raise new issues, a new issue might be raised during litigation in a docketed case if agreement is not reached at Appeals.
 - (2) Appeals officers will not return cases to compliance for additional development when the case file has not been fully developed and the taxpayer has not provided any new information to Appeals. (Prior to AJAC, a case could be sent back to Exam for further development.) Exam has its “one bite at the apple” when it sends a case to Appeals. If a new appraisal is submitted in the midst of the Appeals process, the case will be returned to Exam.
 - (3) The examining attorney may file a formal dissent if Exam does not agree with the settlement by Appeals.

23. GENERATION SKIPPING TRANSFER TAX: POST-ATRA PLANNING AND PRACTICAL POINTERS

Two of the top GST experts in the country (Julie Kwon and Pam Schneider) discussed GST problem issues that have been arising most frequently over the last year following the passage of ATRA.

- a. **Split Gift Election for SLATs.** This is a question very frequently raised by accountants.

Example 1 (No Severable Interest). Assume a settlor creates Trust 1 for descendants and Trust 2 for the settlor’s spouse and descendants (with a “sole and absolute discretion” distribution standard). The spouses make the split gift election. What are the gift and GST effects?

Gift Tax. For gift tax purposes, the gift to Trust 1 is treated as made equally from both spouses, but the gift to Trust 2 is treated as a gift just from the settlor. (Under § 2513, the split gift election applies to gifts to any person other than the donor's spouse; if the interest of the beneficiaries other than the spouse can be ascertained and severed from the interest of the spouse, the election is effective for the transfer to the severed interest for other beneficiaries. For a more detailed discussion of this issue, see Item 15.e. of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.)

GST Tax. For GST purposes, the gift to Trust 1 is treated as a transfer one-half by each spouse (and therefore each would allocate GST exemption for that portion for the trust to be GST exempt), “regardless of the interest the electing spouse is actually deemed to have transferred under section 2513.” For Trust 2, the rules are not totally clear. The GST regulation provides that both spouses are treated as transferors if “the donor’s spouse *makes* an election under section 2513” (Reg. §26.2652-1(a)(4)), whereas the gift tax regulation provides that the consent is “*effective*” only as to the interest to third parties that is ascertainable and severable from the interest transferred to the spouse (Reg. §25.2513-1(b)(4)). Arguably, that difference in language provides an argument that the transfer to Trust 2 is treated as made one-half by each spouse for GST purposes even though it is a gift *totally* from the settlor for gift purposes. That was not intended, however, and several PLRs provide (without explaining their reasoning) that if the specific transfer at issue is totally ineligible for the split gift election, the transfer is treated as being made entirely from the settlor for GST purposes. PLRs 200551009, 201108010 and 201125016. (These are 9100 requests for extensions of time to make GST exemption allocations. The PLRs do not indicate whether the IRS rejected a taxpayer argument that the exemption would be allocated one-half by each spouse or whether the taxpayer acknowledged from the outset that the exemption would be made only from the donor with respect to a transfer to a trust that included the spouse as a discretionary beneficiary without a severable interest.)

Example 2 (Severable Interest). Assume the same facts as above except that Trust 2 has an ascertainable standard for distributions and the spouse’s interest in the trust is severable. In this situation the transfer to Trust 2 is treated for gift tax purposes as a transfer one-half from each spouse as to the portion of the trust to the severable interest of the beneficiaries other than the spouse (and as a transfer solely from the settlor to the spouse as to the spouse’s severable interest). For GST purposes, however, the entire transfer to Trust 2 is treated as made one-half from each spouse (and each spouse would allocate GST exemption for one-half of the total transfer). Reg. §26.2652-1(a)(4).

Practical Pointer: If the split gift election is made for a year in which one spouse makes a transfer to a “SLAT” with the other spouse as a discretionary beneficiary, be very careful in making GST exemption allocations to make sure that the allocation is being made from the proper person. (An allocation from the wrong person would not be effective, and the trust might end up being only partially GST-exempt.)

Life Insurance. If a life insurance policy is transferred to a trust, do not make the split gift election for that year. If the insured dies within three years, the policy will be included in the insured's estate, and insured will be treated as the transferor of the trust. §2652(a)(1)(A). If the split gift election had been made, the insured's spouse would have been the transferor of one-half of the trust, but at the insured's death, the transferor would change as to that half. The inclusion ratio of a trust does not change except in certain circumstances, one of which is the change of the transferor. Therefore, the inclusion ratio would change as to one-half of the trust, creating considerable complexity. **Practical Pointer:** Do not make a split gift election for the year in which a spouse transfers a life insurance policy to a trust that is intended to be exempt from the GST tax.

b. ***When and How to Allocate the Annual Inflation Adjustment Addition to the GST***

Exemption Amount. Assume donor gives \$25,000 to grandchildren in February 2013 and gives \$5.25 million to a long-term trust in December 2013. The \$5.25 million of GST exemption available in 2013 is not enough to fully shelter both trusts. As of February 2013, \$25,000 can be allocated to the direct skip (and will be allocated to the direct skip under the automatic allocation rules unless the gift tax return provides otherwise). As to the December gift, there is only \$5.225 million of remaining GST exemption—which would not cause the trust to be fully GST exempt (*i.e.*, it would have an inclusion ratio greater than zero). As of January 1, 2014, however, the GST exemption amount increases to \$5.34 million. Can it be allocated to the 2013 gift, and if so what is the effective date and what value is used for determining the inclusion ratio as a result of the exemption allocation? No one knows the answer. To place this issue into perspective, based on these numbers the inclusion ratio would be extremely small even if the additional \$90,000 of GST exemption cannot be allocated to the 2013 transfer.

The confusion arises because neither the timely return rule nor late return rule clearly applies. For allocations made on a timely return, the exemption allocation is (1) effective, and (2) uses valuations as of the date of the gift. For allocations made on a late return, the exemption allocation is (1) effective, and (2) the valuations are used as of the date of the late allocation. (The date that the allocation is “effective” is important if a taxable distribution or taxable termination occurs before the effective date—in which event a GST tax would be imposed.)

If the gift tax return for the 2013 gifts is filed by April 15, it would be a timely return, suggesting that the GST exemption is (1) effective, and (2) the valuations are used as of the date of the gifts. However, the additional \$90,000 of GST exemption available on January 1, 2014 could not be *effective* as of the date of the December 2013 gift because the additional exemption did not exist on that date. As to the additional \$90,000 of allocation, perhaps the effective date and valuations would be applied as of the earliest logical date—January 1, when the additional exemption became available. Beth Kaufman wrote an article taking the position that the additional exemption could be applied on a timely filed return for gifts made during the prior year. Beth Shapiro Kaufman, *Allocation of Indexed GST Exemption*, LEIMBERG EST. PL. NEWSLETTER #2140 (Sept. 11, 2013). Her article also recommends how to report the

allocation if the decision is made to allocate the additional \$90,000 of 2014 exemption to the 2013 transfers on a timely filed return.

Some planners suggest that the values on the date of the allocation would apply (but that is inconsistent with the timely return allocation rules).

Observe that this same issue has existed throughout the 2000s as the GST exemption has been increasing. Perhaps this issue has not arisen previously because the gift exemption remained at \$1 million during that period and gifts typically were not made each year to utilize the increasing GST exemption.

If the late return rules apply, the difference would be that the GST tax could apply to GST transfer events occurring before the effective date of the allocation, and values on the date of allocation would apply for purposes of determining the inclusion ratio. If values have risen substantially during that time frame, there could be a significant impact on the inclusion ratio calculation. If the additional 2014 GST exemption can only be used on a late-filed return, if the donor extends his or her income tax return due date (and don't all of our clients do that), the late return could not be filed until after October 15, 2014, risking that substantial appreciation could occur during that delay.

What Can Be Done To Get Back to a Fully Exempt Trust? (a) Use a qualified severance to create a small trust having an inclusion ratio of one and with most of the assets in a trust having an inclusion ratio of zero. (b) Similarly, the trust could be decanted into exempt and non-exempt trusts. (c) Make a distribution of enough assets prior to the filing date so that the value of the trust assets on the filing date is equal to or less than the available GST exemption to allocate on that date.

Inherent Uncertainty; Do Not Use This Strategy in a Planning Mode. The potential of allocating the additional \$90,000 of GST exemption available on January 1, 2014 to 2013 transfers should be considered only in a clean-up mode. Do not make transfers in a year relying on the ability to make timely allocations of the additional indexed GST exemption that becomes available on January 1 of the following year.

Inherent Uncertainty; Leaving Long Term Uncertainty Regarding the Trust Inclusion Ratio. A significant disadvantage of attempting this strategy is that uncertainty would exist, perhaps for decades, as to whether the trust is fully exempt. No statute of limitations runs on the inclusion ratio of the trust until the statute of limitations runs (*i.e.*, three years) following the later of (1) a GST transfer from the trust, or (2) the death of the donor. Reg. §26.2642-5(b).

Interesting Somewhat Metaphysical Issue: Most GST exemption allocations are made by formula. If the additional indexed exemption available on January 1 of a year can be allocated on timely returns, is such additional exemption automatically allocated by the formula allocation? If so, has this inadvertently impacted thousands of formula GST exemption allocations in the past when gifts during a year have exceeded the GST exemption for that year but there was an increase in the GST exemption on January 1 of the following year?

Practical Pointer: If gifts are inadvertently made in excess of the GST exemption in a year, be very thoughtful before attempting to allocate the additional indexed exemption available on January 1 of the following year. The IRS has not provided guidance regarding its position on the issue, and inherent uncertainty would result for years as to the inclusion ratio of the trust.

- c. **Crummey Trusts** . The issue that most commonly arises for the GST experts is how Crummey trusts are treated for GST purposes.

No Automatic Qualification for Exception From Having to Allocate GST Exemption. Whether the trust transfer qualifies fully for the gift tax annual exclusion does not necessarily avoid the necessity of allocating GST exemption to the trust. (The transfer is disregarded for GST purposes and no exemption need be allocated, only if the transfer qualified for the annual exclusion, there is only one beneficiary of the trust, and that beneficiary's interest is "vested" (meaning that the asset will be paid to the beneficiary's estate if he or she dies before the termination of the trust.)) (As a practical matter, only §2503(c) "minor's trusts" will meet those requirements.) In that event, the transfer to the trust qualifies for an exception from being treated as a direct skip subject to the GST tax. §2642(c)(2). (The Form 709 almost invites return preparers to make the mistake of believing that no exemption need be allocated to all annual exclusion transfers.)

Practical Pointer. GST exemption must be allocated (either affirmatively or by automatic allocation) to annual exclusion gifts to trusts, other than single beneficiary vested trusts, if the trust is to be GST-exempt.

Application of Automatic Allocation Rules to Crummey Trust Gifts. The automatic allocation rules for indirect skips were enacted in EGTRRA (in 2001) and apply for transfers to "GST trusts," as defined in §2632(c). Generally, if GST transfers may be made from the trust, it is a "GST trust." However, there are numerous complex exceptions, one of which applies if the transferred asset would be included in the estate of the beneficiary if the beneficiary were to die immediately after the transfer. That would include Crummey trust transfers; BUT, there is an exception to the exception (meaning that the trust is a GST trust) if the Crummey withdrawal power is within the annual exclusion amount. (This probably is based on whether the transfer in a particular year in fact qualifies for the annual exclusion, and does not require that the trust instrument expressly limit the Crummey withdrawal power to the annual exclusion amount.) Therefore, a Crummey trust may flip in and out of being a GST trust for any particular transfer, meaning that there would be automatic allocation for some transfers but not others. If that happens, the legal costs of determining the inclusion ratio based on the additions made in each of the years (based on values in each of those years) can be quite expensive. The client may prefer that the planner assume that no exemption allocations have been made and allocate enough exemption to cover the full value of the trust.

If there is any possible uncertainty as to whether a trust is a GST trust, affirmatively elect-in to automatic allocation treatment for all transfers to the trust (if the goal is for the trust to be GST exempt).

Transferor May Change If No “5 or 5” Limit on Lapsing of Withdrawal Rights. Only the “transferor” can allocate GST exemption to the trust. (If there are multiple transferors to a trust, the portions of the trust attributable to different transferors are treated as separate trusts for GST purposes. §2654(b)(1).) The transferor, with respect to a gift, is the donor who is subject to the gift tax (whether or not gift tax is payable).

§2652(a)(1)(B). If the Crummey withdrawal power lapses as to an amount in excess of the greater of \$5,000 or 5% of the trust, the excess is treated as a taxable gift by the power holder. If such a lapse occurs, the power holder would be treated as the transferor of the portion of the trust attributable to that excess lapsed amount; only the power holder’s GST exemption could be allocated to that portion of the trust, and any of the grantor’s GST exemption allocated to the trust with respect to that portion will have been wasted. This creates a nightmare of complexities, because invariably the power holder is not aware that he needs to cause any GST exemption to be allocated to the trust, and if the trust is not a “GST trust” that receives automatic allocations of GST exemptions, the trust will be partially non-exempt.

Practical Pointer. For gifts to Crummey Trusts that are subject to withdrawal rights, if the goal is to allocate GST exemption so that the trust has a zero-inclusion ratio, use “hanging” powers so that the lapse cannot exceed a “5 or 5” amount in any year. (If an incomplete gift approach is used, by giving the power holder a testamentary limited power of appointment over the lapsed portion in excess of a “5 or 5” amount, the power holder would become the transferor as to that portion at his or her death and would have to allocate GST exemption to the trust at that time—thus wasting some of the GST exemption that the original transferor had allocated to the trust.)

d. **GRATs and ETIPs.**

Does the ETIP Rule Apply Before the Termination of the GRAT? A strange regulation could be interpreted to mean that GRATs are not generally subject to the ETIP rules. Reg. §26.2632-1(c)(2)(ii)(A) says that the ETIP rules do not apply “if the possibility that the property will be included [in the gross estate of the grantor or the grantor’s spouse] is so remote as to be negligible,” which is the case if there “is less than a 5 percent probability that the property will be included in the gross estate.” The intent of that provision may have been to test whether there is a 5% chance that the value would be included in the grantor’s estate if the grantor were to die within the GRAT term. As a practical matter, attorneys are not relying on this possible interpretation to allocate GST exemption at the creation of GRATs. (As discussed below, however, there may be little downside to making an allocation capped by the nominal value of the remainder interest.)

If the ETIP Rule Does Not Apply to GRATs, How Much GST Exemption Would Have to Be Allocated To Achieve an Inclusion Ratio of Zero? The answer is not totally clear, but the denominator of the inclusion ratio is probably based on the full value transferred to the GRAT, not just the nominal value of the remainder interest. See §2642(a)(2)(B) (denominator of the applicable fraction is “the value of the property transferred to the trust”). Some planners have suggested, however, allocating GST exemption to the GRAT when it is created just in case the ETIP rule does not apply and in case allocating exemption equal to the nominal remainder value is sufficient to cause the

trust to be fully exempt. For example, a formula allocation could be made of “so much as is necessary to achieve a zero inclusion ratio, but not more than the value of the remainder.” In light of the uncertainty over the amount of GST exemption needed in this circumstance, if GST exemption is allocated at the creation of a GRAT, it is essential to put a cap on the amount allocated.

Risk of Automatic Allocation of GST Exemption to GRAT. If the GRAT remainder will pass in a manner that could potentially have distributions to skip persons, and IF the ETIP rule does not apply, there would be automatic GST exemption allocation when the GRAT is created. It is likely that the amount allocated would be the entire value of the property transferred to the trust, even though all of that current value (and more) will be distributed back to the donor—thus likely wasting GST exemption. To be sure of preventing this result, an election against automatic allocation of GST exemption could be filed when the GRAT is created.

Electing-Out of Automatic Allocation at End of ETIP. The gift tax return that is filed for the GRAT when it is created can elect out of automatic allocation at the end of the ETIP—to avoid automatically allocating an undetermined amount of GST exemption when the GRAT terminates. See Reg. §26.2632-1(b)(2)(iii)(A)(1). The election in or out of automatic allocation can be changed before the ETIP ends. Reg. §26.2632-1(b)(2) and (3), and (c).

Practical Pointer: Do not allocate GST exemption to a GRAT at its creation, either by affirmative allocation or automatic allocation, unless the allocation is capped at a very nominal value of the remainder interest. (If the automatic allocation is made inadvertently or purposefully at the beginning of the GRAT, however, it can be changed before the end of the ETIP.)

Affirmative Allocation of GST Exemption Prior to End of QTIP. If an affirmative allocation of GST exemption is made before the end of the ETIP, the allocation is irrevocable and cannot be changed. Reg. §26.2632-1(c)(1)(ii). Exemption should not be affirmatively allocated to GRATs (other than the possible strategy discussed above of allocating exemption equal to the nominal value of the remainder value in the unlikely event that might be enough to cause the trust to be GST-exempt.) However, Pam Schneider suggests that regulation is suspect and could be challenged if a large amount were at issue. (The statute states that GST exemption “shall not be made before the close” of the ETIP. § 2642(f). “How can the IRS write a regulation that something you are not allowed to do is irrevocable because they told you that you are able to do it?”)

Allocation at End of GRAT Term. There is considerable uncertainty as to how GST exemption can be allocated at the end of the GRAT term if the goal is to make the allocation to some but not all trusts that receive the GRAT assets at the end of the GRAT term. (For example some of the assets might pass to the grantor’s children outright and the balance might pass to long-term trusts. There would be no need to allocate any exemption to the portion passing outright to the grantor’s children.) One possible alternative might be to sever the GRAT before the end of the trust term, but it is not clear how that would be done (before the GRAT has split into separate trusts).

The retroactive allocation rules do not seem to help; they apply “if the child falls in the wood chipper” and unexpectedly dies “out of order.”

Item 8 on the Treasury Priority Guidance Plan for 2013-14 deals with this issue: “Regulations under §2642 regarding the allocation of GST exemption to a pour-over trust at the end of an ETIP.” (That item was first added in the 2012-2013 Plan.) The AICPA had sent multiple letters to the Treasury requesting a guidance project on this issue. The letters point to situations in which the grantor would want to allocate GST exemption either affirmatively or by automatic allocation to some but not all trusts that would receive the GRAT assets at the term of the ETIP. Ron Aucutt quotes the correspondence from the AICPA, giving some glimpse on what issues the IRS might consider in this project in his ACTEC Capital Commentary. Aucutt, ACTEC Capital Letter No. 34, Priority Guidance Plan Published, Commissioner Nominated (Aug. 12, 2013).

- e. ***Determination of Inclusion Ratio; Late Allocations.*** The “exclusion ratio” (that is not a tax term) is generally the GST exemption allocation allocated to the trust divided by the value of the trust at an appropriate valuation date. For timely filed returns, the value on the date of the transfer applies (Reg. §26.2642-2(a)(1)); for late returns, the value of trust property on the date of the late allocation applies (there is a special rule allowing use of the value on the first day of the month of the transfer except for a life insurance policy if the insured has died by the date of the late allocation) (Reg. §26.2642-2(a)(2)).

The allocation is both (1) effective, and (2) uses values as of the date of the transfer for a timely allocation and the date of the allocation for a late allocation.

Late allocations may be desirable if the assets have declined in value from the date of the gift. A difficulty is that most clients extend their income tax returns, which results in an automatic extension of the gift tax return due date—to October 15. (There is no way to extend just the income tax return due date and not the gift tax return due date.) This can be problematic, because it means that the gift tax return making the late allocation cannot be filed until after the October 15 due date, and the value may increase by that time.

Practical Pointers. Some planners say that a client should never make a direct skip transfer above the annual exclusion (that still permits birthday gifts to grandchildren), and should never make a significant distribution from a trust to a skip person after a transfer is made to the trust but before the gift tax return is filed allocating GST exemption to the transfer. That would take away the flexibility of making a late allocation if the value of an asset transferred to the trust plummets in value. A late allocation would mean that the allocation is not effective on the date of the GST transfer, resulting in having to pay GST tax with respect to the direct skip or taxable distribution.

Similarly, some planners suggest never making a significant direct skip transfer. Instead, they suggest making the transfer to a trust expected to hold the asset until after GST exemption allocation is made. If the transferred asset falls in value, the donor could make a late allocation based on the lower value, and the trust could later

make a taxable distribution to the skip person. If a timely exemption allocation is not made to a direct skip (and if the person elects out of automatic allocation), a GST tax would be due with respect to the direct skip because on the effective date of the transfer there would have been no exemption allocated to the transfer.

- f. **Statute of Limitations to Determine Finality of Inclusion Ratio.** Sections 2642(b)(1) and 2642(b)(2)(A) clarify the valuation provisions for timely and automatic allocations. The inclusion ratio is generally based on values as finally determined for estate or gift tax purposes (but for gifts when there is not a timely filed return or for allocations made at the end of an ETIP, there would not be a transfer subject to gift tax as of the relevant date in order to have a value as finally determined for gift tax purposes). (Those statutory provisions were clarified by EGTRRA in 2001.) The regulations (issued previously in 1995) state that the inclusion ratio does not become final until the *later* of (1) the expiration of the statute of limitations on the first GST tax return that is filed using that inclusion ratio (with a special rule for the cessation of a qualified use under §2032A for special use property), or (2) the expiration of the statute of limitations for estate tax purposes on the estate of the transferor. Reg. § 26.2642-5(b). Generally speaking, there is no finality on the inclusion ratio to determine the percentage of a trust that is GST-exempt until three years after the *later* of (1) the first GST transfer from the trust for which a GST return is filed, or (2) the death of the donor.

Many circumstances may cause uncertainties in determining a trust's inclusion ratio, such as whether GST exemption was automatically allocated to a transfer, when exemption can be allocated (e.g., to a GRAT at its creation?), the value of assets on the date of a late allocation or allocation at the end of an ETIP, whether the transferor has changed as a result of lapsing Crummey rights, whether the right person has allocated exemption to split gifts (in particular, if the donor's spouse is a discretionary beneficiary of the trust), or for GST exemption allocations to partially exempt trusts (in which event the inclusion ratio is based in part on the value of all of the trust assets at the time of the allocation). There can be no finality on the inclusion ratio until, at the earliest, three years and nine months after the death of the transferor. Making taxable distributions from a trust during the transferor's life does not cause the "statute of limitations on the inclusion ratio" to run.

Practical Pointer. Uncertainty can exist for many years (or decades) regarding a trust's inclusion ratio. It may not be determined with finality until over three years after the settlor's death. This can be particularly problematic for late allocations to transfers involving hard to value assets (such as life insurance policies), because there would not have been a gift tax audit to determine the fair market value of the property.

- g. **NRA as Beneficiary.** If the trustee makes a distribution to a non-resident alien skip-person beneficiary, the Trustee is required to file Form 706-GS(D-1), similar to a K-1, to give information to the beneficiary that there has been a taxable distribution. The filing requirement exists even if the trust has a zero inclusion ratio. A copy must be provided to the distributee, and the form includes specific instructions to the distributee about filing Form 706-GS(D) to report the taxable distribution and pay GST tax. If the NRA-beneficiary does not pay the GST tax, collecting the tax may be very

difficult for the IRS. The trustee has no duty (or authority) to pay the GST tax, and there is no provision for the IRS to hold the trustee responsible for the NRA-beneficiary's refusal to pay GST tax.

- h. ***Basis Considerations.*** Basis adjustment planning considerations are receiving a great deal of attention. Observe that the GST tax has an impact on that planning. For non-exempt trusts, if a taxable termination occurs at a beneficiary's death (for example, when the last non-skip person dies), a GST tax is imposed and a basis adjustment is allowed for all of the trust assets as long as the taxable termination occurs as a result of the death of an individual. §2654(a)(2). (Therefore, there would be no reason to cause estate inclusion for a beneficiary whose death will result in a taxable termination of a non-exempt trust.)

Even for GST non-exempt trusts, though, there may still be reasons to cause estate inclusion for a beneficiary who is not the last surviving non-skip person. For example, if the settlor has two children, a taxable termination will not occur until both children have died. When the first child dies, if that child has excess estate exclusion amount, causing estate inclusion for that child may result in a basis adjustment of the trust assets.

24. FIXING TRUSTS—MODIFYING IRREVOCABLE TRUSTS

- a. ***Overview of Modification Techniques.*** Techniques for modifying irrevocable trusts are construction, reformation, division, amendment, and decanting. For a detailed discussion of the state law requirements for these various techniques, see Items 66-75 of the ACTEC 2012 Summer Meeting Musings found [here](#) and available at www.Bessemer.com/advisor.
- b. ***Which State Law Applies?*** The requirements for each modification technique vary from state to state. Determining the governing state law is therefore important. There may be different governing law that applies for issues regarding validity, construction, or administration of the trust.

With respect to construction, the law designated by the trust settlor generally controls.

For administration issues, the governing law will typically be the law of the place of administration, unless the trust instrument specifically provides otherwise. The power to divide the trust is generally administrative, especially if the trusts have identical terms. Decanting is not as clearly an administrative issue because it can be used to alter the beneficial interests of the trust, but some state laws have designated decanting decisions as being administrative. (The New York decanting statute says that the New York law applies if the trust is administered and at least one trustee is located in New York, even if the instrument says that the law of another state governs administrative issues.)

For a detailed discussion of the trust situs and governing law issues, see Items 76-82 of the ACTEC 2012 Summer Meeting Musings found [here](#) and available at www.Bessemer.com/advisor.

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- c. **Delaware Developments Regarding Governing Law Issues.** Provisions of the Delaware Code relating to decanting, division, and nonjudicial settlement apply to a trust as long as Delaware law governs the administration of the trust. Several recent Delaware Supreme Court cases referred to as the *Peierls* decisions clarify that Delaware law generally will govern the administration of a trust that allows a successor trustee to be appointed unconstrained by geography, once a Delaware trustee is appointed and the trust is administered in Delaware. That is not the case, however, if the governing instrument specifically provides that another state law would always govern the administration trust. A possible constraint is that the *Peierls* decisions provide that if a trust is subject to the continuing jurisdiction of a court in another state, it may be necessary to “obtain the permission of that court to terminate such accountability.” For example, that constraint may apply for testamentary trusts because of the court’s supervision of the probate process. It might also apply to inter vivos trusts if a suit regarding the trust is pending in another state’s court.
- d. **Tax Consequences.** Changes to an irrevocable trust may not be recognized for tax purposes because of (1) the *Bosch* rule, and (2) the completed transaction rule. Under *Bosch*, a state court decision is not binding on the IRS unless the decision is made by the highest state court of last resort (or the decision reflects the position that would be taken by the highest court of the state). The completed transaction rule provides that the tax consequences of a transaction are determined when a transaction is completed, and a later modification will not change the tax result. Construction proceedings, however, determine what is meant by the terms of the instrument retroactive back to the date of the transaction.

Modification actions may cause adverse tax consequences. For example, a modification that reduces the beneficial interest of a beneficiary may be treated as a gift by the beneficiary if the beneficiary’s consent is required. However, if the trustee is permitted to take the action under the terms of the instrument, (for example by making a distribution either under a complete discretion standard or an ascertainable standard) a beneficiary’s consent arguably should be irrelevant as to whether the beneficiary makes a gift.

Various cases have held that *construction* actions were successful in achieving desired results. *Estate of Sawyer v. Commissioner*, 73 T.C. 1 (1979) (marital deduction); PLRs 200045004 (marital deduction); 200006027 (settlor did not have power to replace trustees with herself, so grantor trust avoided); 9729036 (QSST).

Reformation actions to correct scrivener’s errors may correct the tax consequences if the settlor’s intent is clearly established. *Estate of Kraus v. Commissioner*, T.C. Memo. 1990-339 (marital deduction); PLRs 200040012 (modification of trust did not cause loss of GST effective date protection based on the settlor’s intent); 200040012; 200144018; 200201017. A few cases have allowed favorable tax consequences if a reformation was based on what the settlor would have wanted if she had been aware of certain facts or laws. *Berger v. United States*, 46 A.F.T.R.2d 6146 (W.D. Pa. 1980)(rescission); *Neal v. United States*, 82 A.F.T.R.2d 5429 (W.D. Pa. 1998) (release based on §2036(c) could rescinded following the retroactive repeal of

§2036(c)); *Breakiron v. Gudonis*, 2010 U.S. Dist. LEXIS 80888 (Mass. Dist. Ct. 2010)(rescission of disclaimer allowed because of mistaken effect of the disclaimer).

- e. **Pre-Transaction Construction Actions.** In Rev. Rul. 73-142, a settlor reserved the power to remove and replace the trustee with no express limitation on appointing himself, and the trustee held tax sensitive powers that would cause estate inclusion under §§2036 or 2038 if held by the settlor at his death. The settlor obtained a local court construction that the settlor only had the power to remove the trustee once and did not have the power to appoint himself as trustee. After obtaining this ruling, the settlor removed the trustee and appointed another, so the settlor no longer had the removal power. In Revenue Ruling 73-142, the state court determination, which was binding on everyone in the world after the appropriate appeals periods ran, occurred before the taxing event, which would have been the settlor's death. The IRS reasoned that *Bosch* did not apply to this type of situation:

Unlike the situation in *Bosch*, the decree in this case was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death). Thus, while the decree would not be binding on the Government as to questions relating to the grantor's power to appoint himself as trustee prior to the date of the decree, it is controlling after such date since the decree, in and of itself, effectively extinguished the power. In other words, while there may have been a question whether the grantor had such power prior to the decree, there is no question that he did not have the power thereafter." Rev. Rul. 73-142, 1973-1 C.B. 405 (emphasis added).

For a discussion of the important planning ramifications of this Revenue Ruling, see Item 10 of the Heckerling Musings 2012 found [here](#) and available at www.Bessemer.com/advisor.

- f. **Decanting.** For a detailed discussion of the state statutory requirements for decanting and a summary of the income, gift, estate, and GST consequences of decanting, see Items 63-70 of the ACTEC 2013 Annual Meeting Musings found [here](#) and available at www.Bessemer.com/advisor.

If a decanting results in a trust with minor administrative changes, that will likely be viewed as a continuation of the same trust (avoiding the necessity of filing a last tax return for the trust, obtaining a new tax ID number for the new trust, etc.)

Common law authority for decanting was recognized in a Massachusetts opinion in 2013, but the reasoning of the opinion was based on an interpretation of the particular trust instrument, including that the trust instrument authorized the trustee to make distributions to a beneficiary or to apply distributions "for his or her benefit." *Morse v. Kraft et al.*, SJC-11233 (Supreme Judicial Court Suffolk County July 29, 2013). The significance of a clean ruling that common law authorized decanting irrespective of trust language would have been that one of the GST grandfather rules allows transfers to a new trust without invalidating the GST grandfather protection if state law authorized the distributions to the new trust at the time the exempt trust became irrevocable (which for a grandfathered trust would have been on or before September 25, 1985). Reg. §26.2601-1(b)(4)(A)(1)(ii). For an analysis of the *Morse* case, see Item 40 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

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- g. **Statutory Power Release Statutes.** Some states have power release statutes permitting the release of certain tax sensitive powers (for example, Illinois).
 - h. **Example Modification Situations.** Examples of situations in which modification actions might be helpful include: addressing concentrated investment positions; changing the grantor trust status of the trust; utilizing a trust protector; creating a “quiet trust”; extending the duration of the trust; or terminating a credit shelter trust that serves no benefit in light of the increased federal estate tax exclusion amount.

25. RESIDENCE AND DOMICILE ISSUES—STATE INCOME TAX ISSUES

- a. **State Income Taxes—Generally.** Forty-four states have a state income tax. The top rates range from 3.07% (Pennsylvania) to 13.3% (California). State income taxes are quite significant for planning since they are paid every year—not just at death.
- b. **Residence.** State income tax is generally based on residence (rather than domicile). Residents are generally taxable on all income, whereas nonresidents are only taxable on income attributable to real property, tangible personal property, and business activity within the state (typically referred to “source income”). Residence is based on bodily presence. The states vary, but the typical test is to treat an individual as a resident if the individual is physically present in the state for more than 183 days during the year. (Presence anytime during a day counts, unless the presence is merely traveling through the state.) Some states (example, Delaware) also require a place of abode in the state to be a resident. Some states apply their income tax if the individual is either domiciled or a resident of the state,
- c. **Domicile.** A person’s domicile is a place where the person has been physically present and *intends* to remain permanently, and the permanent home to which the person intends to return if the person leaves. State death taxes are typically based on the decedent’s domicile.
- d. **Double Taxation Risk.** Two or more states may claim that an individual is a resident or domiciled in the state, which can result in double taxation. States often provide no credit for taxes paid to another state. Commuters who live in one state and work in another state must be very careful about this. For example, an individual who lives in Pennsylvania but works in Delaware would want to be careful not to purchase a “place of abode” (even a vacation home) in Delaware; otherwise the individual may be taxed both in Delaware and Pennsylvania.
- e. **Changing Domicile.** Domicile is like super glue—it is easy to get on but really hard to get off. To change domicile, the taxpayer must abandon the old domicile, establish a new domicile, and establish the intent to remain at the new domicile indefinitely. That must normally be proven by clear and convincing evidence.

An individual may have to move late in life to be near family members who can assist in caring for the individual. The individual may not have the mental ability to develop the intent to change domicile. If retaining domicile in the original state is preferable, argue that domicile has not changed because of the absence of intent. If changing domicile would be preferable, consider having a guardian appointed who can consent to the change on behalf of the ward.

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- f. **Residence Status for Trusts.** The issue of when states have sufficient nexus with a trust to impose a state income tax on the trust has been considered on constitutional grounds by various courts over the years. See Nenno, *Let My Trustees Go! Planning to Minimize or Avoid State Income Taxes on Trusts*, 46TH HECKERLING INST. ON EST. PL., ch. 15 (2012).

All of the 43 states that tax trusts plus the District of Columbia tax a trust as a “resident trust” based on one or more of the following five criteria: (1) if the trust was created by a resident testator (for a testamentary trust), (2) if the trust was created by a resident trustor (for an inter vivos trust), (3) if the trust is administered in the state, (4) if the trust has a resident fiduciary, and (5) if the trust has a resident beneficiary. Observe that the governing law of the trust is not one of those criteria (except in Louisiana; also in Idaho and North Dakota that is a factor considered along with other factors). A trust included in one of the first two categories is referred to as a “founder state trust” (i.e., the trust is a resident trust if the founder of the trust was a resident of the state).

See Item 20.d of the 2012 Heckerling Musings found [here](#) and available at www.Bessemer.com/Advisor for a summary of the court cases that have addressed the constitutionality of state tax systems that tax trusts based on the testator of a testamentary trust or settlor of an inter vivos trust residing in the state. Based on those cases, most commentators believe that taxing a nonresident trust solely because the testator or settlor was a resident is probably unconstitutional. However, if that state’s court system is utilized, for example, because of a probate proceeding in that state, chances are better that the state does have the authority to tax the trust.

Three state court cases in 2013 have been consistent with this trend—finding that Illinois, New Jersey and Pennsylvania could not tax trusts merely because the settlor was a resident of those states when the trust was created. *Linn v. Dep’t of Revenue*, 2013 IL App (4th) 121055 (Dec. 2013)(no Illinois connections with inter vivos trust other than that the settlor was an Illinois resident when the trust was created; “what happened historically with the trust in Illinois has no bearing on the 2006 tax year”); *Kassner v. Division of Taxation*, 2013 N.J. Tax LEXIS 1 (January 3, 2013)(mere fact that testator of testamentary trust resided in New Jersey not sufficient authority for New Jersey to tax trust on its out of state income [“source income” allocated to New Jersey from S corporation was subject to New Jersey taxation]); *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013) (trust’s “only presence in Pennsylvania was Settlor’s status as a resident in 1959 when he created the Trusts and the residences of the Trusts’ discretionary beneficiaries, neither of which provides the necessary substantial nexus with Pennsylvania for the Trusts to be subject on all of their income. Settlor retained no continuing control or power of appointment over the Trusts’ property and the in-state beneficiaries are discretionary and have no current or future right to the Trusts’ income or assets.”)

Practice Pointer: If a state taxes a trust based solely on the resident status of the settlor when the trust was created, the tax is likely unconstitutional. The planner must decide between filing returns each year and taking the position on the returns that the

trust is not a resident in order to cause a statute of limitations to run (which puts the state taxing authority on notice to audit the return), or not filing with the risk that the state years later could seek taxes, penalties and interest.

26. POWER TO ADJUST OR UNITRUST ELECTION

- a. **Rationale.** The rationale of the power to adjust statutes is that a trustee who invests for total growth under the Uniform Prudent Investor Act may have significant investments in equities to preserve the long-term value of the trust for remaindermen. This may result in diminished trust accounting income (interest, dividends, and rents). Exercising the power to adjust between income and principal or making the unitrust election allows the trustee to invest for total return while still being able to make appropriate adjustments to treat the income and remainder beneficiaries fairly.
- b. **Power to Adjust; Section 104 of UPAIA.** Forty-seven states plus the District of Columbia have statutes permitting the power to adjust. These statutes are crafted based on §104 of the Uniform Principal and Income Act of 1997.

The basic requirements under §104 to be able to exercise the power to adjust are (1) “the trustee invests and manages trust assets as a prudent investor” [this means that the trustee is investing in a “total return” manner under the Uniform Prudent Investor Act—for example, if the trust is invested in a single concentrated position under the direction of an investment advisor, the power to adjust presumably would not apply], (2) “the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income,” and (3) the trustee is otherwise unable to exercise the duty of impartiality between the income beneficiary and remainder persons. UPAIA §104(a).

In exercising the power, the statute lists a number of factors that the trustee “must” consider including the expected duration of the trust, the settlor’s intent, the beneficiaries’ circumstances, the need for liquidity or regularity of income, and “the actual and anticipated effect of economic conditions on principal and income and effects of inflation and deflation.” UPAIA §104(b).

The statute precludes exercise of the power in various circumstances, largely designed to avoid tax consequences (such as diminishing the income interest of a marital trust or if the beneficiary is the trustee or if the trustee would benefit from the adjustment). UPAIA §104(c).

The power to adjust typically is exercised to transfer principal to income but can result in transferring income to principal (for example, in a very high interest-rate environment).

When the power to adjust is exercised, the trustee typically targets a distribution amount approximately equal to some appropriate percentage of the trust assets.

- c. **Does Power to Invade Principal Preclude Exercising Power to Adjust?** If the trust instrument permits distributions of principal as well as income, most trustees prefer to accommodate adjustments between the current and remainder beneficiaries by making principal distributions rather than exercising the power to adjust. However, if there is an

ascertainable standard that would not permit the appropriate principal distributions, the trustee might still want to exercise the power to adjust. Can it do so if there is a principal invasion power?

Some state statutes allow the power to adjust even if there is an invasion power, and list the consideration of that power as a factor that a trustee “may” consider. The UPAIA §104 provision is not totally clear. The second basic requirement under §104(a) is that “the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income.” The Comment to §104 has a paragraph discussing this requirement and gives several example situations that would meet this test, and the last example says the income requirement “will be met because the terms of the trust do not permit the trustee to distribute more than the trust accounting income.” However, the Comment does not **specifically** say the power cannot be exercised if the trustee has the discretion to distribute income and principal. The list of factors that the trustee must consider in deciding whether to exercise the power to adjust specifically includes whether there is a power to invade principal or accumulate income and the extent to which the trustee has invaded principal or income in the past. (That seems to suggest that having the power to invade principal is merely a factor to be considered but does not necessarily preclude exercising a power to adjust.) Some authorities disagree. Gillette, Guzman, & Bruns, *FIDUCIARY ACCOUNTINGS AND THE UNIFORM PRINCIPAL AND INCOME ACT*, at 199 (2014) (“If the trustee has the power to distribute income *and* principal to a beneficiary, however, UPIA § 104 does not authorize the trustee to adjust between income and principal since the understatement or overstatement of the trust’s income does not adversely affect the trust’s beneficiaries.”)

- d. **Unitrust Election.** There is no Uniform Act dealing with the unitrust election, but over 30 states have adopted unitrust election statutes. These allow the trustee to allocate between income and principal at a fixed rate, calculated on the annual fair market value of the trust. Some states provide a range of permissible percentages that the trustee can distribute (3-5%) while others allow only a set percentage (generally 4%).

The unitrust election is less flexible than the power to adjust, and it not as widely used as the power to adjust.

- e. **Process for Power to Adjust Decision.** In deciding whether or not exercise the power to adjust or to make a unitrust election, the trustee must (1) have a process, (2) follow that process, and (3) document the decision. As part of that process, the trustee will need to consider what the trust remainder target should be in order to “exercise the duty of impartiality between the income beneficiary and remainder persons.” Many trustees will target leaving a remainder value equal to the inflation adjusted value of the initial trust corpus. That may differ if the trustee determines that the settlor’s overriding intent is to provide for the current beneficiary for a specified time (or for the beneficiary’s life). In that event, one trust company determines the “ancestral life expectancy” of the individual and adds about 10 years (to account for the fact that wealthier individuals tend to have better health care and live longer than average).

Based on the remainder target, the trustee would balance the choice of the investment portfolio with the unitrust or adjustment amount to adopt a course of action that is

likely to produce the targeted remainder amount. In making that balancing decision, the trustee would consider all of the factors listed in §104(b) of the UPAIA.

The adjustment amount may be reviewed annually. This is more difficult to do with a unitrust.

- f. **Capital Gains in DNI.** The trustee should consider, in connection with the power to adjust, whether to treat capital gains as being in DNI (and therefore taxed to the beneficiary to the extent that distributions “carry out” the capital gains to the beneficiaries who receive distributions). Whether the trust or the beneficiary has to pay income taxes with respect to capital gains may impact the adjustment amount that is chosen. In light of the very compressed tax brackets that apply to trusts for purposes of the regular income tax and the 3.8% surtax, the overall tax costs may decrease by including capital gains in DNI (but not always; for example if the beneficiary lives in a “high tax state” or if the trust has significant capital loss carryforwards). The decision will obviously be impacted by whether the capital gains may be included in income under the IRS regulations. (See Item 9.I above for a discussion of these requirements.)
- g. **Survey of Corporate Fiduciaries.** An anonymous survey of members of the Trust Management Association of the American Bankers Association, completed by 50 institutions, addresses various issues regarding the power to adjust. 70% of the responding institutions reported using the power to adjust or unitrust provisions in less than 10% of trust accounts. 15% reported using them for approximately 20% of accounts. Therefore, the adjustment power is not widely used.

Almost all institutions preferred using a principal invasion power rather than a power to adjust. In order, institutions preferred using (1) a principal invasion power, (2) the power to adjust, and (3) the unitrust election.

Some institutions typically use a single percentage, while others use an available range of percentages, with approval being required for using a percentage outside that range.

For difficult to value assets, a number of institutions seek appraisals of those assets; one does not adjust trusts that hold difficult to value assets.

For family partnership interests in trust, some use the underlying asset value while others use discounted values of the interest, depending on whether the trust holds a minority share. Some institutions will not adjust trusts with family limited partnership interests.

The institutions typically have either never allocated capital gains to DNI or have done so only under unusual or extraordinary circumstances. (That may change in light of the recent income tax and surtax developments.)

27. FUNDING UNFUNDED TESTAMENTARY BYPASS TRUSTS

Mickey Davis (Houston, Texas) addressed complexities that arise in funding testamentary trusts and, in particular, arguments that can be made to reduce estate taxes in the surviving spouse’s estate when the bypass trust has not been funded. The focus in these types of cases may be a fight with the IRS to reduce estate taxes at the surviving spouse’s subsequent death (by claiming that the assets should have been owned by-or were owed to-

the bypass trust). Other times, the fight will be between the remainder beneficiaries of the bypass trust vs. the beneficiaries of the surviving spouse's estate (if they are different).

- a. **Significance.** Through ignorance, laziness, procrastination, or willful misconduct, testamentary trusts may not have been funded. This can become a major estate tax problem at the second spouse's subsequent death if the unfunded trust was a credit shelter trust that should have owned assets (and the growth of those assets) that are in the surviving spouse's gross estate. (Unfunded trusts may arise more frequently in the future when standard formula clauses in wills that have not been updated bequeath formula amounts to bypass trusts that will not be needed to avoid paying estate taxes at the surviving spouse's subsequent death because of the large increase in the estate tax exclusion amount.)
- b. **Tax and Legal Complexities.** The funding process involves a wide variety of tax and legal issues including: (i) impact of the formula structure (e.g., whether the formula amount is a pecuniary amount and the type of pecuniary clause that is used [a true worth, minimum worth, or fairly representative clause] or a fractional share [or "pick and choose" fractional share]), (ii) how selection of the funding date and valuation date can impact amounts allocated, (iii) income tax capital gain recognition that might occur on funding pecuniary bequests (and that capital gain will be subject to the regular tax as well as the 3.8% surtax on net investment income), (iv) how valuation discounts are considered in funding bequests, (v) special income tax effects in the year of the estate's termination, (vi) the deductibility (or more typically, the nondeductibility) of interest on pecuniary bequests, (vi) documenting transfers of assets into the trust, and (vii) obtaining appropriate receipts (and possibly releases).
- c. **"Funding" After Second Spouse's Death.** The surviving spouse's estate may wish to take the position that the assets that should have been in the bypass trust should be excluded from his or her estate. Four theories have emerged as possible rationales.
 - (1) **"Vested in the Bypass Trust" Approach.** The "vested" approach may apply if the assets were left in the original decedent's name and the surviving spouse took no actions inconsistent with ownership by the bypass trust. *Estate of Richard v. Commissioner*, T.C. Memo. 2012-173 (2012)(wife died first with a will leaving stock to a bypass trust for husband; although husband's estate tax return mistakenly included wife's 140 shares of stock, it was clear that they should have been included in wife's estate, and thereafter passed to credit shelter trust created under her will; the shares remained in wife's name and husband took no overt actions to indicate that he owned the shares).
 - (2) **Constructive Trust Approach.** A constructive trust is an equitable principle based on avoiding unjust enrichment. A "constructive trustee" may be ordered to convey to the rightful owner either the property originally impressed with the trust or other property purchased with the proceeds of the sale of the original property. See RESTATEMENT (SECOND) OF TRUSTS §202 (1959). This doctrine may prevent assets wrongfully in a person's name from being included in the person's gross estate. *Stansbury v. United States*, 543 F. Supp. 154 (N.D. Ill. 1982), *aff'd*, 735 F.2d 1367 (7th Cir. 1984). Complexities arise in determining the

amount that should have been in the trust when there have been mutations. Under tracing principles, there may be a presumption against the person who wrongfully held and commingled assets with his own, under which disbursement are deemed to come first from the wrongful owner's own property, maximizing the amount in the constructive trust. Indeed, if the wrongful owner cannot distinguish his or her own funds, the entire commingled fund may become subject to the constructive trust. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT §59 (2011). The IRS, however, may be unwilling to apply this state law principle when the effect is to "reward" the estate of the wrongdoer with a substantial decrease in estate tax liability. The IRS might conceivably argue that the surviving spouse effectively "distributed" the trust assets to himself or herself. A further complexity is whether the trust should have to file back income tax returns for all the years the assets were effectively held in trust.

- (3) *"Claim Against the Estate" Approach.* The surviving spouse, who misappropriated the assets, may be treated as owning the assets while owing a "debt" to the unfunded bypass trust or its remainder beneficiaries that is deductible to the surviving spouse's estate under 2053(a)(3). In *Estate of Bailey v. Commissioner*, 741 F.2d 801 (5th Cir. 1984) father's intestate estate should have passed to his son (\$74,000). Mother kept all of the assets, making over \$900,000 of gifts to the son during her life, and dying with \$1.6 million of assets. Following mother's death, the son argued that mother's estate owed him \$765,000 and claimed an estate tax deduction for that debt. The Tax Court concluded that mother's gifts to son far exceeded the wrongfully withheld inheritance and denied any deduction. The Fifth Circuit held that mother's use of the funds for 30 years gave rise to a constructive trust. The court noted that the gifts to son were reported as gifts of her own property, not as a settlement of the son's claims. The Fifth Circuit remanded to the Tax Court to determine the amount of the claim that was deductible and the Tax Court concluded, after considering expert testimony, that the entire claimed debt deduction was allowed. (The court imprecisely used constructive trust terminology despite the claim being couched in terms of damages.)
- (4) *Resulting Trust Approach.* A resulting trust is an equitable reversionary interest that can arise in two situations: (a) an express trust fails or makes an incomplete disposition, or (b) if one person pays for property and causes title to be taken in the name of another person who is not a natural object of the purchaser's bounty. The first of those theories arose in PLR 9338011. The trustee tired of administering a trust and distributed all of the assets to the income beneficiary, who kept them segregated from her other assets. The ruling concluded that the express trust failed and that a Tennessee court would find that a resulting trust had been created for the income beneficiary during her lifetime with the remainder passing to her issue. Therefore, the assets were not included in the income beneficiary's gross estate.

The statute of limitations to bring a state law cause of action to recover the wrongfully held assets may not run if the remainder beneficiaries were not aware of the lack of funding of the trust.

An advantage of the “debt” approach vs. the “constructive trust” or “resulting trust” approach is that all of the assets are in the surviving spouse’s gross estate (and therefore entitled to a stepped-up basis), even though the debt offsets the amount of estate tax.

An interesting compliance issue that arises is whether the executor must file an estate tax return if the application of any of the three theories other than the debt theory would result in the decedent owning assets worth less than the filing threshold. If no return is filed, no statute of limitations will run.

28. PRACTICAL TIPS IN DEALING WITH AGING CLIENTS (AND DIMINISHED CAPACITY ISSUES)

Robert Fleming (an elder law attorney in Tucson, Arizona) offered helpful practical tips in dealing with aging clients, particularly those who may have dementia issues.

- a. **Significance of Dementia.** Our preconceived notions of dementia are typically incorrect. In fact, very few people (less than 5%) of persons under age 70 have dementia. About half of persons older than about 80 or 85 are demented to some degree.
- b. **Resource.** A wonderful book about dealing with dementia is *The 36-Hour Day: A Family Guide to Caring for People Who Have Alzheimer Disease, Related Dementias, and Memory Loss* by Nancy L. Mace and Peter V. Rabins. Mr. Fleming often gives the book to clients, and they are uniformly appreciative.
- c. **Types of Dementia.** Alzheimer’s disease is characterized by slow and gradual deterioration, whereas Vascular Dementia generally results in a stair-stepped degradation (getting suddenly worse in stages from a series of small strokes). Neither is reversible. Alzheimer’s disease results in about 50% reduction in life expectancy after diagnosis; Vascular Dementia results in about a two-thirds reduction in life expectancy.

A treatable cause of “dementia” (that is not dementia at all) is depression-which can result in confusion, inability to concentrate and limited attention span.

- d. **Practical Tips in Dealing with Aging Clients.** Various conditions other than dementia affect elder clients, including loss of vision, hearing, and attention span to details. Practical tips in dealing with these conditions and dealing with aging clients are as follows.
 - **Seating arrangement.** Sit the client with his back to the window, so that the light is on the planner’s face. The client’s ability to see and hear the planner will be better.
 - **Talking.** When talking, keep your mouth uncovered and do not lean on your head. That makes the client’s ability to understand more difficult to hear. Talk slowly, enunciate and speak loudly. (If the planner asks “can you hear me okay or do you want me to shout?” none will answer to shout.)
 - **Chairs.** Use chairs sitting slightly higher than usual. That makes getting in and out of the chairs easier for aging clients.

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- *Noise machine.* In a small office, have the receptionist turn on a soft noise machine in the reception area so that family members who bring the client to the office will not be able to hear conversations in the conference room.
 - *Baked bread.* Mr. Fleming's office makes bread in a bread machine every morning, leaving a pleasant smell in the office reminding aging clients "of their grandmother's houses."
- e. **Meet With Clients Alone.** Mr. Fleming's best advice is always to have the initial estate planning meeting with the client alone. He sends a confirming letter to prospective clients saying that he is happy for relatives to bring the client to the office, but he will meet with the client alone in the conference room. Upon arriving, if the relative wants to follow to the conference room, say "I want to meet with your father alone for a few minutes first." As the client leaves the office, tell the waiting-relative: "It turns out that we didn't need to talk any further; Mr. ___ agrees that I can share the documents with you once they are prepared. Will you be bringing your parent to the next meeting when he signs the documents?" Reasons for this approach – (1) He wants to be able to testify that he always does that. (2) He had a situation in which the daughter met with her father and him in the client conference, telling him how the father wanted to change his will. Mr. Fleming then said he wanted to talk to father alone for a few minutes. Father got close to him and whispered "don't change the will." What does he do at that point with the daughter? He resolved that day he would never let children in the conference room in the initial meeting with aging clients. Thereafter, he has had two clients leave because of this approach; the children bolted into the conference room five minutes after the conference began and said they did not want to use him as the attorney. That confirmed for him that he was using the right approach.
- f. **Capacity to Engage in Estate Planning.** A diagnosis of dementia does not mean that the client can no longer engage in estate planning. The client may still have testamentary and contractual capacity. Two commonly used tests used by the medical community for testing mental ability are: (1) the Folstein mental test (a brief 30-point questionnaire, such as giving a patient a three-step instruction like "take this paper in your right hand, fold it in half, and lay it on the floor"); and (2) the Short Portable Mental Status Questionnaire (SPMSQ). Attorneys should not give those tests unless they are trained to do so. (They don't determine legal capacity anyway.) If possible, work into the conversation off-hand questions about things such as the client's mother's middle name, today's date, the day of the week, the prior President's name, etc. (though that can be hard to work into normal conversation). When asking questions about what the client wants to do, don't ask questions that can be answered with a simple "yes." A declining client may answer "yes" to everything. If a question is a yes-no question, ask the question again later in a way that would require a "no" answer.
- g. **Undue Influence.** Attorneys are sensitive to capacity issues, but undue influence is harder to determine, because the attorney does not know the "back story" of what is going on at the client's home. All influence is not "undue"—relatives and friends do influence each other. Look out particularly for exploitation.

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- h. **Ethics Issues.** Model Rule 1.14 addresses clients with diminished capacity. The attorney's obligation is to make the smallest accommodation possible to have as normal a relationship as possible with the client. There are exceptions if the attorney is worried about the client's safety or financial well being, in which event the attorney may share confidential information, but only to the extent reasonably necessary to protect the client's interests. The comment to Rule 1.14 lists a variety of actions the attorney can take, from consulting with family members (and having such persons participate in discussions with the client "generally does not affect the applicability of the attorney-client privilege") through instituting guardianship proceedings.

Other applicable ethics rules are Rule 1.6 (client confidentiality) and Rule 1.7 conflicts.

As to conflicts, the attorney cannot represent family members who want to become a successor fiduciary to the client; taking over a fiduciary responsibility is adverse to the client and attorneys cannot assume representation of matters adverse to existing clients. (The practical reality is that if the attorney advises the child about the parent's trust and financial affairs, and receives a call from the parent saying that the child has stolen from the parent, the attorney could not represent either of them.)

- i. **Standard for Substituted Agents Acting on Behalf of Principal.** The modern trend is to act under a "substitute judgment" standard—meaning to do what the client would likely do if she could arise out of her fog for a few moments. This is contrasted with a "best interests" standard of what the agent thinks is best.
- j. **POLST.** A growing trend in the medical community is to have "Physicians Orders on Life-Sustaining Treatment." It is a community based "do not resuscitate" order. It is a standardized single page form documenting a conversation between a doctor and seriously ill patient or the patient's surrogate decision maker, signed by the doctor (and sometimes by the patient). It is different from an Advance Directive in that it is designed to be actionable throughout the entire community by doctors and first responders. About half of the states have POLST directives.

29. GIFTS OF FRACTIONAL INTERESTS IN ART

Estate of Elkins, 140 T.C. No. 5 (2013) held that fractional interest discounts for art can be allowed, but determined that the appropriate discount was only 10%. The court concluded that the Elkins children would be anxious to acquire the decedent's fractional interest to preserve for themselves 100% ownership and possession of the art, and that a hypothetical willing buyer and seller of decedent's interest in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. It allowed a nominal 10% discount because a hypothetical purchaser could not be certain that the Elkins children would agree to pay the full pro rata fair market value for those interests. That reasoning seems to violate the principle of not basing valuation on what a strategic buyer would pay for the asset. For a more complete analysis of the *Elkins* case Item 36 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

Jeff Pennell was told by an experienced art dealer that creating fractional interests in art is not a great idea. Jeff gives two reasons. (1) If the client will keep the art year-round, the

client must pay a fair rental value (to avoid §2036 if the client has made gifts of the fractional interests), and there is no mechanism to determine the fair rental value of fine art. (2) Collectors of fine art may at some point want to borrow against the collateral of their existing collections and holding mere fractional interests in the art could impede their ability to borrow in the future.

30. MANDATORY INCOME REQUIREMENT FOR MARITAL TRUST

- a. ***Mandatory Income Requirement for QTIP and General Power of Appointment Marital Trusts.*** QTIP trusts and “general power of appointment marital trusts” require that the spouse be entitled to all of the income from the trust. §§2056(b)(5), 2056(b)(7)(B)(ii).
- b. ***Alternate Ways of Satisfying Mandatory Income Requirement.*** The regulations regarding general power of appointment and QTIP marital trusts provide alternate methods to satisfy the “all income” requirement. The spouse must have “that degree of beneficial enjoyment ... which the principles of the law of trusts accord ... the life beneficiary of a trust.” Reg. §§20.2056(b)-5(f)(1), 20.2056(b)-7(d)(2). Problems arise if the trust consists of property that is not likely to be income producing. The regulations provide three alternatives.
 - (1) ***Right to require trustee to convert to income producing property.*** The method that is typically included in trusts is to give the surviving spouse the right to require “that the trustee either make the property productive or convert it within a reasonable time.” Reg. §§20.2056(b)-5(f)(4), 20.2056(b)-7(d)(2). However, in some circumstances, a testator may not want to give the surviving spouse the power to force the trustee to sell the favored estate asset that happens not to be income productive.
 - (2) ***Right to use trust property.*** Another alternative if the trust does not produce “such an income” is “that the spouse should have such use of the trust property as is consistent with the value of the trust corpus and with its preservation.” Reg. §§20.2056(b)-5(f)(1), 20.2056(b)-7(d)(2). If the trust consists of property that can be used by the surviving spouse (*i.e.*, real estate or tangible personal property), the income requirement could be satisfied by allowing the spouse to use that property.
 - (3) ***Spouse can require trustee to provide enjoyment out of other assets.*** A third alternative that is not often used but that may be quite helpful if a testator wants to leave nonproductive property into a marital trust that the spouse cannot force the trustee to sell is if “the applicable rules for the administration require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment, such as payments to the spouse out of other assets of the trust.” Reg. §§20.2056(b)-5(f)(5), 20.2056(b)-7(d)(2). Thus, the will could merely give the surviving spouse the right to require that the trustee distribute to the spouse an amount equivalent to receiving reasonable income. Perhaps this could be described as an amount equal to what the trust income would be if the trust held what is deemed to be productive property under state law.

31. MALPRACTICE ISSUES FROM REVIEWING DOCUMENTS PREPARED BY OTHERS

- a. **Review Document Carefully.** If a planner reviews a document prepared by someone else, the planner must review the document VERY carefully. The document may have provisions buried in the boilerplate that cause problems, or the instrument may omit clauses that are important for technical reasons. It can be much more difficult to review someone else's document than to draft documents using forms that the planner has spent hundreds of hours perfecting.
- b. **Do Not Ignore Remediation Alternatives.** If a problem is spotted, do not ignore planning alternatives that solve or minimize the problem. For examples, disclaimers, tax elections, etc. may be able to solve the problem. If the reviewing planner does not do that, the reviewing planner may have malpractice concerns.

When representing an attorney who has been accused of malpractice because of problems in a document, look very closely to see if the reviewing attorney did anything to cause a problem or failed to take steps that could have ameliorated the problem. If so, when the reviewing attorney's failure is pointed out, the reviewing attorney suddenly becomes very cooperative in trying to solve the problem and working together instead of just pointing fingers. "Do not become a co-owner of the malpractice."

- c. **Advise of Statute of Limitations.** If a potential malpractice problem is spotted, advise the client promptly of the concern and that there are statutes of limitations on malpractice actions (often only one or two years). Make clear that the client should hire an attorney who is experienced in handling malpractice cases.
- d. **Engagement Letter Scope Limitation.** One panelist says that if he is approached to review a potential problem situation, his engagement letter typically excludes filing a malpractice action against another attorney.

32. RECENT CASES ADDRESSING ASSET PROTECTION PLANNING AND DOMESTIC ASSET PROTECTION TRUSTS

- a. **No Cases Yet Recognizing Effectiveness of Domestic Asset Protection Trusts.** Prof. Jeff Pennell points out that there have been eight cases over the last two years addressing asset protection issues, some involving trusts created under the laws of states that recognize "domestic asset protection trusts," and none of them recognized the effectiveness of the transfers against creditors' claims.
- b. **Eight "DAPT Cases" Over Last Two Years.** The eight cases mentioned by Prof. Pennell are listed.

United States v. Evseroff, (2d Cir. June 26, 2013)(fraudulent conveyance case; affirmed district court finding that transfers were actually fraudulent).

Kilker v. Stillman, 2012 WL 5902348 (Cal. App. 4 Dist., Nov. 26, 2012)(unpublished)(fraudulent conveyance; debtor transferred "virtually all of his assets" other than \$500 to a trust for "asset protection and so that his creditors could not go after any equity").

U.S. v. Spencer, No. 10-CV-229 (N.D. Okla. Oct. 2, 2012); *U.S. v. Walters*, (N.D. Okla.) (actual fraudulent conveyance; related cases in which accountant Walter was found to have aided and abetted Spencer in a fraudulent conveyance).

Matter of Morris, 2013 WL 6598701 (Calif. Bar. Ct., unpublished, Dec. 4, 2013)(attorney suspended from practice of law for two years for aiding and abetting in fraudulent transfer; did not involve a transfer to a trust); see Jay Adkisson & David Slenn, *Matter of Morris*, LEIMBERG ASSET PROTECTION PLANNING NEWSLETTER #236 (Feb. 3, 2014).

Battley v. Mortensen, Adv. D. Alaska, No. A09-90036-DMD (Bankruptcy Ct. 2011) (allowed the bankruptcy trustee to recover assets transferred to an Alaska “self-settled trust” under the 10-year “clawback” provisions of §548(e) of the Bankruptcy Act).

In re Huber, 2013 WL 2154218 (Bankr. W.D. Wash., May 17, 2013)(Washington real estate developer created Alaska asset protection trust in 2008 when he was aware of collapsing housing market and that his prospects for repaying loans was fragile at best; trust found to be a fraudulent transfer voidable under both §544(b)(1) [state law fraudulent transfers] and §548(e) [transfer made within 10 years of filing petition for bankruptcy to a self-settled trust or similar device if made with actual intent to defraud creditors]; trust also held invalid under conflict of laws analysis because trust had its most significant relationship with Washington, citing §270 of Restatement (Second) of Conflict of Laws and Washington had strong public policy against “asset protection trusts”).

Rush University Medical Center v. Sessions, 2012 Ill. 112906 (Ill. Sept. 20, 2012)(egregious fact situation in which an individual transferred almost all of his assets to a Cook Islands trust of which the settlor was a discretionary beneficiary, knowing that he had made a large charitable pledge and that his remaining assets would not be sufficient for his estate to satisfy the pledge; court did not address which jurisdiction’s law should apply under relevant conflict of laws principles, but held that the state’s passage of a fraudulent conveyance statute did not supersede Illinois common law principles allowing the creditors of a settlor to reach trust assets to the extent that the trust assets could be distributed to the settlor; the Cook Islands trust owned real estate in Illinois that had sufficient value to satisfy the judgment, so apparently there was no issue about having to enforce the judgment in the Cook Islands; case has caused concern among some planners about whether transfers to domestic asset protection trusts might arguably be incomplete gifts if the settlor resides and has assets in another jurisdiction that does not have “self-settled trust” legislation).

Watterson v. Burnard, 986 N.E.2d (Ct. App. Ohio, Feb. 1, 2013)(litigation commenced when settlor of revocable trust was alive; under Ohio law creditors could reach revocable trust assets while settlor was alive; held that creditor could reach revocable trust asset after settlor had died to the same extent the settlor could have accessed the trust assets during his or her lifetime).

- c. **Proponents’ Counter-Arguments.** Proponents of DAPTs respond that all of those cases involve either (i) fraudulent transfers, (ii) Bankruptcy cases (in which there is a 10-

year “clawback” rule for transfers to self-settled trusts with intent to hinder, delay or defraud creditors), or (iii) a revocable trust.

The also point out that *Dahl v. Dahl*, Civ. No. 090402989 (4th Judicial Dist. Utah Cy, Utah, Nov. 1, 2011) might be read to support domestic asset protection trusts. A Utah resident created a trust under the laws of Nevada, applying Nevada laws. The settlor’s wife unsuccessfully (so far) attacked the trust in a divorce action. That case is now under appeal. See generally Steve Oshins & Jeremy Spackman, *Dahl v. Dahl: Status of Favorable Nevada Self-Settled Asset Protection Trust Case*, LEIMBERG ASSET PROTECTION NEWSLETTER NO. 227 (July 3, 2013). However, some commentators do not view that case as being a DAPT case but an inquiry into whether the claimant was a discretionary beneficiary and whether the trust was irrevocable or revocable (and the summary judgment determined that the choice of Nevada law controlled for purposes of determining whether the trust was irrevocable). See Jay Adkisson, *Why Dahl Doesn’t Support the Viability of Domestic Asset Protection Trusts*, FORBES (JULY 10, 2013). In any event, trust assets have not been reached by a claimant.

Furthermore, proponents indicate that there have been many situations in which persons who created DAPTs have been able to negotiate very favorable settlements with creditors.

- d. **Concern for Potential Tax Implications.** If courts ultimately determine that DAPTs are not effective (and more particularly, whether a settlor who lives in a state that does not have a DAPT statute can create a trust choosing law of a DAPT state that will be effective against the settlor’s creditors), there may be important tax implications.

For example, an individual may wish to create a grantor trust and give an independent trustee the discretion to reimburse the grantor for income taxes attributable to the trust. If the creditors of the settlor can reach the trust assets because of the trustee’s discretion to make payments to the grantor in reimbursement of income taxes, question could arise as to whether the transfer was a completed gift and as to whether some portion of the trust assets would be included in the individual’s gross estate. Some states, such as Texas and Virginia, have revised their statutes to provide that a settlor’s creditors may not reach trust assets if the trustee’s discretion to make payments to the settlor is limited to reimbursement of income tax liabilities for a grantor trust.

Another example could arise with “spousal lifetime access trusts” in which the donee-spouse exercises a testamentary power of appointment to appoint the assets to a trust for the benefit of the original donor-spouse. Under the “relation back doctrine” the donor-spouse is treated under the laws of many states as the settlor of the new trust, which might give the settlor’s creditors access to the trust unless it is a DAPT. (Some states [Arizona, Ohio and Texas among others] have revised their statutes to provide a different result, and would not treat the original donor-spouse as the settlor of the new trust for creditor rights purposes in that situation.) For a discussion of this issue, see Item 15.c-d of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

Panelists expressed concern that the creditor cases are often “bad facts” abusive cases in which courts may be inclined to rule against the protection of trust assets. “There is a bias in the system to go after crooks.” If DAPT trusts are not recognized as being effective in these “bad facts” cases, the IRS might cite those “bad facts-bad law” cases to assert that §2306 applies in other cases.

33. IRS VALUATION ART PANEL

The Art Advisory Panel of the Commissioner of Internal Revenue is a group of art experts assembled by the IRS to review art appraisals from taxpayers and make recommendations to the Art Appraisal Services unit in the Office of Appeals of the IRS. The Art Panel does not know whether a particular case is one in which the taxpayer wants a high value (an income tax charitable deduction case) or in which the taxpayer wants a low value (a gift or estate tax case), but general understanding is that Art Panel experts can often tell (either from the context surrounding the appraisals submitted to the Panel, or because the panelists know significant items that have been given to museums over the last several years). The Panel usually looks at art valued at \$50,000 or more. The Panel just released its fiscal year 2012 report. It reviewed 444 items in 43 different cases. The total value reviewed was about \$282 million and the Panel suggested total net adjustments of about \$66 million. It recommended accepting 51% and recommended adjustments to 49% of the appraisals it reviewed. On the adjusted items, the Panel recommended a net 52% reduction on the charitable contribution appraisals and a net 47% increase on items in estate and gift tax appraisals.

34. INTEREST ON GRAEGIN LOAN NOT DEDUCTIBLE; MAJORITY INTEREST IN LLC VALUED WITH LOW MARKETABILITY DISCOUNT, *ESTATE OF KOONS V. COMMISSIONER*, T.C. MEMO. 2013-94

For a more complete description of *Estate of Koons v. Commissioner*, T.C. Memo. 2013-94, see Item 38 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

- a. **Low 7.5% Lack of Marketability Discount.** *Estate of Koons v. Commissioner* allowed only a 7.5% marketability discount in valuing the stock in a closely held company owned by the decedent’s revocable trust. The low discount was largely based on the fact that the decedent’s children had agreed to have their interests redeemed before the decedent’s death; when the redemption was completed soon after the decedent’s death, the decedent’s revocable trust owned a controlling interest.
- b. **No Interest Deduction Allowed on Graegin Note.** In addition, the court disallowed a \$71.4 million interest deduction for estate tax purposes on a \$10.75 million note documenting a loan that the estate borrowed from an LLC controlled by the decedent’s revocable trust. The note provided for interest at 9.5% per year with principal and interest due in equal installments to be paid over 6 ½ years, but the payments would not begin for over 18 years. The court reasoned that the revocable trust could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate’s only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave

the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years “hinders the ‘proper settlement’ of the Estate.”

35. NET GIFT OFFSET BY DONEE’S ASSUMPTION OF POTENTIAL §2035(b) ESTATE TAX LIABILITY IF DONOR DIES WITHIN THREE YEARS, *STEINBERG V. COMMISSIONER*

- a. **Synopsis.** The donor made gifts in 2007 to her four adult daughters, with the donees agreeing to pay two separate liabilities of the donor (hence, these types of gifts have been referred to as “net, net gifts”): (1) the federal gift tax imposed as a result of the gifts, and (2) any federal or state estate tax liability imposed under § 2035(b) if the donor died within three years of making the gifts. The only issue in this summary judgment action requested by the IRS is whether the second element, the assumption of any estate tax liability under § 2035(b) if the donor died within three years, may constitute consideration in money or money’s worth that can be subtracted in determining the amount of the gift under § 2512(b). *Steinberg v. Commissioner*, 141 T.C. No. 8 (Sept. 30, 2013).

The majority opinion (joined by eight judges) denied the IRS’s summary judgment motion. The majority reconsidered and reversed the Tax Court’s position in *McCord*, reasoning that the potential estate tax liability was not too speculative to consider and that the § 2035(b) liability assumption satisfied the estate depletion theory because it would replenish the estate by relieving it of such estate tax liability. The majority concluded that there are genuine disputes of material fact as to whether the donees’ assumption of potential §2035(b) estate tax liability constituted consideration in money or money’s worth, and that the court would no longer follow its prior position in *McCord*.

A concurring opinion (joined by six judges) believed that the IRS might be able to establish at trial that the § 2035(b) liability assumption, under the surrounding facts of the case, was merely a method of apportioning estate taxes among the estate beneficiaries, or might be considered as merely adding some additional enforcement mechanisms beyond the state apportionment statute that apportions § 2035(b) liability to donees of gifts that give rise to such liability.

A dissenting opinion (by Judge Halpern) maintained that allowing an offset for the assumption of potential estate tax liability under § 2035(b) would frustrate the purpose of § 2035(b), which is to mitigate in part the disparity between the tax bases subject to gift tax and estate tax.

- b. **Donee’s Assumption of Potential §2035(b) Estate Tax Liability is not Typical.** Having the donee assume the potential § 2035(b) estate tax liability typically results in a relatively small gift offset (depending on the age of the donor). Unless the donor is quite elderly, the actuarial likelihood of dying within three years is small enough that the present value of this assumption of potential liability results in a relatively low offset of the gift amount. (However, for an 89 year old individual—as in *Steinberg*—the gift offset can be significant; it was an offset of \$5.8 million for a \$71.6 million

net, net gift in Steinberg.) For a younger donor, it would be a much lower gift offset, but the estate inclusion might still be the full § 2035(b) liability if the donor in fact dies within three years. The donor may not want to take that potential estate tax risk in return for a relatively small gift tax reduction.

- c. **Detailed Analysis.** For a detailed analysis of *Steinberg*, and a calculation approach for valuing the net gift if a donee assumes the potential §2035(b) estate tax liability, see Item 42 of the Hot Topics and Current Developments Summary (December 2013) found [here](#) and available at www.Bessemer.com/Advisor.

36. RECIPROCAL POWERS, PLRs 201345004, 201345026, 201345027, 201345028.

Each of PLRs 201345004, 201345026, 201345027, and 201345028, involving the same fact pattern, permitted the modification of irrevocable pre-1985 trusts to add a “distribution trustee” who could make distributions in addition to an independent trustee to the beneficiary under a non-ascertainable standard. The facts of the PLRs stipulated that the distribution trustee could not be a related or subordinate party, and “a cousin cannot serve as a Distribution Trustee for a trust if the beneficiary is serving as the Distribution Trustee for the cousin’s trust.” The rulings concluded that the beneficiaries would not have §2041 general powers of appointment and the GST grandfathered status of the trust was preserved. There is no way of knowing whether the IRS required the limitation of not having reciprocal cousins as trustees of each other’s trust as a condition on granting a favorable ruling. In any event, these PLRs serve as a reminder of the potential “reciprocal powers” IRS argument.

The 1969 *Grace* case (395 U.S. 316) involved reciprocal interests rather than powers. Subsequent cases have differed regarding whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under §§2036(a)(2) or 2038. *Estate of Bischoff v. Commissioner*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to §§2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. U.S.*, 694 F.2d 1261 (Fed. Cir. 1984); Tech. Adv. Memo. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Commissioner*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).

37. VALUATION OF INVESTMENT HOLDING COMPANY; VALUATION METHOD, BUILT-IN GAINS TAX ADJUSTMENT, LACK OF CONTROL AND MARKETABILITY DISCOUNTS, AND UNDERVALUATION PENALTY, *ESTATE OF RICHMOND V. COMMISSIONER*, T.C. MEMO 2014-26

- a. **Brief Synopsis.** The decedent’s 23.44% interest in a closely-held investment holding company (a C corporation) that owned \$52 million of publicly traded securities was determined. *Estate of Helen P. Richmond v. Commissioner*, T.C. Memo 2014-26 (February 11, 2014) (Judge Gustafson). The court rejected the estate’s approach of valuing the company based on a capitalization of the dividends, reasoning that the net asset value approach was more appropriate for a non-operating company that held publicly traded stock.

The court determined the present value of the built-in gains (“BIG”) tax at the entity level, rather than just including a BIG tax discount as part of the marketability discount. A dollar-for-dollar liability offset was not allowed (the case is not appealable to either the 5th or 11th Circuits, which allow dollar-for-dollar discounts). The court examined the present value of the BIG tax by assuming the stock portfolio would be sold over 20 and 30-year periods and by using various discount rate assumptions. (The court did not consider the built-in gains tax on future appreciation in its analysis.) The BIG liability allowed by the court was 43.16% of the total BIG tax liability if all of the assets had been sold immediately at the date of the decedent’s death.

The lack of control discount (7.75%) was determined by reference to reference to closed-end fund studies (both parties agreed to that approach).

The lack of marketability discount (32.1%) was determined based on data from restricted stock/pre-IPO stock studies (which produced discounts ranging from 26.4% to 35.6%, with an average of 32.1%). Both side’s experts used on those same studies.

The estate did not meet its burden of proving reasonable cause to avoid a 20% undervaluation penalty. The Form 706 used as the value for the stock the value conclusion on an unsigned draft report by an accountant who had some experience preparing appraisals (having written 10-20 valuation reports) but who did not have any appraiser certifications.

- b. **Basic Facts.** The decedent died on December 10, 2005 owning a 23.44% interest in a 77-year old family-owned investment holding company that owned a \$52 million portfolio of publicly traded securities. The company had a long history of paying dividends, with the dividends increasing by about 5% per year. The corporation was a C corporation with about \$45 million of unrealized appreciation. The parties agreed that the capital gains tax liability on that appreciation (when the assets were sold) was \$18,113,083, based on a 39.74% combined federal and state tax rate. However, the stock would not likely be sold for many years; the company had turnover rate of about 1.4% per year, which would suggest that a complete turnover of the securities would take 70 years. The company’s financial advisor periodically recommended that the company sell substantial amounts of its securities to diversify the portfolio, but the company never did so because of the BIG tax liability that it would incur on selling the stock.

The executors engaged an accountant to value the decedent’s interest in the company. The accountant had prepared 10-20 valuation reports and had testified in court, but did not have any appraiser certifications. He used a capitalization of dividends method. An unsigned draft of his valuation report valued the decedent’s interest at about \$3.1 million. He was never asked to finalize the report and without further consultation, the estate reported the decedent’s interest in the stock at the \$3.1 million amount on her estate tax return.

The IRS’s deficiency notice valued the stock interest at about \$9.2 million and assessed a 40% valuation misstatement penalty. At trial, the estate used a different valuation expert, who valued the stock at \$5 million. The IRS’s valuation expert at trial valued the stock at \$7.3 million, and the IRS acknowledged at trial that the 40%

gross valuation misstatement penalty does not apply, but that the 20% substantial valuation understatement penalty applies.

- c. **Burden of Proof.** The estate argued that the burden of proof shifted to the IRS, but the court decided the case on the preponderance of the evidence.
- d. **Estate's Valuation Approach.** The estate argued that the company should be valued on a capitalization of dividends approach in light of the fact that the company had an established reliable history of paying dividends. The expert used a capitalization rate of 5.25% (determined by subtracting the 5% annual dividend growth rate from the 10.25% market rate of return for a comparable risk investment). That approach produced a value of the decedent's interest of \$5.046 million. The estate's expert also calculated the company under a net asset value approach to corroborate the reasonableness of the valuation approach. The net value approach produced a value of \$4.722 million (but relied on a dollar-for-dollar BIG tax reduction, an 8% lack of control discount, and a 35.6% lack of marketability discount).
- e. **IRS's Valuation Approach.** The IRS's expert used a net asset method, with a 6% lack of control discount and a 36% lack of marketability discount that included a 15% discount for the BIG tax liability. The IRS expert's value was \$7.33 million.
- f. **Net Asset Valuation Approach Adopted.** The court reasoned that the dividend capitalization approach "may be entirely appropriate where a company's assets are difficult to value." However, the capitalization of dividends method "is based entirely on estimates about the future," and the result is extremely sensitive to variations in the assumptions that are made. (To support this reasoning, the court quotes a well-known business valuation treatise co-authored by the estate's expert.) "The estate's valuation method therefore ignores the most concrete and reliable data of value that are available--i.e., the actual market prices of the publicly traded securities that constituted PHC's portfolio." The net asset value ("NAV") method relies on assumptions of appropriate discounts, "but the NAV method does begin by standing on firm ground--stock values that one can simply look up." A hypothetical willing buyer would take into consideration not only the actual dividends paid but that the company's assets consisted of securities that "without controversy" totaled \$52 million. The court concludes: "For such reasons, courts are overwhelmingly inclined to use the NAV method for holding companies whose assets are marketable securities" (citing *Estate of Litchfield v. Commissioner* (2009), *Estate of Smith v. Commissioner* (1999), and *Estate of Ford v. Commissioner* (1993)). The cases cited by the estate to justify using the capitalization of dividends approach all involved companies that were operating companies or owned stock in closely held operating companies whose underlying assets were difficult to value.
- g. **Built-In Gains Liability.** The company had unrealized appreciation of about \$45.58 million, which the parties agreed would produced a BIG tax of about \$18.1 million, assuming a 39.74% combined federal and state tax rate.

The Notice of Deficiency allowed *no* discount for the BIG tax, "a position that the Commissioner does not defend, and for good reason." The court summarized why taking into account the BIG tax in some manner is required:

An investor could have easily replicated PHC in December 2005 by contributing \$52 million to his own new holding company and then having it purchase the very same types of securities that were in PHC's portfolio. No investor interested in owning such a company would have been indifferent to the fact that acquiring PHC meant acquiring an eventual liability of \$18.1 million. An investor would therefore have insisted on paying less than \$52 million to acquire PHC; if PHC had offered no discount, an investor would simply buy the stocks and be better off. That is, the market would have required a discount, and any fair market valuation must reflect a discount.

The court noted that the case would be appealable to the 3rd Circuit and rejected the dollar-for-dollar approach that has been adopted by the 5th Circuit (*Estate of Dunn v. Commissioner* and *Estate of Jameson v. Commissioner*) and the 11th Circuit (*Estate of Jelke*).

[A] prospective BICG tax liability is not the same as a debt that really does immediately reduce the value of a company dollar for dollar. A 100% discount, on the other hand, illogically treats a potential liability that is susceptible of indefinite postponement as if it were the same as an accrued liability due immediately. We do not adopt this approach.

The dollar-for-dollar approach has been rejected by the 2nd Circuit (*Estate of Eisenberg v. Commissioner*) and 6th Circuit (*Estate of Welch v. Commissioner*) as well as in prior Tax Court cases.

The court rejected the IRS's expert's approach of merely including the BIG tax reduction as a part of the lack of marketability discount, reasoning that the marketability discount is applied at the individual level. The BIG tax liability, on the other hand "is a liability of the entity, which affects its net asset value [and] we find it appropriate to determine the BICG tax liability at the entity level." (Footnote 20.) The court rejected the IRS expert's method of arriving at a 15% BIG tax discount, but made present value calculations assuming the portfolio would be sold over 20 or 30 years periods (based on the IRS expert's testimony that a potential investor would expect the portfolio to be turned over within a period of 20 to 30 years, because the estate offered no other evidence as to an expected turnover period that a hypothetical willing buyer would assume). Based on various assumed discount rates with assumed turnover periods of 20 and 30 years, the court calculated present values of the BIG tax liability ranging from \$5.5 million to 9.6 million. Because the IRS's expert's number (and the IRS concession) of \$7.8 million falls within that range, the court uses that as the BIG tax present value liability in determining the net asset value of the company.

The court made no mention at all of whether the BIG tax liability should take into account future assumed appreciation in the portfolio, requiring a greater tax liability in the future as opposed to an investor who could simply acquire the same pro rata portfolio and would not incur the corporate "double tax" on the subsequent appreciation.

- h. **Lack of Control Discount.** Both sides' experts used closed-end funds studies (based on 59 different closed-end funds) to determine the lack of control discount. (This is a traditional widely-accepted approach to determining lack of control discounts.) The estate's expert selected the mean discount number (8.0%), but the court adjusted the discount by throwing out three outliers (the two highest values and the lowest value) and using the resulting mean discount, 7.75%. (The court made no attempt to determine which of the 59 funds best matched the investment holding company being

valued, or to compare the professional management advantages of typical closed end funds as compared to the investment holding company with its simple “buy and hold forever” strategy, or to compare the sizes of the closed-end funds to the investment company. Any of those factors may have increased the size of the discount from the simple mean of the averages.)

- i. ***Lack of Marketability Discount.*** The court clearly explains the rationale for the lack of marketability discount:

A prospective investor is likely to pay more for an asset that will be easy to sell and less for an asset that may be difficult to sell. In this case, PHC owns easy-to-sell publicly traded stocks; but we value an interest in PHC itself, which is a family-owned, non-publicly traded company the stock of which has no ready market. The parties agree that a marketability discount--i.e., a discount attributable to the cost and difficulty of finding a willing buyer for a non-traded closely held interest--is appropriate here if PHC is valued by a net asset valuation method.

Both experts used seven studies of restricted or pre-IPO stock, comparing the selling prices of restricted or pre-IPO stock with the selling prices of unrestricted or post-IPO shares. The studies produced discounts ranging from 26.4% to 35.6%, with an average discount of 32.1%. The IRS expert used the lowest of that range, 26.4%, and reduced it further for several reasons. The estate’s expert used the very highest of that range, 35.6%, arguing that stock that would be owned indefinitely should be entitled to even more discount than stock whose public trading is restricted for only a defined period. The court used the average of the studies, 32.1%.

(As with the lack of control discount, the court made no attempt to consider the unique characteristics of the investment holding company being valued as compared to the companies involved in the restricted stock/pre-IPO studies. The opinion indicates that there was testimony by the estate’s expert as to various factors suggesting that the marketability discount should be higher than just the mean of the averages produced by the various studies involving restricted stock or pre-IPO stock, both of which would seem to have significantly greater prospects of being much more marketable within a relatively short time frame as compared to owning an interest in a 78-year old closely-held company that has never had a public market.)

- j. ***Seriatim Calculation Approach.*** The court determined the value of the decedent's interest in the stock, using the net asset value method, with the following approach, applying the lack of control and marketability discounts in a "seriatim" manner:

Value of assets less liabilities	52,144,041
- Present value of BIG tax liability	- <u>7,817,106</u>
= Net asset value	44,296,935
X % of stock owned by decedent	<u>0.2344</u>
=	10,383,202
- Lack of control discount (7.75% of 10,383,202)	- <u>804,698</u>
	9,578,504
- Lack of marketability discount (32.1% of \$9,578,504)	- <u>3,074,700</u>
= Value of decedent's interest	6,503,804

- k. ***No Reasonable Cause to Waive Substantial Underpayment Penalty.*** The 20% substantial valuation misstatement penalty does not apply if there is reasonable cause and good faith by the taxpayer. §6664(c)(1). Even though the estate hired an accountant to provide the valuation number that was used on the Form 706, the court held that did not constitute reasonable cause. Treasury Regulations make clear the "[r]easonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property." Reg. §1.6664-4(b)(i).

The court cited several reasons for its conclusion that the accountant's activities did not support a reasonable cause and good faith position by the estate. (1) The accountant had some appraisal expertise but did not have any appraisal certifications. (2) The accountant testified at trial but "[t]he estate did not proffer him as an expert witness and did not demonstrate that he is qualified as an expert in valuation." (3) The estate merely used the number on the unsigned draft report. (4) The estate never discussed how the accountant arrived at the value used other than that two prior transactions used the capitalization of dividends approach. (5) The estate did not explain what defects in the accountant's valuation resulted in the initial \$3.1 million value being abandoned at trial in favor of the higher \$5 million value, so the value on the Form 706 "is essentially unexplained."

The court in particular emphasized the fact that the estate did not rely on a certified appraiser:

In order to be able to invoke "reasonable cause" in a case of this difficulty and magnitude, the estate needed to have the decedent's interest in PHC appraised by a certified appraiser. It did not.

The estate had the burden of proving that it acted with reasonable cause and good faith and it "failed to make such a showing."

I. Observations.

- (1) *Primer on Valuation of Interest in Closely-Held Investment Holding Company.* The court's opinion very clearly explains the process for valuing an interest in a closely-held investment holding company that consists predominantly of publicly-traded securities, including the rationale for use of the net asset value method and the rationale for the BIG tax value reduction and the lack of control and marketability discounts.
- (2) *Danger of "Going Cheap" on Appraisals.* The estate's use of an accountant who was not a certified appraiser, merely relying on the final number in a draft without further consultation regarding the reasonableness of the approach used, and without even proceeding to the point of paying for a final report ultimately resulted in the estate having to pay a 20% substantial undervaluation penalty (assuming the court's position is not reversed on appeal).

Observe the difficult position that the estate's attorneys had at trial because of this approach that was used in preparing the Form 706. They had the accountant testify to try to support the reasonableness of the estate's reliance on his draft report, but the estate had to engage a reputable certified appraiser as its trial expert, who used a value about 65% higher than the value reported by the accountant. Tax litigators uniformly suggest the wisdom of approaching the preparation of the Form 706 as a precursor to preparing for litigation. Being forced to hire different "real" experts for trial inherently raises questions about the positions taken on the Form 706.

A few prior cases have also noted that simply acquiring an outside appraisal is not an absolute qualification for the "reasonable and good faith" exception to the penalty. *Estate of Josephine Thompson v. Commissioner*, 499 F.3d 129 (2nd Cir. 2007) ("reliance on ... an appraiser does not necessarily demonstrate reasonable cause and good faith," but reliance on an appraiser does satisfy the reasonable cause exception if "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith;" reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law"); *Berquist v. Commissioner*, 131 T.C. 8, 23 (2008).

The estate made the interesting argument that the widely divergent values reached by four professionals (one of which was the IRS's auditor in the estate tax audit, who arrived at a value that was more than 25% higher than what the court determined was the correct value) support the difficulty of valuing the interest. The court responded that "further supports the importance of hiring a qualified appraiser."

On the other hand—valuation is difficult and burdened with many uncertainties. Even though the accountant was not a "certified" appraiser, he had experience in preparing appraisals (having prepared 10-20 written appraisals) and testifying about appraisal matters. He held an MS degree in taxation and had 20

years of experience. He was a certified financial planner (CFP). He chaired his firm's corporate service department and must have had considerable experience in dealing with businesses. The head of a reputable national appraisal firm, who would be benefitted by an absolute requirement to use "certified" well established appraisal firms for appraisals, views the opinion as being unduly strict in its view of what is needed to meet the good faith exception to penalties:

I do not want to hide the fact that, as the head of a valuation firm that does nothing but valuation work, this decision is at least superficially appealing. Valuation being as tricky an issue as it is, experts whose "day job" is something very different (accounting, in this case) probably would be better off without dabbling in the valuation arena. As would their clients. Having said that, this decision seems unduly harsh and I have a hard time believing it will survive on appeal. [The accountant] simply wasn't that badly qualified. (It is also unclear what "certified" means in this context.) I do agree he got the valuation wrong, and chose poorly when deciding his valuation methods, but if these kinds of errors are enough to make it unreasonable for taxpayers to rely on an appraisal, then I believe there are many, many taxpayers that should be alarmed today. Espen Robak, *BIG Loss for Estate of Richmond – With Penalties on Top*, PLURIS VALUATION CASE ALERTS available at <http://www.pluris.com/valuation-case-alerts/23/BIG-Loss-for-Estate-of-Richmond---With-Penalties-on-Top->.

In any event, the court's words, in a case involving a valuation "of difficulty and magnitude," engage a certified appraiser.

- (3) *Estate Barely Triggered 20% Penalty, Undervaluation Penalties Tougher Now.* The Pension Protection Act of 2006 toughened the undervaluation penalties for returns filed after August 17, 2006. After that time the 20% penalty applies if the value claimed on the return is from 65% to 40% (up from 50% to 25%) of the correct value. (Observe that the Richmond family was unfortunate to just barely fall under the 50% limit that applied prior to August, 2006. The value on the return (\$3,149,767) was 48% of the value ultimately determined by the court (\$6,503,804)—just under the 50% level that triggered the imposition of the penalty.) After August of 2006, the 40% undervaluation penalty applies if the valuation claimed is 40% (up from 25%) or less of the "correct" value. I.R.C. §6662 (g-h).

It is ironic that penalties apply to the estate for undervaluations, but no "penalty" applies if the IRS examiner overvalues assets in an audit. In this case, the IRS Notice of Deficiency overvalued the decedent's interest (\$9.2 – 6.5 million, or \$2.7 million) close to as much as the estate undervalued the interest on the Form 706 (\$6.5 – 3.1 million, or \$3.4 million).

Applying the penalty in this case, in which the estate was just barely under the 50% threshold, particularly when slight variations in some of the selected adjustments would have taken the estate below the penalty threshold, does seem harsh. For example, if the court had used an 8% lack of control discount (the median of the closed-end fund studies) and a lack of marketability discount of 34.1% (which is within the 26.4-35.6% range of discounts both parties agreed was relevant for consideration), the value reported on the Form 706

would have been more than 50% of the finally determined number, thus avoiding the penalty.

- (4) *Seriatim Discount Calculation.* The “seriatim” lack of control and lack of marketability discount determination is sometimes confusing to planners. The court in footnote 9 gives a simple formula for how to determine the overall discount, assuming a 6% lack of control and a 36% lack of marketability discount:

Discount for lack of control + [(1 – discount for lack of control) x (discount for lack of marketability)] = 0.06 + [(1 – 0.06) x (0.36)] = 0.3984

- (5) *BIG Tax Reduction Determined Without Regard to Consideration of Tax on Future Appreciation of Corporate Assets.* Interestingly, the court cites the *Estate of Litchfield* case (T.C. Memo 2009-21) in its discussion of determining the present value of the BIG inherent tax liability, but does not mention at all its approach of considering future appreciation of corporate assets in determining the appropriate BIG tax liability adjustment.

In *Litchfield*, both appraisers used the present value approach for determining the BIG tax liability adjustment. A key distinction between the approaches of the parties was that the taxpayer’s expert considered an amount of assumed appreciation in the assets during the holding period and took into consideration the additional capital gains taxes attributable to that appreciation in some manner.

There is no consistency in the cases as to whether future appreciation should be considered. On one hand, the corporation is being valued as of a particular valuation date, and arguably neither increased liabilities nor increased asset values should be taken into account. On the other hand, a purchaser buying a corporation with appreciating assets will have to incur a second level capital gains tax on future appreciation that a purchaser of directly owned assets will not have to bear. As a result, prospective purchasers presumably will pay less for the corporate interest that would be subject to the additional tax on future appreciation, and an adjustment should be made in some manner with respect to the built-in gains tax attributable to future appreciation. The court in *Litchfield* agreed that an adjustment should be considered with respect to the additional level of capital gains taxes on future appreciation.

On the facts presented to us, we believe that, as of the valuation date, a hypothetical buyer of LRC and LSC stock would attempt to estimate this extra corporate level tax burden on holding-period asset appreciation and would include the estimated cost or present value thereof in a built-in capital gains discount that would be negotiated between the hypothetical buyer and seller.

The court in *Litchfield* observed that one of the IRS’s own experts in another case acknowledged that he would take into account holding-period asset appreciation in calculating appropriate valuation discounts. (*Estate of Dailey*, T.C. Memo 2001-263). In addition, *Estate of Borgatello*, T.C. Memo 2000-264,

included capital gains taxes on estimated holding period asset appreciation in determining the amount of built-in capital gains discount. In contrast, the Tax Court in *Estate of Jelke* did not include post-death appreciation in determining the built-in gains discount. The built-in gains adjustments allowed in *Litchfield* were not “dollar-for-dollar,” but were very substantial.

There is no indication in the *Richmond* case whether this “subsequent appreciation” issue was raised by the parties.

38. NEW YORK ESTATE, GIFT, GST, AND TRUST INCOME TAX ISSUES

- a. ***New York Sales of Tangible Personal Property to Grantor Trusts Are Subject to New York Sales Tax.*** The New York State Department of Taxation and Finance issued Advisory Opinion TSB-A-14(6)(S) on January 29, 2014 that has created tremors in the New York planning community. The Advisory Opinion takes the position that sales of tangible personal property to grantor trusts or revocable trusts (in particular the Opinion addressed exercising a substitution power in a grantor trust) would be recognized as sales for purposes of the New York sales tax. “Even though such a transfer may be a non-event for income tax purposes, it will still be a sale under the sales tax as long as it is made to a separate entity.” The “resale exception” may apply, but only if the asset was sold to the trust for one purpose only—resale.

The state sales tax rate is 4.0%, but the combined state and city sales tax is often double that or more. The sales tax rate in New York City is 8.875% in New York City. A sale of \$10 million tangible personal property to a grantor trust would generate a sales tax in New York City of \$887,500. Persons who have considered contributing tangible personal property (such as art) to a grantor trust, but in the past have given cash to the trust and allowed the trust to purchase the asset at a later time, may wish to rethink that strategy.

A possible alternative is to contribute the tangible personal property item to an LLC and sell an interest in the LLC (generally treated as an intangible asset) to the grantor trust. (For example, some planners in California have used that approach to avoid application of the California sales tax to sales of art to grantor trusts.) How the New York taxing authorities will react to that approach is unknown.

- b. ***New York Estate, Gift and GST Tax Proposals.*** New York currently has a \$1 million state estate tax exclusion amount. In 2013, there are about 430,000 households with investable assets of at least \$1 million according to some estimates. That represents nearly 6% of all households in the state. An estate that is just below the \$5.34 million threshold would have to pay a New York estate tax of \$431,600.

Governor Cuomo’s 2014-2015 proposed budget proposes to reduce the New York state estate tax by increasing the exclusion amount (currently \$1.0 million) to \$5.25 million over four years beginning April 1, 2004, with indexing to approximate the federal applicable exclusion amount (currently \$5.34 million). Governor Cuomo estimates that the \$5.25 million threshold would eliminate about 90% of estates now covered by the tax. The proposal will also reduce the top New York estate tax rate from 16% to 10%. New York is one of very few states with a state GST tax, and the proposal would repeal the New York GST tax. The proposal does not create a state gift tax for New York, but

adjusted taxable gifts made on or after April 1, 2014 by a New York resident would be included in his or her gross estate for purposes of calculating the New York estate tax (regardless when the New York resident died).

The New York Assembly's Democratic majority has announced that it supports raising the exclusion to \$3 million but not reducing the top rate from 16% to 10%.

- c. ***Income Taxation of Trusts.*** Accumulated income in a trust is not subject to New York income tax for (i) non-resident trusts (created by someone who is not domiciled in New York when it becomes irrevocable), (ii) exempt resident trusts (trusts created by New York domiciliaries but that have no New York trustees, assets or source income), and (iii) incomplete gift, non-grantor (or "ING") trusts (structured so that the transfer to the trust is an incomplete gift and so that the trust is not a grantor trust under §§671-678 of the Code). The proposal changes these results in two ways.

First, the proposal would tax the income of an ING trust that is established by a New York resident to the grantor of the trust. The proposal would not apply to ING trusts that are liquidated on or before June 1, 2014.

Second, the proposal would apply a "throwback tax" to distributions from non-resident trusts and exempt resident trusts to New York beneficiaries. (The proposal applies to distributions of accumulated income on or after June 1, 2014.) California imposes a similar throwback tax. The New York State Bar Association Tax Section has requested that the throwback tax be delayed because of technical problems with the proposal and difficulties of incorporating the federal rules by reference. See *Throwback Tax in New York Budget Plan Raise Concerns, NYSBA Tax Section Says*, BLOOMBERG DAILY TAX REPORT (March 11, 2014).

39. FAMILY LIMITED PARTNERSHIP ATTACK FOR ESTATE INCLUSION WITHOUT ANY DISCOUNTS, *ESTATE OF WILLIAMS*

The IRS assessed about \$1.5 million in estate taxes and \$300,000 penalties regarding a property that was transferred to a family limited partnership by the decedent four years before his death. *Estate of Jack Williams*, T.C. No. 29735-13 (petition filed December 19, 2013). The partnership owned real properties, business and investment assets. The IRS appears to have "thrown the kitchen sink" at the estate with a wide variety of arguments including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction occurring at the decedent's death, undervaluation of the underlying partnership assets, the partnership lacked a valid business purpose or economic substance, the decedent retained enjoyment of the partnership assets triggering estate inclusion of the assets under §2036, ignoring restrictions on the right to use or sell the partnership interest under §2703(a), ignoring liquidation restrictions under §§2703, 2704(a) and 2704(b), any lapse of voting or liquidation rights in partnership is a transfer under §2704(a), and that gifts of partnership interests should be brought back into the estate under §2036 and should be removed from the decedent's adjusted taxable gifts.

The estate maintains that the partnership had various non-tax purposes including limiting future potential personal liability of the decedent, limiting litigation risks associated with future improvements and maintenance on various real properties, pooling of income in one entity to provide centralized and continuous management of properties and to diversify and reducing investment risk, facilitating transfers without having to fractionalize real property

interest, provide a structure of ownership and operation of real properties to provide continuity and minimal interruption upon the death of a partners, , minimizing litigation among family members or spouses and preservation of family harmony, increased marketability of the partnership and an affiliate company that was the lessees of commercial property owned by the partnership. The estate maintains that the transfers to the partnership were bona fide and for full consideration decedent retained assets outside the partnership that were more than adequate to maintain his then current lifestyle, and that §2036 should not apply. The estate also argues that it adequately disclosed gifts of the partnership interests on gift tax returns. (Attorneys for the estate are John Thornton and Kevin Belew, Boise, Idaho)

In summary, the IRS is attempting to increase the value attributable to the decedent's limited partnership interest from \$4.5 million to \$7.7 million.

40. VALUATION OF REAL PROPERTY IN 2009 (WHEN COMPARABLES WERE NOT AVAILABLE REFLECTING DEPRESSED VALUES FOLLOWING THE 2008 "CRASH" BECAUSE PROPERTIES WERE NOT SELLING), *ESTATE OF LOVINS*

The valuation of various real estate interests owned by decedent's estate is at issue in *Estate of James David Lovins, Sr.*, T.C. Docket # 002071-14 (petition filed February 5, 2014). The IRS is alleging an estate tax deficiency of \$6.8 million and a penalty of \$1 million. The basic dispute is how to value real estate interests when the decedent died in 2009. To what extent in valuing real property is the impact of the "Great Recession of 2008" and its impact on the real estate market considered? Appraisers valuing depressed real estate in 2009 often were unable find any comparables at low values, because properties were not selling at all in the immediate aftermath of the recession.

41. APPRAISER FAILED TO TESTIFY; ESTATE ARGUING LOWER VALUE THAN ON FORM 706, *ESTATE OF TANENBLATT*

The value of a 16.67% member interest in an LLC owning a commercial building in Manhattan was determined in *Estate of Tanenblatt*, T.C. Memo 2013-263 (opinion by Judge Halpern). The estate initially used Management Planning, Inc. (MPI) to value the LLC interest, which was valued at \$1.8 million using a 20% lack of control discount and a 35% lack of marketability discount. The IRS accepted the net asset value in the MOPI appraisal but said that the discounts should have only been 10% and 20% respectively, resulting in a value of \$2.46 million. The estate countered at trial by getting a new appraisal valuing the interest at about \$1 million.

The estate merely attached the new appraisal to its petition for redetermination but did not serve a copy of the report on other parties as required under Tax Court rules (and the estate did not qualify her as an expert), so the appraisal was not in evidence. The new appraiser did not testify because of a fee dispute. The estate attacked the MPI appraisal (the appraisal it used to support the value on the Form 706) as well as the IRS appraisal.

This case raises the issue of taking the position at trial that a value is lower than stated on the estate tax return. The court noted that "values or discounts reported or claimed on an estate tax return may be considered admissions and, to some extent binding or probative, restricting an estate from substituting a lower value without cogent proof that hose

admissions are wrong.” There was “no cogent proof” in this case that the value reported on the estate tax return was wrong.

The ultimate conclusion was that a 10% lack of control discount and 26% lack of marketability discount was appropriate, valuing the interest at \$2.3 million.

42. EARLY TERMINATION OF CHARITABLE REMAINDER TRUSTS

- a. ***Commutation of Interests Allowed, PLRs 201325018-201325021*** . Private letter rulings 201325018-201325021 are notable as providing guidelines for terminating a charitable remainder trust (CRT) early with the parties each receiving amounts equal to their actuarial values in the CRTs; few of these rulings are now issued in light of a no-ruling position announced in 2008.

The IRS typically does not issue rulings regarding the early termination of a CRT, but these rulings requests were submitted before that no-ruling position was first announced in Rev. Proc. 2008-4, 2008-1 C.B. 121. (Has it really taken **7 years** to consider these ruling requests???) Husband and wife were the unitrust beneficiaries of NIMCRUTs that were to last until the surviving spouse’s death. The spouses were unhappy with the investment returns and the spouse and the charity wished to have the trusts terminated, distributing the actuarial value of the unitrust interests to the spouses and the remaining value to the charity. The value of the unitrust interests was determined using the \$7520 rate and the Treasury life expectancies using the methodology in Reg. §1.664-4. The rulings concluded that even though the spouses were disqualified persons, the terminating payments to the spouses were not direct or indirect acts of self-dealing because the allocation method was reasonable. Any capital gain recognized by the spouses on the termination of the trust would be capital gain. The private foundation termination tax under §507 does not apply similarly because the values passing to the spouses and the charity, respectively, were determined appropriately under Reg. §1.664-4.

- b. ***Transfer of All Non-Charitable Interests to Charitable Remainder Beneficiary, PLR 201321012***. In private letter ruling 201321012 husband and wife had created separate CRTs, paying unitrust amounts to the spouses until the death of the survivor. They each retained the right to change the charitable remainder beneficiary. They both decided to terminate their respective CRTs by relinquishing the right to change the charitable remainder beneficiary and by conveying their remaining unitrust interests to the charitable beneficiary. They received a gift tax charitable deduction for the value of the remainder interests and they received gift and income tax charitable deductions for the value of their unitrust interests that conveyed currently to charity.

43. GARNISHMENT FROM DISCRETIONARY SPENDTHRIFT TRUSTS

A recent Florida district court of appeals case has reversed the trend of states that did not allow garnishment of distributions made from a discretionary trust. *Berlinger v. Casselberry*, Case No. 2D12-6470 (Fla. 2d Dist. Ct. App. Nov. 27, 2013).

The general rule is that a creditor (including an ex-spouse) of a discretionary beneficiary of a “discretionary trust” cannot “reach or otherwise attach” the assets of the trust. A Nevada law says that does not preclude a garnishment of any distributions that are made to the

beneficiary, but courts in various states have made clear that a creditor cannot garnish distributions from such a trust and the trustee cannot be held liable for making distributions.

There are several relevant statutes in Florida. A statute addressing spendthrift trusts generally provides that trust assets are *not* exempt from the claims of spouses or claims for child support. FL. TRUST CODE §736.0503(2)(a). A separate statute dealing specifically with “discretionary trusts” does not have that exception. For discretionary trusts, a creditor cannot compel a distribution nor can a creditor “attach or otherwise reach” the interest, if any, which the beneficiary might have as a result of the trustee’s authority to make discretionary distributions to or for the benefit of the beneficiary. FL. TRUST CODE §736.0504. In *Berlinger* the ex-wife argued that she was not trying to “reach or otherwise attach” the beneficiary’s interest in the trust, but merely to garnish any distribution that the trustee decided to make to the beneficiary. The Florida supreme court had previously allowed garnishment of distributions made to a beneficiary from a discretionary trust in *Bacardi v. White*, 463 So. 2d 218 (Fla. 1985). Many Florida planners thought that cases had been superseded by the discretionary trust statute cited above. The court, however, ruled that *Bacardi* is controlling, and allowed the garnishment. A request for rehearing has been filed in the case. There is a good chance this case will ultimately be decided by the Florida supreme court.

In the meantime, if an individual wants to provide strong creditor protection for beneficiaries of third-party discretionary trusts, consider establishing sufficient contacts with and applying the law of a state that has strong spendthrift protection and that specifically mentions garnishment.

44. MATERIAL PARTICIPATION BY TRUSTEE , *FRANK ARAGONA TRUST*

a. **Synopsis.** The Frank Aragona Trust qualified for the “real estate professional exception” under §469(c)(7) so that rental losses were not disallowed as passive activities for purposes of the passive activity loss rules of §469. The IRS raised and the court addressed two major issues. First, the court rejected the IRS’s contention that a trust can never qualify for the real estate professional exception even though the regulations refer to personal services “performed by an individual.” The court concluded that if the trustees are individuals, their work can be considered “work performed by an individual” and that a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

Second, the court ruled that the trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. Three of the six co-trustees were full time employees of an LLC that managed the rental properties. The court concluded that the activities of the trustees, including their activities as employees of the LLC, are considered in determining material participation. The court reasoned that their activities as employees counted because (1) Michigan statutory law requires trustees to administer the trust solely in the interests of the beneficiaries, and (2) a Michigan case makes clear that trustees are not relieved of their duties of loyalty by conducting activities thorough a separate entity controlled by the trust. Also, the court rejected the IRS argument that two of the co-trustees owned minority interests in some of the entities that conducted the rental operations and that

some of their activities were attributable to their personal portions of the businesses. The court gave several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014) (Judge Morrison).

- b. **Basic Facts.** The Frank Aragona Trust owned real estate rental properties and also owned interests in wholly owned entities and owned majority interests in other entities that conducted rental real estate activities. (It also owned majority and minority interests in entities that conducted real estate holding and development activities. Those entities that held and developed real estate were not involved in the issues in this case.)

The trust benefitted the grantor's five children, who shared equally in the trust income.

The grantor was the initial trustee. Following his death, there were six co-trustees-- his five children and one independent person as co-trustees. One of the children served as the "executive trustee" and "the trustees formally delegated their powers to the executive trustee (in order to facilitate daily business operations), "but the trustees acted as a management board for the trust and made all major decisions regarding the trust's property."

Three of the children were full time employees of an LLC that operated the properties.

The LLC that managed the properties was wholly owned by the trust (and was treated as a disregarded entity for income tax purposes). The LLC employed "several people" in addition to the three children, "including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks."

The 5 children were paid \$72,000 per year as a trustee fee. Those with limited involvement in the business were paid the same trustee fee as those who were full time employees of the LLC. The independent trustee (an attorney) was paid \$14,400 per year.

The trust claimed losses from the rental operations in 2005 and 2006, which contributed to net operating losses that the trust carried back to its 2003 and 2004 years. The issue is whether those rental losses are deductible or whether they should be treated as passive activity losses that are not currently deductible.

c. **Holdings.**

(1) A trust can qualify for the "real estate professional" exception under §469(c)(7) so that rental losses are not disallowed as passive activities for purposes of the passive activity loss rules of §469. If the trustees are individuals, their work can be considered "work performed by an individual" (as required by a regulation), so a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

(2) The trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. The activities of three of the co-trustees as employees were considered in determining whether the trust materially participated in the business. Activities by two- co-trustees who also owned minority interests in some of the rental entities were not apportioned between the trust and their personal portions of the businesses.

d. **Analysis.**

(1) *Rental Losses Are Passive Unless the Real Estate Professional Exception Applies.* Any rental activity is considered a passive activity, §469(c)(2), unless what has been termed the “real estate professional exception” under §469(c)(7) applies.

The exception in §469(c)(7) has two tests. First, more than one-half of the “personal services” performed in trades or businesses by the taxpayer during the taxable year are performed in real property businesses in which the taxpayer materially participates. §469(c)(7)(B)(i). Second, the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. §469(c)(7)(B)(ii). [Observe that both of these tests requires material participation by the taxpayer, just to meet the real estate professional exception, aside from the general material participation requirement under §469(c)(1)(B). But presumably the same standards would apply for the general material participation requirement as for the material participation requirement that is part of the real estate professional exception.]

(2) *Trusts Can Satisfy the Real Estate Professional Exception.* The IRS argued that a trust can never meet the real estate professional exception. [This is consistent with the IRS’s position in CCA 201244017.] The regulations describe “personal services” as that term is used in the first of the two tests for the real estate professional exception as meaning “any work performed by an individual in connection with a trade or business.” Reg. §1.469-9(b)(4). The IRS argues that, based on its regulations, a trust is not an individual so cannot possibly meet the requirements of the real estate professional exception. The court rejects this argument. While comments in the House Report and Conference Committee Report for §469(c)(7) state that the provision applies to “individuals and closely held C corporations,” the Reports do not say that the exception applies only to individuals and closely held C corporations. Congress could have excluded trusts if had meant to do so; other exceptions in the passive loss rules apply only to “any natural person,” but the §469(c)(7) exception does not have that limitation.

The court reasons that if the trustees are individuals, they can meet this regulatory requirement:

If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered “work performed by an individual in connection with a trade or business.” Sec. 1.469-9(b)(4), Income Tax Regs. We conclude that a trust is capable of performing personal services and therefore can satisfy the section 469(c)(7) exception.

(3) *Little Authority Regarding Material Participation by Trust.* Section 469(h) states that material participation requires “regular, continuous, and substantial” involvement in the operations of the business. Regulations address how individuals or corporations meet the material participation requirement, but there is no statute or regulation addressing how a trust materially participates. There is one line in the legislative history about trust material participation. S. Rept. No 99-313, at 735 (1986), 1986-3 C.B. 1, 735 states that a trust “is treated as materially participating in an activity ... if an executor or fiduciary, in his capacity as such, is so participating.”

(4) *Activities of Non-Trustee Employees.* One case has addressed material participation by a trust. It held that the activities of non-trustee employees can be considered in

determining whether a trust materially participated in a ranching activity. *Mattie K. Carter Trust v. United States*, 256 F. Supp.2d 536 (N.D. Tex. 2003).

The *Aragona* court specifically noted that it was not faced with deciding whether the activities of non-trustee agents or employees should be disregarded. (Footnote 15).

(5) *Activities of Trustees as Employees Are Counted*. The IRS argued that the activities of the three co-trustees as full-time employees of the LLC should not be considered because (1) they performed their activities as employees, and (2) it is impossible to disaggregate the activities they performed as employees and as trustees. [This is consistent with the IRS's reasoning in TAM 201317010.]

The court concluded that the activities of the trustees, including their activities as employees, should be considered in determining whether the trust materially participated in real-estate operations. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity controlled by the trust.

The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also *In re Estate of Butterfield*, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302).

Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 (“Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.”) Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

(6) *Activities of Trustees Who Also Co-Own Interests in the Business Are Counted*. The IRS argued that some trustees owned minority interests in some of the real estate activities and some of their activities were attributable to their personal portions of the businesses. Despite the individual minority ownership interests of two co-trustees, the trust materially participated. The court gave four reasons for considering the activities of the co-trustees who co-owned minority interests in the same business entities. (1) Their combined interests were not a majority interest. (2) Their combined interest was never more than the trust's interest in the entities. (3) Their interests as owners were compatible with the trust's goals for the success of the joint enterprise. (4) They were involved in managing day-to-day operations of the businesses.

(7) *Multiple Fiduciaries*. If there are multiple fiduciaries, how many of them must be involved in the business in order for the trust to materially participate? [Technical Advice Memorandum 200733023 provides that merely labeling a person involved in the

business as a “special trustee” will not suffice. The determining factor is whether the special trustee had powers that could be exercised solely without the approval of another trustee. If so, material participation of the special trustee would suffice. This raises concern of whether a majority of the multiple fiduciaries must be involved in the business.] The *Aragona* court did not address how to determine material participation by a trust that has multiple trustees. However, in *Aragona*, three of the six co-trustees (*not* a majority) were full-time employees of the LLC that operated the real estate business. Therefore, *Aragona* suggests that having a majority of co-trustees involved in the business is not required in order for the trust to materially participate.

e. **Observations.**

(1) *Case of Huge Importance; Increasing Significance Because of 3.8% Tax on Net Investment Income.* There has been only one other case (*Carter Trust*, a federal district court case) addressing how a trust materially participates in a business. This is the first case exhibiting how the Tax Court will address the issue—and it is a “regular” Tax Court case, not just a memorandum opinion.

The issue in *Aragona Trust* was whether the trust could deduct business losses under §469. Whether a trust materially participates in a business is increasingly important because non-passive business income is not subject to the 3.8% tax on net investment income (NII). The issue has far more importance than when the only issue was the ability to deduct losses under §469. Many trusts own interests in businesses that result in hundreds of thousands if not millions of dollars of business income per year. Whether that trust income is subject to the additional 3.8% tax can be quite significant. Furthermore, Richard Dees (Chicago) points out that the regulations under §1411 take the position that the characterization of trust income as NII is made at the trust level, and distributing income to a beneficiary who is actively involved in a business does not convert the income from being NII at the trust level to being non-NII at the beneficiary level. Reg. §1.1411-3(e)(3)(ii). (For grantor trusts, the participation in the business of the grantor deemed-owner of the trust is determinative.)

(2) *“Regular” Tax Court Opinion.* This is a “regular” Tax Court opinion, not a memorandum opinion of one judge. Taxpayers faced with similar situations know they can challenge the IRS in the Tax Court, rather than in a district court, and know the Tax Court’s position.

(3) *Possibility of IRS Guidance Project.* There is little guidance regarding how a trust or estate “materially participates” in a trade or business, under either the §469 or §1411 regulations. The §1411 final regulations declined to provide any guidance regarding this issue, despite the fact that it is now of much greater importance than for just the passive activity loss rules. The Preamble to the final regulations points out that “the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date.” The IRS requested comments, including “recommendations on the scope of any such guidance and on specific approaches to the issue.”

While *Aragona Trust* provides very important viewpoints of the Tax Court, various issues remain for which the IRS could provide helpful guidance (for example, whether material

participation by a decedent would be “tacked” to the estate or perhaps to a testamentary trust for some period of time).

(4) *Overview of IRS Growing Attacks on Trust Material Participation.* Regulations addressing passive activity rules for trusts and estates have never been written. The IRS position is that the trustee must be involved directly in the operations of the business on a “regular, continuous, and substantial” basis. The IRS points to the legislative history of §469, which states very simply:

Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating. S. Rep. No. 99-313, at 735.

The IRS lost the only prior reported case that has addressed material participation by trusts. (The *Mattie K. Carter Trust* case is discussed below.) Since then, the IRS has issued several informal ruling positions, generally taking a strict approach toward trust material participation.

Letter Ruling 200733023 disagreed with the *Carter Trust* decision and said that activities of “Special Trustees” would not be considered in determining the trust’s material participation if they did not have the authority to commit the trust to any course of action without approval of the trustees.

Letter Ruling 201029014 was taxpayer friendly in recognizing that a trust could materially participate in the activities of a multi-tiered subsidiary through the activities of its trustee even though the trustee had no direct authority to act with respect to the business in its capacity as trustee (because of the remote relationship of the trust to the subsidiary).

Technical Advice Memorandum 201317010 takes a very hard-nosed approach, refusing to recognize the activities of a co-trustee who was also the president of a subsidiary of an S corporation in which the trust owned an interest, reasoning in part that the activities were largely in the individual’s capacity as employee and not as trustee. The *Aragona Trust* case in particular seems to undermine the IRS’s strict approach in that TAM.

This prior case and these prior rulings are discussed in more detail below. Query whether, following its loss in *Aragona Trust*, the IRS will change its harsh attacks on seemingly every effort by a trust to materially participate in a business.

(5) *Specific Facts of Aragona Trust Involved Wholly Owned Management Entity.* The court’s reasoning in *Aragona Trust* was related to the specific facts of the case. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity wholly owned by the trust (citing *In re Estate of Butterfield*, which refers to trustees who are directors of a corporation controlled by the trust). The court’s reasoning is understandable in light of the fact that it specifically addressed the fact scenario presented by the *Aragona Trust*. The court gave no indication that it would necessarily limit its reasoning to that situation. Indeed, the first rationale (that the trustee must look out solely for the interests of trust beneficiaries) seems to acknowledge that any activities of a trustee must be consistent with the trustee’s duties to the beneficiaries.

(6) *Can Trustee Ever “Take Off Its Hat” As Trustee?* Some commentators have described this issue in terms of whether a trustee can ever “take off its hat” as a fiduciary. Under this approach, all activities of a trustee should be considered in determining material participation by the trust.

A review of the existing tax guidance supports considering all of a trustee's actions in a trust-owned business in whatever capacity the trustee acts in determining whether the trust materially participates. The non-tax authorities support this conclusion too: the trustee is unable to completely remove her trustee “hat” when donning a different “hat” in a different capacity in the business. Where a trustee also acts in a potentially managerial role (e.g., for an entity the equity interests of which are trust assets), the trustee's fiduciary duties extend to her managerial activities. A trustee cannot disregard her fiduciary obligations to the beneficiaries when acting in another capacity, for example, as an employee or director, in a business owned by the trust. Because the trust will be a shareholder, the fiduciary duties a trustee owes the beneficiaries will not conflict with the fiduciary duties a director owes the shareholders. If they do, however, the director/trustee will have to recuse herself. Thus, all of the actions undertaken by an individual trustee with respect to any activity owned directly or indirectly by the trust are subject to her fiduciary obligations to the trust beneficiaries and, therefore, relevant to determine whether the trust materially participates under Code sections 469 and 1411. Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1*, TAX NOTES 683, at 688-700 (Aug. 12, 2013) (Question 10) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2*, TAX NOTES 785 (Aug. 19, 2013).

In support of his analysis, Mr. Dees cites (and quotes) the Restatement (Third) of Trusts §78, Bogert on Trusts and Trustees §543 (Dec. 2012), and *In re Schulman*, 165 A.D.2d 499, 502 (N.Y. App. Div. 3d Dep't 1991).

(7) *Activities of Non-Trustee Agents of Trust Constituted Trust Material Participation, Mattie K. Carter Trust v. U.S.* A 2003 federal district court was the first to address in a reported case what activities can qualify as material participation under the passive loss rules for trusts and estates. *The Mattie K. Carter Trust v. U.S.*, 256 F. Supp.2d 536 (N.D. Tex. 2003). In the *Carter Trust* case, the trust operated active ranch operations, and the trustee hired a ranch manager (who was not a trustee). The IRS maintained that was not material participation for the trust because the trustee individually did not materially participate. The taxpayer maintained that, analogous to a closely held C corporation (see footnote 3 of the opinion), it could only participate in an activity through its fiduciaries, agents, and employees and that the activities of employees and agents of the trust should be included. The District Court sided with the taxpayer, concluding that material participation should be determined by reference to all persons who conducted the business on the trust's behalf, including employees as well as the trustee. Participation is tested by the activities of the trust itself, which necessarily entails an assessment of the activities of those who labor on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust. Section 469 states that “a taxpayer” is treated as materially participating in a business if “its” activities in pursuit of that business are regular, continuous, and substantial. I.R.C. § 469(h)(1). The court reasoned that measuring the trust's participation by reference only to the trustee “finds no support within the plain meaning of the statute. Such a contention is arbitrary, subverts common sense, and attempts to create ambiguity where there is none.” The court observed that no regulations are on point, but “the absence of regulations and case law does not manufacture statutory ambiguity.” The court acknowledged that it had studied the “snippet of legislative history IRS supplied” (including the Senate Finance

Committee Report) as well as a footnote in the Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986, at 242 n.33, but the opinion concludes that "the court only resorts to legislative history where the statutory language is unclear, ... which, ... is not the case here."

Aragona Trust in footnote 15 said that it was not faced with and did not address whether activities by non-trustee employees are considered in determining a trust's material participation.

(8) *Technical Advice Memorandum 200733023; Rejection of Carter Trust Reasoning, Treatment of Special Trustee*. The IRS disagreed with *Carter Trust* in Technical Advice Memorandum 200733023, concluding that notwithstanding the *Carter Trust* decision, the sole means for a trust to establish material participation is by its fiduciaries being involved in the operations, relying primarily on the legislative history that made specific reference to "an executor or fiduciary, in his capacity as such" clause. The ruling also reasoned that because a business will generally involve employees or agents, a contrary approach would result in a trust invariably being treated as materially participating in the trade or business activity, rendering the requirements of §469(h)(1) superfluous.

TAM 200733023 also addresses the effect of having Special Trustees with responsibility for the business. The ruling concluded under the facts of that situation, the Special Trustees were not fiduciaries for purposes of §469, because they gave recommendations but they were not able to commit the trust to any course of action or control trust property without the Trustees' express consent. The Trustees retained final decision-making authority over all facets of the business. The ruling reasoned that if advisors, consultants, or general employees could be classified as fiduciaries simply by labeling them so, the §469 material participation requirement for trustees would be meaningless. Furthermore, the ruling concluded that even if the Special Trustees were considered fiduciaries, many of their activities would not count in determining the trust's involvement in the business, because time spent negotiating the sale of the trust's interest in the company and resolving a tax dispute with another partner was not time spent managing or operating the business.

(9) *PLR 201029014; No Strict Application of "In Such Capacity" Clause in Legislative History*. Private Letter Ruling 201029014 reiterates the general IRS position that a trust materially participates in business activities only if the trustee is involved in the operations of the entity's activities on a regular, continuous, and substantial basis. It did not mention the *Carter Trust* case, but it cited the Senate Report's "in such capacity" language. The issue was whether a trust could materially participate in the business of a subsidiary (Sub 2) of a subsidiary (Sub 1) owned by a partnership in which the trust owned an interest. In light of the trust's remote relationship with Sub 2, a strict application of the "in such capacity" clause in the legislative history would seemingly have prevented the trustee from being able to materially participate, because any actions of the trustee in the business of Sub 2 would have been taken in some capacity other than as trustee. In PLR 201029014, the IRS did not apply this strict approach, but agreed with the taxpayer that the trustee could materially participate in Sub 2 through the trustee's regular, continuous and substantial involvement in the operations of Sub 2.

(10) *TAM 201317010; IRS's Most Recent Strict Attack—Activities of Co-Trustee Who Was President of Business Not Counted in Determining Trust's Material Participation.* If a trust owns an interest in an active trade or business operation, a planning consideration will be whether to name some individual who is actively involved in the business as a co-trustee. However, the IRS questioned that strategy in Technical Advice Memorandum 201317010 (released April 26, 2013). The trust in that TAM had owned stock in an S corporation. The trust had a trustee and a "Special Trustee." The trustee "did not participate in the day-to-day operations of the relevant activities" of the company. The individual who was the Special Trustee was also the president of a qualified Subchapter S subsidiary of the S corporation. The trust instrument limited the Special Trustee's authority in selling or voting the S corporation stock. The IRS concluded that the trust did not materially participate in the activities of the company for purposes of the §469 passive loss rules. The ruling highlights two issues: (1) the Special Trustee's authority was limited to voting and selling the S corporation stock; and (2) the Special Trustee's activities as president were not in the role as fiduciary. As to the first issue, the ruling concluded that time spent serving as Special Trustee voting the stock of the company or considering sales of stock would count for purposes of determining the trust's material participation in the business, but the "time spent performing those specific functions does not rise to the level of being 'regular, continuous, and substantial.'" As to the second issue, the ruling stated in its recitation of facts that the individual serving as president and Special Trustee "is unable to differentiate time spent" as president, as Special Trustee, and as a shareholder. The ruling reasoned that under §469 the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement, or else an owner would invariably be treated as materially participating because most businesses involve employees or agents. The ruling concluded that the work of the individual serving as Special Trustee and president "was as an employee of Company Y and not in A's role as a fiduciary" of the trust and therefore "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company.

TAM 201317010 creates a significant distinction in the treatment of individuals vs. trusts with respect to the "employee" issue. For individual taxpayers, their activities as employees of a business will be considered for purposes of determining their material participation in the business. For trust taxpayers, the IRS position is that the activities of a trustee as an employee of the business cannot be considered to determine the trust's material participation in the business.

Aragona Trust goes a long way toward rejecting the IRS's strict position in TAM 201317010. The IRS's arguments in *Aragona Trust* were very similar to its reasoning in TAM 201317010 for not considering the activities by the LLC employees/trustees in the business operations:

[The IRS] reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

The court's rejection of the IRS's position direct rejection of this reasoning calls into question the basic tenets of the TAM. Furthermore, the court rejected the same type of reasoning with respect to its refusal to consider separately the activities attributable to the trust portion and the individual portion of the business by the trustees who also owned personal interests in the business.

Query whether the distinction of serving as employee of the wholly owned LLC in *Aragona Trust* vs. serving as employee of the corporation in the TAM is significant?

(11) *Comments of ABA Tax Section Recommend Recognizing All Activities of Trustees in Determining Trust Material Participation.* Comments to the proposed regulations under §1411 by the American Bar Association Tax Section submitted on April 5, 2013 recommend that the IRS issue new proposed regulations regarding material participation for a trust or estate for purposes of §1411. The Tax Section Comments propose that such regulations recognize material participation by an estate or trust under any of three tests, one of which is that “[t]he fiduciary participates in the activity on a regular, continuous, and substantial basis, either directly or through employees or contractors whose services are directly related to the conduct of the activity.” In addition to recognizing actions through employees or contractors, material participation of a trust could be based on direct participation of the fiduciary, and in that context, the Tax Section Comments reason that

any time spent working on the activity should be considered towards meeting the material participation requirements regardless of whether the fiduciary is working on the activity as a fiduciary or in another role, for instance as an officer or an individual investor. If there are multiple fiduciaries, time spent by the fiduciaries could be aggregated for purposes of determining material participation.

(12) *Multiple Trustees.* There is no guidance regarding what activities of multiple co-trustees are needed to satisfy the material participation requirement. Must all co-trustees materially participate? A majority? Any one co-trustee? *Aragona Trust* does not address this issue expressly, but on the facts of the case, material participation by each of three out of six co-trustees (not a majority) was sufficient. At a minimum this suggests that material participation by a majority of co-trustees is not required.

Can the activities of the co-trustees be aggregated? For example, if the 500 hour test that applies to individuals is applied to the activities of trustees, would the trust materially participate if the co-trustees in the aggregate devoted 500 hours to the business? This issue was not presented in *Aragona Trust* because each of three co-trustees met the 500 hour test (because they each worked “full time” for the LLC).

(13) *Outstanding Resource.* For a detailed discussion of the application of the non-passive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1*, TAX NOTES 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2*, TAX NOTES 785 (Aug. 19, 2013). Another excellent resource including planning strategies with respect to the trust material participation issue is Steve Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (2014) (a 500+ page article addressing a variety of tax and estate planning issues for businesses available from the author at sgorin@thompsoncoburn.com).

45. INTERESTING QUOTATIONS

- a. *Attorneys General*. “In discussing the role that state attorneys general have in enforcing charitable trusts, Professor Robert Sitkoff says that “charitable trusts are enforced by the AG—Aspiring Governor.” – Robert H. Sitkoff
- b. *Tax Reform?* There are two chances of tax reform in 2014—slim and none.” – Dennis Belcher
- c. *GRATs—More Than Just Money*. Richard Covey is quoted in a December 16, 2013 Bloomberg article (“Accidental Tax Break Saves Wealthiest Americans \$100 Billion”) as referring to GRATs as “romantic” and “beautiful,” in what the article refers to “as the elegant of tax maneuvers.” – Dennis Belcher
- d. *Don’t Tell*. “This does not mean that nobody in my office is using *Wandry* clauses. They don’t tell me everything—THANK GOODNESS.” – Carol Harrington
- e. *You Pay For What You Get*. “Getting a TAM is not cheap—at least when we do it.” – Carol Harrington
- f. *Last Resort*. If a statute of limitations has run on a refund, there may be theories such as the duty of consistency to try to argue for relief. “Equitable arguments are made when you screw up on the statute of limitations. It is always a bad situation if you are doing research on equitable doctrines. They are the last resort when something else went wrong.” – Carol Harrington
- g. *Take What I Say With a Grain of Salt*. “As many of the people who work for me know, I sometimes just make stuff up.” [But Carol, we all believe it when you say something.] – Carol Harrington
- h. *Quick Wealth*. “There’s an old proverb that an inheritance quickly gained at the beginning will not be blessed at the end.” – Ron Aucutt
- i. *Trust Disclosure*. “There is a concern that letting children know about the existence of large trusts may result in laziness, create a sense of entitlement, and keep the children from leading productive lives. Really? They see the big homes, servants, planes, and they don’t suspect there’s wealth somewhere? – Ron Aucutt
- j. *Asset Protection Planning*. “Asset protection planning is a wonderful arrangement that attorneys use to protect their clients from creditors—but you expect your bill to be paid?” – Ron Aucutt
- k. *Two Basic Estate Planning Principles*. “There are two basic principles of estate planning. First, the estate plan must work the next day ... but must also work 2-5 years from now in a reasonable way....Flexibility is needed so the plan works in at least a reasonable way in the future.... Second, the client will be less inclined to make lifetime gifts than their lawyer. It’s easy for us to say, ‘you should give away your money.’... Clients often have a different agenda.” – Tom Abendroth
- l. *Portability as an Asset*. “When you’re dealing with second spouse, you have to think about portability as an asset. The DSUE amount is really an asset that you are leaving to the surviving spouse outright. They can use it however they want.... If, for whatever reason, a client would not leave a significant asset outright to the spouse, then the

client should leave the DSUE amount outright to his or her spouse. The client should designate whether portability should be elected at all and who is making that decision.... Also, indicate how it can be used and what the limits are.” – Tom Abendroth

- m. *Blended Families*. “Planning for non-standard families might be called ‘Planning for the non-boring family.’ Not Ward, June, Wally and the ‘Beav’- but the Brady bunch.” – Tom Abendroth
- n. *But It’s Only \$10 Million*. “Janet could make a gift of the DSUE amount shortly after John dies. But the question in estates of this size – Is Janet really willing to do that? ‘Ten to twenty million dollars,’ a lot of our clients would say, ‘doesn’t buy what it used to.’” – Tom Abendroth
- o. *Change?* “Here’s the thing that you figure out about estate planners around the country. We are exactly the same person. Trust me-we’re exactly the same... We’re all risk averse and we like to do things the way we’ve been doing it and gosh darn it, we don’t want to change. The way we have been treating the applicable exclusion is absolutely wrong moving forward.” – Paul Lee
- p. *You Just Thought You Were Estate Planners*. “Stop calling yourself estate planners, you are income tax planners now. Because the center point of estate planning is now the step-up in basis, there will be lots of circumstances where you will want to force estate tax inclusion.” – Paul Lee
- q. *Imminent Death*. Consider making gifts to modest parents—“because they are closer to the applicable exclusion maturity date.” – Paul Lee
- r. *Smoking What?* Planning to get a basis step-up for free is referred to by some at “freebasing.” – Paul Lee and Read Moore
- s. *The Elders Among Us*. “There’s enough gray hair and no hair in this room to remember 2001.” – Paul Lee (giving credit to Jeff Pennell)
- t. *Just Die--Really Passive Planning*. In California, the advantage of retaining assets to achieve a basis step-up at death usually outweighs the estate tax savings from transfer planning. California has the trifecta of the highest state income tax, no state estate tax, and community property so that all assets get a basis step-up at the first spouse’s death. “Just die with your assets.” – Paul Lee
- u. *Precision*. “If you want precision go to the Chicago Field Museum, where you will see the Tyrannosaurus rex, ‘Sue.’ A young married couple asked the security guard how old the bones are. The security guard said ‘those bones are 65 million, 2 years and 3 months and 6 days old.’ The couple was quite impressed, and asked how he could be so precise. The security guard said “the first day I got here they told me those bones are 6 million years old, and I’ve been working here 2 years 3 months and 6 days.” – Chris Hoyt
- v. *Blondes*. “The blond driver was pulled over by the blond police officer. The police officer asked for identification. She did not have her driver’s license and could not find any picture ID, but in looking through her purse, she found a mirror. She looked at it and told the police officer that was her and handed the mirror to the policeman. The

police officer looked at it and handed it back saying ‘If I had known you were a police officer I wouldn’t have pulled you over.’” – Chris Hoyt

- w. *Golf*. “Personally, I don’t play golf. I find it a very frustrating game—the windmills, the little gates that go up and down ...” – Chris Hoyt
- x. *Woes of the Rich*. One way to avoid the 3.8% tax on net investment income is to get one’s adjusted gross income below the threshold of \$250,000 for married couples or \$200,000 for single persons. “The rich people look at us with envy. ‘How do you do it?’ I’m not going to share my secret with you.” – Chris Hoyt
- y. *Guardian Ad Litem*. “In a state court action, the court will appoint guardian ad litem—a “guardian ad obstructionosim”—and they get paid to not take any risks.” – Jonathan Lurie
- z. *Subchapter J*. What three words are scarier than “You’re under arrest”? --Distributable net income. – George Karibjanian
- aa. *Marital Bliss*. Tenancy by the entirety is one of the few benefits that you get from being married.” – Richard Franklin
- bb. *Jeff, Get a Life!* After Prof. Jeff Pennell noted that he checked on January 1, 2014 to make sure that the IRS did not drop regulations on December 31 regarding application of the 2% haircut rule for the deduction of miscellaneous itemized deductions by trusts under §67(e) and possibly imposing an unbundling requirement on trusts. (The IRS has committed that it will not impose an unbundling requirement until the trust tax year that begins after the final regulations are issued—so there is a reprieve from any unbundling requirement for at least another year.) Dennis Belcher responded, regarding Jeff’s activities on the New Year’s Day holiday: “You lead an exciting life, Jeff.” – Dennis Belcher
- cc. *Congressional Stymie*. “I find it remarkable to listen to the U.S. Senate complain about the inability of the Afghanistan government to act. Am I the only one that finds that remarkable?” – Dennis Belcher
- dd. *Jane Austen on Annuities*. “Certainly not; but if you observe, **people always live for ever when there is an annuity to be paid them**; and she is very stout and healthy, and hardly forty. An annuity is a very serious business; it comes over and over every year, and there is no getting rid of it. You are not aware of what you are doing. I have known a great deal of the trouble of annuities; for my mother was clogged with the payment of three to old superannuated servants by my father’s will, and it is amazing how disagreeable she found it. Twice every year these annuities were to be paid; and then there was the trouble of getting it to them; and then one of them was said to have died, and afterwards it turned out to be no such thing. My mother was quite sick of it. Her income was not her own, she said, with such perpetual claims on it; and it was the more unkind in my father, because, otherwise, the money would have been entirely at my mother’s disposal, without any restriction whatever. It has given me such an abhorrence of annuities, that I am sure I would not pin myself down to the payment of one for all the world.” – Jane Austen, *Sense and Sensibility*, as quoted by Dennis Belcher

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- ee. *Unwelcome Advice.* In commenting about the *Lawrence* case in which the settlor of a foreign asset protection trust was jailed for several years after being found in contempt, Jeff Pennell observed “Bring your toothbrush is not the answer your client wants to hear.” – Jeff Pennell
- ff. *All In Your Perspective.* “My office is in an old converted building. I tell my friend across the street in the nice new building that I have much the better deal. I have a good view out my window of the nice new buildings as opposed to the view my friend has of my building.” – Robert Fleming
- gg. *Practice Up.* “I have posted on my mirror at home a card that I look at every morning. The card says 100, 93, 86, 79, 72, etc. A common question to test if someone has mental difficulties is to ask them to count backwards from 100, subtracting 7 each time. When someone asks me that, I’m going to be prepared.” – Robert Fleming
- hh. *Never Say Never.* “I co-authored a law review article some years ago saying that an attorney should *never* file a guardianship against a client. Galleys of the article came out on the same day I filed my first petition for guardianship for a client.” – Robert Fleming
- ii. *Let’s Talk Turkey.* Robert Fleming advises that every family should at some point have “The Talk”—about everyone’s views on life sustaining treatment. “There’s one day in everyone’s year when there is an extra hour and everyone is around. The turkey always takes an hour longer than expected. So have the talk on Thanksgiving Day between the parades and the turkey.” – Robert Fleming
- jj. *DOMA Overload.* “Many of you are in “DOMA Coma” or are “Windsor Weary.” – Prof. Lee-Ford Tritt
- kk. *Backdating.* Congress passed the American Taxpayer Relief Act of 2012 in 2013. “All of a sudden, I’m not so concerned about backdating my documents anymore.” – Sam Donaldson
- ll. *Thin Tax Brackets.* The 35% income tax bracket for single taxpayers begins at \$405,100 and the 39.6% bracket begins at \$406,750. “That’s right. The 35% bracket for single people covers \$1,650 of taxable income. I would submit that’s a pretty thin tax bracket. That’s anemically thin. That’s Angelina Jolie scary thin. We’re used to seeing those kinds of brackets in section 1(e) when you talk about the taxation of trusts and estates. We don’t see that with carbon-based taxpayers. You don’t need a whole lot of taxable income before you’re into the 39.6% bracket - you know, the Kim Kardashian/Kirstie Alley tax bracket where there’s ample room.” – Sam Donaldson
- mm. *Tax Extenders.* In discussing the income tax extender provisions allowing teachers’ expenses to be deducted “above the line” in arriving at adjusted gross income, Sam Donaldson asked why we have tax provisions that expire every year and have to be renewed annually. “Because it’s the basic self interest of our legislators. As soon as they make it permanent, they can’t keep taking credit for it. As long as you make it an extender provision, you can routinely come back to your constituents and say – ‘Thanks to me I kept your above-the-line deduction. If it hadn’t been for me, my evil colleagues in Congress would have struck that down because secretly they all meet

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- together and say how much they hate teachers and hated the fact they had to attend Saturday school and can't wait to stick it to them. But I was the one who was there to defend you.' If they made it permanent, which wouldn't cost a whole lot of revenue, then they could say they made it permanent but everyone forgets about it. My wife doesn't give me much credit for that trash I took out on that Tuesday in October." – Sam Donaldson
- nn. *Non-Athletic Supplies.* "My favorite part of this above-the line deduction for teacher expenses is the fact the statute expressly states no above the line deduction is allowed for non-athletic supplies in health and PE courses. I have to confess – I was like, 'what the heck is that?' Only in the legislative history, as it gives examples and parentheticals, does it say – condoms." – Sam Donaldson
- oo. *Implicit Consent.* The exclusion for discharges of debt on principal residences expired at the end of 2013. "So if I contact my bank today and ask, 'can you release me from \$40,000 of my mortgage,' – I make that call once a week and I can't seem to get a response from the bank one way or the other. So I'm assuming that are complicit by assent-their silence indicates they're good with the plan. So that's how I'm proceeding." – Sam Donaldson
- pp. *Xerox at Its Best.* In giving an example of how the 50% bonus depreciation and §179 expensing election have changed in 2014, Sam Donaldson used an example of a really expensive piece of equipment – an \$800,000 photocopier. "This is a state of the art photocopier. This thing will take a picture of your butt without you even removing your pants. And it will do the touch-up automatically, so as to remove all the warts and the wrinkles and the flab. We all know it's really a \$100,000 photocopier and \$700,000 for the toner, but it's \$800,000 of photocopier." – Sam Donaldson
- qq. *Capitalizing Expenses.* "If it's a capital expenditure, and the anticipated benefit will last substantially beyond the end of the year, then I have to capitalize the cost—which means that I don't just use the 'shift key,' I have to ..." . – Sam Donaldson
- rr. *Economic Stimulus.* The 100% exclusion on gains from the sale of §1202 stock applies to stock acquired in 2013 and that is held for five years before being sold. "Some think that's a little bit funky. 'If this is all in the name of economic stimulus, that not really stimulating the economy today, that's stimulus 5 years from now. And all those ads say if the stimulus last more than 4 hours, you're supposed to call your doctor.'" – Sam Donaldson
- ss. *Cash Will Do.* "Qualified conservation real property easements are terrific. I give an organization a conservation easement, which is a promise that in perpetuity no owner of this property will change the existing use of this property without the written consent of Major League Baseball and the holder of this easement. ... A subsequent owner who wants to subdivide the property has to comply with the easement, they will have to go to the conservancy organization and say 'we'd like to change the use but because you have this easement, we have to get your permission.' Presumably the conservation organization will say 'it depends on whether it's consistent with our intent.' Which means, 'Will you pay us cash?'" – Sam Donaldson

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- tt. *Kissing Cousins.* The façade easement is the kissing cousin of the conservation easement. “For those of you who grew up in the same part of the country where I did: your kissing cousin –your prom date.” – Sam Donaldson
- uu. *Listen Up Hallmark.* Special IRA rules apply to individuals beginning at age 70 ½ (including the qualified charitable distributions from IRAs). “Shouldn’t Hallmark come out with a ‘Happy 70 ½ Birthday Card’? After you’ve hit 21, what is the next birthday to live for? It’s 70 ½ when the distributions start coming. The card writes itself: ‘May your life be long and your distributions be minimal.’” – Sam Donaldson
- vv. *All In.* For the last several years, charitable contributions by S corporations resulted in outrageously favorable benefits. As the Beatles would say, you’d do this “Eight Days a Week.” – Sam Donaldson
- ww. *Lottery Luck.* A sale of the right to receive future ordinary income is not a capital gain. Courts have consistently applied that doctrine to the sale of future rights to receive lottery payments. “If you want to con anyone, a lottery player is the perfect person, ‘cause they’re already mathematically challenged - they play the lottery. ... A lot of these lottery players take the position that because a sale of lottery winnings is not in the list of capital assets, the gain will be capital gain... At one point there were 68 different lottery winners that went to the Tax Court all with the theory that they had capital gain on a sale of the lottery winnings. You would think that number 68 would stumble across one of the prior 67 precedents from the Tax Court.... Or perhaps number 68 said ‘I understand the other 67 lost, but I’m a luck guy. I can beat the odds. I did it once. I’ll do it again.’” – Sam Donaldson
- xx. *Short Term Capital Gain.* “Short term capital gain is better than ordinary income, but not much better. It’s like going to the prom with your sister. You’re at the prom, and that’s cool – but it’s with your sister. Those first seven or eight kisses are kind of awkward.” – Sam Donaldson
- yy. *Gift Income Exclusion.* To qualify as a ‘gift’ the transferor must exhibit ‘detached and disinterested generosity made out of affection, respect, admiration, charity or like impulses.’ That puts donees in an awkward position. Now anytime you receive gifted property you say your donor, ‘pardon me, but why are you making this transfer?’ Or if you want to direct the conversation, say ‘I hope you are transferring this out of detached and disinterested generosity made out of affection, respect, admiration, charity or like impulses.’ ... The other awkward question you have to ask your donor is ‘I know this sounds kind of tacky, but what did you pay for it? Because I’m going to take the same basis in this property that you had, so I kind of need to know what you paid for it. So from a tax planning perspective, the tip from today’s presentation is: Leave the price tags on gifted property, because they are helpful for telling your donees their basis going forward.’” – Sam Donaldson
- zz. *No Gifts of Depreciated Property.* The donee’s basis in gifted property for loss purposes is the lesser of the donor’s basis or the fair market value at the date of the gift. Instead of giving depreciated property, the donor “should sell the loss property so that you can claim an income tax deduction for the loss, and give the cash to the beneficiary. (a) Your beneficiary will be so much happier receiving cash than some

sucky asset. But (b), importantly, you have saved that income tax deduction. And the loss of the income tax deduction is our King Lear-like tragedy that we try to avoid in income tax planning.” – Sam Donaldson

- aaa. *Everything In Order.* “If my wife and I live as God intended and I die first ...” – Sam Donaldson
- bbb. *High Net Worth Clients.* “Can we be honest? We come to these conferences and say “‘Oh, yeah yeah, I only represent high net worth individuals - the \$20 million estates and above. I’ve got one of these right now and I’m trying to decide what to do.’ Come on. We say ‘high net worth’ but really there’s a comma there between high and net. So that if *any* client comes into our office with net worth, we say ‘Hi, net worth – I’m happy to be your lawyer.’ Let’s face it, a lot of our clients don’t have estate tax concerns. I mean a lot of these clients have our same last name. They don’t have big taxable estates anymore. For them, it’s all about the step-up in basis.” – Sam Donaldson
- ccc. *Policy Behind Basis Step-Up at Death.* “You can think of it as the impossibility of trying to figure out what carryover basis would be from a person who – you can put them on the stand, but they’re not going to answer many questions as to what they paid for it ‘cause they’re dead.” – Sam Donaldson
- ddd. *Divorce.* “Assume in a hypothetical the house is in the wife’s name, and as part of the divorce decree the house is awarded to the husband. – I just love making hypotheticals where the husband wins. You can do that in law school - completely far-fetched hypotheticals that don’t happen. I’m not speaking on the basis of my first divorce at all. I’m completely over it. That’s what my therapist says.” – Sam Donaldson
- eee. *Unforeseen Circumstances.* If the statutory requirements are not met to qualify for the exclusion of \$250,000 (\$500,000 for married couples) from the sale of a principal residence under §121, a reduced exclusion may be available in several situations. One is for “unforeseen circumstances.” That’s all the statute says. The regulations say an unforeseen circumstance is the “occurrence of an event that the taxpayer could not reasonably have anticipated.” “It all makes sense, right?” ... Several examples are listed. One is death. Really? Death is an unforeseen circumstance? Who would have known that one day you were going to die? ... My favorite one, and I’m not making this up, is multiple births from the same pregnancy. ... I remain convinced that the only reason that is in there – I’m almost positive that is a shower gift that was given by a group of Treasury employees to one of their own who was about to have triplets. ‘We passed around a hat but nobody contributed, so we just wrote a reg that you can sell your house now and you won’t have to pay any tax on the gain. Your friends at Treasury.’

What’s interesting is what’s not in there. When this came out in proposed form, there were commentators who said ‘what about marriage,’ because there are lots of circumstances where the groom has a house and the bride has a house, and one of them has to sell their house and all of their stuff—because they have to move into the

one with all the lace and the knick-knacks and the pretty pink colors. (Perhaps I'm projecting again.) How about if we put marriage in there?

How about adoption? The home they have now is cramped. If we have multiple births from the same pregnancy, why not the adoption out of foster care?

'No, no, no' says Treasury, 'things like marriage and adoption – those are in the voluntary control of the taxpayer.'

Multiple births from the same pregnancy, however, just happen out of the blue. You're walking down the street and you have water weight that's happening in there. How could that have been foreseeable? Who would have thought that by in vitro fertilization, by putting in eight fertilized eggs, would lead to eight kids? 'I had no clue.'" – Sam Donaldson

- fff. *Related Parties.* There are special rules applying to installment sales between related parties. "Who is a related party? ... You are considered to be related to your parents, your children, your siblings. Interestingly, you're related to your spouse – that used to be the case only in West Virginia." – Sam Donaldson
- ggg. *Installment Notes at Death.* Installment notes bequeathed to a beneficiary will result in income as the note payments are made; there is no step-up in basis. "If you die holding an installment note, as Skippy receives the payments he steps into your shoes. Which is kind of gross because you are dead." – Sam Donaldson
- hhh. *Like Kind Exchanges.* "I had a group of students that got all excited about the discussion of like-kind exchanges when we got to the end of it because they thought we were talking about 'like-- kind exchanges' as opposed to 'like-- evil exchanges.' So they were like-- excited, that this was like-- coming. How disappointed they were that like-kind is not Valley-speak." – Sam Donaldson
- iii. *Adjusted Basis.* "One of my all-time favorite Code sections is section 1011. It says your adjusted basis is your basis as adjusted. Thank you, I get it now." – Sam Donaldson
- jjj. *Tax 101.* "The taxation of life insurance is literally 'Tax 101'" (pointing out that §101 of the Code addresses the taxation of life insurance death benefits). – Sam Donaldson
- kkk. *How Are You Feeling?* "If someone wants to pay you for your life insurance policy, and they want to pay you an amount that is more than the surrender value of the policy, you are not doing well. You may not know this, but you are probably 'circling the drain.'" – Sam Donaldson
- III. *Abusive Transactions.* The IRS is applying restrictions on donor advised funds, including restrictions on a DAF from paying for a donor to attend a charitable dinner. "I personally regard that as being sort of insulting, as if the government doesn't think we can't come up with transactions that are more abusive than that. And we're going to discuss those in just a few minutes, and the government has done nothing to crack down on those. But tickets and dinners are a big deal, and donations of cars are big deals, and donations of underwear are big deals." – Turney Berry

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- mmm. *Ancestral Home*. “An ancestral home is a house the parents desperately want the kids to live in that the kids would rather die than live in.” – Turney Berry
- nnn. *Practice Tip*. “If you are dealing with someone who does not want to give something to charity, I have a tip for you. Don’t talk to them about charitable gifts.” – Turney Berry
- ooo. *Typical Clients*. “The bulk of our clients will be too rich for Medicaid planning and too poor for estate tax planning. – Marty Shenkman
- ppp. *Future Trends; Efficiency*. “I recently did estate planning work for a prior client seven years after the prior engagement. The bill to the client was the same as 7 years ago, even though the billing rates are now double compared to 7 years ago. That is because of technology and management changes. In 2006, 70% of the billable time was junior associate drafting time and my time reviewing the associate’s work. This time, 60% of bill was my time meeting with the client in conferences. Getting efficient does not mean lower bills. When the tax elephant is off the table, we can talk about all the other things we talk about—and clients really do listen.” – Marty Shenkman

APPENDIX A

Formula General Power of Appointment With Tiered Formula Based on

Individual Assets Carrying Highest Tax Burden

Provided by Richard Franklin (Washington D.C.)

By-Pass Trust - Spousal Testamentary General Power of Appointment.

1. General Power of Appointment Over Asset #1 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death. The denominator of the fraction shall be the value of Asset #1 as of my spouse's death. Asset #1 shall mean that asset from among the Appreciated Assets (as defined hereinbelow), if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the greatest aggregate amount of federal and state income tax.
2. General Power of Appointment Over Asset #2 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death over (b) the denominator of the fraction in Paragraph 1 above. The denominator of the fraction shall be the value of Asset #2 as of my spouse's death. Asset #2 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the second greatest aggregate amount of federal and state income tax.
3. General Power of Appointment Over Asset #3 of the Appreciated Assets. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason of my spouse's death over (b) the sum of the denominators of the fractions in Paragraphs 1 and 2 above. The denominator of the fraction shall be the value of Asset #3 as of my spouse's death. The Asset #3 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass third greatest aggregate amount of federal and state income tax.
4. Additional General Powers of Appointment Over Additional Assets of the Appreciated Assets. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs 1 – 3 over additional assets of the Appreciated Assets, with each successive asset of the Appreciated Assets being that asset of the By-Pass Trust subject to the next highest aggregate amount of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax

payable by reason of my spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.

5. Last General Power of Appointment. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.
6. Appreciated Assets of the By-Pass Trust. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Section 1014(a) of the Code if such assets passed from my spouse within the meaning Section 1014(b) of the Code [OPTIONAL PROVISION: ,provided, however, that any Family Assets shall be considered last (and then classed based on greatest aggregate amount of federal and state income tax in a similar manner as provided above) For purposes of this Section the term "Family Assets" means _____ (e.g., the family farm or private family company, which is unlikely to be sold in the near future, etc.)]. For this purpose, blocks of shares of the same stock in the same company and having the same basis shall be considered as a block as one asset.
7. How Exercised. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular assets of Appreciated Assets free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.

THIS SAMPLE FORM IS A DRAFT FOR CONSIDERATION BY PLANNERS. THERE IS NO WARRANTY FOR ITS USE FOR ANY PURPOSE. IT IS INTENDED ONLY TO PROVIDE GUIDANCE TO A PRACTITIONER IN DRAFTING AND SHOULD NOT BE RELIED UPON FOR ANY OTHER PURPOSE.

APPENDIX B

Sample Form of Contingent General Power of Appointment

Provided by:

Day Pitney

Blue Back Square

75 Isham Road, Suite 300

West Hartford, Connecticut 06107

Section X. Contingent Powers of Appointment. Notwithstanding any provision herein to the contrary except the provisions of Section 3 of PART IV and in addition to any other power of appointment granted hereunder, each beneficiary of any trust hereunder (an “Applicable Trust”) who is a member of the most senior generation of the beneficiaries of such trust (an “Applicable Beneficiary”) shall have the following powers:

Contingent General Power of Appointment to Reduce Death Taxes. Each Applicable Beneficiary shall have the power to appoint the smallest fractional share of an Applicable Trust, if any, that would reduce to the minimum the aggregate federal and applicable state estate tax and generation-skipping transfer taxes (“Death Taxes”) payable upon the Applicable Beneficiary’s death. If the Applicable Beneficiary has a power of appointment equivalent to the power under this paragraph (a) with respect to other trusts, the Applicable Beneficiary’s power under this paragraph (a) shall apply to the Applicable Trust in the proportion that the value of the Applicable Trust bears to the value of all such trusts to which the Applicable Beneficiary has such a power of appointment. If any trust property is included in the estate of an Applicable Beneficiary for purposes of any Death Taxes as a result of this power of appointment, the Trustee shall pay over to the Applicable Beneficiary’s estate, or pay directly, from such property, an amount equal to that increment of such tax liability attributable to the inclusion of such property in the Applicable Beneficiary’s estate.

Contingent General Power of Appointment to Reduce Capital Gains Taxes. Each Applicable Beneficiary shall have the power to appoint those Appreciated Assets of an Applicable Trust that (i) are not subject to a power of appointment under paragraph (a) preceding; (ii) have in the aggregate a value less than or equal to the largest amount that would not cause an increase in the Death Taxes payable upon the Applicable Beneficiary’s death; and (iii) have in the aggregate the greatest Appreciation. If the foregoing power may apply to some but not all assets with the same Appreciation as a percentage of basis, it shall apply to all those assets in the proportion that the value of each such asset bears to the total value of all such assets. The following rules and definitions shall apply to this paragraph:

If the Applicable Beneficiary is the beneficiary of more than one trust that includes the power provided in this paragraph (b) or an equivalent power, the following provisions shall apply:

Trusts with the Same Remainder Beneficiaries shall be aggregated and treated as a single trust for purposes of applying the power in this paragraph (b).

With respect to all other trusts, the power under this paragraph (b) shall apply in the proportion that the value of the Appreciated Assets in each such trust bears to the value of the Appreciated Assets in all such trusts.

“Trusts with the Same Remainder Beneficiaries” shall mean trusts for which, after taking into account any exercise by the Applicable Beneficiary of a power of appointment over such trust other than a power granted under this paragraph (b), the identity and type of interests of the vested and contingent remainder beneficiaries are identical; provided, however, that differences in the timing of the distribution of property, differences in whether distribution is outright or in trust, and differences in powers of appointment held by beneficiaries following the Applicable Beneficiary’s death shall not be considered.

“Appreciated Assets” shall mean property that, if included in the Applicable Beneficiary’s estate for purposes of Chapter 11 of the Code, would have its basis determined pursuant to Section 1014(a)(1), 1014(a)(2) or 1014(a)(3) of the Code immediately after the Applicable Beneficiary’s death, subject to the limitations of subparagraph (4) following.

With respect to an Applicable Trust that (i) has an inclusion ratio of zero, as defined in Section 2642(a) of the Code, and (ii) does not pass on the Applicable Beneficiary’s death, in default of the exercise of the power of appointment, solely to non-skip persons, as defined in Section 2613 of the Code, assets of such Trust shall not be Appreciated Assets to the extent that the value of such assets exceeds the Applicable Beneficiary’s exemption from generation-skipping transfer tax pursuant to Section 2631 of the Code available at the time of the Applicable Beneficiary’s death, reduced by the value of any transfers occurring at the Applicable Beneficiary’s death, other than pursuant to this paragraph (b) or an equivalent provision, to which an effective allocation of the Applicable Beneficiary’s exemption from generation-skipping transfer tax could be made.

“Appreciation” shall mean the amount by which the value of property exceeds its income tax basis immediately prior to the Applicable Beneficiary’s death.

General Provisions Applicable to this Section. For purposes of determining the property, or fraction thereof, subject to a power of appointment provided under this Section: Taxes shall be computed assuming that the power is not exercised.

Property shall be valued in accordance with Chapter 11 of the Code applied as if such property were included in the Applicable Beneficiary’s estate.

The Trustee may rely on information provided by the legal representative of an Applicable Beneficiary’s estate in determining the trust property subject to the power of appointment.

A power of appointment under this Section may be exercised by an Applicable Beneficiary by will duly admitted to probate upon any terms and conditions, including further trusts, to or for the benefit of the creditors of the Applicable Beneficiary’s estate. No exercise of this power of appointment shall be effective unless it shall make specific reference to this provision. Any portion of such property which such Applicable Beneficiary shall not have effectively appointed shall be distributed as otherwise provided in this Trust Agreement.

THIS SAMPLE FORM IS A DRAFT FOR CONSIDERATION BY PLANNERS. THERE IS NO WARRANTY FOR ITS USE FOR ANY PURPOSE. IT IS INTENDED ONLY TO PROVIDE GUIDANCE TO A PRACTITIONER IN DRAFTING AND SHOULD NOT BE RELIED UPON FOR ANY OTHER PURPOSE.