

Efficient Use of the Temporary \$5 Million Gift and GST Tax Exemptions Redux¹

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Introduction

A rather compelling case can be made to use the temporary \$5 million gift and GST (generation-skipping transfer tax) exemptions now. Those exemptions and the \$5 million current estate tax exemption are scheduled to be reduced to \$1 million after 2012. It is possible they may disappear even earlier if so recommended by the so-called "Super Committee" of the Congress that is considering ways to reduce our nation's deficits.

This article explains why using the exemptions now is important, how they may be most efficiently used and offers specific drafting suggestions. It also explains why it may be best to use the exemptions to create an Alaska (or Nevada) trust. It discusses why married couples may wish to use their exemptions for each other even if either or both of the spouses have a descendant from another union. Furthermore, sample trust language are attached for use by single and by married property owners.

The Case for Using the Large Exemptions Now

It usually is best to use an exemption as early as it becomes available. One reason is that the exemption may be eliminated by the law. As mentioned above, the large exemptions will disappear, under current law, after 2012. Hence, the \$5 million exemptions may be viewed as "use it or lose it" opportunities.

In addition, it usually is best to transfer property out of a taxpayer's tax estate as early as possible in order for the income and gain (and not just the amount of the exemption) also to be excluded from estate and GST tax. This is based, in part, on Albert Einstein's observation that compounding is the most important matter in the universe.

For example, if a taxpayer transferred \$5 million in 2011 and died in 2041 (30 years later) and if the property grew at a rate of six percent (6%) a year (historically, a low return for a well balanced portfolio), nearly \$29 million would be excluded from the property owner's gross estate. If the property grew at three percent a year, over \$12 million would be excluded. If it grew at ten percent (10%) a year, over \$87 million would escape estate and GST taxation.

Those numbers are significant. In fact, they are so significant that many individuals will hesitate making such transfers for fear of being locked out of enjoying the property especially if their retained wealth suffers a "reversal of fortunes." This article will explain, as little later, how a taxpayer may retain an interest in the transferred wealth, as well as its growth and income, essentially for life while still using the exemptions at this time.

Another Key to Avoiding the Most Tax: The Grantor Trust

¹ This article is derived, in part, from the January 2011 issue of the Alaska Trust Company newsletter.

Some might view the concept of experiencing a ten percent (10%) annual compounded return, after tax, as fanciful. However, historically, equities (such as publicly traded stock) do average a ten percent (10%) or greater average annual return over 30 year periods. However, the returns will be reduced, and in some cases, significantly by income tax on the gain and dividends the equities return.

However, it is relatively simple to avoid having the trust's profit eroded by tax. That can be done by making the trust a so-called "grantor trust." The taxable income of such a trust is attributed for Federal income tax purposes to the trust's grantor even though the trust receives the income and gain. Hence, the trust will grow income tax-free, the most powerful factor in financial planning.

The effect of having the trust grow tax free by having the grantor pay the income tax might seem to make the financial situation of the grantor even more dire. Not only has the grantor lost the underlying property as well as the growth and income it produces but pays income tax on income the grantor has not received. However, because the grantor may be made a beneficiary of the trust which owns the property, the grantor can benefit from the trust assets. In fact, the grantor may personally benefit more from that than he or she would if he or she retained ownership of the property: the assets in the trust may be immunized from claims of the grantor's creditors, as explained below.

Keeping an Interest in Transferred Property

As mentioned above, the amount that may be removed from a taxpayer's estate by gifts early in life may retard the desire to make such transfers because the taxpayer may lose all interest in those assets. However, there is a way in which the taxpayer can retain a discretionary interest in the property and yet have it excluded from his or her estate. That may occur by transferring the assets to what is called a "self-settled" (or created for oneself) trust created in a jurisdiction so that the self-settled nature of the trust will not cause the trust to be included in the grantor's gross estate. That turns on creditor rights.

Until 1997, virtually all American jurisdictions provided that all creditors of a grantor could attach property the grantor placed in trust for himself or herself even if the grantor was not trying to defraud any creditor and even if the grantor could receive trust distributions only in the discretion of an independent trustee. See, e.g., New York EPTL 7-3.1. However, on April 1, 1997, Alaska adopted legislation that permitted individuals to create self-settled Alaska trusts that would not be subject to the claims of the grantor's creditors provided certain conditions were made.

The tax law has long provided that a transfer to a self-settled discretionary trust that remains subject to the claims of the creditors of the grantor is not a completed gift (and, therefore, not subject to gift tax) and is included in the grantor's gross estate for Federal estate tax purposes. See, e.g., *Outwin v. Commissioner*, 76 TC 153 (1981), *acq.* 1981-2 CB 1; Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 77-378, 1977-2 CB 347; Rev. Rul. 2004-64, 2004-2 CB 7. On the

other hand, the law also has consistently provided that if the grantor's creditors cannot attach the assets in a self-settled discretionary trust, the transfer to the trust is a completed gift the trust is not included in the grantor's gross estate, unless the grantor retains some interest or power other than being eligible to receive trust distributions in the discretion of another as trustee. *See, e.g., Estate of Uhl v. Commissioner*, 241 F. 2d. 867 (7th Cir. 1957); *Estate of German v. United States*, 7 Ct. Cl. 641 (1985); Rev. Rul. 2004-64, *supra*.

In fact, the IRS has ruled that a self-settled trust created under Alaska law will not be included in the grantor's gross estate unless there is an implied understanding or other factor that would cause estate tax inclusion. PLR 200944002 (not precedent). In fact, the key part of the private letter ruling is:

"In addition, the trustee's discretionary authority to distribute income and/or principal to Grantor, does not, by itself, cause the Trust corpus to be includible in Grantor's gross estate under § 2036. *We are specifically not ruling on whether Trustee's discretion to distribute income and principal of Trust to Grantor combined with other facts (such as, but not limited to, an understanding or pre-existing arrangement between Grantor and trustee regarding the exercise of this discretion) may cause inclusion of Trust's assets in Grantor's gross estate for federal estate tax purposes under § 2036."**

As explained in detail in a recent article, it seems that such a self-settled trust probably can be governed only by the laws of the state of Alaska (and, perhaps, Nevada) and be excluded from the grantor's gross estate. See Rothschild, Blattmachr, Gans & Blattmachr, "IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate," 37 Estate Planning 3 (Jan. 2010). Although there are now about 15 self-settled asset protection trust states, each, except Alaska and Nevada, permits at least some creditors to access the trust property. These creditors often include claims by a spouse or child for support and the state for obligations owed to it. Rev. Rul. 2004-64, *supra*, strongly indicates that, if any creditor of the grantor can attach the trust assets, the entire trust is included in the grantor's gross estate. In any case, the IRS has only issued a favorable ruling with respect to Alaska self-settled trusts.

Hence, by creating a self-settled trust in Alaska, a taxpayer may be able to use his or her gift and GST tax exemptions, remain eligible to receive distributions and yet have the trust excluded from his or her gross estate for Federal estate tax purposes. By the way, the grantor can even retain the right to remove and replace trustees (as long as the substituted trustee cannot be someone related or subordinate to the grantor within the meaning of section 672(c)). See Rev. Rul. 95-58, 1995-2 CB 1.

Still Worried About Estate Tax Inclusion?

Although PLR 200944002 is quite explicit in its holding that an Alaska self-settled trust will not be included in the gross estate of the grantor (barring a finding that there was an implied understanding that the grantor would receive benefits from the trust), private letter rulings cannot be cited or used as precedent. *See* Section 6110(k)(3) of the Internal Revenue Code ("Code"). In any case, there are ways to structure the trust so that the risk of estate tax inclusion,

if the private letter ruling is not followed by the IRS and the courts, can be reduced if not totally eliminated.

Section 2036 of the Code is the provision that typically has been used by the courts and the IRS to find that a self-settled trust is included in the grantor's gross estate. *See, e.g., Paxton v. Commissioner*, 86 TC 785 (1986). Section 2036(a)(1) causes estate tax inclusion if the grantor retained the right to the trust income. The section applies even if there is no explicit or legally enforceable retention. As indicated above, it applies even if there is an implied understanding trust income will be paid to the grantor. The "theory" in applying section 2036 to cause estate tax inclusion of a self-settled trust where the grantor's creditors can attach the trust assets is that the grantor retained the power to "relegate" his or her creditors to the trust assets.

However, the section only applies if the grantor has such an interest at death, not before death. Therefore, if someone (such as a trust protector or someone else) can expunge the grantor's interest as a beneficiary of trust prior to the grantor's death, section 2036 cannot apply. Of course, section 2035 causes estate tax inclusion if the grantor had a section 2036 interest which he or she transferred within three years of death. However, if someone (such as a trust protector) expunges the grantor's interest, it does not seem the grantor has made a transfer of his or her interest in the trust. Note, however, that TAM 199935003 (not precedent) indicates that section 2035 might apply if the grantor set up the arrangement so his or her interest could be eliminated. It seems questionable whether that private letter ruling is correct. But, obviously, it will be best to expunge the grantor's interest more than three years prior to death if the law develops that the IRS and the courts will not follow the conclusions in PLR 200944002, *Estate of Uhl, supra* and *Estate of German, supra*.

More Protection for Married Persons

One option for a married person is not to create a self-settled trust but rather to create a perpetual GST exempt trust for his or her spouse. As long as the couple remains "happily" married, both the spouse and the grantor may enjoy the trust to the extent the trustee makes distributions to or for the benefit of the spouse or makes the use of trust property (such as a home or a work of art) available to the spouse.

The grantor's spouse could be given a sufficiently broad special power of appointment, exercisable at death (or even during lifetime) to appoint the trust property to a class that includes the grantor. It could be made exercisable only with the consent of a non-adverse party (perhaps, a sibling of the grantor) to ensure spouse will not exercise it in a manner that the grantor would find inappropriate. In addition, the non-adverse party could block any change in the spouse's exercise that the non-adverse party had previously consented to. Therefore, if the grantor's spouse exercised the power soon after the trust was created to continue the trust for the grantor if the spouse dies first, the non-adverse person could be given the power to prevent the spouse from changing the exercise.

Even if the spouse who dies first does not continue the trust for his or her spouse (or originally created the trust), the surviving spouse will be no worse off: he or she will remain the beneficiary

of the trust the deceased spouse created for the survivor. Hence, even spouses with descendants from other unions can create trusts for each other without a true erosion of each spouse's wealth.

Of course, if the spouse does exercise the power of appointment to continue the trust for the grantor, it might be, under applicable local law, that the grantor's creditors could attach the trust assets because, even though the grantor succeeded to his or her successor interest by reason of the exercise of a power of appointment by the spouse, the grantor did, in fact, create the trust. As a consequence, if it is anticipated that the spouse will exercise any power of appointment in favor of his or her spouse who is the grantor, it would be prudent to create it under the laws of the state of Alaska or, perhaps, Nevada.

Of course, if each spouse creates a trust for the other, the reciprocal trust doctrine may be triggered. That doctrine causes the beneficiary of the trust created by the other taxpayer to be treated, for tax purposes, as the actual grantor of the trust. For example, if the wife creates a trust for her husband and he creates a trust for her, he may be treated as creating the trust for his benefit and she treated as creating the trust for her benefit. If the spouses have even an implied understanding that each would receive the income of the trust or have a power to control the beneficial enjoyment of the trust property, estate tax inclusion would occur. See, e.g., *Estate of Grace*, 395 US 316 (1969); *Estate of Bischoff v. Commissioner*, 69 TC 32 (1977). In other words, application of the doctrine would mean that each spouse would be treated as having created his or her own self-settled trust. If the trusts are created in Alaska, that should not be problematic as far as estate tax inclusion is concerned by reason of PLR 200944002. However, it would be best if the doctrine was not applied. In any case, if the trusts are "substantially" different the doctrine should not apply. See, e.g., *Levy v. Commissioner*, 46 TCM (CCH) (1983), in which the IRS conceded that, if one spouse had a presently exercisable special power of appointment and the other did not, the doctrine could not apply.

Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trustsm", 21 *Probate & Property* 52 (July/August 2007), make suggestions on how to avoid the reciprocal trust doctrine when spouses create trusts for each other. These include making the standards for payments to the spouses different. For example, distributions to one spouse might be limited to health, education, maintenance and support and no standard (or reason) for the other spouse. Also, one spouse might be granted a lifetime special power of appointment while the other has no such power, exactly what the IRS conceded in *Levy v. Commissioner* would foreclose the reciprocal trust doctrine from applying. Funding one spouse's trust with assets different from those used to fund the other spouse's trust also is appropriate to consider. Another difference is to grant one spouse a testamentary limited power of appointment and either not granting one to the other spouse or make the class of potential appointees more narrow and to allow the power to be exercised only with the consent of some non-adverse party. Also, consideration may be given to having the trusts created at somewhat different time and naming trustees, especially those who hold the power to make discretionary distributions, different in each trust. The sample language attached includes these distinctions.

Don't Forget about Generation-Skipping Aspects

Presumably, the grantor of the trust will allocate GST exemption to the trust. However, the 2001 Act and 2010 Tax Act, which introduced the \$5 million gift and GST exemptions, provide that the tax law is to be applied after 2012 as though the Acts had never been enacted. Although it seems unlikely, it might be possible that the IRS will contend that, if the Acts had not been enacted, the exemptions would be only \$1 million (although the GST exemption would have been adjusted above \$1 million by inflation to around \$1.36 million). Hence, that could mean that the initial entire GST exemption of the trust would be eroded after 2012 down to around \$1.36 million. Hence, the trust would not be entirely exempt from GST tax but only partially so. This may suggest that two trusts be created, one equal to the \$1.36 million and another equal to any excess given to the trust. They both could be created under the same document.

There is also one other step that might be considered. That is to make the trust a so-called “skip person” trust. If for example, the trust initially were only for a living grandchild, then it would be protected from GST tax in its entirety until the grandchild and all older beneficiaries die, even if the IRS contends successfully that after 2012 only \$1.36 million will be considered the maximum available GST exempt amount even for transferred made before 2013. The reason is that a transfer to such a trust is a “direct skip” and, to avoid GST tax on that transfer, the GST exemption would be applied when the trust is created. That, in turn, cause the trust to be immunized from GST tax in all events at least through the generation of the grandchild. The sample language attached integrates this.

Any Unique Additional Upside?

As mentioned above, under the law of most states, assets in a self-settled trust are forever subject to the claims of the grantor’s creditors even if the grantor was not attempting to hinder, delay or defraud any current or future creditor. It is just the law of most states. However, under “black letter” law, creating the trust under the law of a state that protects such trusts from creditor claims should immunize the trust from later creditor claims. The Restatement (Second) of Conflicts of Laws provides, in effect, that it is the law that governs the trust (other than with respect to real estate) that determines whether a creditor of a beneficiary can attach the trust assets. Specifically, Section 273(b) provides:

“WHETHER THE INTEREST OF A BENEFICIARY OF A TRUST OF MOVABLES IS ASSIGNABLE BY HIM AND CAN BE REACHED BY HIS CREDITORS IS DETERMINED . . . IN THE CASE OF AN INTER VIVOS TRUST, BY THE LOCAL LAW OF THE STATE, IF ANY, IN WHICH THE SETTLOR HAS MANIFESTED AN INTENTION THAT THE TRUST IS TO BE ADMINISTERED AND OTHERWISE BY THE LOCAL LAW OF THE STATE TO WHICH THE ADMINISTRATION OF THE TRUST IS MOST SUBSTANTIALLY RELATED.”

Nevertheless, Section 548(e) of the United States Bankruptcy Act (11 USC) provides, in part, “[T]he trustee [in bankruptcy] may avoid any transfer of an interest by the debtor in property that was made on or within 10 years before the date of filing of the [bankruptcy] petition if (A) such transfer was made to a self-settled trust or similar device; ... (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder,

delay, or defraud any entity to which the debtor was or became on or after the date that such transfer was made, indebted.”

Hence, a transfer to a self-settled trust, even one created under the law of a state that immunized such a trust from the claims of the grantor’s creditors, can be reached in bankruptcy but only if the bankruptcy proceeding begins within ten years and the grantor had an actual intent to hinder, delay or defraud his or her creditors. However, a very strong case can be made that, if the grantor created the trust to use the temporary \$5 million exemptions, the motive was not to hinder, delay or defraud creditors but simple to accomplish the most efficient estate planning possible. In fact, although the purpose of the trust is to avoid estate tax, that could not fall under Section 548(e) of the Bankruptcy Act because the grantor never could be liable for that tax.

Hence, the “bonus” a grantor gets by using the temporary exemptions from taxation is to gain asset protection as well accomplish extremely efficient estate tax planning.

Any Unique Downside?

As strange as it may seem, making a large gift might possibly cause what is, perhaps, an unexpected result when the donor dies if the estate tax exemption then is smaller than the gift tax exemption used during lifetime. In effect, the benefit of the larger exemption may be "recapture" when the grantor dies (or makes a taxable gift in the future) although all growth and income earned on the gift should not be recaptured. That gift tax exemption recapture might occur because the calculation of estate tax under section 2001(b) is based, in part, on the amount of adjusted taxable gifts. This can cause, in some cases, estate tax not just to be higher than the what the tax would be if the estate tax rate were just applied to the taxable estate but actually can result, it seems, in estate tax greater than the gross estate. That, in turn, raises complications. It is anticipated that Treasury Department of the Congress will "cure" this potential problem. But right now the result is uncertain and thought should be given to this possible effect. In any event, there seems to be no recapture of the use of the larger GST exemption. Nevertheless, as explained earlier, if the tax law is administered as though the 2001 and 2010 Act were never enacted, the use of the GST exemption could be eroded although, as also mentioned above, this effect can be minimized by making the trust to which the property is transferred a “skip person” such as providing for living grandchildren to be the exclusive initial beneficiaries of the trust.

One real potential downside of transferring appreciating property prior to death in a manner that it will not be included in the grantor's gross estate is loss of the "step up" in basis permitted for most inherited property under section 1014 of the Internal Revenue Code. However, a case has been made that the step up in basis occurs if grantor trust status ends by reason of the grantor's death even if the property is not included in the grantor's gross estate. *See* Blattmachr, Gans & Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death", 97 *Journal of Taxation* 149 (Sept. 2002). And it appears, under current law, that the practical effect of a step up in basis can be achieved by having the grantor purchase the appreciated assets back prior to death without any gain or income recognition. *Id.*; Rev. Rul. 85-13, 1985-1 CB 184; Gans, Blattmachr & Zeydel, "Supercharged Credit Shelter Trustsm", *supra*.

Summary and Conclusions

The increase in gift tax and GST exemptions to \$5 million for only 2011 and 2012 provides an extraordinary and unique opportunity to effectuate significant lifetime estate planning. Some may readily take advantage of that by creating a long term "dynasty" trust for descendants. However, others may be hesitant to part with such a large amount of wealth. However, creating a self-settled trust in Alaska or, perhaps, Nevada seems to provide an opportunity to use those enhanced exemptions without terminating all interests in the trust property. For a married couple, the opportunities can be even more substantial by providing additional opportunities to retain an interest in the trust property.