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Journal of Estate & Tax Planning

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Martin Shenkman

From: stevesletters@leimbergservices.com
Sent: Friday, January 24, 2014 10:09 AM
To: Martin Shenkman
Subject: FLASH: Marty Shenkman's Heckerling 2014 Nuggets Steve Leimberg's Estate Planning Newsletter

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2188

Date: 24-Jan-14
From: Steve Leimberg's Estate Planning Newsletter
Subject: FLASH: Marty Shenkman's Heckerling 2014 Nuggets

Over the course of many years, **LISI** has been delighted to provide members with **Marty Shenkman's** notes from the proceedings at the **Heckerling Institute on Estate Planning**. Heckerling, as it is affectionately known, is the nation's leading conference for estate planners, attorneys, trust officers, accountants, insurance advisors and wealth management professionals. 2014 was the 48th installment of Heckerling, and for those not fortunate enough to be in sunny Orlando, the meeting this year ran from Monday, January 13 through Friday, January 17.

This year, Marty decided to do something little different. Instead of producing daily notes of each day's proceedings, Marty put together a 50-page analysis containing his observations on the proceedings. Marty refers to his commentary as his "Heckerling 2014 Nuggets" and we'd think you'd agree with us when we say that they are in fact gold.

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Because of the length of Marty's commentary, **LISI** has made it available to members through the following link: Marty Shenkman's Heckerling 2014 Nuggets

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Paramus, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of more than 40 books and 800 articles. In addition to authoring his amazing Heckerling notes for **LISI**, he is a co-author with **Jonathan Blattmachr** and **Robert Keebler** of 2012 Estate Planning: Tax Planning Steps to Take Now available through amazon.com.

Marty is the Recipient of the 1994 Probate and Property Excellence in Writing Award, the Alfred C. Clapp Award presented by the 2007 New Jersey Bar Association and the Institute for Continuing Legal Education; Worth Magazine's Top 100 Attorneys (2008); CPA Magazine Top 50 IRS Tax Practitioners, CPA Magazine, (April/May 2008). His article "Estate Planning for Clients with Parkinson's," received "Editors Choice Award." In 2008 from Practical Estate Planning Magazine his "Integrating Religious Considerations into Estate and Real Estate Planning," was awarded the 2008 "The Best Articles Published by the ABA," award; he was named to New Jersey Super Lawyers (2010-13); his book "Estate Planning for People with a Chronic Condition or Disability," was nominated for the 2009 Foreword Magazine Book of the Year Award; he was the 2012 recipient of the AICPA Sidney Kess Award for Excellence in Continuing Education; he was a 2012 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planning Counsels; and he was named Financial Planning Magazine 2012 Pro-Bono Financial Planner of the Year for his efforts on behalf of those living with chronic illness and disability. He sponsors a free website designed to help advisers better serve those living with chronic disease or disabilitywww.chronicillnessplanning.org.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Marty Shenkman

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Heckerling 2014 Nuggets

By: Martin M. Shenkman, Esq.

Contents

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Heckerling 2014 Nuggets

1. **Key Concepts**.
    a. **The Profession**.
        i. While it is clear that the planning paradigm has changed, and as a result estate tax planners need to reposition themselves in a manner that is more relevant, what do we reposition ourselves as? While no estate planner ever just advised on estate tax planning, that was certainly the role that many clients viewed as paramount. Perhaps we should describe ourselves as what we have always really been, counselors and advisors.
        ii. But something more specific will help us understand our evolving role, as well as communicate it to clients. One of the simple and obvious quotes from the entire week of proceedings is also one of the most important and insightful: "**We are in the wealth preservation business**." We protect wealth during the wealth accumulation phase, advise on retirement, and guide clients and the objects of their largess, including charities, on the transmission of wealth. We guide clients on protecting themselves and their wealth when confronted with cognitive challenges and dementia. With the new tax paradigm, tax planning (income, gift, estate, GST, surtax) will be vital, but a less emphasized portion of the equation for many clients. The breadth and scope of what have always done, and what we will continue to do, can often be subsumed under the moniker "wealth preservation."
    b. **Trust Administration**.
        i. Trust administration must receive greater attention to address the new tax paradigm:
            1. The change in the relationship between income and estate taxes (including the 3.8% surtax).
            2. The implications of modern trust drafting (broad fiduciary powers, indemnification provisions, divided fiduciary positions, etc.).
            3. The growing use of decanting, merger, trust protector actions to modify existing trusts, and more.
    c. **Income Tax versus Estate Tax: The New Paradigm**.
        i. **Income tax is the new estate tax**.
        ii. Planning has changed because estate and income tax rates have become so much closer than they have been for more than a decade. For some clients the combined state and federal income tax, and 3.8% surtax, can exceed transfer tax rates. This is a significant paradigm shift. Planning will have to address in greater detail the income tax basis of assets, especially those with ordinary income tax classification.
        iii. Estate planning will become more **granular**.
            1. Planning must become more granular by asset. In the past it had been common to plan for the estate as a whole, perhaps identifying certain assets, such as retirement plans, that had to handle differently. The approach now has to be the exact opposite. The default approach will now be to consider the planning options for

each asset, in a much more specific or granular manner. Only in that manner can a determination be made as to an appropriate course of planning as to whether estate inclusion for basis step up, or transfer to minimize estate taxes, is advisable.

2. Planning must become more granular by client residence and domicile. Planning had been quite similar regardless of state of domicile for many years. More recently planning has been differentiated based on whether or not the client's state decoupled from the federal tax system. Post-ATRA the change in the relationship of combined state and federal income tax (along with the 3.8% surtax) and state death tax (if applicable) and federal estate tax (if applicable) will require that planning be differentiated by state of residence and domicile given the significant variation in state income and death taxes, and the relationship of both to possible estate taxes.

d. **Non-Tax Planning Considerations**.

i. Planning will refocus more, for most clients perhaps even including those subject to a federal estate tax, on non-estate tax considerations such as:

1. Asset protection planning;
2. Planning for how distribution objectives will be achieved. This will include not only the naming of fiduciaries and the crafting of distribution provisions but the use of charitable planning; and
3. Planning for later years post-retirement.

2. **Situs, Nexus, Domicile and Residency.**

a. **Introduction**.

i. Planning for residence and domicile will grow in importance and become a common part of the general estate planning discussion, not merely a point to address when a client requests, at retirement or death.

ii. Planning the initial situs of a trust, which state laws will govern, and which state or states can tax trust income, is growing in importance.

iii. The increasing use of decanting and techniques to modify existing trusts will make these issues more complex.

b. **Taxation of Trusts**.

i. Some states make it clear how to avoid tax.

ii. Washington DC, Illinois and Pennsylvania have been problematic in that any trust created by a resident testator, or trustor, will be taxed as a resident trust even though this approach is unconstitutional.

iii. Federal tax system has become less favorable to trusts so many advisers have recommended increasing distributions to beneficiaries. But beneficiaries may be liable for state income tax on the distributions

iv. A trust was created by a Pennsylvania testator but had no Pennsylvania fiduciaries, assets or beneficiaries. The court determined that the trust should not pay Pennsylvania tax, reasoning that to assess tax violated the Commerce Clause even though the trustor and the discretionary beneficiaries lived in Pennsylvania. McNeil v. Comm., 67 A.3d 185.

v. A New Jersey resident created a testamentary trust. In 2006 the sole trustee resided in New York and the trust was administered outside of New Jersey. The trustee filed and paid New Jersey tax on S corporation income attributable to income from New Jersey, but not on S corporation income attributable to non-New Jersey sources. The fact that the tax return showed a New Jersey address was not deemed significant by the Court. The court reconsidered the Pennoyer and Potter landmark cases and held that since the trust was not administered in New Jersey, the Trustee was a New York resident and therefore could only be taxed on New Jersey source income. Residuary Trust A. v. Director, 27 NJ Tax 68 (2013).

vi. The increasing complexities of trusts using various fiduciaries will complicate these decisions and planning to avoid state income tax.

c. **Importance to Estate Planning Decisions**.

i. For clients under the federal estate tax exemption, state estate tax is the tax to avoid, and that may depend on the state to which they have the closest tax connection. States generally tax those who are resident for income tax purposes, and estates of those who were domiciled in the state.

ii. With some state income taxes reaching 13%+ the determination as to which state a person resides for income tax purposes can have significant economic implications.

iii. With about 20 states having a death tax, determining when they can assess that tax is also critical.

d. **Domicile and Residency**.

i. Generally, the taxpayer must be "domiciled" in a particular state for that state to subject him or her to a death tax. The Black Law Dictionary defines "domicile" as "The place at which a person has been physically present and that the person regards as home; a person's true, fixed, principal, and permanent home, to which that person intends to return and remain even though currently residing elsewhere." That simple definition can give rise to a myriad of issues, among them that more than one state may claim the person as a domiciliary to tax the estate. Adding to the complexity are the varying definitions some states have.

ii. While many people feel that they have moved out of a particular state, their "moving" might not be sufficient to break the tie of domicile in that prior state. The determination may turn on a subjective intent of whether there is an intent to return. Domicile and residency often go hand-in-hand, but not necessarily. You might make more than a transitory visit to a state thereby subjecting yourself to income tax in that state, but retain your domicile elsewhere. Delaware, for example, includes in the definition of a resident for income tax purposes anyone who is domiciled in the state.

iii. A California case provides an extensive listing of factors to consider in the residency analysis and may be a useful starting point. Appeals of Stephen D. Bragg, 2003-SBE-002 (May 28, 2003). The decisions are very fact specific which means reviewing any case law in the states at issue will be critical. It also means that those who plan carefully to have the facts support the position they intend will likely fare better. The analysis has another dimension when evaluating income taxation of trusts. New Jersey, for example, provides that if a resident trust does not have any assets in New Jersey or income from New Jersey sources, and does not have any trustees in New Jersey, it is not subject to New Jersey tax. Thus, careful planning and administration of trusts may afford valuable opportunities to minimize estate income taxation of trusts.

3. <u>**3.8% Surtax Tax Nuggets**</u>.
    a. <u>**Kiddie Tax May Trump Medicare Tax**</u>.
        i. The Medicare Surtax may be avoided by distributions to children subject to the 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 Medicare tax on passive income applies. IRC Sec. 1411. If the child's AGI is under $200,000 the child will not be subject to the Medicare tax.
        ii. Complex trusts with a sprinkle power should consider this distribution planning opportunity. Consider including all descendants as beneficiaries of a bypass trust, not just the surviving spouse, to facilitate this type of planning.
        iii. For this tip to succeed a separate income tax return must be filed for the child. Do not report the child's unearned income on the parent's income tax return. If the child's unearned income is reported on the parent's return, the parent's MAGI will be considered and the Surtax may apply.
    b. <u>**Sale of Business**</u>.
        i. Gain from sale of business property. If the taxpayer works in the business, gain on the sale of S corporation stock will in part be exempt. Proposed regulations said to look through the business and look at underlying assets. If sold for more than underlying assets, e.g., good will, that is subject to the tax. Regulations were re-proposed to address issues.
        ii. What is the cost of compliance compared to the tax involved? The rules are so complex that they may not be cost effective to address upon the sale of a business. Consider the cost of an appraisal to ascertain the information that the Regulations require. Is it worthwhile?
    c. <u>**Planning Tips to Reduce the Surtax**</u>.
        i. Reduce your income below the threshold amount if you are close, e.g. $200,000 for a single taxpayer.
        ii. Use trusts and FLPs to shift income to lower bracket family members.
        iii. Convert NII to non-NII.
        iv. Make interest tax exempt by investing in municipal bonds.
        v. Move investment assets into life insurance which is protected by a tax favored envelope.
        vi. Move interest, dividend and annuity assets into IRA accounts. Easiest way to do this is a Roth conversion and using non-IRA (i.e., non-protected) income producing assets to pay the tax cost incurred.

vii. If the client is making gifts to family or charity, shift the value of the assets producing the desired cash flow, and let the donee/recipient retain the income producing assets if they won't be subject to surtax by the donee but the donor was subject to the surtax.

viii. Trustee fees can be used to adjust how much NII is distributed. In regular income tax world trustee fees can generally be allocated against just certain types of income included in DNI (such as interest income) if that is more highly taxed and reported that way on the K-1. Specially allocating trustee fees will also impact the amount of NII that is deemed to be distributed. If you can do this in the income tax world it should affect the NII Surtax world in a similar manner. Note that in the regular income tax world some portion of expenses must be allocated to non-taxable income, e.g. muni-bonds, and lose the deduction to that extent. After making the trustee fee allocation for general income tax purposes and determining how much of each type of income is distributed under the regular DNI rules, a deduction for trustee fees is then allowed in determining the amount of undistributed NII that is subject to the surtax, but the trustee fees must be allocated proportionately among NII and non-NII items.

4. **Other Income Tax Planning Nuggets**.

   a. **State Income Tax Savings through NINGs and DINGs**.

      i. Delaware Incomplete Non-Grantor trusts ("DINGs") and Nevada Incomplete Trusts ("NINGs") may be used to avoid state income tax in a high tax state.

      ii. DINGs had been structured to avoid powers that could trigger grantor trust status. A distribution committee was used to approve distributions which could be made only with the consent of an adverse party. Because the donor retained a testamentary power to appoint the remainder of the trust assets among the donor's descendants the transfer was not a completed gift. The donor's consent power over the trust income and principal rendered the gift incomplete. The use of DINGs had been chilled by the IRS reexamining its earlier conclusions. These rulings likely will encourage a resurgence of DINGs and NINGs.

      iii. These rulings made the transfer an incomplete gift by the client/settlor retaining a lifetime special power of appointment limited to a HEMs standard, held in a non-fiduciary capacity. PLR 201310003, 4, 5 and 6.

5. **Trust Income Tax Nuggets**.

   a. **Filing Family Income Buckets**.

      i. There may be a change in perspective on trust administration and the counsel to provide trustees and families. In the past, if a client had created a dynastic trust the objective of maximizing family wealth overall and in the longer term would likely have been met by retaining income inside the dynastic trust to avoid estate taxation. Now, however, the greater spread in potential income tax rates from the highest to the lowest federal rate (including and not including the 3.8% tax), and the potential variation in state income taxation for the trust and the beneficiaries will create situations when it is now preferable, from the perspective of maximizing family wealth, to distribute income. There is, however an issue that will concern many families, namely making distributions outright to trust beneficiaries. It may be feasible to create a partnership in which the trust and the beneficiaries are partners. This may permit the allocation of income to the beneficiary for tax purposes without the actual distribution of hard assets.

b. **Trusts and Passive Loss Rules**.
   i. While it had been important to know the characterization of a trust as active or passive participant in rental real estate and other activities for the passive loss rules, that distinction has become more important as a result of the application of the 3.8% surtax to trusts. Trusts are subject to this tax once income reaches about $12,000.
   ii. One court held that the activities of the fiduciaries, employees and agents can be considered. Mattie K. Carter Trust, 256 F. Supp. 2d 536 (N.D. Tex. 2003).
   iii. The IRS has consistently taken the opposite approach. The limited approach the IRS has advocated of only considering the activities of the trustee was reiterated in TAM 201317010. The IRS analogizes to the rules governing a closely held business, namely that only the activities of the owner are considered. Thus, the IRS will only consider what the trustee does in his or her capacity as trustee. This is such a restrictive interpretation that it makes it unlikely for a trustee to be able to meet this test. See also TAM 200733023 and PLR 201029014.
   iv. In evaluating whether the trustee materially participates, the structure of the entities owned by the trust may be relevant. For example, a member managed LLC in which all members, including the trustee on behalf of the trust, can participate may be preferable.

c. **Grantor Trusts Capitalizing on the Income and Estate Tax Disconnect Under Scrutiny**.
   i. Practitioners have exploited the disconnect between the income and transfer tax treatment of grantor trusts for many years, and with much success. One taxpayer sold stock to an irrevocable defective grantor trust ("IDGT) for a self-cancelling installment note ("SCIN"). Only a small amount of the payment was included in the decedent's estate. CCA 201330033; Estate of William M. Davidson v. Commissioner of Internal Revenue (Tax Court Docket No. 13748-13).
   ii. Another similar transaction is where a client creates a trust for a beneficiary, e.g., a child, and funds the trust (a "BDIT" as referenced below) with a one-time gift of $5,000. The terms of the BDIT instrument grant to the child a $5,000/5% power to withdraw. When the power lapses, the trust is treated treat as if the child withdrew $5,000 and contributed the cash to the trust, and that transforms the child as the grantor and deemed owner of the trust for income tax purposes. IRC Sec. 678. Then the child sells a highly appreciated asset to the trust. There should be no inclusion of that asset in the estate. This sale is often for a private annuity or a SCIN.

iii. The government is well aware of the impact of these planning opportunities and is pursuing restrictions from several perspectives.

1. Treasury is paying close attention to the movement of highly appreciated assets without income tax consequence through these types of transactions. The Treasury no ruling list includes beneficiary defective trusts ("BDTs") (also called beneficiary defective inheritor's trust "BDITs").
2. The Treasury has demonstrated its dislike for the above transaction by providing that if a private annuity or SCIN have not paid off by death the estate will include the value of the assets transferred to trust as if it was an IRC Sec. 2036(a)(1) transfer. This would be a double inclusion since the asset value would be included in the estate, as well as the annuity or note payments received.
3. President Obama's 2014 budget proposal proposed including in the gross estate of a person deemed to own a trust under the grantor trust rules that portion of the trust attributable to a sale, exchange, or "comparable transaction" between the owner and the trust, if the trust is a grantor trust for income tax purposes (i.e., if that transaction was disregarded for income tax purposes).

iv. It is presumed that a more traditional irrevocable life insurance trust ("ILIT") will be an exception from the changes enacted to clamp down on sales to IDITs and BDTs. This presumption, however, might not provide adequate protection in light of changes that have occurred in trust planning in recent years, particular in 2012 and subsequent years. It has become more common to structure these complex trusts so that they own life insurance as well. This permits the income from the assets transferred to the trust to be used in part to fund insurance premiums. Even if an ILIT exception is provided for, how will the lines be drawn?

v. If Congress is looking for a payment to offset another income tax law change some of these changes may be addressed as an offset. This suggests that clients that might benefit from this type of planning should consummate such plans before a change becomes effective. While clients might be unlikely to heed timing warnings as they had in 2012 (remember the parable about the little estate planner that cried tax-wolf), such warnings are appropriate. The importance of completing this type of planning is especially important given the new income and estate tax paradigm that has resulted in an advantage for potentially many clients to preserve their exemption amount to permit retained assets to achieve a step-up in basis on death without an estate tax. That planning objective heightens the importance of using note sale transactions (and GRATs which are also subject of Administrative proposals to restrict them) to leverage the transfer of assets without the use of exemption.

6. **Threshold Issues to Evaluating Basis Step-Up Versus Inter-Vivos Transfer**.

a. **Threshold Issue No. 1 – Character of Assets**.

i. The key to planning is obtaining better understanding of the tax nature of the client's specific assets ("granular" asset planning as noted in the introduction). Estate planners typically think of stocks and bonds as the default or presumed assets, but there are other holdings that may really benefit more from a step-up in basis.

ii. Copyrights, patents, art and other creator-owned intellectual property has a zero basis and will trigger ordinary income if sold. Therefore, this is perhaps the most beneficial asset to plan to have included in the creator's estate for basis step up purposes. If a client dies with these assets, their basis will be increased to the fair value on death and become long-term asset for capital gains purposes. If, instead, the planner counsels the client to gift these types of assets during his or her lifetime (what had until recently been common planning advice), the overall tax costs could be exacerbated.

iii. If a client dies with negative basis commercial real estate interests, the step-up may solve the income tax issue.

iv. Gold, artwork and collectibles are taxed at a 28% capital gains rate, plus a 3.8% Medicare surtax rate, so that these assets might also be better retained in the client's estate.

v. Consider a prioritization of which assets should be retained and which transferred inter-vivos. Ideally the remaining exemption amount should cover the estate tax value of the retained assets, or insurance planning or other steps can be used.

b. **Threshold Issue No. 2 – State Tax Profile for Client and Heirs**.

i. To ascertain which planning approaches are likely to be optimal, the tax profile of the benefactor, and heirs/beneficiaries must be ascertained. This is the "granular" tax planning as noted in the introduction.

ii. For example, New York and New Jersey have an estate tax (although New York is considering proposals to significantly increase its exemption). California, in contrast does not have an estate tax. Thus, there will be a greater advantage to shifting asset values out of a New York estate than out of a California estate.

iii. Federal income tax rates are much higher than in the past, and the 3.8% Medicare Surtax may also apply. This must be considered in combination with the state income tax that is likely to apply.

iv. California, while it no longer has a state estate tax, has the highest income tax rates in the country, over 13%. Combined state and federal ordinary income tax rates are higher than transfer taxes.

v. So in states like California it will generally not preferable not to shift assets out of the estate and instead secure a step up in income tax basis on death. In New York and other states where the gap between estate and income tax is higher, selective transfers out of the estate may be preferable.

vi. This is far from simple. Which states do the heirs live in today? Where are they likely to live in the future when gains on sale of inherited or gifted assets being evaluated will be realized? Even if the state is known, will the use of a DING or NING mollify the anticipated tax? Might a tax deferred IRC Sec. 1031 exchange be used?

vii. A decision tree with probabilities must be used to evaluate the spectrum of potential outcomes for each client asset and potential tax scenario.

viii. Consider the gradations or bands of estate tax that may apply to a particular situation. The estate tax cost of retaining assets in the estate is:

1. Zero on the asset value up to the state exemption amount (assuming a decoupled state).
2. Then state estate tax on amount above state exemption and up to the federal exemption amount. The range is about 6.4% to 16%.
3. Above the federal exemption amount the tax rate is 40% plus the state estate tax impact.

ix. Growth in the exemption amount is substantial. With average inflation in 2034 the exemption will be nearly $9 million per individual.

c. **Checklist: Factors to Consider in Evaluating Estate Inclusion versus Transfer to Save Estate Taxes**. When evaluating the benefits of incurring an estate tax to achieve a step up in basis or transferring an asset to save an estate tax at the possible expense of sacrificing a basis step up the following factors could be considered in evaluating estate and income tax options to pursue:

i. Time horizon for holding the asset. When might the asset be subjected to a tax realization event? For example, if the asset is a family vacation home that may remain in the family for generations, the present value of any possible income tax cost is negligible. The probability of sale may also be negligible. If the client is charitably inclined might the potential use of a CRT alter the analysis?

ii. Life expectancy for the client. However, since there is a strong correlation between wealth and life expectancy a more realistic figure than mere average expectancy should be used. Even if somewhat crude, it is feasible to obtain more tailored personal life expectancy based on the client's actual medical history. Again, how invasive will a client permit the process to become in order to enhance the likelihood of a tax optimal decision? Will more moderate wealth clients be willing to incur the costs of such an analysis? Without this how relevant will the life expectancy age be for purposes of the analysis? How is the risk of premature death factored into this analysis? If a gift is made, an early death may result in very little subsequent appreciation that is removed from the donor's gross estate for estate tax purposes, but the basis step up would be lost for the full amount of unrealized gain. Each time the client meets with his or her advisers there is some risk that the client will die prior to the next review meeting. While the statistical likelihood of this may be small for many clients, many clients buy term life insurance and less than 2% of term life insurance policies ever pay.

iii. Size of the gross estate. This however, is far more complex than assembling a balance sheet. Growth rates of client assets, spending patterns, and a range of other factors must be considered. This also then must be compared to the anticipated inflation adjustments to the exemption amount.

iv. The tax character of the specific asset being planned for must be considered. Planning must be more granular than it generally has been in the past. For example, some assets will benefit more from a basis step up on death than other assets. For example, negative basis real estate or collectibles may be near the top of the list of assets that will benefit. Non-appreciating assets will obviously not benefit.

v. State of residence or domicile of the client is important as it may affect the determination of estate tax on death. However, when statistics for moving are considered, and in particular, when anecdotal evidence of practitioners' experience with clients affirmatively moving to avoid a state estate tax, how can or should this be factored into the analysis? A move that eliminates state estate tax may change the analysis in a meaningful manner.

vi. State of residence (not necessarily domicile) of the beneficiaries and the anticipated marginal income tax bracket of the beneficiaries. This too can be quite complex and could entail a considerable number of rather uncertain variables. How might relocation affect the tax status of the beneficiaries? What if each beneficiary lives in a different state? What if each beneficiary has a different tax profile? While trusts owning the assets could be divided so that each beneficiary could pursue his or her own planning options, that increases the cost and complexity of the planning. Also, many beneficiaries, even more so if they live in a different state than their benefactor, may have different tax advisers with different perspectives on planning. To really ascertain the tax brackets of various beneficiaries, the consideration of whether that beneficiary will have investment counsel sophisticated enough to harvest gains and losses to minimize the costs involved may be relevant. The propensity of each beneficiary to charitable giving and the possible use of a CRT or charitable gift annuities to mitigate tax costs may be relevant. With the resuscitation of DINGs and NINGs might the client use these techniques to avoid state income taxes?

vii. Expectations about future inflation are important to quantify. This too could in reality be much more complex in that different assets may have inflation rates that differ considerably from other assets.

7. **<u>Basis Maximization Nuggets</u>**.

   a. **<u>Gift Creatively and Carefully</u>**.

      i. If an asset has appreciated substantially, consider borrowing using the asset as collateral for the loan, and then gift the cash. The appreciated asset will remain in the estate for a basis step up, the debt will reduce the value of the estate, and the cash can fund a gift. If the gifted cash will be used for expenses by donees there may be no detriment to this planning.

      ii. If the funds are to be invested by the donee in appreciated assets the plan may be flawed. See discussion of family loans below.

   b. **<u>Use General Powers of Appointment</u>**.

      i. An advisor can manage tax basis by forcing estate-tax inclusion when income tax benefits are greater than the transfer-tax costs. How do you do so? One approach is the creative granting of general powers of appointment to beneficiaries who have excess exclusion.

ii. A general power of appointment is a right given to a person to designate or appoint where assets can be distributed. A general power includes the right to appoint assets to that person's estate or creditors. So giving a relative who has modest wealth a general power to appoint assets in a trust can cause those trust assets to be taxable in a small estate where they will trigger no estate tax. Assets in the trust will all get a step-up in tax basis.

iii. If the power holder dies without exercising a GPOA the property subject to the power is include in the power holder's estate and will be subject to a step-up in basis. Treas. Reg. Sec. 1.1014-2(b)(2).

iv. Clients will no doubt be concerned about granting a GPOA. Several approaches can be used to mitigate its scope without sacrificing the intended tax result. The GPOA could be a "limited" GPOA so that the power holder can only appoint to his or her creditors. This limits the scope of the power to lessen its use to appoint assets to those other than the intended heirs of the grantor. Also, the power can be subject to the consent of a non-adverse person. More specifically, the person holding the consent power cannot have a substantial interest adverse to the exercise of the power in favor of the decedent, his or her estate, his or her creditors or the creditors of his or her estate. Treas. Reg. Sec. 20.2041-3(c)(2).

v. Consider also including in a trust that may grant a GPOA a named trust protector who can grant or modify the terms of a limited power of appointment "LPOA" and convert it to a general power of appointment. The real issue is who would be willing to serve as a protector with this broad decision making authority? Can a protector be sufficiently indemnified for acting, or choosing not to act on this type of power? See the discussions about trends in trust law and the limitations on exoneration powers elsewhere in this article.

vi. The use of a trust protector could be applied in a more refined manner to determine each year, based on the inflation increase in the available estate and GST exemption, state of marriage, state of domicile, etc., to grant GPOAs as needed against specific types of assets.

vii. GPOA are not to be treated lightly. Might the grantor of a GPOA increase the assets over which a spouse could exercise an elective share?

viii. Push assets up the generation line to use parent's unused exemption. For example, the client could transfer assets to a grantor trust that has provisions to create general powers of appointment. If the grantor trust is formed in Delaware, Nevada or South Dakota there is no requirement to give notice of the power to the power holder. While this works in theory, might the IRS challenge the reality of a power that no one who could exercise it was aware of? Is this a bit akin to the Zen Koen of the sound of one hand clapping.

c. **<u>JEST</u>**.

i. An approach advocated by several commentators is referred to as the Joint Exempt Step-up Trust, or "JEST." This technique is advocated for those in non-community property states in order to mimic the result of a community property law that would provide a basis step up for all assets on the death of the first spouse.

ii. The spouses establish a joint revocable trust which becomes irrevocable on the death of the first spouse who is granted a general power of appointment over the entire trust corpus. This power causes all assets to be included in the estate of the first to die spouse. These assets can then be transferred to bypass and QTIP trusts.

iii. If the assets contributed by the first to die spouse are insufficient to fund a bypass trust, arguments are advocated for using assets of the surviving spouse to complete the funding of a separate credit shelter trust.

d. **Swap Powers**.

i. Another approach is to ensure that clients die with the lowest-basis assets. If a client has made transfers to a grantor trust, he or she may be able to exchange or swap cash for appreciated assets held in the trust, thereby bringing those assets into their estate for a step-up.

ii. To make this swap power viable, consider drafting standby purchase instruments. Also endeavor to have lines of credit and other cash resources secured well in advance. Caution is in order because the Greenbook proposals may limit the ability of the grantor to so manage assets as it was proposed to affect transactions after the date of enactment (but the Greenbook would only cause subsequent appreciation or income to be subject to a gift or estate tax).

iii. This power, while interesting in theory, creates a number of practical issues. How can it be exercised? While one commentator quipped in humor that clients should be called weekly to assure that they are still well enough to exercise the power, when should it be exercised? At minimum, at every investment adviser review (perhaps quarterly) and certainly at each annual estate planning meeting, this should be addressed. The practical challenge with this is whether or not clients will participate in regular meetings.

e. **Planning to Avoid Discounts**.

i. Entities whose interests would be valued at a discount could be dissolved, but this would undermine all the other non-tax benefits the planning had initially been intended to achieve.

ii. Governing agreements could be restated to permit the parties to withdraw. While this will retain the entity intact, which may preserve asset consolidation or management objectives, it may eviscerate any asset protection benefits.

iii. Other approaches may be viable that can minimize or negate discounts without jeopardizing other benefits. For example, what if most of the client's remaining assets were transferred to the entity? What if the operating agreement or partnership agreement mandated that any member or partner who dies shall be paid a partial liquidating distribution sufficient to cover death taxes on the interest held? While this might cause estate inclusion, will it negate discounts?

f. **<u>Situs</u>**.

i. Change the situs of a self-settled domestic asset protection trust ("DAPT") to a non-DAPT jurisdiction as a means to create estate inclusion if the basis step-up is more important than the estate exclusion, assuming that the DAPT was a completed gift trust. This could be a creative way to let a client have their asset protection cake and eat their basis step-up too.

ii. This presumes that you believe that a self-settled trust can succeed as a planning technique. There are certainly differing views on the efficacy of self-settled trusts. Perhaps the naysayers might simply argue that if a client dies with a DAPT that it is included in the client's estate for basis step-up purposes. Both practitioners and the IRS will have to be careful what they wish for. In the new Alice-in-Wonderland world of post-ATRA planning in some cases taxpayers will benefit from taking the positions the IRS had previously urged.

8. **<u>Decoupled State Planning Options</u>**.

a. **<u>Outright Bequest to Spouse with Reliance on Portability</u>**.

i. The simplest of the planning approaches is to have the first spouse to die bequeath all assets outright to the survivor. In a decoupled state with a low estate tax exemption, this simplistic approach may likely result in an otherwise avoidable state estate tax on the second death.

ii. Many clients may opt for this relatively simplistic plan and rely on portability rather than use the disclaimer estate plan that was common prior to portability (but portability does not apply for state estate tax purposes in most states).

iii. This is the unplanned approach that may require practitioners retained after the first spouse's death to take corrective action to address not only state estate tax exposure, but the additional risks of the family wealth being exposed to lawsuits, elder financial abuse, or the risk of remarriage.

b. **<u>Outright Marital Bequest with Disclaimer Bypass Permitted.</u>**

i. Retain the outright marital bequest but also incorporate into the will or revocable trust a contingent bypass trust, perhaps limited to the lesser of the federal or state exemption amount, if the surviving spouse makes a qualified disclaimer.

ii. This disclaimer approach will be used as a default by many if a mandatory testamentary bypass trust is not acceptable to the client.

iii. The type of disclaimer planning is subject to the traditional issues and concerns that have always existed for qualified disclaimers. For a disclaimer to be valid under federal estate tax rules it must comply with the requirements of Code Section 2518 (including the "no acceptance of benefits" requirement that can be easy to violate inadvertently).

iv. The most significant concern with using disclaimers has been whether a surviving spouse would actually relinquish his or her outright ownership of the inherited assets by disclaiming.

v. Another shortcoming of the disclaimer approach, when contrasted with a Clayton QTIP is the disclaiming spouse cannot be granted any powers of appointment over the disclaimer bypass trust, thereby limiting future planning flexibility.

c. **<u>Mandatory State Exemption Bypass Trust with Remainder Outright to Spouse and Reliance on Portability</u>**.
    i. Many practitioners believe the preferable approach in a decoupled state is to fund a mandatory state exemption bypass trust on the first death. This can provide a state estate tax savings on the second death and the loss of basis step up on the second death can be dealt with by managing the assets, distributions of appreciated assets, asset location decisions, etc.

d. **<u>Mandatory Bypass with Remainder to State Exemption QTIP/Federal Bypass.</u>**
    i. Massachusetts and Washington permit a state only QTIP election. Massachusetts has a $1 million state estate tax exemption. Washington has a $2 million exemption.
    ii. In a decoupled state that has an estate tax exemption that is lower than the federal exemption amount, and a separate state QTIP election, the client can create a three part trust plan.
    iii. The client can shelter the state exemption amount from future state and federal estate taxes by creating a state exemption bypass trust, which would hold $1 million in Massachusetts.
    iv. Next, the client's will can create what many practitioners refer to as a "gap trust," which will hold an amount equal to the excess of the federal exemption amount ($5,340,000 in 2014) over the state exemption amount, $1 million, or $4,340,000. By making a state only QTIP election for the gap trust, but not a federal QTIP election, the gap trust is treated as a bypass trust for federal purposes although it is treated as a QTIP trust for state purposes. By creating a gap trust, the state estate tax is deferred until the surviving spouse's death.
    v. The final component of this three part plan is a marital bequest of any balance of the estate in excess of the federal exemption amount which bequest may take the form of a QTIP Marital Trust or other bequest that qualifies for the marital deduction.
    vi. There is also an obvious loss of distribution flexibility, which limits the ability to shift income to lower bracket family members, since all of the net income of a QTIP trust must be distributed annually to the surviving spouse.

e. **<u>Mandatory Bypass with Remainder to QTIP Trust When State does not Recognize a State Only QTIP Election</u>**.
    i. In some decoupled states, New York and New Jersey as examples, the state exemption is lower than the Federal exemption, but a separate state-only QTIP election is not always permitted. The federal QTIP election (or nonelection) is binding for state estate tax purposes as well. Note that Governor Cuomo's budget bill, released January 21, 2014, calls for increasing the New York exemption to parity with the federal exemption amount over a phase in period. If this occurs these issues will become moot for New York decedents.

ii. Pre-ATRA practitioners had to help clients evaluate whether incurring a state estate tax on the first spouse's death in order to maximize funding the bypass trust at the higher federal exemption amount, might be worthwhile. However, with portability now permanent, and a high inflation adjusted exemption also made permanent, it may be less likely that federal estate tax savings will be realized. Therefore, there is less incentive to incur a state estate tax cost on the first death in order to fully fund a bypass trust, when the estate of the surviving spouse is not likely to be subject to the federal estate tax.

iii. If the estate files a federal estate tax return (Form 706) to elect portability, the estate is bound by the federal QTIP election (or nonelection), and is precluded from making a separate QTIP election for New Jersey or New York state estate tax purposes because of the consistency requirement in state law. However, if no federal estate tax return is filed, the executor can make a separate state QTIP election.

f. **Mandatory Bypass with Delaware Tax Trap Marital for Balance of Estate**.

i. The application of the Delaware tax trap may present a planning opportunity to cause estate inclusion when desired. IRC Sec. 2041 (a)(3). Historically, the Delaware tax trap was a concern in that it could result in subjecting an otherwise tax exempt trust to tax. Post-ATRA, it might be desirable to intentionally trigger the Delaware tax trap causing estate tax inclusion, if the inclusion is in an estate that is of modest wealth and will not trigger any estate tax.

ii. If state law governing the instrument creating the power has eliminated the rule against perpetuities triggering the Delaware Tax Trap could be problematic. This will make it a practical issue in many states to harness this mechanism.

iii. To spring the Delaware Tax Trap and cause estate tax inclusion under IRC Sec. 2041(a)(3) the following steps must occur:

1. The beneficiary must exercise the limited power of appointment to leave the assets to another trust that gives someone a "presently exercisable general power of appointment"; and
2. Under applicable state law that newly created presently exercisable general power of appointment must postpone the vesting of any interest in the property, or suspend the outright or absolute ownership of the property, for a period that is ascertainable without regard to the date that the initial limited power of appointment was created.

g. **Outright Bequest to Spouse followed by Gift to Heirs using DSUE**.

i. There are several risks associated with any estate plan based on portability. If the surviving spouse remarries and the new spouse dies, the ported exemption, the DSUE, from the first spouse to die could be lost. Also, since the first to die spouse's unused exemption is no longer inflation indexed, the longer the surviving spouse lives, the greater the risk that the now combined estate may increase in value to the point of exceeding the aggregate exemption available to the surviving spouse. For clients domiciled in non-decoupled states, none of these steps would be necessary, as the first spouse to die could simply bequeath assets up to his or her federal exemption to a bypass trust to benefit the intended heirs and no tax would be due. In a decoupled state that same plan could generate a significant state estate tax on the first spouse's death. Hence, a circuitous route is required in a decoupled state to arrive at the same point.

ii. Soon after the first spouse's death, the surviving spouse makes a gift in an amount equal to the DSUE. The simplest donees might be the couple's children and/or grandchildren, in trust or otherwise.

iii. No state estate tax should be due with respect to the assets gifted by the surviving spouse. All of the future appreciation with respect to the assets gifted will not be subject to estate taxes on the later death of the second spouse. However, the gifted assets will not qualify for a step up in basis on that later death.

h. **Outright Bequest to Spouse followed by Gift to Grantor Trust to use DSUE and Preserve Swap Rights**.

i. The above planning idea (to fund a state exemption bypass trust, gift the remaining estate outright to the surviving spouse, followed by the spouse making a gift to heirs to utilize the DSUE), has a similar shortcoming as that of a bypass trust in that it does not provide for a basis step up at the second death. IF the gift is made to an irrevocable gift trust that is designed as a grantor trust, and which incorporates a swap power (although a purchase of assets would also be feasible with grantor trust status) as to the donor/surviving spouse. The swap power could enable the surviving spouse to transfer cash or other high basis assets to the trust in exchange for highly appreciated assets held in the trust. If the swap power is so exercised, this would allow the appreciated assets to benefit from a basis step-up upon the surviving spouse's subsequent death. No income tax would be triggered on this estate tax advantaged exchange, since the transaction would be disregarded as between a grantor and his or her grantor trust.

i. **Outright Bequest to Spouse followed by Gift to DAPT to use DSUE and Preserve Swap Rights**.

i. While the above approach of an outright marital bequest followed by a gift by the surviving spouse to heirs provides a solution to a number of estate planning issues, including the optimal utilization of the DUSE and avoiding state estate tax in a decoupled state on the first death, the shortcoming is obvious. The surviving spouse loses all access to the gifted funds and as a result there will likely be very few surviving spouses willing to pursue such planning. It should be noted that the surviving spouse could borrow money from the irrevocable gift trust at the Applicable Federal Rate, but that will likely prove insufficient solace to convince a reluctant surviving spouse.

ii. Another option is for the surviving spouse to gift the assets to a self-settled domestic asset protection trust ("DAPT") of which he or she is, or could be (e.g. added by a person acting in a non-fiduciary capacity), a discretionary beneficiary in addition to other named heirs (e.g. the children and grandchildren). This could provide somewhat comparable results economically, although perhaps not comparable legally, to the bypass trust with which practitioners and clients alike are familiar.

j. **<u>Outright Bequest to Spouse followed by Non-qualified Disclaimer to use DSUE.</u>**
   i. One of the personal, not tax or legal, issues posed by the options presented in the preceding paragraphs is that the decisions and complexity of creating the donee grantor trust may be viewed as a burden by the surviving spouse. This may be addressed by incorporating the terms of the intended trust into the will or other dispositive document.
   ii. In order for such a spousal disclaimer to accomplish the intended objectives in a decoupled state, i.e., achieve a similar result to an outright distribution to the spouse followed by a gift, the disclaimer by the surviving spouse must be a non-qualified disclaimer. If the disclaimer into the target trust were a qualified disclaimer, it would taint qualification of the bequest for the state estate tax marital deduction and thereby trigger a state estate tax on the death of the first spouse. Thus, the requirements of a qualified disclaimer must not be met.
   iii. If the target trust is to be a self-settled trust, and the client is domiciled in a non-DAPT jurisdiction, then the recipient trust should be established in an appropriate DAPT jurisdiction to serve as the receptacle for the non-qualified disclaimer.

k. **<u>State Exemption Bypass Trust and Gap QTIP Trust followed by Spouse's Gift of Income Interest to use DSUE</u>**.
   i. There is yet another possible approach to facilitate the surviving spouse using the DSUE of the first spouse to die, without triggering state estate tax on the first death in a decoupled state. A drawback to the preceding approaches is that if the surviving spouse did not follow through on the intended plan the dispositive results could be different than what was desired. There was no assurance that an outright bequest to the surviving spouse would be followed by a gift to the intended beneficiaries. As noted above, a will contract could be used to obligate the surviving spouse, but that could also taint the intended results. The use of a QTIP Trust followed by a non-qualified disclaimer presents another option for planning in a decoupled state.
   ii. A common pre-ATRA approach to planning in a decoupled state has been to fund a state bypass trust, a federal "gap" trust and a marital QTIP trust for assets above the exemption amount.
   iii. The excess over the state exemption amount can be bequeathed to or divided into a separate gap QTIP trust so that the surviving spouse can make a "gift" under Section 2519 of only the amount equal to the DSUE, i.e., what was bequeathed to the gap trust, not the excess.
   iv. Prior to portability, the personal representative in a decoupled state commonly choose whether or not to elect to qualify the gap trust for QTIP

marital deduction treatment. However, under this planning scenario QTIP marital deduction must be elected.

v. The surviving spouse will then give, transfer or disclaim under a non-qualified disclaimer his or her income interest in the gap QTIP trust and this will be treated as a disposition of the entire value of that trust. If a surviving spouse who is the beneficiary of a QTIP trust with respect to which the marital deduction was elected disposes of all or part of the income interest in that QTIP trust, the disposition of the income interest will be treated as a taxable disposition by the surviving spouse, of not just the value of the income interest, but of the entire principal amount. The gift by the spouse is technically comprised of two components, the value of the income interest plus the value of the entirety of the QTIP principal reduced by the value of the income interest.

vi. Because the transfer of the income interest constitutes a deemed transfer of the entire value of the gap QTIP, nothing remains to be taxed in the surviving spouse's estate upon her later death.

vii. All of the above would be achieved with a trust in place that could continue to provide principal distributions to the Wife, as surviving spouse. This gap QTIP 2519 approach may prove simpler, less costly and less risky from an asset protection and tax perspective then the self-settled trust option discussed above. The Wife could be a discretionary beneficiary of gap QTIP trust principal (but not income) from inception and after the IRC Sec. 2519 gift of the income interest. That might be more palatable to the surviving spouse than the hybrid self-settled trust approach used by some practitioners, or the deferred distribution approach other practitioners might incorporate in the self-settled trust option.

viii. It appears that the surviving spouse's being included as a discretionary principal beneficiary of the gap QTIP trust should not cause estate inclusion. Treasury Regulation § 25.2519-1.

ix. A non-qualified disclaimer of the QTIP income interest should be treated as a disposition. PLR 200022031 specifically treats a non-qualified disclaimer as a disposition. Other forms of dispositions to trigger IRC Section 2519 may also be effective because the term "disposition" is interpreted broadly under IRC Section 2519. The surviving spouse should not make a qualified disclaimer of the income interest, in a decoupled state without a gift tax, to accomplish the desired result. This is similar to the discussion above. If the Wife were to make a qualified disclaimer of the income interest in the gap QTIP trust, that would result in treating the funding of the gap QTIP trust as being made directly by the Husband, the first spouse to die. This, in turn, would cause the gap QTIP trust to be ineligible for the state estate tax marital deduction and thereby incur a state estate tax at the first death (i.e. to be imposed in a decoupled jurisdiction with a lower exemption amount).

x. Many wills and trust agreements include spendthrift language that incorporates an anti-alienation clause. Depending on the language of that provision, it may prevent the desired disposition of the gap QTIP income interest by the surviving spouse.

9. **Portability**.
   a. **Introduction**.
      i. A key issue is how practitioners should handle the new portability of the estate-tax exclusions between spouses. The traditional estate plan was built on a bypass trust (which gives a surviving spouse access to wealth but does not include it in the survivor's estate) and a marital trust (which qualified for an unlimited estate-tax marital deduction). With portability now permanent, surviving spouses can benefit from the first-to-die spouse's exemption without a bypass trust. In addition, assets passed to the surviving spouse will receive another step-up in basis at his or her own death.
      ii. But relying on portability has its drawbacks. There is no portability for state estate taxes (except in Hawaii) and the generation-skipping transfer tax, for instance. Further, if the bequest is outright, there is no protection from lawsuits or future spouses.
      iii. How important is the loss of a basis step-up on bypass trust assets? The problem with examples of the potential benefits of this second step-up is that they often assume that the assets that pass to the credit shelter trust spouse are retained for the life of the surviving spouse. This is likely to be true only if the assets are closely held stock in a family business or real estate. By contrast, a portfolio of marketable securities in a bypass trust is likely to turn over during the surviving spouse's life. The result may be only modest appreciation at the second death.
   b. **Various Aspects of Planning Affect Portability Decision**.
      i. Increase in exemption is the most significant change in estate planning. The inflation adjustment may increase the exemption to nearly $8.5 million by 2030 if the inflation rate is 3%.
      ii. Change in the relationship between marginal income tax rates and marginal estate tax rates have changed historically.
      iii. Facts and circumstances are critical. What is the prospect of wealth accumulation for the client? What is the life expectancy for clients? What is the nature of their assets and how likely are they to have gain?
      iv. The estate plan must work the next day if the client dies prematurely, but it should also work in future years. The plan should be flexible enough to work in a reasonable way.
      v. Clients will be less inclined to make lifetime gifts.
   c. **Advantages and Disadvantages of Portability Versus Bypass Trust**.
      i. Portability is simple. There is no need to retitle assets. But does the client need trusts to provide security as to how dispositions will be handled?
      ii. Portability is good to deal with assets that the clients were uncomfortable putting in a bypass trust, e.g. an asset that depreciates. Under prior law, that may have been only way to use the exclusion. Retirement accounts are a prime example of a declining value asset used to fund bypass trusts. Now, clients can simply name as the beneficiary of retirement benefits the

surviving spouse. If the bypass trust is "short" of assets, portability will cover the difference by securing the exemption.

iii. Other assets like a residence have also been awkward to put into a bypass trust in the past, e.g., the home sale exclusion may be jeopardized. With portability this does not have to be done to safeguard the exclusion.

iv. GST planning has traditionally used a bypass trust but if the client relies on portability instead, the GST exemption of the first spouse to die in the QTIP trust can be used by making a reverse QTIP election but it is a "leaky" GST trust because of the mandatory income payout to the surviving spouse. The QTIP trust is thus not as efficient as a bypass trust which is not subject to that requirement.

v. Some practitioners might suggest that the bypass trust minimizes estate tax audit issues since the bypass trust assets are not included in the survivor's estate.

d. **<u>Portability in non-Standard Families</u>**.

i. View the DSUE amount as an asset that the surviving spouse can use personally.

ii. Should executor be given discretion to use portability? Who should be named as executor?

e. **<u>Decoupled State Estate Tax</u>**.

i. New York (which is now reconsidering the size of its exemption), and Massachusetts have a $1 million exclusion. The decision as to relying on portability on the federal level is more difficult. If client wish to use the full federal exclusion on the first death they will pay a significant state estate tax. The more common option is to fund a state exemption bypass trust, incur no state estate tax on first death, and port the difference of the federal exemption.

ii. Some elderly clients move from tax free states like Florida back to live with family as they age thus subjecting themselves to state estate tax. So even wills for clients in non-decoupled states might consider incorporating some planning for this possibility.

f. **<u>Planning for Different Wealth Levels</u>**.

i. $4 million couple. Joint assets include life insurance and retirement benefits. Years ago tax planning would have been undertaken for this client. They no longer need credit shelter or other planning (assuming that they are not in a decoupled state). The only planning issue is whether the client would want trusts for non-tax reasons, e.g., to assure assets are managed or do not pass to second spouse. Planners still need to counsel clients about the proper titling of assets. Consider state death taxes, e.g., it may be advisable to fund a state exemption trust. Also consider the age of the clients and their prospects for future financial change. Are they in a significantly wealth accumulation mode?

ii. $5-$10 million couple. Client has $8 million net worth including homes in two states, and investments that may grow substantially. A bypass trust may be warranted, perhaps a modified credit shelter plan might be advisable. The couple may create trusts but not put a lot of attention into the division of assets to maximize bypass trust funding. Perhaps $2 million of assets may pass to a bypass trust on the first spouse's death, and the rest to the surviving spouse along with the DSUE. The uncertainty is what appreciation may be realized after the death of the first spouse. This hypothetical estate could grow substantially. If the couple relies on portability entirely that growth could trigger a federal estate tax. Funding a larger bypass trust may minimize this risk. In the alternative, a grantor trust could be created when both spouses are alive, or by the surviving spouse, to use some portion of the exemption, grow assets outside the estate and reduce the risk of inflation trigger an eventual tax.

g. **<u>Deferring the Decision</u>**.

i. Disclaimer can be used to provide a period to use hindsight to fund a bypass trust.

ii. Another approach is to fund a single QTIP trust. All assets would be bequeathed to a QTIP on the first spouse's death. Then rely on the executor to make a partial QTIP election, or not. This can defer the decision making for 15 months after the death of the first spouse to die. This could be coupled with Clayton QTIP arrangement so that the non-elected portion can pour into a family trust in the discretion of an independent trustee. This approach is better than a disclaimer approach because the Clayton approach permits the surviving spouse to retain powers of appointment over the credit shelter trust. This is not permissible in a disclaimer plan.

iii. In second marriages non-tax planning considerations should control.

10. **<u>Repurposing Existing Plans</u>**.

a. **<u>Title to Assets</u>**.

i. The initial estate planning meeting for married couple has for well more than a decade included the discussion of titling of assets. That discussion often focused on optimal asset titling - endeavoring to provide each spouse with sufficient assets in his or her name so that, whichever spouse died first, there were sufficient assets to fund a bypass trust.

ii. For clients in decoupled states, this type of planning may still be advisable in order to optimally fund a state exemption bypass trust at the first spouse's death. However, the potential tax benefit from this planning will be substantially less than the benefit from planning when a federal estate tax was anticipated.

iii. For many clients, the decision process may be quite different and there may be no need from an estate tax planning perspective to retitle assets as between the spouses. In other cases there may be a number of reasons to continue to divide assets between the spouses, but the determination as to whose name those assets should be in may be quite different then under prior law.

iv. Place assets in the name of the spouse with the least liability exposure. In the past, clients often had to weigh the benefit of being able to fund a bypass trust against the risk of retaining assets in the name of the spouse with the greater malpractice or other liability exposure. Now, with the benefit of portability, it may be feasible to shift assets to the spouse with the lower risk profile, and rely on portability to preserve the exemption of the higher risk profile spouse. While this may negate the ability to use a state exemption bypass trust in a decoupled state that does not recognize portability, the cost/benefit analysis could be sufficiently different under the new planning paradigm to have the planning scales tip in favor of asset protection.

v. One or both spouses may have assets that were pre-marital, or received by gift or inheritance and thus not subject to equitable distribution upon divorce. In the past, the client would have to weigh the potential tax benefits of transferring otherwise immune assets to the other spouse to facilitate funding a bypass trust should that spouse die first, versus negating the immune nature of the assets involved. Now, in these instances, the decision may be to retain the immune nature of the assets and instead rely on portability to preserve the estate tax exemption. As with the asset protection analysis above, for clients in decoupled states the inability to fund a state exemption bypass trust may be weighed in this process, but could result in a different conclusion then previously when the potential of a federal estate tax had to be considered.

vi. Retaining appreciated assets to achieve a basis step up on death is an important tax planning step for many moderate wealth clients. Achieving the basis step up may be the only tax consideration if there is no state estate tax. If there is no state estate tax, the residence can simply be held until death in order to obtain the basis step up. However, asset protection and long-term care planning may be of concern for some clients.

vii. If the client is domiciled in a decoupled state, then the comparison of potential state estate tax and capital gains might be required to ascertain whether planning to avoid state estate tax might outweigh the loss of the basis step up. This analysis can be significantly more complicated than a simple comparison, requiring consideration of future marginal tax rates, holding periods, etc. So, for example, if a family vacation home may be held indefinitely, the basis step up may be academic and saving state estate taxes may be preferable.

viii. While the above considerations may be relevant to the determination of title, there is a more significant consideration that many generic discussions have overlooked. If the asset in question is a personal residence in a decoupled state, retaining title in the client's name of that single asset may shift the facts and circumstances analysis to weigh in favor of the client being deemed domiciled in that state, thereby subjecting his or her entire estate to estate tax in the decoupled state. Thus, the determination of optimal asset ownership must consider not only the unique characteristics of the particular asset, but in the case of real property, especially a personal residence, the impact on the determination of domicile.

ix. In one case the decedent was treated as domiciled in two different states: "Dorrance died on September 21, 1930, at his residence in Cinnaminson, Burlington county, N.J… the Tax Commissioner, finding, upon evidence presented by the executors, that Dorrance was at the time of his death domiciled in New Jersey, assessed the amount stated as the tax …Dorrance had a residence also in Pennsylvania. That state claimed that he was domiciled there at the time of his death; and promptly commenced proceedings to subject his estate, including the intangible property, to the Pennsylvania inheritance tax."

x. A New York case that received a blizzard of media attention held that a Connecticut commuter was taxable as a statutory resident of New York state because he owned a vacation home in the Hamptons. The fact that the home was rarely used was of no import. Matter of John and Laura Barker, Tax Appeals Tribunal, No. 822324 Jan. 13, 2011.

xi. Therefore, if a primary residence is the potential tie that may create an income tax or estate tax nexus to the client's former state of residence and/or domicile, it may be advisable to remove the house from the client's name to sever that tie. However, if the family wants to retain the house, the answer may be a sale to family members using the home sale exclusion to avoid capital gains tax. This may provide a sufficient basis step up in a small estate, and minimize state income and estate tax audit risks.

xii. Many states afford protection from creditors to a home, or other assets, held jointly between spouses as tenants by the entirety. Prior to portability being made permanent, clients had to weigh the benefits of retaining the asset protection of tenants by the entirety (under which the surviving spouse would have full ownership of the home after the first spouse's death) or retitle the asset, perhaps to a tenants-in-common to facilitate funding of a bypass trust. Now, with the high permanent exemption and portability the moderate wealth client can retain the asset protection afforded by a tenancy by the entirety without any federal estate tax detriment.

b. **Irrevocable Trusts Generally**.

i. Existing irrevocable trusts should be reviewed to ascertain what, if any, purpose they serve, or can be made to serve, in the new tax environment. Trust decanting may provide an efficient mechanism to salvage the trust purpose. Decanting can be accomplished in one of three ways:

1. Pursuant to the terms of the trust, if the governing instrument permits a transfer of trust assets to the new trust.
2. Under state statute. A growing number of states permit decanting pursuant to state statute.
3. Under state common law.

ii. Decanting may enable a trustee to:

1. Extend the term of an existing trust, although generation skipping transfer tax issues must be addressed;
2. Correct scrivener errors;
3. Add a spendthrift provision to protect trust corpus from potential claims of a beneficiary's creditors;

4. Change trustee provisions;
5. Change governing law and situs to a state that is more favorable to achieving trust objectives;
6. Convert a non-grantor trust to a grantor trust, or vice versa; or
7. Qualify a trust as a special needs trust under applicable state law if the successor trust lacked these provisions.

iii. Caution must be exercised in decanting a trust that is GST exempt or grandfathered to avoid tainting that benefit.

c. **Irrevocable Life Insurance Trusts ("ILITs").**

i. Repurpose existing ILITs if the insurance is no longer needed for its initial purpose (e.g., to pay estate tax), or if the trust no longer optimally serves the moderate wealth client's purposes.

ii. The insurance may be cashed in and the proceeds distributed to current beneficiaries and the trust terminated.

iii. The insurance may be retained and the trust modified or decanted to better meet current needs.

iv. Many ILITs simply hold life insurance and a nominal bank account, but the trust provisions may permit a much more robust trust that can serve as a spousal lifetime access trust to receive and hold additional gifts in order to save state estate taxes or for other purposes.

d. **Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") Gifts and Discounts**.

i. Many FLPs/LLCs were formed to secure valuation discounts and to provide a vehicle for making annual exclusion or other gifts. For the moderate wealth client, completed gifts of interests in these entities would remove these interests from the estate and the potential for a basis step up at death. Further, the discounts on the retained interests may provide no estate tax benefit, but reduce the potential basis step up available to FLP assets on death. In such cases, taxpayers could simply liquidate the entity, but there may be good reasons not to do so. The FLP may provide a useful management structure, minimize investment management fees by pooling family investment assets, the costs of liquidation may be viewed as an impediment, etc.

ii. Existing planning intended to create discounts may no longer provide a positive tax benefit for the moderate wealth client. It may be feasible to negate that planning. Partnership or operating agreements can be amended to eliminate discounts and/or cause inclusion in the client's estate.

iii. If the governing document permitted or mandated distributions by the entity to the estate of a partner/member to pay estate taxes, this would violate IRC Sec. 2036 and would seem to require estate tax inclusion. Similarly, if the entity accumulated cash to pay income and/or estate tax of partners/members, this may violate IRC Secs. 2036 and 2038. This may be preferable to liquidating the entity if other purposes are served, e.g., control, management, investment consolidation, or avoidance of the transfer for value rules applicable to life insurance.

iv. Since the moderate wealth client is no longer subject to a federal estate tax, the governing document may be amended to eliminate whatever bothersome provisions may have been incorporated to qualify gifts of entity interests for the annual exclusion since that would no longer be necessary or beneficial.

v. Entity interests that have been intentionally fractionalized, e.g., between different grantor trusts, may be reconsolidated in order to negate the discounts.

vi. The taxpayer's estate could maintain that the decedent had a retained interest in the FLP in an attempt to cause estate tax inclusion and thereby secure a basis step up on prior gifted interests. For example, in the Kelly case the Service lost its Sec. 2036 argument, but the position taken by the Service is illustrative of an argument a taxpayer may advance, and ideally take pre-mortem planning steps to support the claim. The taxpayer transferred real estate assets to FLPs, and made gifts of limited partnership ("LP") interests to her heirs. A management company owned 100% by the taxpayer was the 1% general partner of the FLPs and received a management fee. The taxpayer's estate reported only the value of the LP interests that the decedent owned at death. The Service argued that the management fees paid by the FLPs represented a retained interest in the transferred properties. Although the Tax Court held that the transferred LP interests were not included in decedent's estate, the position taken by the Service under IRC Sec. 2036, namely that a decedent's gross estate includes the value of any transferred property in which the decedent retained an interest during his life, is the position that moderate wealth estates may seek to take in order to avoid basis quashing discounts and even include prior gifts in the estate to secure a basis step up.

vii. For wealthier clients it may be advisable to review and bolster the FLP/LLC if discounts are desired.

viii. For those concerned about the viability of existing DAPTs, grafting one or more FLPs/LLCs onto the plan may provide an essential element of protection.

e. **Family Limited Partnerships ("FLPs") and Limited Liability Companies ("LLCs") Income Shifting and IRC Sec. 704(e)**.

i. Existing FLPs and LLCs– repurposing an FLP/LLC that no longer offers estate tax savings into an income shifting tool subject to IRC Sec. 704(e) and the Kiddie tax. Given the greater progressivity of the income tax rates, a client with heirs in lower income tax brackets may benefit from this revised approach.

ii. For transfers of FLP/LLC membership interests to be respected for income tax purposes, the FLP/LLC will be tested under the provisions of IRC Sec. 704(e), the family partnership rules. A failure to meet these tests could result in a portion or all of the FLP/LLC income being taxed solely to the transferor member, rather than to the donees of the FLP/LLC interests (e.g. the transferor's children). The IRC Sec. 704(e) requirements are directed at determining in whom the actual ownership of the FLP/LLC interests is vested. These rules are designed to ensure that the allocation of partnership income follows this economic reality.

iii. Capital must be a material income-producing factor in the partnership. This requirement is perhaps most easily met for transactions involving the transfer of real estate properties and other valuable assets to an FLP/LLC, since capital is usually the primary if not only material income producing factor in a real estate investment. Other transactions can be far less certain. The donee members (e.g. the transferor's children or other heirs) must be the real owners of the capital interests given to them. IRC §704(e)(1). The donee members must have genuine interests in the FLP/LLC. They must be entitled to receive a portion of the assets on withdrawal from the FLP/LLC and they must be able to transfer their interests in the FLP/LLC without financial detriment. These requirements can be interpreted as implying that the donees are the real economic owners of their capital interests in the FLP/LLC. The donees must have dominion and control over their FLP/LLC interests.

iv. Can a client make gifts of FLP interests, have the donees receive distributions and report income for years at their lower brackets, and then on death include all those gifted FLP interests in his or her gross estate for basis step up purposes under IRC Sec. 2036? To achieve this seemingly inconsistent approach the gifts would have to pass muster under the family partnership rules of IRC Sec. 704(e), yet the IRC Sec. 2036 strings would have to be strong enough to cause estate inclusion, among other requirements. Is this feasible to accomplish?

v. There are other creative ways to use liquidating and non-liquidating partnership distributions to secure basis increases. These too may become more common in the new tax paradigm.

f. **<u>Qualified Personal Residence Trusts ("QPRTs").</u>**

i. A QPRT may have been created when the estate tax exemption was significantly lower, or out of fear that the exemption would be reduced. Now, with a permanent high inflation adjusted exemption, the moderate wealth client may realize no estate tax benefit from the QPRT, but it will prevent estate inclusion and the heirs will forgo a basis step-up. In these instances, clients may wish to advocate for the positions previously taken by the Service, namely that there were retained interests in the residence and the property has to be included in the grantor's estate under IRC Sec. 2036(a)(1) and realize a basis step up.

ii. This might be accomplished by having the grantor continue to reside in the residence while paying a nominal or no rent, executing a lease with a term "for life" and other steps that corroborate IRC Sec. 2036(a) strings. It may be feasible for the grantor simply to buy back the residence if there is no concern whether or not the QPRT is qualified. However, the language of the trust instrument should be reviewed to ascertain if this may be prohibited.

iii. Obligations of the trustee should be considered. If the trustee rents a house back to a parent/grantor following the term of the trust for $1/year might a child/beneficiary of that remainder trust hold the trustee accountable for violating his or her fiduciary duty?

g. **Bypass Trusts**.

   i. Repurposing a bypass trust that no longer offers estate tax savings into an income shifting tool can improve upon a trust that had been designed with a different tax paradigm in mind.

   ii. Terminate the bypass trust if the estate tax savings is insignificant (e.g., a small state estate tax savings) or non-existent (e.g., the client is domiciled in a non-decoupled state) if the termination is permitted under the trust terms. Presumably, before termination, the potential asset protection benefits, and income shifting advantages will be confirmed as not sufficient to justify the cost or perceived hassle of maintaining the bypass trust. If there is some desire for control or asset protection, it may be feasible to create a FLP or LLC to hold bypass trust assets and thereby provide some asset protection on liquidated bypass trust.

   iii. Administer the bypass trust in a more advantageous manner. Some bypass trusts include not only the surviving spouse but all descendants and even other family members as current beneficiaries. Prior distributions may have been only to the surviving spouse and no one questioned the treatment. However, it may now be feasible to expand distributions of current income to include lower tax bracket family members for income shifting purposes.

   iv. Modify the bypass trust by its terms.

   v. Decant to a new trust.

h. **Family Loans**.

   i. Low interest family loans have been a common planning tool for a parent or other benefactor to provide financial assistance to an heir, and in particular to shift wealth. So long as the borrower/heir can earn more than the interest rate charged on the loan, a beneficial wealth shift will occur.

   ii. However, the premise underlying these transactions was that the estate tax cost to the benefactor of holding the cash in his or her estate and investing it would be greater than the capital gains to be realized by the heir on using the borrowed cash to invest. For moderate wealth clients that estate tax cost may no longer be an issue so that investing the cash in the parent's estate and having death step up the basis on any appreciation earned on the cash so invested may be preferable.

   iii. Also, depending on the nature of the loan (e.g., if it was not used to purchase a residence and was not secured by that residence to qualify for the heir for a home mortgage interest deduction) the heir may realize no income tax benefit from the interest payment, while the benefactor incurs an income tax cost on the interest paid.

   iv. For the moderate wealth family, the loss of the anticipated estate tax benefit, coupled with the increase in income tax costs on the loan interest, may make this transaction unfavorable from a tax perspective.

   v. One simple approach to resolve this is to repay the loan. If that is not feasible or desirable perhaps the benefactor can make a gift to the heir and then the heir can repay the loan. Alternatively, have benefactor forgive the loan in the form of a gift if there is no concern over using the benefactor's lifetime exemption. Certainly, it is advisable to revisit intra-family loans for moderate wealth families and evaluate them.

vi. If the loan proceeds were used to purchase a home with the loan proceeds, qualifying the loan for the home mortgage interest deduction may sufficiently adjust the tax consequences of the transaction to justify retaining the loan in place.

vii. If investment assets were purchased instead of a home, the unrealized appreciation in those assets will not be afforded a basis step up at the lender's death. Those types of intra-family loans may be better off being repaid since the wealth shift may no longer be tax-prudent. However, if child repays the loan to the parent by transferring appreciated assets in-kind, this will likely trigger a taxable gain to the child.

viii. If the heir needs the funds and a loan is necessary, it may be feasible to repay the loan unwinding the transaction, and then substituting a better structured arrangement for a moderate wealth family. The benefactor could fund an irrevocable trust benefiting the intended heir and retain a limited testamentary power of appointment in order to cause estate tax inclusion and secure a basis step up at death for appreciated trust assets. The trust could loan funds to the heir-beneficiary without an interest charge. This could eliminate the income tax whipsaw.

ix. If the goal of the initial intra-family loan was the arbitrage of the excess of the investment earnings over the low loan rate, a better approach may be for the moderate wealth benefactor to make a gift to an irrevocable grantor trust for the intended heir. The assets would grow outside the estate, but the grantor trust status would provide a safety valve to swap highly appreciated assets back into the benefactor's estate to gain a basis step up.

11. **Drafting Nuggets**.

a. **What Are Other Planners Doing**?

i. OK, so the estate planning world has changed. Different approaches will be used as the default or general estate plan. But the $64,000 Question is what is everyone else doing? Someone polled a broad group of estate planers as to what they would use as a hypothetical estate plan for couple with a $7 million estate and the following general approaches are being used by practitioners:

1. 30% - Outright to surviving spouse using portability.
   a. It is really hard to imagine how an outright bequest can be optimal in light of aging heirs needing protection, divorce risks, asset protection risks, and more.
   b. Whether or not portability provides a solution to a federal estate tax, it should not negate the security and other benefits of trust planning.
2. 40% – bypass trust.
   a. Using a bypass trust can certainly provide a range of important benefits other than federal estate tax, including:

GST planning benefits, state estate tax planning benefits in a decoupled state, the non-tax benefits noted above and more.

b. However, the mere use of yesterday's bypass trust is passé and likely inadequate. Planning ideas from investment location considerations, creative uses of general powers of appointment to cause estate inclusion, characterizing a bypass trust as a grantor trust, distribution provisions to permit the distribution of appreciated property, drafting changes to facilitate the inclusion of capital gains in trust accounting income and more all warrant consideration. These and other planning techniques permeated the week's conferences. So while the general survey indicated a use of bypass trusts, the real issue is whether or not practitioners have upped their game for the new planning rules.

3. 20% - joint trust.
   a. There is a psychological benefit to using a joint trust in that many married clients look at all their assets as joint assets.
   b. Another objective of joint trusts is to endeavor to secure a basis step up for all assets on the death of the first spouse. A bit of background. Planners in common law states may use joint trusts to replicate the income tax results available to married couples living in community property states.
   c. In a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin) at the death of the first spouse, the surviving spouse receives a full step-up in income tax basis for both the assets inherited from the deceased spouse, and for the surviving spouse's half share of community property held by deceased spouse and the surviving spouse. IRC Sec.1014(a) and (b).
   d. Couples in non-community property states use joint trusts to achieve the same result but the IRS has held that the additional basis step up is not realized. TAM 9308002 and PLR 200406004. Joint trusts also raise more difficult administrative problems then separate trusts. Some commentators have gone so far as to questions whether you save anything more than paper with a joint trust. See, Roy M. Adams and Thomas W. Abendroth, The Joint Trust: Are You Saving Anything Other Than Paper?, 131 Tr. & Est. 39 (Aug. 1992).
4. 10% other.

ii. A shortcoming of the poll above is that the focus is on testamentary planning. Managing assets during the many later post-retirement years and through disability, asset protection planning during peak earning years, minimizing state estate tax in a decoupled state (especially a state without a gift tax) requires inter-vivos planning at an earlier point in time then testamentary planning can afford.

b. **Powers of Attorney**.
   i. Gift provisions should be reviewed. As discussed above, many, perhaps even most, moderate wealth clients will no longer benefit from gift provisions in their powers of attorney. Leaving these provisions in powers, if unneeded, might be harmless in many cases, but not necessarily in all cases. The gift power can also be used as a spigot by unscrupulous agents to bleed wealth from a client. Is the incremental risk, however modest, worthwhile if there is no apparent tax benefit?
   ii. Many durable powers permit gifts to a class of donees that are limited to the gift tax annual exclusion amount. In other cases, e.g., when a client has created a SLAT or DAPT there may be significant benefit to permitting the agent, to make not only annual nontaxable gifts, but to make larger gift transfers to utilize the client's remaining gift exemption. That may be the flexibility needed to reduce or eliminate state estate tax in a decoupled state. The client may be willing to permit such large gift transfers if the only permissible donee is an irrevocable trust the client himself or herself created.
   iii. In some instances under the new tax paradigm, the safest option for the client will be to have the power of attorney expressly prohibit the agent from making gifts. If there is no estate tax benefit why risk that provision being abused?

c. **Revocable Trusts**.
   i. Gift provisions should be reviewed and revised as appropriate. See the discussion in the preceding section on gift provisions in durable powers of attorney.
   ii. Consider, especially if the client is domiciled in a decoupled state without a gift tax, granting to trusted third party a power to eliminate the grantor's power to amend and/or revoke the trust, perhaps entirely, or only as to certain assets which have not significantly appreciated. This should constitute a completed gift of those assets, which would permit a quick completed gift (e.g., even on a weekend when bank and brokerage firms are closed) of those assets that have not substantially appreciated, in order to reduce the client's state estate tax exposure.
   iii. This power could also be crafted to direct and designate a particular appreciated asset to be held by an irrevocable trust, e.g. a children's trust that is incorporated within the revocable trust agreement, so that the client would no longer be a beneficiary of those assets.

d. **Wills**.
   i. Review with the client the possibility of including more flexible options in the governing instrument: the possible use of a "Clayton-QTIP" trust provision. If assets are bequeathed to a QTIP trust and the personal representative does not make a QTIP election or makes only a partial QTIP election, the portion that is not elected to be a QTIP could pass into the bypass trust via a Clayton provision. This offers a significant

advantage post-ATRA in that given the higher income tax rates the Clayton approach would permit a sprinkle or spray trust so that income can be distributed to lower bracket beneficiaries which could be advantageous to a pure spousal distribution structure.

ii. Consider broad distribution provisions, or even an express provision providing for the power to distribute substantially appreciated assets, the right to make charitable gifts from the bypass trust, the ability to have capital gains designated as included in "fiduciary accounting income" (not allocated to corpus), and perhaps other options. Consider the potential QTIP issue in certain decoupled states discussed above.

iii. Flexibility in planning, drafting and implementation can provide options to mitigate the loss of tax basis and state estate tax costs. Based on the preceding discussions, wills for clients who may be domiciled in or own property in decoupled states might include a state exemption trust, a gap QTIP trust for the amount in excess of the state exemption and up to the federal exemption, and a traditional marital QTIP trust for the excess over the gap QTIP trust. The gap QTIP trust might include a range of powers and a modified spendthrift clause in order to create the flexibility necessary to achieve some of the planning options discussed above. For example, the gap QTIP trust might be structured as a QTIP trust with a standby general power of appointment if the QTIP will not qualify for the state estate tax marital deduction, and the spendthrift language in the trust might be modified.

iv. If the client's estate is sufficiently large (even if well below the federal exemption level), or if the client faces liability exposure that is significant, by funding an intervivos bypass trust (other than in Connecticut/Minnesota, or in those states up to their exemption amounts), they may provide substantial current asset protection benefits, safeguard assets in the event of elder financial abuse and similar problems, and save greater state estate tax than a bypass trust funded to the state exemption amount will permit at death. The lifetime SLAT approach may prove especially useful for growing assets outside the reach of a state estate tax in a state with a gift tax.

v. For more modest wealth clients consider having a disclaimer bypass trust provision included in their wills. This should add little if anything to the cost of the plan but will provide flexibility if there is a reason in the future to fund the bypass trust. This might also address a state estate tax if the client resides in a decoupled state, or if the client moves to a decoupled state, asset protection, control and other benefits.

vi. If the client's will is old and provides for a mandatory bypass trust the added flexibility of a disclaimer approach may be preferable. Then, if following the death of the first spouse, there is no significant benefit to funding the bypass trust, the costs and administrative burdens of establishing and funding the trust, and filing annual trust income tax returns, can be avoided.

vii. Historically, many bypass trusts included only the spouse as beneficiary. Also, many bypass trusts limited distributions to an "ascertainable standard." When the clients revise their wills, consider adding all descendants as beneficiaries to permit sprinkling income of the bypass trust to family members in the lowest income tax brackets. Also consider an express provision to permit distributions of substantially appreciated assets to the surviving spouse, if appropriate in order to obtain a basis step up on the second death.

viii. Investment provisions may need to be reconsidered in order to facilitate the asset location strategies described below. If there is a benefit to creating a bypass trust, but other options for addressing potential appreciation are not desirable, it may be feasible to solve the problem with asset location decisions, e.g., holding only bonds in the bypass trust. However, if the provisions of the governing document do not permit such a lopsided asset allocation, the trustee may be violating fiduciary duties of diversification, etc. The language should be broad enough not to restrict optimal asset location decisions. A mandate to adhere to modern portfolio theory might be suggestive rather than mandatory, or at least permit the trustees to consider application on a family wide basis, not only for the bypass trust considered alone. That would permit the trust investment decisions to be part of an overall plan, but yet specialized within the trust to meet tax goals.

ix. Bypass trust language may grant powers of appointment to a greater degree than in past in order to facilitate estate tax inclusion on the death of certain beneficiaries to secure a basis step up for appreciated assets.

x. Distribution powers may be broadened to facilitate the distribution of appreciated assets from complex trusts.

xi. Provisions permitting changes in trust situs, governing law and trustees will become more common, and perhaps broader, to take advantage of the growing use of decanting to modify trusts to better fit future tax and other needs.

e. **Irrevocable Trusts**.

i. The use of an intervivos bypass trust, or spousal lifetime access trust, which can accomplish a range of objectives, might become more popular as a means of accomplishing a number of the goals the moderate wealth client is typically seeking to achieve. This trust could also serve the needs of the typical life insurance trust as well. If gifts are made while the client is alive to minimize state level estate taxes as well, this same trust might substitute for, or eliminate, a testamentary bypass trust.

ii. An irrevocable life insurance trust ("ILIT") will still make sense post-ATRA to hold life insurance to keep the proceeds out of the client's state or federal taxable estate, and even if no tax is likely to be due, to protect the insurance proceeds for the intended heirs. Regardless of the estate tax implications, an ILIT has and will continue to protect life insurance proceeds for a surviving spouse or descendants from a new spouse, creditors and other predators. ILITs have been and will remain a mainstay of estate planning. But with some modifications, what had been a common ILIT can offer the cost and simplicity conscious moderate wealth client a single multi-purpose trust to accomplish many planning goals.

iii. If the client is domiciled in a state that has a low state estate tax exemption they may face a significant state estate tax, the use of a multi-purpose intervivos trust may address these issues with less complexity then the planning described earlier in this article. Further, if the same trust can achieve several important goals, the client may perceive more value being received.

iv. Intervivos QTIP trusts with a bypass trust back to the donor spouse can provide asset protection planning benefits. As a QTIP the assets are included in the donee spouse's estate for basis step up purposes. The donor spouse can benefit from a bypass trust formed on the death of the QTIP trust donee. The assets that come back to the donor spouse in some states will remain creditor protected, but not in all states. If state law does not provide protection the initial QTIP and subsequent bypass trust should be formed in a state that permits self-settled trusts.

f. **SLAT/ILIT Example**.

i. Clients live in a decoupled state that has only a $1 million state estate tax exemption. They have a $6 million family net worth, ½ held by each spouse, plus a $2 million term life insurance policy. With the new exemption and portability there is no worry about federal estate tax. But the life insurance should probably be held in an irrevocable trust (ILIT) even if just to protect such a large death benefit. The traditional testamentary plan would be to fund a bypass trust on the first death with $1 million in order to avoid any state estate tax at the first death. The balance of the estate would pass to the surviving spouse either outright or in a trust qualifying for the marital deduction. Any of the various planning options illustrated earlier in the article could be pursued for this amount. But in any event, on the second death, there is a second $1 million state exemption. Unfortunately, that leaves several million (assuming the insurance is in the trust or lapsed) subject to state estate tax at the second death. If instead of relying solely on the post-mortem planning illustrated above, the couple each established a non-reciprocal SLAT for the other, and the SLATs were designed to hold life insurance as well, a number of benefits could be realized.

ii. The insurance proceeds would be removed from both spouses' taxable estates and no state estate tax would be incurred.

iii. The trusts established to protect the insurance proceeds could serve a dual or triple purpose.

iv. As a SLAT, each spouse could contribute some assets to the trust immediately thereby achieving some measure of asset protection when they are employed and more concerned about such issues.

v. If income producing assets are contributed to the SLAT/ILITs, they could generate the cash flow necessary to pay annual insurance premiums. This could obviate the need for annual gifts or Crummey powers and simplify the administration of the trusts.

vi. How would these trusts fit within the income tax planning needs for the moderate wealth clients? For most wealthy taxpayers the new higher income tax rates are more of a concern than estate taxes given the large permanent inflation adjusted exemption. Seeking a tax shelter within the tax favored envelope of a permanent insurance policy is nothing new, but the results might be more enticing post-ATRA for those moderate wealth clients in the highest tax bracket. So perhaps the traditional term insurance plan and ILIT of days of old might give way to a more modern SLAT/ILIT holding a permanent life insurance policy, the cash value of which might be accessed by the client during retirement.

vii. A SLAT, by its very nature (i.e. benefiting the grantor's spouse) will be treated as a "grantor trust" for income tax purposes, so that the client remains taxable on the earnings that accrue inside the trust. This is a great estate reduction tool. It also means that prior to the client's death highly appreciated assets inside the trust can be swapped for cash so that the appreciated assets are pulled back into the client's estate and obtain a step up in basis.

viii. Upon the client's death, grantor trust status will end and the SLAT/ILIT will become a "complex" trust that can distribute income to anyone including the spouse and all heirs. With the increased graduation of tax rates, distributions can be made to lower bracket heirs who are under the threshold for the 3.8% Medicare tax. So a SLAT/ILIT can also serve as a great income shifting tool.

ix. The SLAT can provide creditor protection for assets held inside the trust. This is an advantage over the asset protection planners afforded by a testamentary bypass trust provides funded on the first spouse's death. That may be when the client and his or her spouse are past retirement so that their asset protection concerns are less pronounced.

x. How does this fit clients' newly growing desire for cost efficiency and simplicity? They may rely on a single trust instead of several. The client can "test drive" the plan today rather than burdening the spouse with dealing with the complexity after the client's death. Finally, the client can ease into the plan rather than feel pressured to commit to all the funding at one time. The client can put in as little as he or she wants into their SLAT/ILIT now, and if comfortable, can add more property to the trust in future years. As the clients age, they can perhaps transfer even greater sums into the trust to enhance state estate tax savings.

xi. For the moderate wealth client, advisers may even consider truncating the Crummey power process in the client's insurance trust. If the client funds a SLAT/ILIT with significant assets to gain the asset protection and the decoupled state estate tax savings, those real dollars can fund life insurance premiums without the annual Crummey power ritual which typically required a formal written notice and acknowledgment by the Crummey beneficiaries.

xii. There is little new with this approach, just a slightly different application to perhaps better fit the new planning rules, and in a manner that some clients might find more appealing.

12. **Tax Audit and Compliance Nuggets**.
    a. **Valuation of Gifts of FLP and LLC Interests**.
        i. The IRS may argue that valuation discounts apply to the valuation of the FLP/LLC interest donated to charity, no different than the discounts taxpayers have advocated for gift and estate tax purposes. However, since many taxpayers will no longer benefit from these discounts, since so few taxpayers will be subject to a federal estate tax, it will become more common for the partnership or operating agreements to be amended to provide liquidation rights and transfer rights (rather than restrictions) so that the discounts could be reduced or even eliminated.
        ii. Even if the valuation issue is resolved, there are a host of other potential hurdles to consider:
            1. A gift of FLP/LLC interests may trigger ordinary income to the donor if the FLP/LLC has unrealized receivables or appreciated inventory. IRC Sec. 751(a);
            2. A donation of FLP/LLC interest could also accelerate any unrecognized installment gain. Rev. Rul. 60-352; and
            3. If the FLP/LLC has debt, even non-recourse debt, gain may be triggered on the donation because the partner is treated as having received payment for his or her entire share of partnership liabilities; this can trigger "phantom" capital gain income to the donor. IRC Sec. 752; Treas. Reg. Sec. 1.752-1(d); Rev. Rul. 75-194.

13. **Trust Administration Nuggets**.
    a. **Introduction**.
        i. Perhaps the theme of trust administration can be summed up by suggesting that the drafting attorney print on the cover page of each trust, the estate planning equivalent of "**Professional Driver…closed course…do not attempt**." Trust administration, as the discussions following make clear, is not for the inexperienced. The landmines are too numerous.
        ii. A second observation on trust administration might be summarized in the adage "Be Careful What You Wish For." Planners have wanted flexibility, but now the various shapes and sizes of powers, fiduciaries and other modern trust techniques will all have to be dealt with.
    b. **Recordkeeping**.
        i. A successor trustee has a duty to review administration of a prior trustee and determine if there is a cost/benefit of taking action. Adequate records of administration must be maintained. Records promote loyal administration of the trust. Records enable beneficiaries to take a more meaningful review of the decision making process. Records protect the trustee. "I did not diversify and here is why and here is the detailed report." **Mantra:** "**Feed the file. The file is your friend.**"
    c. **Unfunded Bypass and other Testamentary Trusts**.

i. An informal poll suggests that 40% of practitioners have clients that have not funded bypass or other testamentary trusts. This situation will likely grow dramatically as testators die that did not revise outdated documents created before the current high permanent inflation adjusted exemptions.
ii. It is not uncommon that a surviving spouse fails to fund a bypass trust formed under his or her spouse's will. It might be just an oversight, perhaps the surviving spouse was overwhelmed by the loss, etc. But what can be done after the fact to correct the situation? First identify the assets to be used to fund the trust. Determine, generally under state law, how income earned in the intervening period should be allocated among beneficiaries, including the to-be-funded trust. Be alert for discounts or premiums if a fractional interest in an asset is used to fund the trust. A funding agreement, along with transfer documents, may confirm the decisions made.

d. **Trustee Liability/Power Breach of Trust**.
i. The developments over the years of how trusts are drafted will affect administration of trusts in several significant ways. Breach of trust comes in two primary ways. One breach can be demonstrated if the trustee lacked the power to have taken the action that was consummated. These claims are rare and vanishing given the broad manner in which trusts are drafted with extensive redundant power provisions and default state laws give extensive power provisions.
ii. The second type of claim is that while the trustee had the power to act, the action was in violation of the fiduciary duties. The question to ask is whether or not the exercise of the power was appropriate. While the trustee may have had power to, for example, to buy a particular stock, that doesn't mean it was loyal or prudent to buy the stock.
iii. Modern trust practice trust litigation will focus more on the latter claim. That also means that for those counseling trust clients, greater attention should be given to assuring not merely that a particular action was permissible under the terms of the trust, but that it was appropriate. Corroborating this will be increasingly important.

e. **Liability of Various Fiduciaries**.
i. Historically, co-trustees had to act unanimously. Modern practice is that a majority of trustees can act. Even if it is contemplated that certain trustees will have certain functions (e.g., distributions), the other trustee may have a duty to go to court and stop the other co-trustee from committing a breach.
ii. If co-trustees are taking an action that violates their fiduciary duties, another co-trustee cannot simply look the other way. Instead, there may be an obligation for the "good" trustee to seek court action to stop the other co-trustees from violating their duties or the terms of the trust.
iii. This change in decision making by co-trustees is why many opt not to have co-trustees, and also why directed trusts and similar arrangements have grown.

iv. The non-acting trustee cannot merely resign to avoid liability. To resign, a trustee must give notice to all others. A trustee cannot resign if he or she knows other trustees are going to undertake an inappropriate act. There is an affirmative duty to stop it, not merely bail out. In re Rothko 372 N.E. 2d 291 (1977).

f. **Judicial Review and What is a Trust**.

i. The combined use of an independent trustee and a discretionary distribution standards makes a trust more secure from a divorce, or other challenge to a beneficiary. In contrast, if the trust mandates that distributions may be made to the beneficiary to maintain his or her health education maintenance and support ("HEMS"), under some state laws a divorcing spouse of a beneficiary may be able to reach trust distributions, or worse. The growing use of these broad distribution standards may have some trustees assuming that they are beyond review. That is not the case.

ii. If a trust mandates distributions then the trustee is liable if he does not follow the terms of the trust. While that may seem obvious in a trust with mandatory specific distributions (e.g., distribute income, or a unitrust amount), what about a discretionary trust? What about a trust that provides that distributions shall be made "at such times and in such amounts as the trustee determines." That may leave the trustee more flexibility to determine to whom to make distributions, when to make them, and even how much to distribute.

iii. The trustee is subject to judicial review even with such a broad standard. This might come as a surprise, especially to non-institutional trustees.

iv. One flexible approach is to allow the trustee to make distributions in the trustee's discretion taking into consideration the then relevant circumstances. The decisions are thus able to be delegated to the trustee by the trust instrument, and are effectively postponed from the time the trust is created to the later dates on which distributions are made. The downside of this is that the discretion may be exercised inappropriately or "badly."

v. What are the terms of the trust? What are the circumstances of the beneficiaries? Did the trustee exercise discretion prudently? What exact language is in the trust governing instrument? Potential for problems abound. If the instrument says "in the style of life the beneficiary has become accustomed" then the trustee must familiarize itself with the lifestyle of the beneficiary. What are the beneficiaries other resources? Must or should the trustee look at the beneficiaries other resources? Does the instrument provide guidance? If no guidance there is a default view. Under the Restatement of Trusts 2nd the beneficiaries' other resources may be considered. Under the Restatement of Trusts 3rd the answer is perhaps more in flux.

vi. What if the discretion in the trustee is even broader? What if the governing instrument permits distributions "in the trustee's sole and absolute discretion." Is there any potential for judicial review in such an instance? If the trustee does not make a distribution and a beneficiary wants to challenge this, it can be an issue. Even this strong language does not mean that there is no judicial review. In all events the trustee is subject to review. If that were not true then the assets would not be held in "trust." As the powers granted and indemnifications provided in many trust instruments grow so broad and all-encompassing it would seem that there is no room for judicial review. However, it is that potential for review that may be the protection the beneficiaries need, and the presence of which assures that the arrangement remains a "trust."

vii. All powers held by any trustee are subject to judicial review. The broad and strong language weakens the intensity of the court's review. It communicates to the court that the "tie" goes to the trustee and that the grantor did not want invasive review. But the court nonetheless will review. It is merely a difference in the degree of review.

g. **Exoneration and Exculpation Clauses**.

i. Exoneration clauses may provide that a trustee is not liable for certain types of breaches. This does not mean that the trustee is immune from a suit, and it does not mean that a court won't find that the trustee has breached fiduciary responsibilities.

ii. While a trustee may not have to pay for good faith negligence, an exoneration clause will not exonerate reckless behavior or bad faith.

iii. While some trustees may try to push the line further, seeking even broader exoneration from liability, the line cannot be pushed beyond some point because the trust, if it is to remain a trust, must still be a fiduciary relationship.

h. **Mandatory Arbitration Clause**.

i. Many trustors believe that mandatory arbitration may be preferable to court action to limit the costs and animosity of a later dispute among beneficiaries (typically family members). While mandatory arbitration can certainly be agreed to in a contractual arrangement, it is not certain that it will succeed in the trust context.

ii. The trust is the embodiment of the donor's disposition and the beneficiary takes the gift (interest as a beneficiary in the trust) subject to these conditions.

iii. The real issue is whether a trustor can impose unilaterally a mandatory arbitration clause on the beneficiaries. One view would permit trusts to mandate arbitration on the basis that it is simply part of the trustor's freedom of disposition. Others may argue that part of the mandatory core of trust fiduciary law that a trustee can be taken before a court. If that is not the case then arbitration should be allowed. On the other hand, others may view an arbitration clause as a contractual arrangement that requires the consent of the beneficiary.

i. **Power to Adjust**.

i. The power to adjust income/principal amounts is yet another tool available to many trustees, the exercise or non-exercise of which may lay the foundation for a challenge by those affected.

ii. 70% of institutions said they used power to adjust or to adopt a unitrust approach in less than 10% of trust accounts, so usage is not wide.

iii. An important factor to consider before exercising a power to adjust is whether or not there are principal invasion rights. Most institutions prefer to exercise a power to invade principal if that will suffice, before exercising a unitrust election or a power to adjust. The rationale is quite obvious, the power to invade has been around for a long time. There is a more developed body of law as well as institutional procedures and comfort in dealing with principal distributions. Fiduciaries know how to document the decision process for principal distributions. A well-developed body of case law defines the standards by which a court may review distribution decisions. The power to invade may be viewed as being more flexible. Basis of assets distributed out in principal invasion has more flexibility than the unitrust or power to adjust. A unitrust approach is the least favorable strategy. For example, a 4% unitrust can raise questions with investment strategy.

iv. The litigation risks of all these flexible options is a concern for fiduciaries. Trustees must endeavor to consider all the implications of the decisions about whether to adjust income/principal amounts, track out gains as part of DNI, adopt a unitrust approach, or consider other alternatives. Anything can be questioned by current or future beneficiaries.

v. One approach is to obtain a written agreement, a consent document, from current and remainder beneficiaries that addresses the key decisions made (or not), e.g. unitrust election, types of investments, who would pay capital gains, etc. If all of the issues are set forth, in advance, in an agreement, it may provide an approach to avoid litigation in the future.

j. **Trust Administration Recommendations**.

i. With the likely growth in the use of trusts resulting from the myriad of tax-oriented trusts already established, the aging population, asset protection planning and other factors, the incidence of non-institutional trustees misconstruing and misapplying broad reaching trust provisions is also likely to increase. Advising clients on the proper administration of these trusts on a periodic basis is critical. Much of prior estate planning services focused on estate tax minimization. Clients need to be educated about the importance of ongoing counsel in the administration of trusts.

viii. "Feed the file. The file is your friend." This is especially critical for non-institutional fiduciaries, even attorneys and CPAs acting as fiduciaries, because non-institutional trustees are unlikely to have the processes and procedures in place to do so unless they expressly make the effort to document not only events, but the decision process leading up to them.

ii. Can accountants preparing trust income tax returns finalize the return, or advise on tax planning, without knowledge of what the trust instrument provides, and whether the fiduciary is reasonably acting in accordance with trust provisions?

14. **DOMA and Same-Sex Marriage Nuggets**.

a. Existing plans for same-sex couples need to be reviewed and in many, if not most cases, revised. While recent changes are monumental, they are not nearly as simple or universal as many clients believe.

b. New York residents married in Canada in 2007 where same sex marriage was recognized. One spouse died in 2009 bequeathing assets to her spouse who claimed the federal estate tax marital deduction. The surviving spouse filed suit claiming Section 3 of DOMA was unconstitutional. That section provides that for federal purposes, a marriage must be between one man and one woman permitted states not to recognize same sex marriages performed in another state or country where same-sex marriage was recognized. The Supreme Court held that Section 3 of the Defense of Marriage Act ("DOMA") unconstitutionally deprived persons of equal liberty in violation of the Fifth Amendment. Windsor v. United States, 570 U.S. ___, 133 S. Ct. 2675. Marriage is no longer defined for federal law as between a husband and wife. State definitions of marriage will now control, so if a client is married a state that recognizes same-sex marriage, the federal government will have to recognize it too.

c. In June 2008 the California Supreme Court found that the prohibition on same sex marriage was unconstitutional. In November 2008 California voters enacted Proposition 8 adding to the California constitution a prohibition against same-sex marriage. Several same-sex couples challenged the constitutionality of Proposition 8; California refused to defend the suit, the court allowed proponents of Proposition 8 to intervene, the district court held that Proposition 8 was unconstitutional and the 2nd Circuit affirmed (on the grounds that Proposition 8 violated the Equal Protection Clause as failing the rational basis test). The US Supreme Court (now dealing with a state law in contrast to Windsor which dealt with a federal law) held that private citizens lacked standing so the 2nd Circuit holding remains law. Hollingsworth et al. v. Perry et al., 570 U.S. ___, 133 S. Ct. 2652 (2013).

d. An Ohio federal district court ordered the Ohio registrar of death certificates not to accept a death certificate for a gay couple unless it recorded his status as married and his same-sex surviving spouse's status as his surviving spouse. The case was brought to list the spouse on the death certificate of the decedent's spouse, which was important for burial, insurance and other purposes. Obergefell v. Kasich, 2013 U.S. Dist. LEXIS 102077 (S.D. Ohio July 22, 2013).

e. The trend toward greater acceptance of same-sex marriage will likely continue. Practitioners should be cautious to assure that the intended planning objectives are met.

f. The IRS updated a prior ruling that dealt with common law marriages to address same-sex marriages. The federal government will generally follow a state of celebration rule. So if the couple is married in a state where same sex marriage is valid, that is all that is required for recognition for federal tax purposes . If clients were married in a state that recognizes same sex marriages but then moved to a state that does not, they will retain the protection of marriage status for income and estate tax purposes. Rev. Rul. 2013-17, 2013-38, IRB 201. However, some federal laws are still based on domicile so the state of celebration cannot govern. Social Security is one example.

g. The changes mean for the first time same sex couples, married in a state that recognizes same-sex marriage, can plan their estates using marital trusts and all the planning options other spouses have used. Wills and all other planning needs to be reviewed and documents revised.

h. If a same sex spouse died recently and a tax was paid, it may be advisable to file a refund claim. Even though the IRS pronouncements generally apply prospectively, income tax refunds are permitted. Perhaps estate tax refunds will be too.
i. If one same sex spouse had left a pension to a charity or parent, if no waiver of a spousal right of election was signed, with DOMA repealed, the surviving spouse may have a claim on these retirement assets.
j. Registered domestic partners or those who have entered civil unions will not be treated as married for federal tax purpose. These couples should evaluate the benefits of being married in a state that permits it since the tax consequences of marriage are now available with certainty, and the economic benefits can be substantial.
k. Couples should amend prior income tax returns for 2011 and earlier open tax years (3 years from filing) and file a married filing joint return before the statute of limitations runs (but only if doing so would save taxes). The savings for some could be significant. What happens to couples that filed single and would have paid more tax if they had filed married filing joint? The IRS will not require that they amend prior returns and pay more tax.

15. **Charitable Nuggets**.

a. **Two Generation CRUT**.

i. There may be a more interesting beneficiary to name for an IRA than what most taxpayer use. This approach may be ideal for baby boomers in their second, or later marriages, and who have some of their 1970s do-good idealism intact. In the past many taxpayers named a bypass trust as beneficiary to use up their estate tax exemption, benefit their surviving spouse, and assure that the value would not be taxed in the survivor's estate. That was not a winner for a lot of reasons. But there may be a better way.
ii. Name a two-generation charitable remainder unitrust (CRUT) as beneficiary. The surviving spouse would get an annuity for life, e.g., 5% of the value of the trust each year (perhaps analogous to the payment of income from a bypass trust). When the surviving spouse dies the annuity stream could be paid to the children (e.g., to children of a prior marriage – boomers have a higher divorce rate than all preceding generations) for their lives. There would be no income tax triggered by leaving the IRA to the CRUT. This is because CRTs are tax exempt. PLRs 199901023 and 9820021. On the death of the last child whatever assets remained in the CRUT would pass to the designated charity. That might be consistent with the way boomers begin to redefine retirement and estate planning as they did every other social institution over their lifetimes.

b. Grantor Charitable Lead Trust.

i. With higher income tax rates and substantial appreciation in the stock market in 2013 might there be an uptick in the use of grantor charitable lead trusts ("CLTs")?

ii. CLTs while generally structured as non-grantor trusts, can be structured as a grantor trust so that the donor may benefit from a current income tax charitable contribution deduction. The deduction would be the present value of the qualified annuity or unitrust interest to be paid to the charitable beneficiary. IRC Sec. 170(f)(2)(B). In the remaining years of the CLT the grantor will be taxed on all of the income of the CLT. Thus, the value of the current contribution deduction must outweigh the income taxes that will be due in those future years. While some taxpayers have structured grantor-CLTs in the past using municipal bonds it is not clear given the current low interest rates that approach is viable.

iii. How can the CLT be characterized as a grantor trust to achieve this result?

1. If the grantor has a reversionary interest with a value greater than 5 percent of the value of the trust assets at the time assets are transferred to the trust, the trust is a grantor trust. IRC Sec. 673.
2. If a reversionary interest with a value greater than 5 percent of the value of the trust assets at the time assets are transferred to the trust is held by the grantor's spouse the CLT will be characterized as a grantor trust. IRC Sec. 672(e).
3. Although the above approaches are the most common, it may be feasible to achieve the desired result if the grantor retains a power to substitute assets, for assets of an equivalent value, in a non-fiduciary capacity. IRC Sec. 675(4)(C).

c. **<u>Use CRTs to Defer and Perhaps Avoid the Medicare Tax</u>**.

i. Charitable remainder trusts ("CRTs"). Charitable remainder trusts, as tax exempt trusts, are not subject to the Medicare tax. However, when the CRT makes distributions to current non-charitable beneficiaries, some portion of a distribution may be characterized as NII and subject to the Medicare tax in the hands of the beneficiary.

ii. While the CRT itself is exempt from income tax, the annuity or unitrust distributions made to individual beneficiaries are subject to regular income tax and Medicare tax.

iii. Under the final regulations, net investment income is classified and distributed using the four existing classes of income provided for under IRC Sec. 664. These capture the historic categorization of income earned. This has been referred to as "WIFO," or worst in first out, so that the most costly categories of taxable income are deemed distributed first. NII would similar be identified.

iv. The NII of the CRTs beneficiary attributable to the beneficiary's annuity or unitrust distribution will be deemed to include an amount equal to the lesser of: (1) the total amount of distributions for the year and (2) the current and accumulated NII of the CRT. Prop. Reg. Sec. 1.1441-3(c)(2)(i). If there is more than one beneficiary the NII is apportioned among the beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the trust for that year.

v. For example, if a taxpayer gifts appreciated property to a CRT which is subsequently sold by the CRT, there is no immediate imposition of regular income tax or Medicare tax under IRC Sec. 1411 on the capital gain which is NII. The full amount of the sale proceeds can be reinvested in the trust.

vi. The deferral of the recognition of NII by having made the gift to the CRT which sells the assets instead of the individual donor may effect not just a deferral but an avoidance of the Medicare tax. For example, if the gain were realized in one year by the taxpayer much of the gain could be subject to the Medicare tax. It is possible for some moderate income taxpayers that the spreading of that gain out over many years as part of the CRT tier system may result in the realization of that NII in sufficiently small quantities that the taxpayer's MAGI remains under the threshold amount necessary to trigger the Medicare tax in future years.

d. **Disclaimer Charitable Bequest**.

i. If a client's estate is taxable, an heir may be better off receiving a charitable fund which he or she can direct, in an amount unreduced by federal estate tax, then a lesser sum unencumbered by charitable use restrictions. The practical dilemma is that such flexible planning is often made impractical by some heirs needing the unencumbered bequest. The more flexible solution may be to create a disclaimer mechanism that permits each heir to individually determine whether or not she wishes the larger charitable restricted fund.

ii. A parent must bequeath $166,666 for a child to receive $100,000 net of tax. The child may view himself or herself as being better off having a charitable fund of $166,666 that he or she can direct. For a grandchild, a grandparent must bequeath $233,333 in order to pay estate tax of about $93,333, leaving $140,000, and $40,000 of generation skipping tax (on a tax exclusive basis) to net the grandchild with $100,000. Would the grandchild prefer a charitable fund of $233,333 instead of an unrestricted $100,000?

iii. For smaller amounts creating a private foundation will be impractical, so that using a donor advised fund ("DAF") approach will have to be used. Unfortunately, there are issues with the disclaimant directing funds in a DAF; however, a DAF in a community foundation can avoid that issue because the community foundation's board of directors has ultimate authority over the distributions. Therefore, the heir who chooses to disclaim does not have control. See PLR 200518012 and 9532027.

e. **Is a Bequest Worthwhile and What can Be Done**?

i. Charitable bequests have been commonly included in many wills. After all, an unlimited deduction is permitted from the gross estate for bequests and other transfers to qualifying public, charitable, religious, and other organizations. IRC Sec. 2055. However, post-ATRA few estates will be subject to an estate tax.

ii. Perhaps a better approach will be to include an express provision in the client's durable power of attorney permitting charitable donations and authorizing the agent to make advancements against bequests under the will.

f. **Foundation Governing Documents**.

i. Consider including, as a precaution, restrictive provisions in the bylaws and other governing documentation (e.g. a conflict policy) for a private foundation, that prohibits persons defined as "interested" from having any vote or involvement with funds received from a related donor or similar transactions.

ii. A recent ruling highlights how taxpayers can successfully structure private foundation transactions with related party donors.

iii. A taxpayer created a charitable lead trust ("CLT"). The taxpayer's son was the sole trustee of the CLT and a private foundation created by the taxpayer and the taxpayer's spouse was the current charitable beneficiary. The board of directors of the foundation consisted of the parents and children.

iv. The bylaws provided that during any time when the foundation was the beneficiary of a charitable trust established by a director, officer, or substantial contributor, that person would be prohibited from acting with respect to funds received by the foundation from the related charitable trust. The foundation's governing documents provided that funds contributed by a related charitable trust would be held in a separate account with independent records.

v. The IRS held that gifts to the CLT would constitute completed gifts for federal gift tax purposes. The mere fact that the related foundation was the charitable beneficiary would not obviate this conclusion as constituting a retained power over the property transferred to the trust. The IRS based this favorable conclusion on the facts that the trust instrument specifically prohibited the taxpayer from serving as trustee of the trust and the governing documents of the foundation prohibited him from taking any actions concerning the funds received from the related CLT.

vi. The IRS similarly held that arrangement did not give rise to a retained interest under IRC Sec. 2036 or 2038 that would cause inclusion in the taxpayer's estate.

vii. PLR 201323007 (March 4, 2013).

g. **NIMCRUTs Reformation to Correct Technical Issues will Become More Important**.

i. A recent private letter ruling confirmed the ability to correct a defect in a CRT. The donor/grantor created a net income make-up charitable remainder unitrust ("NIMCRUT") under I.R.C. § 664(d)(3) and Treas. Reg. § 1.664-3(a)(1)(i)(b) to benefit Grantor. The donor contributed stock to the NIMCRUT. The trust agreement provides that upon the donor's death the trustee shall distribute the remaining income and corpus to a 501(c)(3) public charity.

ii. The donor retained the power to change the charitable remainder beneficiary for another public charity. The trustee was also given a limited power to amend the trust agreement for the sole purpose to ensure that it continues to qualify as charitable remainder unitrust within the meaning of IRC Sec. 664. Following the creation of the NIMRCUT the IRS issued final regulations under Treas. Reg.§ 1.664-3 regarding charitable remainder unitrusts which provided that proceeds from the sale or exchange of corpus contributed to a unitrust must be allocated to the unitrust's corpus, not to the unitrust's income, at least to the extent of the fair market value of those assets on the date of their contribution. Additionally, the preamble to those regulations indicates that taxpayers do not have to treat the make-up amount as a liability when valuing the assets of a NIMCRUT.

iii. The trust agreement failed to comply with Treas. Reg. § 1.664-3(a)(1)(i)(b)(3) in that it prevents the trust from being able to continue to qualify as a CRUT as intended by the donor. Because the trust agreement lacks conformity with the final regulations under Treas. Reg. § 1.664-3, the trustee has been restricted from being able to accept additional property contributions. The trustee petitioned the appropriate state court to reform the trust to address the above issues. The IRS held that the reformation of the trust as ordered by the Court will not cause the NIMCRUT to fail to qualify as charitable remainder unitrust under IRC Sec. 664.

h. **Charitable Deductions: The Devil's in the Details**.

i. To qualify for a charitable contribution recordkeeping rules must be met. Also, if the donor receives a benefit as a result of making a contribution to a qualified organization, only the amount of the contribution that is more than the value of the benefit received can be deducted. A recent case addresses these issues and provides another reminder that meeting the documentation requirements is essential to qualify charitable contributions as deductions.

ii. The general rules for substantiation of a charitable gift are as follows. A charitable contribution of more than $250 must be documented by a contemporaneous written acknowledgment from the recipient charity which describes the property contributed, and states whether any goods or services were provided to the donor. If goods or services were provided, they must be described and estimate of the value must be provided. IRC Sec. 170(f)(8)(A). While acknowledgement is typically provided for each individual contribution of $250 or more, it is also permissible for a charity to provide acknowledgements on a periodic basis (e.g., quarterly). The acknowledgement must include the amount of the cash gift, or a description of any property other than cash which was donated. If the charity provides any goods or services to the donor that fact also must be acknowledged. Also, the goods and services must be described and a good faith estimate of their value must be indicated. If the goods or services consisted solely of "intangible religious benefits" (e.g. attendance at a religious service) that also must be acknowledged. The acknowledgement is considered contemporaneous if it is received on or before the date the applicable tax return is filed or the due date for such return (including extensions). IRC Sec. 170(f)(8).

iii. In the recent case, the required written acknowledgements were not provided. Because the taxpayer was actively involved in the recipient charity the taxpayer argued that her personal bank statements and those of the charity sufficed to meet the contemporaneous record requirement. The court disagreed noting that the bank statements could not corroborate whether or not goods or services were provided. The court also dismissed the taxpayer's arguments that because she was effectively on both sides of the transaction that the formalities of contemporaneous receipts were not necessary. Villareale v. Commissioner, T.C. Memo 2013-74.

16. **Insurance Nuggets**.

a. **Insurance to Address Basis Planning**.

i. If the benefit of the step-up in basis by retaining assets until death is significant, insuring the estate tax cost that retaining those assets will create can be a valid option. Thus, the need for insurance and ILITs, remains.

b. **Estate Inclusion**.

i. Retaining the right to receive dividends on a life insurance policy to benefit his former spouse was not deemed an incident of ownership and the policy was not included in his estate. CCA 201328030.

c. **Trust Owned Life Insurance ("TOLI") Risks.**

i. A life insurance trust owning a life insurance policy has been, and should remain, one of the most common estate planning techniques and one of the most important components of the financial security for many client families. Yet the statistics concerning TOLI are anything but reassuring.

ii. 90% of ILIT policies are managed by non-professional individuals, not institutional or professional trustees. That is not a surprise as most clients would balk at paying what they would consider unnecessary and costly fees for professional trustees to serve, or consultants to manage the policies. The reality is that many of these trust plans are time bombs waiting to explode and the cost of professional management of the policies pales by comparison to the liability the trustees may face, and the damage that undermining a vital component of many families financial security can bring.

iii. The majority of TOLI polices purchased over the past 30 years transfer policy performance risk from the carrier to the policy owner/trustee. Most trustee are not aware of this and don't understand its implications. The trustee can transfer all performance risk to the carrier by purchasing a guaranteed death benefit policy.

iv. Approximately 40% of in force non-guaranteed TOLI polices are carrier illustrated to lapse during the insured's lifetime or within 5 years of estimated life expectancy.

v. Approximately 12% of in force guaranteed TOLI polices have compromise guarantee features that can only be corrected with risk management attention.

d. **TOLI and UPIA**.

i. TOLI should not be a buy and hold strategy, but rather a buy and manage approach. Many agents will help a trust buy a policy, but few will really help manage it.
ii. Trustees, even professionals, can be sued. The best defense is a documented review of the actions taken. A corroborated process is essential. The KeyBank case highlighted this. The court decision was influenced by the trustee's reliance on an outside independent entity with no policy to sell and no financial stake in the outcome. In re Stuart Cochran Irrevocable Trust, 901 NE 2d 1128 (Ind Ct of App 2009).
iii. The Uniform Principal and Income Act ("UPIA") applies to TOLI decisions.
iv. The UPIA is a default rule that the terms of the ILIT can modify.
v. Sec. 2 requires trustees to manage assets as a prudent investor would, including consideration of the "the special relationship of that asset to the purposes of the trust." An ILIT is a perfect example of this special relationship.
vi. The standard of prudence for an institutional trustee applies to institutions, but an amateur trustee will not be held to the same standard. That does not, however, mean no responsibility.
ix. Sec. 3 requires diversification unless the trustee believes that because of the special circumstances the purposes of the trust are better served without diversifying. While prudent investing ordinarily requires diversification, circumstances can overcome the duty to diversify. Many seem to operate under the baseless assumption that diversification does not apply to life insurance. For example, if $3 million of coverage is being obtained, consider three $1 million policies using different types of policies, each from different companies.
vii. Sec. 9 allows trustees to delegate investment and management functions that a prudent trustee could properly delegate. A trustee must exercise reasonable care in selecting the agent, establishing the scope of the delegation and periodically reviewing the agent's actions. In the case of life insurance, if the trustee does not have the acumen to manage the life insurance policy or policies held in the ILIT, delegation is certainly worth considering. The statistics noted above belie the assumption of individual trustees that they have the skills to manage life insurance policies.

d. **TOLI Review Checklist**.
i. An insurance policy must be reviewed not less than every few years. Term and no lapse guarantees should be reviewed every two years. Review whether a policy can be improved at least every five years.
ii. The review should consider the policy, insurance company stability, owner and beneficiary designations, and other factors.
iii. Have client needs changed?
iv. Is the insurance company still highly rated?
v. Different policy types have different risks; this should be considered in the review. It may be advisable in a larger insurance plan to have different policy types involved to diversify the risks.

vi. The illustration is not a guarantee. Don't use illustrations to compare different types of policies, and a layperson should not use them to compare different policies of the same type.
vii. Evaluate investment returns. This is the most critical factor in pricing policies. Dividends on a participating product, credited interest on a universal life policy, or equity performance on a variable policy are important elements of the investment return on policies.
viii. Make projections to assure that the policy should be in-force until 90% of life expectancy.
ix. Consider fixed administrative expenses, such as home office expenses.
x. Company solvency is a key risk. While there are state guarantee funds, they only generally recover $300,000 in death benefit, so the majority of death benefit is exposed.
xi. How have actual investment returns compared to the returns projected when the policy was purchased? It is not only the level of returns, but the volatility, that must be considered. Lower than anticipated returns in early years can destroy a policy. Illustrations assume constant returns which can be very misleading. The analysis should be done using Monte Carlo simulations.

e. **Remediation of Problem Policies**.
i. Is it a bad policy or has it simply be underfunded?
ii. Policy exchange may be beneficial. This should be evaluated every five years. It should be to benefit beneficiaries, not brokers. It has been suggested that only about 1/3rd of policies should be replaced.
iii. The TOLI market has been the target of commission motivated replacement schemes using policy analytics known to be neither credible nor appropriate for predictive value and policy comparison purposes.
iv. First assess whether there is a problem. Evaluate all remediation possibilities.
v. Can increased funding or a decreased death benefit remedy a problem situation?
vi. Will an exchange of the policy solve the issue?
vii. What are the benefits of a surrender of the policy or sale into the life settlement market if the policy is likely to lapse before death?

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